



**THE IMPACT OF THE 2004 TAX LEGISLATION  
ON THE SMALL SCALE FARMING SECTOR**

**BY**

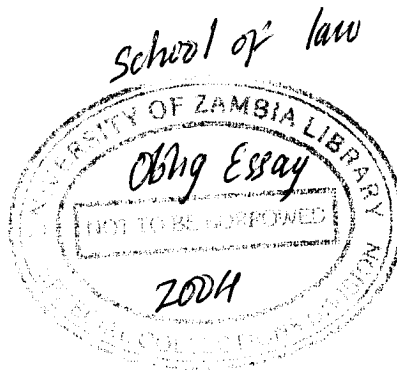
**MARTIN WILLIAM PHILLIPS**

**99357381**

A dissertation submitted to the School of Law of the University of Zambia in partial fulfilment of the requirements for the award of degree of Batchelor of Laws (LLB).

SCHOOL OF LAW  
UNIVERSITY OF ZAMBIA  
LUSAKA

November 2004



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**SCHOOL OF LAW**

I recommend that the obligatory essay prepared under my supervision by:

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Entitled

**THE IMPACT OF THE 2004 TAX LEGISLATION  
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be accepted for examination. I have checked it carefully and I am satisfied that it fulfils the requirements pertaining to format as laid down in the regulations governing obligatory essays.

Supervisor .....

  
Dr. N. Simbyakula

Date: .....

9th December 2004

## DECLARATION

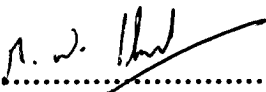
I, **Martin William Phillips**, computer no. **99357381**, do declare that I am the author of the directed research essay,

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and that it is a product of my own ingenuity and that due acknowledgment has been given where other scholars' works have been used or cited. I truly believe that this research has not been previously presented in the school for academic work.

Student's Name: ..... MARTIN WILLIAM PHILLIPS .....

Signature: .....  .....

Date: ..... 9<sup>th</sup> DECEMBER 2004 .....

## **DEDICATION**

**To my Parents, William Trevor Phillips and Molly Noel Phillips  
who taught me to stand on my own feet.**

**And**

**To Edwin and Clara Silubonde and all at Rothbury Farm,  
who have been a second family and a great support to me in Zambia.**

# THE IMPACT OF THE 2004 TAX LEGISLATION ON THE SMALL-SCALE FARMING SECTOR

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## **PREFACE/ACKNOWLEDGEMENTS**

I wish to acknowledge, with deep gratitude, the invaluable advice and sound instruction given to me over the last four and a half years by the academic staff of the School of Law at the University of Zambia, who have guided my part-time studies for the degree of Batchelor of Laws (LLB). I also wish to thank the administrative staff of the School of Law for all the practical assistance rendered to me during my studies.

I would like to especially thank Dr. R. N. Simbyakula, my supervisor for this obligatory essay, for his assistance in enabling me to complete this work and also the staff of the Ministry of Finance and National Planning for their co-operation, without which I could not have done this study.

I must also thank the farming community in Lusaka West, for the open and generous manner in which they have accepted me as part of their community and for the insights and experience I have gained in the course of my interaction with them over the last ten years.

Last, but not least, I would also like to thank all my fellow students in the part-time “class of 2004” for persevering with me and for the mutual encouragement and support that we gave to each other that certainly helped me to complete my degree of Batchelor of Laws (LLB).

### **List of Statutes and Subsidiary Legislation**

1. The Income Tax Act, Cap. 323 of the Laws of Zambia
2. The Income Tax (Amendment) Act of 2003 (Act No. 3 of 2003), Government Printer.
3. The Income Tax (Amendment) Act of 2004 (Act No. 1 of 2004), Government Printer.
4. Statutory Instrument No. 11 of 2004, The Value Added Tax (General) (Amendment) Regulations of 2004.
5. The Registration of Business Names Act, Cap. 389 of the Laws of Zambia.
6. The Companies Act, Chapter 388 of the Laws of Zambia

## **Abbreviations/Acronyms**

CSO	Central Statistical Office
GDP	Gross Domestic Product
GRZ	Government of the Republic of Zambia
HIPC	Highly Indebted Poor Country
IMF	International Monetary Fund
K	Kwacha
LUSE	Lusaka Stock Exchange
MDG	Millennium Development Goal
NAPSA	National Pension Scheme Authority
PAYE	Pay as You Earn
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PSV	Public Service Vehicle
RAMCOZ	Roan Antelope Mining Company of Zambia
SAF	Structural Adjustment Facility
SDR	Special Drawing Right
SMP	Staff Monitored Programme
VAT	Value Added Tax
WTO	World Trade Organisation
ZANACO	Zambia National Commercial Bank
ZESCO	Zambia Electricity Supply Corporation
ZRA	Zambia Revenue Authority

## ABSTRACT

By end-2003, Government was “off track” with the IMF and HIPC “completion” was unattainable. Excessive government borrowing had to be curbed and this required, *inter alia*, that the tax effort be raised to nineteen percent of GDP. Thus, a three percent presumptive tax on annual turnovers of under K 200 million was introduced and farms producing unprocessed produce could no longer claim back input VAT.

Using tax entity models for small-scale farms, PSV operators, employees and “high-profit, low-cost” enterprises, this paper shows that the change in the tax treatment of small-scale farms fell short of accepted standards of taxation and wider notions of justice. Significant horizontal and vertical, inter-temporal and inter-entity, inequity resulted, the cost effectiveness of the tax is not *a priori* demonstrable - especially with high marginal tax rates providing an incentive for tax evasion and avoidance - and there was conflict with society’s wider “growth with equity” objectives. Further, *ex ante* uncertainty as regards tax/penalty liability has arisen, undermining the basic tenets of the “rule of law” by conferring increased discretionary powers on officials (with potentially large material consequences on citizens) without adequate legislative control.

The paper concludes that the main motive for the 2004 tax legislation was to raise revenue, a motive pursued without due regard to recognised standards of taxation, which were violated as a result. These violations could have been mitigated or eliminated if the presumptive tax had been better designed thereby attaining a better balance between revenue and justice to the taxpayer. Thus, a “lower threshold” for the tax could have been factored into the legislation or it could have been based on a presumed level of cost deduction from turnover, with the option given to the taxpayer to deduct actual costs if these were higher.

# **THE IMPACT OF THE 2004 TAX LEGISLATION ON THE SMALL-SCALE FARMING SECTOR**

## **Chapter One**

### **Introduction: The Macroeconomic and Fiscal Context of the 2004 Budget**

The tax legislation supporting the Zambian Government's expenditure estimates for the 2004 fiscal year<sup>1</sup> was formulated in the context of a severe fiscal crisis. On 31st March 2003, the 2000-2003 Poverty Reduction and Growth Facility (PRGF) with the International Monetary Fund (IMF) expired. However, Government had failed to conclude negotiations with the Fund on a new facility for the period April 2003 to March 2006, due to uncertainty about the policy relating to the privatization of the Zambia National Commercial Bank (ZNCB) and the Zambia Electricity Supply Corporation (ZESCO)<sup>2</sup>.

Then, in April 2003, the 2003 civil service wage award, together with the introduction of higher housing allowances with cost implications far outstripping the available budget, meant that the 2003 Budget ceiling on domestic borrowing of K298 billion (1.55 percent of GDP)<sup>3</sup> would be breached. This led to the collapse of any hope of getting back onto a new PRGF arrangement with the IMF for the rest of 2003. In the absence of a new PRGF, Government moved onto a Staff Monitored Programme (SMP) with the IMF, with a view to re-establishing a sound record of macroeconomic - and in particular fiscal -

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<sup>1</sup> The fiscal year runs from 1st January to 31st December but tax is paid with reference to income received in a "charge year" that runs from 1<sup>st</sup> April to 31<sup>st</sup> March. The period 1<sup>st</sup> April 2003 to 31<sup>st</sup> March 2004 is called the 2004 charge year, the period 1<sup>st</sup> April 2004 to 31<sup>st</sup> March 2005 is called the 2005 charge year.

<sup>2</sup> The Government and the IMF subsequently agreed that the sale of a 49 percent shareholding with management rights in ZNCB would constitute "privatization" while ZESCO would be commercialized as opposed to privatized even though ZESCO privatization was a HIPC "completion point" trigger.

