

A report for the Jesuit Centre for Theological Reflection

## **THE TAXATION SYSTEM IN ZAMBIA**

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Executive Summary

**Final Report**

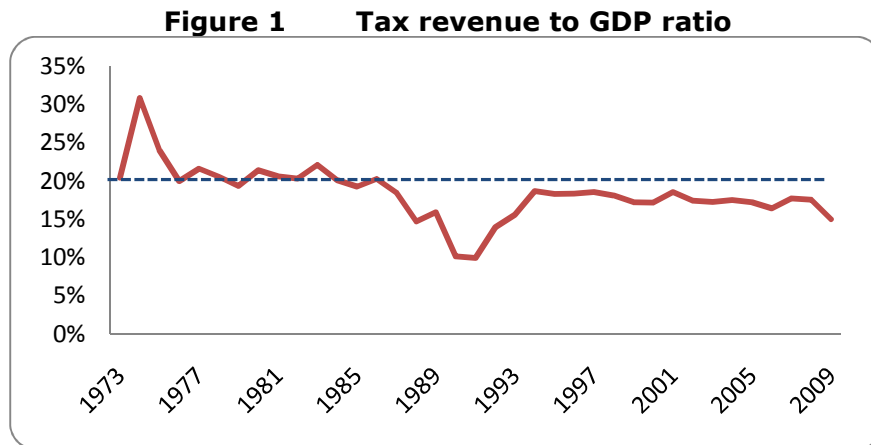
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This study was prepared by Messrs Alfred Mwila, David Manley, Patrick Chileshe, Ezekiel Phiri and Kelvin Mpembamoto for the Jesuit Centre for Theological Reflection (JCTR) The Debt, Aid and Trade (DAT) Programme provided funding for the study. The views expressed in this study are those of the authors and do not necessarily reflect the view of any allied institutions.

## INTRODUCTION

Taxes world over are mainly levied in order to raise revenue to fund government developmental operations and assist to reduce disparity between the rich and the poor and reduce poverty. This study was undertaken on behalf of the Jesuit Centre of Theological Reflection (JCTR), which is a research, education, and advocacy organization that promotes study and action on issues linking faith and social justice in Zambia. The Debt, Aid and Trade (DAT) programme of JCTR commissioned the study to comprehend the taxation system in Zambia with the aim of forming knowledgeable and evidence based opinions on how it affects social justice<sup>1</sup>.

The study uses qualitative and quantitative analysis based on data compiled from various sources. This study was motivated by the poor performance of the revenue system in the last decade. In particular, there has been an evident decline in the share of tax revenue to Gross Domestic Product (GDP), see figure 1.



Source: Central Statistics Office and Zambia Revenue Authority

The performance of some tax types, such as domestic VAT and trade taxes, have also progressively declined. The performance of the mining sector taxes has equally not been impressive and there has been concern as to whether it is being taxed optimally. Another factor that motivated the study was the need to analyse the role of the informal sector in the tax system and how it can sustainably contribute to domestic revenue mobilisation. This is because, up until now, the tax system has relied solely on revenues from the formal sector while the informal sector remains largely untaxed. The last motivating factor was the need to explore how Zambia can raise extra revenue from its traditional exports, like copper, through a financial transaction tax.

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<sup>1</sup> Social justice deals with matters of fair distribution of advantages, assets, and benefits among all members of a society. This can be attained through degree of economic equality through progressive taxation, income redistribution, or even property redistribution.

The premise of this study is that Zambia has the potential to raise more tax revenue and improve social justice by employing prudent policies and practices that improve tax revenue administration. The major objective of the study is to contribute to the existing body of knowledge on the tax system in Zambia by identifying the key challenges and possible success factors. The information generated by this study would be used by the JCTR as research, education, and advocacy tools to lobby relevant authorities on how the current tax system can be best utilized and reorganised in order to attain social justice.

## **Funding sources and overview of the tax system**

Zambian taxes are broadly categorised into three groups as follows: income taxes, consumption taxes and trade taxes. These taxes make up the domestic revenue base for the country. These taxes contribute up to 70 percent to national budget. Other revenues that Government mobilises to supplement tax revenue comes from funding from external donors through budgetary support, Foreign Direct Investment (FDI), and debt provision. Apart from these revenue sources, there are other sources that are not fully exploited yet. These include, local government revenues and alternatives taxes, such as wealth taxes. However, these alternative sources of revenue have challenges that need to be addressed if they are to be reliable and predictable sources of revenue.

