Zambia’s Tax System

“Need for Equity and Efficiency”

Jesuit Centre For Theological Reflection

“Promoting Faith and Justice”

Economic Equity & Development Programme

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1. Introduction

Economies across the world depend on resources collected from both direct taxes (Personal income tax and company tax) and indirect taxes (value added tax - VAT, excise and customs duties) to finance government activities. No government can be sustained without mechanisms for generating domestic revenue. Taxes are therefore a major way for countries to raise revenue to meet social and developmental needs of the people. Taxes also assist in redistribution of wealth or income and can also be used to encourage or discourage certain activities. Taxes therefore help in reducing the gap between the rich and the poor. Taxes play a critical role in encouraging economic growth; reducing disparity between the rich and the poor; and reducing poverty.

2. Funding Sources

Tax revenue is currently the only reliable and sustainable source of government revenue (figure 1). Whilst other sources exist i.e. debt, aid and remittances, they are not reliable as they are unpredictable and can thus be unsustainable. Debt (both external and domestic) has a cost to future generated resources as it attracts interest and can lead to indebtedness if not regulated in a transparent, accountable and participatory manner. Presently, external debt stands at US$3.3 billion and debt service in the last three years (2007 to 2009) has averaged US$58 million. Domestic debt has also been on the increase. It has increased from K7.6 trillion in 2007 to K10.5 trillion in 2009 (Economic Reports).

Taxes contribute up to 70% of the National budget. The Zambian tax system offers a wide base and alternative sources of revenue, and therefore has the potential to contribute even more than is currently the case and hence fill the gap financed by debt and aid. This can therefore, reduce dependency on external financing which is dependent on the global economic performance and thus unpredictable and unsustainable. Tax administration thus needs to be supported to keep it abreast with the growth of the economy and ensure equity and efficiency in resource mobilization.

![Figure 1. Composition of Central Government Revenues](image)

3. Structure and Performance of the Tax System

The tax system in Zambia generally consists of three categories of taxes namely; Income taxes (Pay As You Earn, Company Tax), Consumption taxes (domestic VAT, Import VAT and Excise Duty) and Trade taxes (Customs and export Duty). Income taxes are the largest contributors to the tax revenue base followed by consumption taxes and then trade taxes (figures 2 & 3). There has been a shift on dependence from trade taxes to income taxes.
The contribution and share of tax revenue to Gross Domestic Product has declined from 19.2% in 2000 to 15% in 2009 (figure 4) while the performance of some tax types, such as domestic VAT and trade taxes, have also progressively declined. The tax system has become less responsive and productive. The performance of the mining sector taxes has equally not been impressive. Up until now, the tax system has only managed to capture, effectively tax revenue from the formal sector while the informal sector, remains minimally taxed. This keeps tax distribution heavily skewed towards direct taxes placing a disproportionate burden on formal sector workers. Taxation as a source of government revenue in Zambia is reported to have performed well up to target in the last few years (figure 5). As at end of September 2010, domestic revenues had performed well within target for the year and were expected to over perform by 12% by the end of the year.
Pay As You Earn (PAYE) is in 2011 for instance expected to be the largest contributor to tax revenue at K3, 710.6 billion more than company tax at K1, 337.1 billion and mining tax at K1, 858.4 billion. While maximising tax revenue is the primary concern, income inequality caused by the high tax burden on the few employees in the formal sector is of great concern. Data obtained shows that income inequality has risen over time as the top four deciles enjoyed 83.8 percent and 87.2 percent of income in 1996 and 2006 respectively while the bottom six lost share from 16.2 percent to 12.9 percent. The over reliance on income taxes is not good for the country and has to be rationalised as taxes on income is essentially taxes on production, disposable income and therefore affect economic development and citizen welfare.

Domestic VAT continues to under-perform. Ineffective revenue policy and inefficient collection practices prevent the maximising of resources that can be collected from VAT. The VAT base has been eroding and has reduced from a rate of 20% in 1995 to 16% in 2009. VAT revenues, as a percentage of GDP have fallen from 5.9 percent in 2001 to 3.8 percent in 2009. This could be largely attributed to inefficient and incomprehensive ways of VAT collection. Many basic measures to ensure maximisation of monies collected through VAT are not adhered to by many commercial entities and there is no notable commitment to enforce them. There is still a large section of business that goes on with no record of sale because of lack of simple measures such as cash registers, this affects how much money can be collected by the Zambia Revenue Authority (ZRA).

Income inequality in Zambia is very high. This is attributed to poor implementation of wealth taxes which do not only contribute to tax revenue but also help in bridging the gap between the rich and the poor. Increasing the tax revenue 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.