<sup>3</sup> 2003 Budget Address, paragraph 77.

discipline as the basis for again moving onto a PRGF programme from January 2004. The ceiling on domestic borrowing under the SMP was raised to K618 billion (3 percent of GDP) to accommodate the 2003 pay award and new housing allowances.

However, an SMP with the IMF was deemed insufficient by Zambia's co-operating partners for them to release new balance of payments/general budget support. It also meant that Zambia could not reach the "completion point" under the Highly Indebted Poor Country (HIPC) initiative in December 2003, and so would not become eligible for substantial debt relief that, at about US\$ 3.8 billion, is approximately equivalent to the size of Zambia's GDP and would halve Zambia's international debt stock.

Further, it became clear during the IMF mission to Lusaka in November 2003 that the outturn for several parameters would be at variance with the agreed programme under the SMP. These slippages were primarily of a fiscal nature, due, *inter alia*, to greater borrowing than agreed under the SMP to finance unbudgeted retrenchment packages for Roan Antelope Mine (RAMCOZ) workers and to maintain Government operations and debt service obligations in the face of lower than programmed balance of payments/general budget support. In the event, domestic borrowing by Government during 2003 was K 1,047 billion, or 5.1 percent of GDP.<sup>4</sup>

Given these slippages under the SMP, it was still not possible to proceed to a full PRGF from January 2004 and an extension to the SMP to 30th June 2004 was sought by Government and agreed to by the IMF. A key fiscal element under the extended SMP

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<sup>4</sup> 2004 Budget Address, paragraph 19.

was to re-establish control over fiscal borrowing by containing it to K 504 billion (2 percent of GDP). This was to be achieved, *inter alia*, by constraining civil service remuneration (excluding housing allowance arrears payments and retrenchment under the Public Service Reform Programme) to 8 percent of GDP while raising the domestic revenue to GDP ratio to 19 percent of GDP. This is about one percent of GDP higher than the 18.06<sup>5</sup> percent level achieved in 2003 and represents about K250 billion more revenue from new taxes.

The presentation, approval and implementation of a Budget for the first six months of 2004 that conformed to these conditionalities under the extended SMP was rewarded by the Board of the IMF approving a new PRGF programme for 2004 to 2007 on 14<sup>th</sup> June 2004. Thereupon, Zambia gained access to SDR 220.01 million (approximately US\$ 320 million), representing 45 percent of its quota, from the IMF over the three-year period of the 2004-2007 PRGF programme.

The first tranche (of SDR 82.5356 million, about US\$ 120 million) of this PRGF loan was disbursed in June and immediately used to pay back to the IMF, principal owing from earlier Structural Adjustment Facility (SAF) loans. Without disbursement of this first tranche of the 2004-2007 PRGF loan, Zambia would have defaulted on her debt obligations to the IMF that were falling due in June 2004. This in turn would have meant that reaching the HIPC “completion point” by the end of 2004 would have become an unrealizable goal.

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<sup>5</sup> Calculated from a revenue figure of K3,679.5 billion in paragraph 57 of the 2004 Budget Address and a GDP figure for 2003 of K20,377.1 billion in Table 2.5 on page 14 of the 2003 Economic Report.

## **Chapter Two**

### **The 2004 Tax Legislation**

When presenting the 2004 Budget tax measures to the National Assembly on 6th February 2004, the Minister of Finance and National Planning stated that he “sought to balance the revenue needs of the Government against the need to provide tax relief to citizens and businesses”<sup>6</sup>.

However, as observed, these “revenue needs” meant that, under the terms of the SMP, the Minister needed to introduce tax measures that, on balance, would not lower the overall tax effort or be simply revenue neutral, but rather would raise the tax effort by about 1 percent of GDP. In this context he proceeded to introduce wide-ranging changes to direct taxes and the Value Added Tax (VAT) system.

The Pay as You Earn (PAYE) tax structure was made significantly more progressive with the exempt income threshold raised by 62 percent from K 160,000 to K 260,000 per month<sup>7</sup>. To balance this increase in personal tax relief, tax rates for those on higher incomes were increased by introducing a new 35 percent rate on income over K 980,000 per month and a top rate of 40 percent on income above K 5 million per month<sup>8</sup>. These changes were effected under section 10(b) of the Income Tax (Amendment) Act of 2004 that amended the Charging Schedule in the Income Tax Act<sup>9</sup>. These tax rate changes, in annual terms, are summarised in Table 2.1 below:

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<sup>6</sup> 2004 Budget Address, paragraph 107.

<sup>7</sup> 2004 Budget Address, paragraph 109.

<sup>8</sup> 2004 Budget Address, paragraph 109.

<sup>9</sup> Chapter 323 of the Laws of Zambia

**Table 2.1: PAYE Tax Bands Following the 2004 Budget**

<b>Income Bands</b>	<b>Tax rate (%)</b>
First K3,120,000 per annum	0
Next K8,640,000 per annum	30
Next K48,240,000 per annum	35
Income above K60,000,000 per annum	40

The combined effect of these changes in the PAYE tax structure was that the 88 percent of workers employed in the formal sector and earning below K 1,580,000 per month had their PAYE tax liability fall, while the top 12 percent of income earners paying PAYE had their PAYE tax liability increase<sup>10</sup>. These changes in the PAYE tax structure were to yield an overall revenue gain of K 23.8 billion<sup>11</sup>.

As regards direct taxes on business income, in addition to measures such as “levelling the playing field” as regards the corporate tax rate paid by companies quoted on the Lusaka Stock Exchange (LuSE)<sup>12</sup> and increasing the farm dwelling allowance from K5 million to K10 million<sup>13</sup>, the biggest change in this area was the introduction of a presumptive tax on businesses with an annual turnover of K200 million<sup>14</sup> or less, with this presumptive tax being a final tax i.e. these businesses would no longer be required to pay corporate tax. This was effected under section 3(b) of the Income Tax (Amendment) Act of 2004 that inserted a new sub-section (2) in section 6A of the Income Tax Act that read “The Commissioner General may make a standard assessment requiring any person carrying

<sup>10</sup> Ministry of Finance and National Planning Press Release, The Times of Zambia, 11th February 2004.

<sup>11</sup> 2004 Budget Address, paragraph 109.

<sup>12</sup> A new incentive for new listings on LUSE was introduced i.e. a 2 percent discount from the normal corporate tax applicable for each sector for one year only and a further discount of 5 percent for companies with more than 33 percent of their shares taken up by Zambians, also for one year only.

<sup>13</sup> Effected under section 8 of the Income Tax (Amendment) Act of 2004

<sup>14</sup> About US\$ 42,000 using the Bank of Zambia average mid-exchange rate of K 4,762/US\$ for the first half of 2004.

on any business, other than the business referred to in sub-section (1), with an annual turnover of two hundred million Kwacha or less to pay tax on turnover at the rate set out in Part II of the Ninth Schedule.” Part II of the Ninth schedule specified a tax rate of 3 percent. An important omission from this measure to introduce a presumptive tax on business turnover was that while there was an “upper threshold” of K 200 million on the turnover subject to the new tax, there was no “lower threshold” set at a level comparable to the exempt portion of personal income. This has had implications for “horizontal” equity with wage earners, as discussed further below.

The stated reason for the introduction of this presumptive tax was that “small businesses with annual turnover of K 200 million and below experience many problems to maintain detailed and elaborate books of accounts” and that they have to hire accountants to prepare their books for tax purposes “which increases their compliance costs”<sup>15</sup>. The Minister further stated, “introducing a presumptive tax creates benefits for both tax administration and taxpayers. For tax administration, the benefit is that presumptive tax reduces enforcement efforts and cost, while broadening the tax base. On the part of the taxpayers, especially small and medium businesses, the cost of compliance is greatly reduced, as they do not have to keep detailed books of accounts. This measure will also improve compliance.”<sup>16</sup> The Minister estimated to raise K 7.3 billion from the introduction of this 3 percent presumptive tax on annual business turnovers of K200 million or less.

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<sup>15</sup> 2004 Budget Address, paragraph 115.

<sup>16</sup> 2004 Budget Address, paragraph 116.

As a corollary to the introduction of the 3 percent presumptive tax on annual turnover of K 200 million or less, changes in the manner the Value Added Tax (VAT) system was operated was also effected. Thus, under section 3 of Statutory Instrument No. 11 of 2004, the Value Added Tax (General) (Amendment) Regulations of 2004, voluntary registration under VAT was abolished and the threshold for obligatory registration under VAT was raised to businesses with annual turnovers in excess of K 200 million. This meant that businesses with an annual turnover under the K 200 million threshold were deregistered and could no longer claim input VAT back from the Zambia Revenue Authority (ZRA) for VAT paid on input items brought for their businesses. The Minister estimated that K 26.3 billion would be raised through this deregistration<sup>17</sup>. In effect, this deregistration measure had the result of worsening the cash flow of all small businesses by K 26.3 billion a year.