Increasing the tax take from wealth transactions can increase the tax base and allow the government to reduce the highly unequal burden on the formally employed, which is unfair and creates economic distortions. The closest tax that reflects wealth transaction in Zambia is the property transfer tax. However, this tax has not performed well because properties are mostly undervalued which negatively affects tax revenue realized from property transactions. The lack of well-trained tax inspectors in property evaluation compounds the problem and as such, tax evasion is common.

The tax administration system faces several challenges, among them the following: a large informal cash economy; low taxpayer compliance; complexities associated with taxation of international transactions; poor traceability of taxpayers; smuggling; and inadequate funding to Zambia Revenue Authority (ZRA), for infrastructural and technological development.

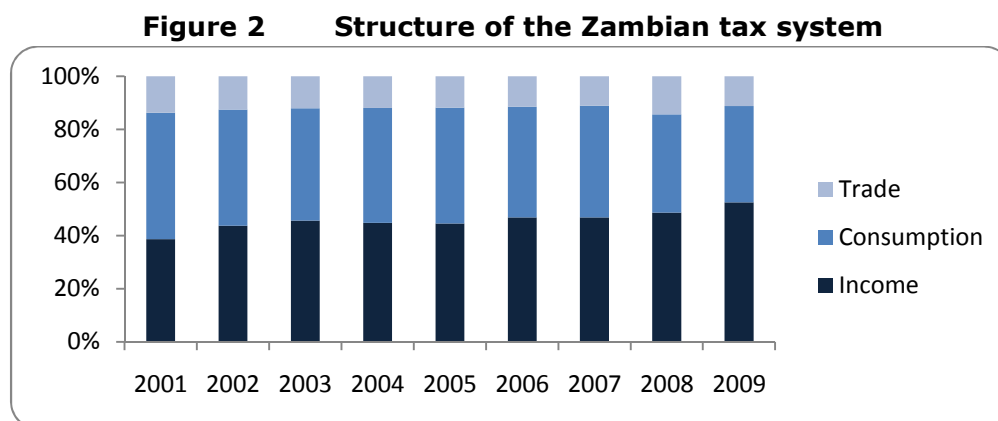
The Zambian tax system has numerous tax types and rates which can result in high effective taxation. The many taxes and rates have the potential to make the tax system complex, and therefore increase the cost of compliance and encourage non-compliance. Further, the tax system is mature and has undergone several administrative and policy reforms. The tax formulation process is inclusive (both government and private sector participate in the formulation process), although it still has some challenges.

The following recommendations were made with respect to Part 2 of the study:

1. Government must explore and create conducive policies to tap on alternative sources of revenue and relieve some pressure on the tax system.
2. Wealth taxation if considered and implemented in Zambia can further, increase the tax base and promote equity.
3. There is need to support the operations of ZRA by providing it with adequate funding for its operations.
4. ZRA must commission a study to determine the optimal level of funding and the impact of increased funding on revenue collection.
5. To avoid the risk of high effective taxation, Government must consider reducing the number of taxes and tax rates.
6. The tax system must develop an effective system of taxpayer services and education that will effectively communicate and educate taxpayers about their tax obligations and associated penalties. This will increase voluntary compliance and minimise cases of negligence, wilful default and fraud in the tax system.
7. Government must further enhance the tax policy formulation by creating a recognised binding legal structure or mechanism that formalises the participation of non- government actors in the national budget process.