Withholding tax on rental income is another way to shift the tax burden to the wealthy. Withholding tax is a government requirement for the payer of an item of income to withhold or deduct tax from the payment, and pay that tax to the government. This includes withholding tax on dividends, interest, rent, commissions, management and consultancy fees. Unfortunately, in Zambia, this tax has not performed very well and has only averaged 5 percent of total revenue collection in the last ten years. The main reason for its poor performance is the lack of disclosure of such earned income by the majority of earners. Particularly for withholding taxes on rental property, very few properties particularly houses are registered for tax purposes.

Recommendations to Improve the Tax system in Zambia

i) Elimination of tax leakages must be prioritised especially in relation to company taxes, and to broaden the tax base to encompass foreign as well as domestic businesses and higher earning informal-sector workers.

ii) Most successes in tax administration and policy efforts have been attributed to support from donors. The government must appreciate and study the optimal support associated with tax administration and policy with a view of providing the required financial and human resources.

iii) A study must be commissioned to determine the optimal level of funding for ZRA and the impact of increased funding on revenue collection.

iv) ZRA must enhance its taxpayer education and taxpayer services to improve tax compliance and ensure efficiency in tax revenue collection.
Recommendations to address Taxation Challenges

i) The tax policy formulation should be enhanced to include much broader stakeholder participation beyond government and the private sector. A legal and binding structure must be created that should formalise the participation of non-state actors in the national budget process.

ii) There is need to fully develop an effective and efficient tax enforcement and compliance strategy. This is in order to have a good and stable structure that has heavy reliance on consumption taxes, like domestic VAT and local excise duties and less on income taxes.

iii) A number of tax exemptions should be considered for elimination, such as some exemptions of the mines from certain import duties and VAT. Investment policies should instead be sharpened to emphasise on resident investors so as to retain and increase the investment capacities in the country.

iv) A study to quantify the impact of domestic tax incentives must be undertaken by government.

v) Trade tax incentives and concessions must be reviewed to ensure they are optimal, promote social welfare, and do not weaken the productivity of the revenue system. Concessions must be targeted to those areas that generate a significant flow of social benefits to society.

vi) Discretionary incentives currently issued by the Minister of Finance must be done with the agreement of Parliament and should be properly debated by various stakeholders. These must be announced early and with a clear start and end time to allow for tax planning. Incentives that are susceptible to abuse, such as capital allowances, must not be allowed as they complicate tax administration.

4. Strategies necessary to capture the informal sector

Despite the growing importance of the informal sector in the Zambian economy, its contribution to tax revenue has been poor. 88% of Zambia's labour force is employed in the informal sector (LCMS). Taxes aimed at the informal sector contributed less than 2% to total income tax collection. Zambia has a tax regime for the informal sector (Turnover tax, Presumptive tax, Base tax and Advance tax), which is not fully exploited. A number of challenges exist in efforts to collect tax from the informal sector because of its characteristics. These include;

- Most business transactions in the informal sector are done in cash and easy to conceal;
- Most informal sector transactions are indifferent to proper record keeping;
- Capacity of the revenue authority may be too low to match the growth of the informal sector;
- Informal sector taxation is sometimes prone to political interference;
- Physical traceability of most informal establishments is a challenge.

Recommendation for Informal Sector taxation

i) Collection of informal sector must be contracted to institutions that have some legitimacy and control, such as councils for base tax and Road Transport and Safety Agency (RTSA) for presumptive tax. Local councils if given authority to collect this tax will assist to eliminate the problem of high cost of collection problem as the council has established structures in most of these markets.

ii) Tax the informal sector through their associations. Associational Taxation is not a new phenomenon; it has been used with great success in Ghana. As a result of this innovative scheme, contribution of informal taxes to total tax revenue collection in Ghana has grown from less than 1% in 1988 to 5.3% in 2003 and 4.9% in 2005.

iii) The revenue authority must develop an innovative model to provide taxpayer services and taxpayer education to the informal sector.
5. Mining Tax regime

Mining revenue despite being on an upward trend, as a proportion of total taxes collected, is relatively low. The most important means of benefiting from the mines is through tax revenues captured. The structure of the mining taxes is presented in figure 6 below. Tax revenue from the mineral sector has risen dramatically since 2005. These revenues represent a growing share of total tax revenues from 5.2% in 2005 to 12.7% in 2009. It is important to note that of the tax types from the mines, PAVE features prominently as the main contributor at 54% on average added to export duty, mineral royalty and company tax. This is in the context of increased mineral production that has doubled from 2001 to 2009 and substantial investment in the mining sector.