Further, the 2004 Budget reduced the list of zero-rated products by making unprocessed agricultural goods and medical supplies/drugs exempt from VAT. The Minister estimated that K 95.3 billion would be raised in 2004 from this measure as producers of these, now VAT-exempt goods would no longer be able to claim back their input VAT. As with the K 26.3 billion revenue arising from the VAT deregistration measure, this K 95.3 billion represents a worsening in the annual cash flows of businesses producing unprocessed agricultural goods (i.e. farms) and medical supplies/drugs.

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<sup>17</sup> 2004 Budget Address, paragraph 131.

## **Chapter Three**

### **Tax Entity Models**

An effective way to assess the impact of the 2004 Budget's tax legislation on the small-scale farming sector, is to compare the inter-temporal (i.e. pre and post 2004 Budget) tax burdens of different farm enterprises as reflected in small-scale farm tax entity "models" categorized by level of turnover and profit margin. These inter-temporal tax assessments can be compared with each other and also with similar inter-temporal tax assessments made for other tax entities.

Before these models are described however, it should be noted from the outset that Zambia has a largely "schedular" tax system as opposed to a "globular" or "unitary" system. Under the latter, a taxpayer's income from all sources is aggregated and subjected to a single, usually graduated, tax rate structure. It is the system used to a greater or lesser extent in most developed economies such as the UK.

Conversely, under a pure "schedular" system, incomes from different sources are subject to different tax systems. Thus, income from employment, rental income, dividends, informal income, interest income etc. will be taxed using their own tax systems such as PAYE and various withholding tax systems and using their own tax rate schedules. While schedular systems have the advantage of being generally easier to administer (e.g. by facilitating taxation at source), they are highly likely to create inequity as everyone is subject to the same rate of tax on each source of income regardless of total income and overall ability to pay tax. As Zambia, like many developing economies, follows a largely

schedular tax system, it is possible to treat the income from different tax entity models as distinct and separate from each other and subject to their own tax regimes.

### ***Small-scale farm tax entity models***

Twenty-four small-scale farm enterprise models will be used to make these inter-temporal tax assessments, with these models based on four different annual turnover levels and six profit margins. Thus, the inter-temporal tax assessments will be made for small-scale farms with annual turnovers of K 25 million, K 100 million, K 180 million and K 220 million and operating at a break-even level and profits margins of 5 percent, 10 percent, 15 percent, 20 percent and 25 percent. The three sets of small-scale farm models with annual turnovers of under K 200 million will be affected by the introduction of the three percent presumptive tax on turnover while the K 220 million turnover model will remain subject to income tax at the rate of 15 percent of profit during the 2005 charge year.

To compare the impact of the 2004 Budget's tax legislation on small-scale farms with other tax entities, the inter-temporal tax burden of other tax entity models will also be calculated. To this end, the inter-temporal tax liability of the following non-farm tax entity models will be assessed.

### ***Other tax entity models: Employees***

Six tax models showing the impact of the 2004 Budget's tax legislation on persons earning income solely from employment, with all emoluments from their employer paid

completely in cash and who make pension contributions to NAPSA<sup>18</sup>, will be used<sup>19</sup>. For these tax entities, income tax is deducted at source from their employers through the Pay As You Earn (PAYE) system. The six models are based on gross monthly income levels of K 250,000 (K 3 million a year), K 500,000 (K 6 million a year), K 750,000 (K 9 million a year), K 1 million (K 12 million a year), K 1,500,000 (K 18 million a year) and K 2,000,000 (K 24 million a year).

None of these tax models are affected by the imposition of the new 40 percent personal income tax rate introduced in the 2004 Budget, but the three higher earning models are affected by the new 35 percent income tax rate introduced in the 2005 charge year on incomes above K 960,000 a month. All models benefit from the standard tax exempt portion of income that rose 62 percent from K 160,000 to K 260,000 a month between the 2004 and 2005 charge years and the tax exemption (up to a maximum of K 180,000 a year) for NAPSA pension contributions paid by employees.

### ***Public Service Vehicle (PSV) Businesses***

Eighteen tax models, representing the impact of the 2004 Budget's tax legislation on PSV operators will be used, with the models based on three types of PSV business, one operating a 15-seat mini-bus, one a 20-seat mini-bus and the third a 25-seat bus. The eighteen models are derived from three annual turnover levels of K 100 million, K 180

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<sup>18</sup> National Pension Scheme Authority.

<sup>19</sup> Since April 1971, adoption of the family as the taxpaying unit by aggregating all family members' incomes and taxing the total was ended when Zambia adopted the "independent"/separate assessment tax principle under which individual taxpayers (whether married or single, male or female) are taxed separately on their own incomes. Apportionment of allowances (e.g. married and child allowances) between husband and wife further entrenched the principle in the 1980s. These were replaced by a "primary" allowance in April 1989 (and later a "tax credit" and presently a "tax exempt portion of income") and the separate assessment principle is now fully implemented.

million and K 220 million, operating at two profit margin levels of 10 percent and 20 percent. These tax entity models were already subjected to a presumptive tax in the 2004 charge year<sup>20</sup>, with the presumptive tax payable dependent not on turnover but on seating capacity. These models are included to assess the equitability of the operation of their presumptive tax system with that imposed on small-scale farms and other small business entities with annual turnovers under K 200 million.

### ***“Low-cost, High-profit” Enterprises***

Three tax models representing the impact of the 2004 tax legislation on “low-cost, high-profit” enterprises with profit margins of 80 percent of turnover will be used. The three models are based on annual turnovers of K100 million, K 180 million and K 220 million. Such a low-cost, high profit enterprises are typical of many professions. For example, it may include a one-man consultancy firm, operating as a “business name”<sup>21</sup> under the Registration of Business Names Act<sup>22</sup>. Business costs in such an enterprise can be kept to a minimum e.g. by working from a study at home, but earn high fees for the consultancy work undertaken, where the principal input generating the income stream for the business is the intellectual effort of the consultant owner.

It should be noted that the above tax entity models are precisely that i.e. models designed to illustrate the impact of the 2004 tax legislation on generalised categories of enterprise with similar characteristics, everything else remaining equal. Thus, for the purpose of

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<sup>20</sup> 2003 Budget Address, paragraph 112.

<sup>21</sup> Defined in s.2 of Cap 389. It is a unique designation that identifies an enterprise and is protected by registration e.g. to protect against “passing off”/getting business by deceit by using another’s goodwill.

<sup>22</sup> Chapter 389 of the Laws of Zambia

analysis, simplifying assumptions are made. In particular, the models factor out all individualistic determinants of tax liability for any particular enterprise e.g. the tax deduction given to a firm employing handicapped workers<sup>23</sup>. The only determinants of tax liability used in the models are the level of turnover or income/profit earned (whichever is the appropriate tax base for the particular entity), the tax rate applicable on that base and any generalized tax exemptions/allowances applicable to a particular category of tax entity rather than taxpayer-specific exemptions or allowances.

Thus, the models do not consider other individualistic determinants of a particular tax entity's liability, such as (for businesses) deductions in liability due to the application of capital allowances, the carry forward of losses or the operation of an enterprise in a rural area in the first five years of business.

However, for individuals, tax deductions allowed for statutory pension contributions (i.e. NAPSA contributions at the rate of 5 percent of salary up to a maximum of K 15,000 a month) and the exempt portion of income, have been incorporated into the calculation of individual tax liability of each individual based tax entity model, as these are general deductions, applicable to all employed persons<sup>24</sup>.

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<sup>23</sup> This deduction of K 240,000 from the gains or profits of the business for each handicapped person employed by the business on a full time basis for the whole or a substantial part of the charge year is conferred by section 43E of the Income Tax Act.

<sup>24</sup> Currently, personal taxpayer-specific tax deductions, as opposed to general personal tax deductions, have virtually disappeared from Zambian tax legislation (with a consequent increase in horizontal inequity) e.g. tax relief allowed for mortgage interest paid in respect of residential property in which an employee lived was removed in the 2002 Budget. Further, the 1996 Investment Act abolished the "special incentives" available under the 1993 Act and retained only the "general incentives" that were already available under the Income Tax Act. However, a new Investment Act is in draft form that has provisions for new special tax incentives for investors.