### The structure and performance of the tax system

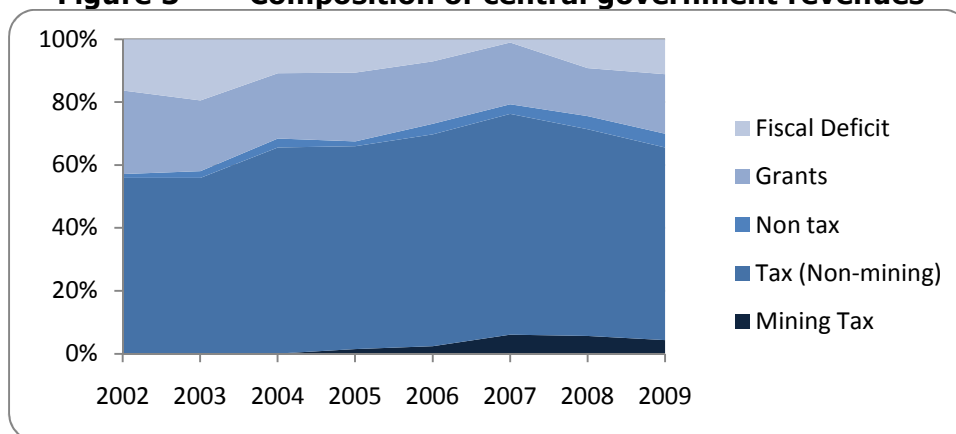
In Zambia, income taxes are the major sources of revenue followed by consumption taxes (domestic VAT, import VAT and excise duty) and trade taxes (customs duty and export duty), as shown in figure 2. Up until ten years ago, international trade taxes used to account for the bulk of the taxes collected but now there has been a shift to income taxes, particularly Pay As You Earn (PAYE). During this same period, the proportion of consumption taxes (domestic VAT, import VAT and excise duty) has also increased steadily.



Most taxes in the Zambian tax system are borne by the formal sector. Even here, only few firms and individuals in selected economic sectors are bearing the burden of tax. In whole, the tax system is responsive and buoyant as it is capable of capturing more revenue when the economy is doing well and similarly records revenue declines during bad times when the economy is in a recession. The tax system can be considered effective going by the good performance of tax collections against set targets and the good tax-to-GDP ratio. However, there has been concern on the performance of the tax system, particularly in the last three years, when there has been some decline.

In terms of adequacy, the contribution of tax revenue to the national budget has increased overtime, rising from 50 per cent in 2001 to 70 per cent in 2010 (see figure 3). The rising contribution of tax to the national budget will eventually make the tax system sustainable especially that donor support is steadily declining.

**Figure 3 Composition of central government revenues**



Source: IMF

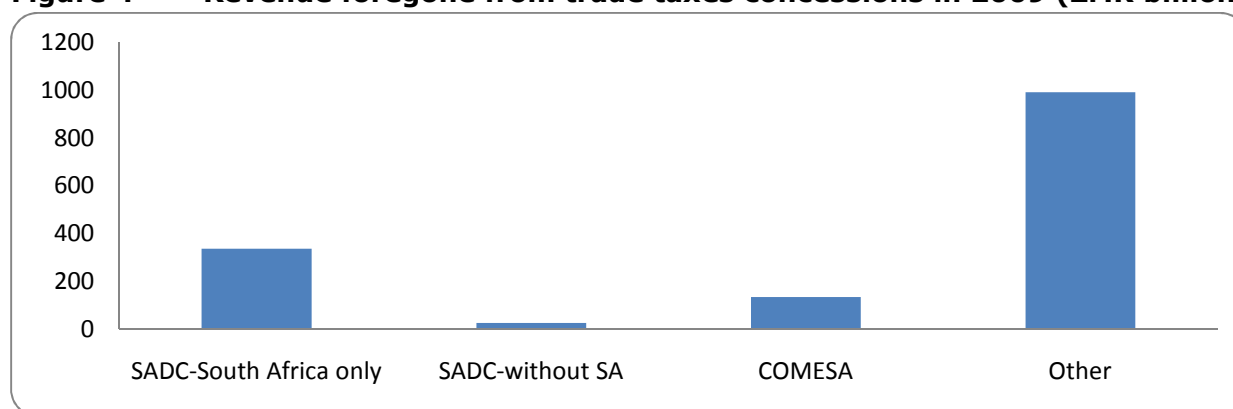
The following recommendations were made with respect to Part 3 of the study:

1. The tax system must move towards a tax structure that relies more on consumption taxes and less on income and trade taxes as these have proved to be volatile and may cause inefficiency and inequity.
2. There should be improvement in the VAT refund administration as the high tax refunds that go to the mining sector (over 90%) have dictated the performance of VAT.
3. There should be greater investment in VAT administration processes using Information Communication Technology (ICT) options.
4. There should also be a major review of exemptions to determine their cost effectiveness and impact on the VAT tax base.
5. There is therefore need to broaden the tax base by spreading to other sectors and individuals, including the informal sector. This is because, the middle-class (those who derive the majority of their income from formal salaries) are faced with the highest burden of taxation.