FIGURE 5 STRUCTURE OF MINING TAX REVENUES (K'BILLIONS)

Zambia’s economy is still very dependent on the mining sector. The Ministry of Finance and National Planning reports that Copper output will in 2010 exceed 720,000 metric tons. This is the highest production since 1973 and the price per metric ton is predicted to hit an all time high in 2011 of more than US$ 11,000 per metric ton (Goldman and Sachs, September 2010). The average price of copper on the international market had reached a record high of US $7,202 per metric ton between January and September in 2010. The price had more than doubled since the start of 2009 and reached as high as $8,241 a ton on 07 October 2010 in London.

The mining sector is large and specialised and as such, mining operations are very complex and provide challenges in taxation by the revenue authority. It is because of the complexity that ZRA established a Mining Tax Unit to ensure sufficient and adequate understanding of mining operation and hence ensure efficient and effective taxation of the mining sector. This capacity, however, is not adequate in ensuring that the mines contribute effectively and efficiently to the tax base. Capacity of the revenue authority should also include auditing of the mines to ensure the financial records reflect the true position of their operational costs and profits.

ZRA has up to now failed to tax the mines efficiently and effectively because of the limited capacity in understanding the mining operations. This has resulted in the failure of the Variable Profit Tax currently in place to capture tax revenue in view of the high copper prices. This makes the windfall tax an appropriate tax measure in ensuring that Zambia benefits from its copper especially during periods of high copper prices through tax revenue which is vital in poverty reduction and developmental programmes. The windfall tax is meant to capture significant tax revenue during high mineral price periods; hence this time is more opportune than ever to introduce it. The windfall tax is effected (at graduated levels) only when the mining company's revenue becomes twice the cost of production. The Mining tax in Zambia needs to revisit and reintroduce the mining windfall tax.

The current PAYE payments in the mines are relatively high but the distribution of income of mining staff is very unequal as there are a number of employees who are comparatively well paid, while a large number earn substantially less and are below the PAYE threshold.
Recommendations for Mining Sector Taxation

i) There should be a much more sufficient capture of tax from the mine to increase resources available for poverty reduction. Hence the capacity of ZRA in relation to the mining activity needs to be improved. This is necessary because mining operations are complex and without the knowledge of the true costs of the mines it is difficult to tell whether the revenue from the mines is optimal.

ii) Capacity must be built in ZRA to audit the mines, follow up on matters of multinational business transactions (transfer pricing) and fully understand the associated geological issues and value chains.

iii) Therefore government should revert to the windfall tax regime to increase tax revenue from the mines as a contribution to both GDP and tax revenue so that the country not only benefits from its resource but also benefit from the high copper prices on the world market.

iv) There needs to be a move towards enforcing a regime that will tax other allied minerals in copper concentrates. Small-scale mining must be made integral to mining policy formulation and tax administration.

6. Tax Incentives

There is a continued proliferation of tax exemptions to companies. The exemptions are facilitated by Section 89 of the Customs and Excise Act, which gives the minister powers to grant exemptions without recourse to parliament. These constitute huge tax revenue losses to the country. What is worse is that there is no sufficient evidence to prove the real value of the tax exemptions to the increase in Foreign Direct Investment (FDI) that Zambia is witnessing. While tax incentives to foreign investors have the potential to promote investment, they tend to deprive the Government of essential resources for delivering to the public, social services promised in the national development plans.

Legislated trade tax concessions and tariff reductions due to SADC and COMESA trade protocols have been eroding the tax base. This is worsened by tax base erosion that results from nationally legislated trade concessions and exemptions. Even if tax incentives do stimulate investment, their net impact on growth could be adverse if the incentives reduce productivity. Incentives offered under Multi-Facility Economic Zones (MFEZs) have the potential to reduce tax revenue in the short-run and increase the cost of tax administration.

Recommendations

i) The government must cost incentives so that they are part of the national budget formulation process.

ii) Government must also undertake a detailed analysis on the costs and benefits of incentives.

iii) The government must improve oversight on the allocation of budget discretionary measure as they are subject to abuse. Parliament should therefore play the over-sight role.

iv) Government should design incentives with the impact of tax administration in mind and thus avoid incentives that can be abused or difficult to administer.

7. Conclusion

There is general consensus that Zambia needs to improve its tax administration and performance in order to ensure increased domestic resource mobilization to support social expenditure and developmental programmes. This is because tax revenue is the most reliable and sustainable means of government revenue compared to aid and loans.

There is also greater need for a fairly distributed tax burden where the burden which currently rests on the few people employed in the formal sector is spread widely to other sectors such as the informal sector. Contribution of the mining sector to tax revenue should also be enhanced to ensure adequate revenue mobilization by the government. The taxation system should thus be adequate, efficient and equitable in contributing to domestic revenue needed in meeting the needs of the poor and promote social justice.