## Chapter Four

### Inter-temporal Tax Burdens on the Model Tax Entities

The impact of the 2004 Budget's tax legislation on the tax liability and effective average tax rates<sup>25</sup> of the various tax entity models described in Chapter Three is calculated and explained in the sections and tables below and is summarised in Appendix I.

#### *The Impact of the 2004 Tax Legislation on Small-scale Farms*

Tables 4.1 to 4.3 show the impact of the measures on the twenty-four small-scale farming models. Table 4.1 shows the annual income/profit earned by each particular model, which, as profit is solely dependent on the profit margin assigned, does not change between the two charge years for each particular model.

**Table 4.1:**  
**Annual Profit (in K m) for the twenty-four small-scale farm models**

Profit Margin	K 25 m annual turnover		K 100 m annual turnover		K 180 m annual turnover		K 220 m annual turnover	
	2004 Charge Year	2005 Charge Year	2004 Charge Year	2005 Charge Year	2004 Charge Year	2005 Charge Year	2004 Charge Year	2005 Charge Year
0%	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
5%	1.25	1.25	5.00	5.00	9.00	9.00	11.00	11.00
10%	2.50	2.50	10.00	10.00	18.00	18.00	22.00	22.00
15%	3.75	3.75	15.00	15.00	27.00	27.00	33.00	33.00
20%	5.00	5.00	20.00	20.00	36.00	36.00	44.00	44.00
25%	6.25	6.25	25.00	25.00	45.00	45.00	55.00	55.00

In both the 2004 and 2005 charge years, the tax rate applicable on farm income/profit was 15 percent. However, whereas this rate was applicable on all farm income/profit in the 2004 charge year, from the 2005 charge year it only applies to farm income/profit from farm enterprises with annual turnovers exceeding K 200 million. For farms with an annual turnover of less than K 200 million, the new presumptive tax of 3 percent of

<sup>25</sup> I.e. tax liability expressed as a percentage of total income/profit.

turnover applies, with this presumptive tax payable irrespective of whether a positive income (i.e. profit) is earned or not, or the level of that profit, if it is positive.

Table 4.2 shows the tax liability of each particular farm model for the 2004 and 2005 charge years. Although, for each particular model, the profit earned does not change, as the 2004 charge year tax liability was based on the income/profit earned whereas in the 2005 charge year it is based on annual turnover (if under K 200 million) and only on profit/income levels if over K 200 million, the tax liability of the farm models with turnovers under K 200 million are significantly different in the 2005 charge year.

**Table 4.2:**  
**Inter-temporal Tax Liability (in K m) for the twenty-four small-scale farm models**

Profit Margin	K 25 m annual turnover		K 100 m annual turnover		K 180 m annual turnover		K 220 m annual turnover	
	2004 Charge Year	2005 Charge Year	2004 Charge Year	2005 Charge Year	2004 Charge Year	2005 Charge Year	2004 Charge Year	2005 Charge Year
0%	0.0000	0.7500	0.0000	3.0000	0.0000	5.4000	0.0000	0.0000
5%	0.1875	0.7500	0.7500	3.0000	1.3500	5.4000	1.6500	1.6500
10%	0.3750	0.7500	1.5000	3.0000	2.7000	5.4000	3.3000	3.3000
15%	0.5625	0.7500	2.2500	3.0000	4.0500	5.4000	4.9500	4.9500
20%	0.7500	0.7500	3.0000	3.0000	5.4000	5.4000	6.6000	6.6000
25%	0.9375	0.7500	3.7500	3.0000	6.7500	5.4000	8.2500	8.2500

The table clearly shows that for breakeven and low-profit farm enterprises, rather than their tax liability reducing to reflect, (in accordance with the aim of achieving “vertical equity”<sup>26</sup>) their reduced capacity to pay in relation to farms with higher profit margins, their tax liability actually rises<sup>27</sup>. It is only at profit margins of 20 percent or higher, that, for farm models with annual turnovers of under K 200 million, the 2005 charge year tax liability falls. Thus, for farm enterprises with profit margins of greater than 20 percent but

<sup>26</sup> As income rises, equity demands that the proportion of income paid in tax should rise, or at least stay constant, but in no way should fall. These equity issues are discussed further in Chapter Five.  
<sup>27</sup> This would be even more so for loss-making farm enterprises.

annual turnovers of under K 200 million, their tax liability fell under the 2004 Budget's tax legislation, irrespective of the fact that they had a higher capacity to pay tax than less profitable (or loss making) farms<sup>28</sup>.

For the five farm enterprise models with annual turnovers exceeding K 200 million, their 2004 and 2005 charge year's tax liabilities remain the same (as both are based on income/profit earned). However, it will be noticed that "vertical" inequity arises again when the tax liability of farm models just under the K 200 million annual turnover threshold are compared with those of farm models just over the K 200 million threshold.

For example, the tax liability of a K 180 million-turnover farm with a 10 percent profit margin (i.e. it has profit of K 18 million) is doubled in the 2005 charge year as compared with its 2004 charge year tax liability. Further it is K 2.1 million (63.6 percent) higher than a farm enterprise with the same profit margin but a turnover of K 220 million a year. This farm only has a tax liability of K 3.3 million in the 2005 charge year, but its absolute profit level is K 22 million. Thus, by increasing turnover (and absolute profit levels) a farm enterprise can significantly reduce its tax liability in the 2005 charge year.

This is an instance where, for this category of farm enterprise, "income effects" may arise i.e. small-scale farms may be induced by the 2004 Budget's tax legislation to raise their production levels to exceed turnovers of K 200 million a year as, in doing so, they will reduce their tax liability significantly. This is discussed further in Chapter Six.

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<sup>28</sup> The 20 percent profit margin division between small-scale farm "winners" and "losers" would have been lower had the presumptive tax rate been lower. E.g. if the rate was 1.5 rather than 3 percent, the dividing profit margin percentage would be ten percent and fewer small-scale farmers would be worse off.

These “vertical” inequities brought into the tax system by the introduction of the 3 percent presumptive tax on turnover is further illustrated in Table 4.3 below that simply shows the average effective rate of tax rate faced by each tax model in the 2004 and 2005 charge years. As profit margins (and hence ability to pay) fall below 20 percent, the proportion payable in tax rises for small-scale farms subject to the 3 percent presumptive tax.

**Table 4.3**  
**Inter-temporal Average Effective Tax Rates on Profit for small-scale farm models**

Profit Margin	K 25 m annual turnover		K 100 m annual turnover		K 180 m annual turnover		K 220 m annual turnover	
	2004 rate	2005 rate	2004 rate	2005 rate	2004 rate	2005 rate	2004 rate	2005 rate
0%	No tax due	Infinite	No tax due	Infinite	No tax due	Infinite	No tax due	No tax due
5%	15%	60%	15%	60%	15%	60%	15%	15%
10%	15%	30%	15%	30%	15%	30%	15%	15%
15%	15%	20%	15%	20%	15%	20%	15%	15%
20%	15%	15%	15%	15%	15%	15%	15%	15%
25%	15%	12%	15%	12%	15%	12%	15%	15%

***The Impact of the 2004 Tax Legislation on Employees***

The 2004 Budget’s tax legislation brought about a significant change in the regime governing the taxation of personal earned income. While all employees benefited from the 62 percent increase in the threshold of exempt income, low paid employees benefited proportionately more, with the very lowest paid falling out of the tax net altogether. However, for higher paid employees, the positive impact of the increase in the tax exempt portion of income was offset by the negative impact of the introduction of the two new PAYE tax bands of 35 percent on income above K 960,000 a month and 40 percent on income above K 5,000,000 a month. The effect of these changes was that employees earning K 1,580,000 a month or less were, from a tax liability point of view, better off, while those earning above this level were made worse off.

The impact of these dual changes to personal income tax introduced in the 2004 Budget’s tax legislation on the employee tax entity models described in Chapter Three is calculated and summarized in Table 4.4. below.