## Tax incentives

Government favours the use of incentives as a means of fostering economic growth. As such, the Zambian tax system offers several incentives, such as low tax rates and tax breaks. However, care has to be taken in designing these incentives if they have to yield the desired results. In Zambia, there is evidence that tax incentives, concessions and exemptions and legislated trade tax concessions and tariff reductions due to the Southern African Development Community (SADC) and the Common Market for East and Southern Africa (COMESA) trade protocols have collectively eroded the tax base, as shown in figure 4. Further, some incentives currently used in Zambia represent serious problems for revenue leakage and administration.

**Figure 4 Revenue foregone from trade taxes concessions in 2009 (ZMK billion)**



Source: ZRA

The following recommendations were made with respect to Part 4 of the study:

1. Government must cost incentives so that they are part of the national budget formulation process. Government must undertake further analysis on the costs and benefits of incentives.
2. Government must improve oversight on the allocation of budget discretionary measures. Discretionary incentives currently issued by the Minister of Finance must be done with the concurrence of Parliament.
3. Government must design incentives with the impact of tax administration in mind and avoid incentives that can be abused or hard to administer.
4. Government must work towards a system of simplified uniform tax rates to control for high effective tax rates that may complicate tax administration and cause tax leakages.

## Taxation of the mining sector

The contribution of the mining sector taxes, over the period 2006 to 2009, averaged 7 per cent (excluding PAYE, which is paid by employees), see table 1. The

contribution of the mining sector to total tax revenue has steadily increased mainly as a result of high mineral prices, increased output, and increase in the mineral royalty rate following policy changes in 2008. Meanwhile, much of the mining industry is still recouping investment costs and when these losses are finally recouped, it is expected that a much larger share of revenue collection will come from the mines.

<b>Mining taxes (K'bn)</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Company Tax	160	603	464	401
Withholding Tax	-	-	-	-
Mineral Royalty	59	68	238	235
Export Duty	-	-	178	15
Windfall	-	-	126	-
PAYE	290	436	596	582
Mining Revenue Total (K'bn)	509	1,107	1,602	1,232
Total tax revenue (K' bn)	6,329	8,194	9,670	9,660
As % of total revenues	8%	14%	17%	13%
Total revenues less PAYE	219	671	1,006	651
As % of total revenues less PAYE	3%	8%	10%	7%

Source: ZRA

Like any other large and specialized operations, mining operations are very complex and provide taxation challenges. ZRA recognises this and now has established a dedicated Mining Tax Unit (MTU) to ensure efficient and effective taxation of the mining sector. Lately, there has been a lot of debate on the choice of tax instrument to use for the mining sector. The debate has mainly been on whether to use a windfall tax based on sales revenue or not.

Zambia's 'Windfall tax' is a tax on sales revenues. However, such a tax regime can put firms under financial strain when costs rise relative to the mineral prices. With a 'windfall tax', operators of more costly mines, such as underground and old mines, would be inequitably taxed compared to those with relatively less costly mining operations, such as open-pit and new mines. A 'Windfall tax may, therefore, pose a threat on the viability of some mines and may lead to closure and related job losses.

Zambia has another option for taxing the mining sector, using the "variable profit tax" regime. Consistent with the principle of taxation, it is a much better instrument as it is more focused towards profits unlike windfall tax which is insensitive to the cost structure of the mines. This notion of "variable profit tax" or taxing super profits is currently applied in the financial sector and will be applied to the telecommunication sector, as announced in the 2011 budget. In both the financial and telecommunications sectors, it is configured on profits and not revenues. As such, with full information disclosure by mining companies, all expected taxes can be captured optimally using variable profit tax.