**Table 4.4**  
**2004 and 2005 charge year tax liability & effective tax rates faced by Employees**

	2004 Charge Year					
Annual Income	3,000,000	6,000,000	9,000,000	12,000,000	18,000,000	24,000,000
NAPSA tax allowance	150,000	180,000	180,000	180,000	180,000	180,000
Taxable income	2,850,000	5,820,000	8,820,000	11,820,000	17,820,000	23,820,000
Income exempt from tax	1,920,000	1,920,000	1,920,000	1,920,000	1,920,000	1,920,000
Tax due	-	-	-	-	-	-
Income taxed at 30%	930,000	3,900,000	6,900,000	9,900,000	15,900,000	21,900,000
Tax due	279,000	1,170,000	2,070,000	2,970,000	4,770,000	6,570,000
Income taxed at 35%	-	-	-	-	-	-
Tax due	-	-	-	-	-	-
Total Tax Liability	279,000	1,170,000	2,070,000	2,970,000	4,770,000	6,570,000
Tax liability (% of income)	9.30%	19.50%	23.00%	24.75%	26.50%	27.38%
	2005 Charge Year					
Annual Income	3,000,000	6,000,000	9,000,000	12,000,000	18,000,000	24,000,000
NAPSA tax allowance	150,000	180,000	180,000	180,000	180,000	180,000
Taxable income	2,850,000	5,820,000	8,820,000	11,820,000	17,820,000	23,820,000
Income exempt from tax	3,120,000	3,120,000	3,120,000	3,120,000	3,120,000	3,120,000
Tax due	-	-	-	-	-	-
Income taxed at 30%	-	2,700,000	5,700,000	8,640,000	8,640,000	8,640,000
Tax due	-	810,000	1,710,000	2,592,000	2,592,000	2,592,000
Income taxed at 35%	-	-	-	60,000	6,060,000	12,060,000
Tax due	-	-	-	21,000	2,121,000	4,221,000
Total Tax Liability	-	810,000	1,710,000	2,613,000	4,713,000	6,813,000
Tax liability (% of income)	0.00%	13.50%	19.00%	21.78%	26.18%	28.39%

Table 4.4 shows that as regards personal income tax, the 2004 Budget’s tax legislation made the tax system more progressive, with the degree of “vertical” equity increasing as the proportion of income paid in tax fell for those on incomes less than K 18,960,000 and rose for those above this annual income level.

***The Impact of the 2004 Tax Legislation on PSV operators***

The 2004 Budget was not the first to introduce presumptive taxation in Zambia. The 2003 Budget had already introduced a presumptive tax on Public Service Vehicle (PSV) operators<sup>29</sup> by inserting a new Ninth Schedule in relation to section 64A of the Income Tax Act<sup>30</sup>. The schedule required PSV operators to pay a presumptive tax based on the seating capacity of each PSV they operated, irrespective of the volume of business it generated i.e. the tax payable was the same whether the mini-bus generated income of just a few million Kwacha during the charge year or income in excess of K 100 million.

The amount of presumptive tax payable under the 2003 Budget by PSV operators was not modified by the 2004 Budget, so the tax liability of these businesses did not change between the two charge years. The amount of annual presumptive tax payable per PSV in both the 2004 and 2005 charge years is set out in Table 4.5 below.

**Table 4.5**  
**Presumptive Tax Rates on PSV Operators Introduced in the 2003 Budget**

<b>PSV Sitting Capacity</b>	<b>Annual Presumptive Tax</b>
64 seater and above	K 7,200,000
50 – 63 seater	K 6,000,000
36 – 49 seater	K 4,800,000
22 – 35 seater	K 3,600,000
18 – 21 seater	K 2,400,000
12 – 17 seater	K 1,200,000
Below 12 seats (including taxis)	K 600,000

On the basis of these presumptive tax rates, the tax liability and effective tax rates for the three types of PSV operator at the various turnover and profit margin levels is set out in

<sup>29</sup> 2003 Budget Address, Paragraph 112.

<sup>30</sup> See Section 10 of the Income Tax (Amendment) Act of 2003 (Act No. 3 of 2003)

Table 4.6. As the rate of presumptive tax payable by each type of PSV operator was not changed by the 2004 Budget’s tax legislation, the tax liability of each model also did change between the 2004 and 2005 charge years.

**Table 4.6**  
**Tax Liability & Effective Tax Rates For PSV Operators (2004 & 2005 charge years)**

	15 seater	20 seater	25 seater	15 seater	20 seater	25 seater
<b>K100m turnover</b>	20 percent profit margin			10 percent profit margin		
Profit (K m)	20	20	20	10	10	10
Tax Payable	1.2	2.4	3.6	1.2	2.4	3.6
Effective tax rate	6%	12%	18%	12%	24%	36%
<b>K180m turnover</b>	20 percent profit margin			10 percent profit margin		
Profit (K m)	36	36	36	18	18	18
Tax Payable (K m)	1.2	2.4	3.6	1.2	2.4	3.6
Effective tax rate	3.33%	6.67%	10.00%	6.67%	13.33%	20.00%
<b>K220m turnover</b>	20 percent profit margin			10 percent profit margin		
Profit (K m)	44	44	44	22	22	22
Tax Payable	1.2	2.4	3.6	1.2	2.4	3.6
Effective tax rate	2.73%	5.45%	8.18%	5.45%	10.91%	16.36%

The table shows that for the same level of profit and profit margin, income earned from operating a mini-bus or bus was taxed significantly less than income from small-scale farms, giving rise, *inter alia*, to “horizontal” inequity, an issue discussed further in Chapter Five below.

***The Impact of the 2004 Tax Legislation on Low-Cost, High-Profit Enterprises***

The impact of the introduction of the three percent presumptive tax on business turnovers of less than K 200 million a year<sup>31</sup> has been exceptionally beneficial to proprietors of low-cost, high-profit enterprises (principally professional persons registered as business names or as private companies, such as a one-man consultancy business) whose turnovers fall below this annual turnover threshold. Assuming that such a business is registered as a

<sup>31</sup> Apart from PSV operators where the presumptive tax based on seating capacity introduced in the 2003 Budget remained in tact.

private company, its income, that was taxed at 35 percent<sup>32</sup> in the 2004 charge year, became liable to only the three percent presumptive tax rate in the 2005 charge year, provided that the annual turnover remained below K 200 million.

This very beneficial impact is illustrated in Table 4.7 below that also illustrates the exceptionally high marginal tax rate paid by such enterprises in the 2005 charge year if their turnover moves above K 200 million.

**Table 4.7**  
**Tax Liability & Effective Tax Rates for Low-cost, High-profit Tax Entities**

	2004 Charge Year		
Annual Turnover (K m)	100.0	180.0	220.0
Profit (K m)	80.0	144.0	176.0
Tax Liability (K m)	28.0	50.4	61.6
Effective Tax Rate	35%	35%	35%
	2005 Charge Year		
Annual Turnover (K m)	100.0	180.0	220.0
Profit (K m)	80.0	144.0	176.0
Tax Liability (K m)	3.0	5.4	61.6
Effective Tax Rate	3.75%	3.75%	35%

The very steep rise in the effective tax rate in the 2005 charge year as annual turnover rises above K 200 million is almost certain to induce tax avoidance strategies as such enterprises face a large incentive to reorganize their business operations so as to reduce their tax liability e.g. by separating their business into two smaller tax entities so that the annual turnover of each one does not exceed K 200 million. This issue will be discussed further in Chapter Six.

<sup>32</sup> No such enterprise is listed on the Lusaka Stock Exchange (LuSE) so the more preferential tax rates in the 2004 charge year do not apply. The 45 percent higher rate of tax payable on bank profits are only applicable on annual profit (not turnover) levels above K 250 million. It is also assumed that these enterprises are not exporting so that the 15 percent tax rate applicable to such enterprises is not applicable.

## Chapter Five

### **Analysis: Inter-Temporal and Inter-Entity Horizontal and Vertical Equity**

Objective analysis of the impact of the 2004 tax legislation on small scale farming enterprises can only be made in relation to recognised standards for assessing the efficacy of taxation. Adam Smith's classic exposition of the "cannons" of taxation in his seminal work "The Wealth of Nations"<sup>33</sup>, are just as relevant today as they were in the eighteenth century. He identified four essential "cannons" i.e. standards that should be observed if a tax was to be favourably assessed, these being - equity, certainty, convenience and cost effectiveness.

In this Chapter we will analyse the impact of the 2004 tax measures on small farmers in the light of equity considerations and leave the analysis in relation to the other three cannons to the next Chapter. As regards equity, Smith stated,

"The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective ability, that is in proportion to the revenue which they respectively enjoy under the protection of the State."<sup>34</sup>

In the Aristotelian tradition of "distributive justice"<sup>35</sup> where "equals are treated equally and unequals, unequally" when allocating rights, duties and burdens across society, by "in proportion to their respective ability" Smith clearly meant equity i.e. equality of

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<sup>33</sup> A. Smith, "The Wealth of Nations" [1776] as quoted by D. Ricardo "The Principles of Political Economy and Taxation" [1817] p. 195-196 Pelican Classics, edited by R.M. Hartwell.