The following recommendations were made with respect to Part 5 of the study:

1. There is need for continued support, both financial and materially, to enable ZRA keep pace with the complexities associated with mining taxation, such as counteracting transfer pricing by mining firms.
2. The use of variable profit taxation is supported as it is administratively consistent with the current practices within the ZRA. This is in view of the fact that the capacity of the Authority is now being reinforced with the establishment of a specialized mining unit.
3. In view of the complex nature of mining taxation, technical tax loopholes, such as the treatment of hedging income<sup>2</sup> and other tax avoidance tendencies, must be addressed. This will reduce the difficulties faced by the tax authority and so increase its capacity to administer the mining tax regime.

### Informal Sector Taxation

In Zambia, the informal sector is growing but its contribution to tax revenue has remained poor, see table 2. In order to meet the ever-growing demand for social services and development there is need to extend taxation to the informal sector. This will enhance tax revenue productivity and attain equity in bearing the tax burden.

**Table 2 Trends in informal sector tax collection since 2004 (in billions)**

	2004	2005	2006	2007	2008	2009
TOT	4.4	9.86	13.11	18.75	23.12	24.1
AIT	0	0	0	12.3	60.8	64.6
Base tax	0	0.07	0.09	0.04	0.03	0.03
Presumptive on minibuses	1	1.05	1.76	1.82	2.29	2.15
Total presumptive	5.4	10.98	14.96	32.91	86.24	90.88
Total income tax	2,038	2,462	2,967	3,841	4,699	5,072
% Share in total income tax	0.27	0.45	0.50	0.86	1.84	1.79

Source: ZRA

Zambia has in place a presumptive tax regime for the informal sector that is simplified and aims to deal with factors hindering the participation of the informal sector in taxation. However, the performance of the informal tax regime has not been impressive although it has the potential to grow if several challenges are

<sup>2</sup> Hedging relates to the practice of buying and selling derivatives like options and futures to protect a business from volatile prices and costs.

addressed. ZRA has started to address some of the challenges and the contribution of taxes from informal sector has been increasing, though slowly.

Taxation of the informal sector is labour-intensive and potentially low yielding especially if undertaken solely by the tax authority. As such, any moves to broaden the tax base by reaching out to the informal sector will need a significant budgetary support for tax administration. Administering taxes in the informal sector has several challenges such as; a large cash-based informal economy that reduces ability to audit transactions; improper record keeping and widespread political interference.

The following recommendations were made with respect to Part 6 of the study:

1. ZRA must consider contracting the collection of such taxes to formal institutions, such as local councils, that have some degree of legitimacy and can exercise control and sanctions in case of non-compliance.
2. ZRA must consider utilising informal sector business associations, such as cross border traders and similar representative bodies, to promote compliance using peer pressure and coherence.
3. ZRA needs to continue developing innovative approaches that can provide less costly taxpayer services, such as e-payment and e-filing and improve taxpayer education to the informal sector.

### **Feasibility of an international Financial Transaction Tax**

Financial Transaction Taxes (FTTs) exist in various forms, although the implementation of one on an international context and across certain asset types, like commodity futures, has not been done on a large scale. Most FTTs are currently specific to individual countries. FTTs could be an efficient, and administratively cheap, means to raise funds for international development and other global objectives.

However, there are two key arguments against FTTs. Firstly, there are real technical problems with its implementation and secondly there is a risk of damaging market liquidity (which is essential to the smooth running of global markets) because an FTT comes with a cost. In terms of technical feasibility, a common argument is that an FTT would have to be globally implemented to avoid market fragmentation and trading migration to untaxed products and services. It also requires a far larger political commitment.

The study analysed the possibility of implementing an FTT on copper transactions with direct remittance to Zambia. The study found that such a proposal would not be feasible. This is because the majority of copper transactions are not based on a physical trade but are purely financial (no copper actually changes hands). As such, these trades cannot be attributed to the trading of copper originating from Zambia.

Therefore, the tax revenue from these trades could also not easily be attributed to Zambia.

The following recommendations were made with respect to Part 7 of the study:

1. An international FTT must be supported although there is no mechanism for direct allocation of revenues according to producer countries. Instead, in line with most common proposals on this topic, revenues would be collected in a common fund that would be allocated along the same lines as all other developmental aid.
2. With regard to the proposal of a FTT levied on commodities in which revenues can be remitted back to Zambia, this study is not supportive. This is because a remittance mechanism would not be at all feasible since the vast majority of trading is not related to any physical commodity.