<sup>34</sup> Ibid. p.195-196.

<sup>35</sup> As opposed to Aristotle's idea of "corrective" justice that entails the restoration of rights, interests and burdens to whatever existed before a wrong was committed.

sacrifice not equality in the amount paid. Today, taxation practitioners distinguish between “vertical” and “horizontal” equity. Vertical equity means that the higher a person’s income, the greater the amount of tax payable in absolute terms should be, as the ability to pay is greater. Indeed, a progressive tax structure entails an increasing proportion of income paid in tax as income rises<sup>36</sup>, not just an increasing amount in absolute terms. As seen in Chapter Four, vertical equity has increased for income earned by employees and taxed through the PAYE system (see Table 4.4) but very significant vertical inequity has arisen for small-scale farms with annual turnovers of under K 200 million where, as profit margins fall below 20 percent, the proportion of profit payable in tax rises between the 2004 and 2005 charge years.

However, even at the same income levels, individuals face different circumstances and have different social and family obligations e.g. a married man with children living in rented accommodation will have greater need for income than an owner-occupier bachelor without any dependants. Thus there is also a need for “horizontal” equity, i.e. even at similar income levels, adjustments should be made in the tax structure<sup>37</sup> to give greater relief to those who have greater social commitments such as raising a family. Again, as observed in Chapter Four, horizontal inequity has arisen following the introduction of the 2004 Budget tax legislation e.g. as between presumptive tax paid by small farms and the presumptive tax paid by PSV operators on the same turnover and profit levels.

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<sup>36</sup> While a regressive tax is one where the proportion of income paid in tax falls as income rises and a proportionate tax is one where the proportion of income paid in tax is constant as income rises.

<sup>37</sup> Through giving taxpayer specific allowances such as a married persons allowance and child allowance.

### ***Inter-Entity/Inter-Temporal Computation Matrix***

The absolute tax liability and the effective tax rate applied on the profit/income earned by the various small-scale farm and other tax entity models in the 2004 and 2005 charge years, calculated in the previous chapter, are also summarized in Appendix I in an Inter-Entity/Inter-Temporal Tax Computation Matrix.

Analysis of these calculations of absolute tax liability and effective tax rates reveal significant degrees of both inter-temporal and inter-entity inequity in the impact of tax liability, with this inequity being both horizontal and vertical in nature. The following examples can be deduced from the computation matrix in Appendix I.

### ***Inter-temporal Horizontal Inequity***

It is inevitable that the tax liability of most if not all tax entities be altered following new tax measures in a Government's annual Budget. Some taxpayers will unavoidably be made worse off<sup>38</sup> as tax rates and structures change. When this happens, "inter-temporal horizontal inequity" i.e. a rise in tax liability on the same level of income between charge years, will inevitably occur.

Such "inter-temporal horizontal inequity" affected many small-scale farms between the 2004 and 2005 charge years. Thus, while the income tax treatment of small-scale farm enterprises with annual turnovers exceeding K 200 million remained unaltered by the 2004 Budget<sup>39</sup>, this was not true for most farms operating with annual turnovers of less

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<sup>38</sup> Conversely, other taxpayers will be made better off as is clearly the case in the 2005 charge year for "high-profit, low-cost" businesses with annual turnovers under K 200 million.

<sup>39</sup> Although their overall tax treatment was negatively affected by making unprocessed agricultural produce exempt from VAT which meant that they could no longer reclaim their input VAT from ZRA.

than K 200 million. All small-scale farm models which became subject to the three percent presumptive tax on turnover following the enactment of the 2004 Budget's tax legislation and had profit margins of less than twenty percent of turnover saw their tax liabilities and the effective rate of average tax on their incomes rise, sometimes dramatically, between the 2004 and 2005 charge years.

The calculations reveal that the lower the profit margin realised by these particular tax entity models, the greater the level of "inter-temporal horizontal inequity". Thus a small-scale farm, regardless of the level of annual turnover (provided it was below K 200 million) operating with a profit margin of five percent of turnover, saw its tax liability quadruple<sup>40</sup>, while one operating with a ten percent profit margin faced a doubling in its tax liability and one operating with a fifteen percent profit margin on turnover saw its tax liability increase by one third. Thus, for this type of business enterprise, significant "inter-temporal horizontal inequity" arose between the two charge years i.e. while the income levels of these enterprises did not change, their liability to income tax rose spectacularly, especially for the lower income earning models.

As already noted it is not strange for some tax entities to be made worse off as tax rates and structures change following a Budget. "Inter-temporal horizontal inequity" (i.e. a rise in tax liability on the same level of income between charge years) will thus inevitably occur. However, in this particular instance, the treatment of small-scale farms in the 2004 Budget may be judged unjust (in the Aristotelian sense of treating equals, equally) as:

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<sup>40</sup> And the effective rate of tax on farm profits rise from 15 percent to 60 percent.

- (a) Other tax entity models - with the exception of employees earning in excess of K 18,960,000 a year, whose higher income bands became liable to 35 and 40 percent tax<sup>41</sup> - did not see their income tax liability rise in the 2005 charge year.
- (b) Even for these high paid employees, the rate of income tax can never exceed 40 percent in the 2005 charge year, although it can approach it at very high incomes<sup>42</sup>. Small farms earning 5 percent profit on their turnover face an effective income tax rate of 60 percent on their profit/income and as the profit margin falls towards the break-even point the rate rapidly escalates to infinity; and
- (c) The stated reason for introducing the presumptive tax was, as given in Chapter Two, to “greatly” reduce the cost of compliance for taxpayers “as they do not have to keep detailed books of accounts”<sup>43</sup>. This is unlikely to be true for many of the small farm enterprise models that earn low profit margins, break-even or make losses, where the tax payable in the 2005 charge year could approach K 6 million (as annual turnover approaches K 200 million) but where the cost of maintaining books is unlikely to be higher than the extra tax payable by these enterprises as compared with their 2004 charge year tax liability<sup>44</sup>.

Indeed, for break-even, and in particular for loss making small-scale farm enterprises, the three percent presumptive tax on turnover became payable in the 2005 charge year even though no income was earned and no tax was payable in the 2004 (and previous) charge

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<sup>41</sup> Also the few large companies who were listed on the LuSE and whose corporate tax rate was raised from 33 percent to the rate applied to most other companies i.e. 35 percent.

<sup>42</sup> E.g. a high earning executive being paid K 50 million a month (about US\$ 10,000) will be taxed at just over K19.6 million a month or 39.25 percent of his income.

<sup>43</sup> Supra note 15.

<sup>44</sup> Also, if the small farms are companies, they will still be statutorily required to keep accounts in conformity with the Companies Act, Chapter 388 of the Laws of Zambia.

years. For these enterprises, the introduction of the three percent presumptive tax on turnover and the “inter-temporal horizontal inequity” so created, can be expected to lead to a significant weakening of their financial viability and threaten their survival as business enterprises.

This is especially the case if these break-even/loss making small-scale farms were previously registered for VAT and lost their registered status from April 2004. Thus, as with all farm enterprises only producing unprocessed agricultural produce, their cash flows were also adversely affected in the 2005 charge year, by their inability to claim back their input VAT.

### ***Inter-entity Horizontal Inequity***

Further glaring instances of horizontal inequity can be seen when making inter-entity tax liability comparisons between different business types within the 2005 charge year as opposed to comparing the tax liability of a particular tax entity between the 2004 and 2005 charge years. Such “inter-entity horizontal inequity” (treating equals unequally i.e. different tax entities earning the same income levels in any given charge year but being taxed at different rates) is evident, for example, when comparing small-scale farm enterprises with Public Service Vehicle (PSV) operators. Even though both types of enterprise are subject to presumptive taxation in the 2005 charge year, as the presumptive tax regimes they face are quite different, very significant horizontal tax inequity has arisen between these two types of business entity following the 2004 Budget.

Thus, a business operating a 15-seat mini-bus pays presumptive tax of K 1.2 million a year irrespective of its profit and turnover levels. This level of presumptive tax is payable in the 2005 charge year by a small-scale farm enterprise with an annual turnover of K 40 million. Any small-scale farm with a turnover between K 40 million and K 200 million will be subject to a higher presumptive tax. As a consequence, while a 15 seat PSV operator with an annual turnover of K 180 million and a profit margin of 20 percent will pay K 1.2 million (only three and a third percent of his profit) in presumptive tax, a small scale farm with the same turnover and absolute profit level will pay K 5.4 million. This is four and a half times as much tax in absolute terms and fifteen percent of his earned profit - a clear instance of a high degree “inter-entity horizontal inequity”.

Further, it was noted in Chapter Two that while the three percent presumptive tax on annual turnover was introduced with an “upper threshold” on annual turnover of K 200 million, no “lower threshold” was set at a level comparable to the exempt portion of personal income. This has given rise to horizontal inequity between low paid employees and small-scale farms earning farm income below the exempt portion of personal income not subject to tax.

Thus a small farm with an annual turnover of K 100 million and a profit margin of six percent will be subject to tax of K 3 million (50 percent of his profit) while a lowly paid employee earning the same level of income i.e. K 500,000 a month or K 6 million a year, will only pay income tax through the PAYE system of K 810,000 (13.5 percent of his income). This particular instance of “inter-entity horizontal inequity” could have been

avoided or minimised by incorporating under section 3(b) of the Income Tax (Amendment) Act of 2004<sup>45</sup>, a provision for a “lower threshold” turnover level set at a level comparable to the exempt portion of personal income.

### ***Inter-entity Vertical Inequity***

“Inter-entity vertical inequity” arises when a tax is “regressive” rather than “progressive”.

As the level of income rises, and so the capacity to pay tax increases, to comply with Smith’s cannon of fairness, average tax rates on income are ideally expected to rise (when the tax is said to be progressive) and not to fall (when the tax is said to be regressive)<sup>46</sup>. However, the introduction of the three percent presumptive tax on annual turnover in the 2004 Budget has brought into the tax system a large degree of regressivity.

For example, as the annual turnover of a small-scale farm rises over the K 200 million “upper threshold” level for the presumptive tax to apply, very significant “inter-entity vertical inequity” arises in the 2005 charge year. Thus a small farm with an annual turnover of K 180 million and a profit margin of 10 percent would, on the K 18 million profit earned in 2005 charge year, be liable to tax of K 5.4 million. This is an effective average tax rate of 30 percent. However, if the same farm enterprise managed to raise its annual turnover to K 220 million and maintain its profit margin at 10 percent, while the absolute profit earned would rise by K 4 million to K 22 million, its tax liability would fall by over K 2 million to only K 3.3 million. The effective average tax rate is halved to

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<sup>45</sup> That inserted a new sub-section (2) in section 6A of the Income Tax Act.

<sup>46</sup> If the rate of tax remains constant as income rises, the tax is said to be “proportional”.

only 15 percent. Thus, as income rises for this tax entity, tax liability falls i.e. the tax system displays regressivity - the hallmark of vertical inequity.

However, even more glaring instances of inter-entity vertical inequity can be seen when comparing small-scale farm enterprises with Public Service Vehicle (PSV) operators and especially with “high-profit, low-cost” businesses such as a one-man consultancy firm operating as a private company.

Appendix I abounds with examples of such “inter-entity vertical inequity”. For example, a twenty-seat PSV operator with a turnover of K 220 million and a profit level of 20 percent (i.e. absolute profit is K 44 million) pays only K 2.4 million in income tax while a small farm with an annual turnover of K 100 million and the same profit margin (so that its annual income level of K 20 million is less than half that of the twenty-seat PSV operator), pays income tax of K 3 million i.e. 25 percent more tax on less than half the income.

“Inter-entity vertical inequity” is, not surprisingly, very apparent when comparing small-scale farms and with “high-profit, low-cost” businesses. A small-scale farm with an annual turnover of K 180 million and a profit margin of 20 percent will pay the same level of income tax as a “high-profit, low-cost” business with the same turnover but a profit margin of 80 percent. In short, although the enterprise earns K 144 million, four times the K 36 million earned by the small farm, both pay presumptive tax of K 5.4 million which is an average tax rate of only 3.75 percent for the “high-profit, low-cost” business, but 15 percent for the small-scale farm.

### ***Inter-temporal Vertical Inequity***

Continuing with the example of the “high-profit, low-cost” business with an annual turnover of K 180 million, the much lower tax liability falling on this business in the 2005 charge year is, in effect, financed in part by the higher tax liability placed on small-scale farms in the 2005 charge year.

Thus the “high-profit, low-cost” business operating at an annual turnover of K 180 million saw its tax liability dramatically fall by almost 90 percent from K 50.4 million in the 2004 charge year to a mere K5.4 million in the 2005 charge year, while a small-scale farm with the same annual turnover and a ten percent profit margin saw its tax liability double from K 2.7 million to K 5.4 million. The same type of small-scale farm with lower profit margins will of course experience even higher proportionate increases in their tax liability.

In essence, between the two charge years, enterprises with much higher incomes (and hence a much greater ability to pay higher rates of income tax) saw their tax liability fall dramatically while small-scale farm enterprises with much lower incomes and lower capacity to pay income tax experienced an increase in the income tax burden.

This may be labelled “inter-temporal vertical inequity” i.e. between charge years, the tax structure is changed to make the impact of income tax much more regressive, with the effective average rate of income tax falling on high income entities falling while the

effective average income tax rate on lower income entities such as small-scale farms increasing, even though they have much less capacity to pay.

Even within the group of small-scale farm models subject to the new three percent presumptive tax on annual turnover in the 2005 charge year there is potential for “inter-temporal vertical inequity”. For such small-scale farms, when the profit margin surpasses twenty percent of turnover, the tax liability/effective average rate of tax applied on income in the 2005 charge year falls below those applicable in the 2004 charge year. In effect, between the two charge years, for the more profitable small-scale farms, although their ability to pay tax was higher, their liability to income tax fell while low profit (and break-even/loss-making) small-scale farm enterprises faced higher tax liabilities/effective average tax rates despite their lower ability (and probably inability if breaking even or making losses) to pay.

## Chapter Six

### **Analysis: Income and Substitution Effects, Certainty, Cost effectiveness And Facilitation of Policy**

*In this Chapter, we will assess the impact of the 2004 tax measures on small-scale farmers in relation to the remaining three cannons of taxation elucidated by Smith. Smith talked about his second canon - certainty - in the following terms.*

“The tax which each individual is bound to pay ought to be certain and not arbitrary.”<sup>47</sup>

Taxpayers must know in advance their tax liability and the manner and timing of its payment so that they can adjust and plan their expenditure. A tax should not be imposed arbitrarily. Arbitrary official acts lacking legal foundation are the antithesis of the rule of law. This canon clearly resonates with the fundamental tenets of administrative law. Along with the supremacy of the law, certainty of the law, and a citizen’s rights and duties under it, is a cardinal element of the observance of the rule of law. Indeed, lack of certainty under the law by the citizen and the exercise of arbitrary official power with its corroding effect on the rule of law was the basis of Hayek’s attack on State Planning and the Welfare State<sup>48</sup>. Smith’s third, related canon is convenience. As Smith said,

“Every tax ought to be levied at the time or in a manner in which it is more likely to be convenient for the contributor to pay it”.<sup>49</sup>

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<sup>47</sup> As quoted by D. Ricardo “The Principles of Political Economy and Taxation” [1817] Pelican Classics, edited by R.M. Hartwell at p. 196.

<sup>48</sup> F.A. Hayek “The Road to Serfdom” [1976] Routledge & Kegan Paul. A more radical attack on the modern state has been made by R. Nozick who sees it as “intrinsically immoral” and proposes a “minimal state” with limited “night-watchman” functions e.g. protection against force/theft/fraud and enforcement of contracts R. Nozick, “Anarchy, State and Utopia” [1974] Basil Blackwell.

<sup>49</sup> Ibid. p.196.

*A tax should be due when the taxpayer has the means to pay and in a manner that makes compliance easier. E.g. for an arable farmer, it would be most convenient for a tax to be paid after the harvest and marketing period, as this will be when he is most able to meet his tax liability. Taxing the taxpayer at a time when he/she is most able to pay will clearly increase tax compliance rates and reduce the time and resources needed to collect tax.* Smith's fourth cannon was cost effectiveness, which he described in the following terms:

*"Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State."*<sup>50</sup>

In short, tax regimes should be designed and operated in such a manner that the cost of doing so absorbs as small a proportion of the tax collected as possible. Tax collection should not cost an exorbitant amount and a tax should be "revenue productive" i.e. have the ability to generate significant amounts of revenue in relation to its collection costs.

To Smith's four classic cannons, others have been advanced, but most echo Smith's ideas. Thus, Mulenga<sup>51</sup> summarises Stiglitz's<sup>52</sup> five characteristics of good taxation as:

- (a) Promoting "economic efficiency", a characteristic discussed in more detail below.
- (b) Being simple to administer, an attribute closely related to Smith's cannon of convenience.
- (c) Flexibility i.e. having the capacity to respond quickly to changing economic conditions, e.g. the ability to reduce the tax liability of consumers and businesses

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<sup>50</sup> Ibid. p.196

<sup>51</sup> Mulenga M. "Taxation in Zambia" Multimedia Zambia [2003] at page 4.

<sup>52</sup> Former Chief Economist at the World Bank

during a recession so as to boost consumption and investment demand in the economy in order to stimulate a revival in economic activity through Keynesian multiplier and accelerator effects<sup>53</sup>,

- (d) Transparency i.e. tax burdens should be easily ascertainable so that taxpayers can clearly know their tax liability (and society can assess if the choices underlying tax policy reflects its values). Transparency is closely related to Smith's cannon of certainty and the requirements for the operation of the rule of law in society;
- (e) Fairness, a characteristic virtually identical to the concepts of vertical and horizontal equity discussed in Chapter Five.

Regarding the promotion of economic efficiency, (Stiglitz's first characteristic) a tax should not lead to an inefficient use or under-use of resources. Taxation can create strong disincentives to work and investment by generating "substitution effects", with leisure replacing work, consumption replacing investment. These disincentive effects are particularly strong where marginal tax rates on income are high (so that an extra unit of income attracts a psychologically high proportion of tax liability) and, in addition, can lead to high levels of both tax evasion and avoidance<sup>54</sup>. Not only is such a situation unfavourable for economic reasons e.g. it will lower economic growth rates, reduce the economy's capacity to generate new jobs etc. but, over the medium term, growth in the tax base will fall behind the growth in demand for public expenditure to support essential public services. If such substitution effects are not reversed, budget deficits and other macroeconomic imbalances will arise and/or public expenditure cuts will be required.

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<sup>53</sup> Keynes J. M. "The General Theory of Employment, Interest and Money" [1936] Macmillan

<sup>54</sup> Tax avoidance covers all legal ways of reducing one's tax liability (e.g. hiring a disabled worker) while tax evasion covers all illegal ways of doing so e.g. deliberately underestimating income.

Alternatively, taxation can produce “income effects” i.e. it can be used to encourage greater work effort and higher levels of investment. Thus, ensuring that marginal tax rates rise by small increments as income rises will, *inter alia*, minimize any deterrence to individuals from increasing their work effort and may indeed provide an incentive to work harder to maintain a given absolute income level. Further, the adoption of accelerated capital allowances for business investment expenditure can be an incentive to encourage more productive investment financed from retained profits if the alternative is to disburse higher dividends that attract higher tax rates and suffer from double taxation.

Finally, taxation is also used to achieve specific socio-economic goals such as the redistribution of national income in favour of lower income groups, deterrence of excessive consumption of potentially socially damaging products through so-called “sin” taxes or promotion of economic activity in a particular region or industry. The high excise duties on alcoholic and tobacco products and the zero-rating for VAT purposes of hotel and guest-house accommodation in Livingstone since the 2001 Budget<sup>55</sup> are Zambian examples of “sin” taxes and using tax to promote a particular industry in a particular area.

### ***Income and Substitution Effects***

The introduction of the three percent presumptive tax on annual turnover below the “upper threshold” of K 200 million a year has created dramatic changes in tax liability for many small-scale businesses and in the effective average and marginal tax rates applicable on their incomes. In such circumstances, the 2004 Budget’s tax legislation can

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<sup>55</sup> 2001 Budget Address, paragraph 144.

be expected to generate significant income and substitution effects, both immediately and over the medium term, as tax entities rearrange their business operations to reduce their exposure to paying tax. These tax-induced changes in business operations may promote or reduce economic efficiency in the wider economy.

Thus, an “income effect” is generated where a small-scale farm operating at a profit margin of ten percent on an annual turnover level of K 180 million in the 2004 charge year is induced to increase the scale of its operations in the 2005 charge year so that annual turnover rises to K 220 million. In such a situation, the tax liability of the farm falls from potentially being K 5.4 million in 2005 (if the farm remained at an annual turnover level of K 180 million) to K 3.3. million as the farm is taxed at 15 percent of its profit of K 22 million rather than at 3 percent of a K 180 million turnover.

This income effect will induce economic efficiency gains for the economy as a whole as, not only is the production level of the particular farm increased, but this increased production will in turn generate increased activity elsewhere in the economy through Keynesian multiplier and accelerator effects on other business enterprises directly and indirectly linked to the farm whose production has increased.

However, it should be recognised that the ability of a small-scale farm to raise its turnover may be limited by “internal” factors such as availability of working capital<sup>56</sup> as well as external “shocks” that may prevent it from achieving an increase in annual

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<sup>56</sup> Especially in the context of the withdrawal of VAT registration from farms in the 2004 Budget which entailed that they could no longer reclaim their input VAT, so adversely affecting their cash flow.

turnover to over K 200 million e.g. failure to get sufficient and/or timely inputs or the collapse of produce prices. This will be considered further below when discussing Smith's cannon of certainty in relation to the presumptive tax.

Conversely, a "substitution effect" may occur where a more profitable small-scale farm operating at a profit margin of 25 percent on turnover of K 220 million in the 2004 charge year is induced to lower its scale of operations so that annual turnover drops to below K 200 million. In effect, in such a situation, it is induced to "substitute" the extra work needed in maintaining turnover at over K 220 million with increased leisure.

If this substitution (at the margin) of work for leisure is induced, tax liability falls from potentially being K 8.25 million in the 2005 charge year (if the farm maintained an annual turnover of K 220 million) to K 5.4. million as the farm is taxed at 3 percent of a K 180 million annual turnover rather than at 15 percent of its profit of K 55 million. Such substitution effects will have negative economic efficiency effects for the economy as a whole as the reduced output of the farm induces negative repercussions on the demand for the products of other enterprises which the farm has direct or indirect linkages with.

However, the behavioural incentives with respect to the income and substitution effects described in the previous two paragraphs are likely to be more asymmetrical than at first appears. A business, while considering its absolute tax liability in deciding a target turnover level, will more likely see its overall post-tax income level a more dominant factor influencing this consideration.

Thus, for the “income effect” example above, the small-scale farm’s post-tax income rises (from K12.6 million to K 18.7 million) as well its tax liability falls (from K 5.4 million to K 3.3 million), so providing a double incentive for the farm to raise production above K 200 million. However, for the “substitution effect” example, while the small-scale farm’s tax liability falls (from K 8.25 million to K 5.4 million) its post-tax income also falls (from K 46.75 million to K 39.6 million). As economic motivation is more strongly determined by the final material position of the economic agent, the “income effect” is likely to be stronger than the “substitution effect” given that the latter is associated with a weaker final material position in terms of disposable income.

However, income and substitution effects for small-scale farm enterprises will not only be induced around the K 200 million turnover level. At all annual turnover levels below K 200 million, where profit margins are below twenty percent and especially as they fall to below five percent (where effective average income tax rates increase quickly to well over sixty percent), small-scale farm enterprises will be under strong pressure to discontinue their current farming activity and substitute it with other, more rewarding, economic activity.

This may be good or bad for the economy as a whole e.g. it would be bad if small commercial farmers were forced out of the formal sector to become largely subsistence farmers, possibly supplementing their incomes by providing seasonal labour if more productive farms are in close proximity. On the other hand, if the substitution effect worked so as to induce such low-margin, small-scale farms to substitute low margin

agricultural activities with more profitable ones<sup>57</sup> e.g. growing higher value crops like paprika or tobacco rather than more traditional, low value crops like maize, then the effect would be positive.

However, not only does such a switch of activity entail the farms overcoming certain “barriers to entry” e.g. acquisition of the requisite skill and knowledge, gaining access to inputs and produce markets etc. faced with an income tax bill in the 2005 charge year that absorbs the bulk of their farm income or even demands payment when it exceeds the income earned, the capacity of these farms to undertake such a “positive substitution” would have been greatly undermined both materially and psychologically.

It should be borne in mind that, as the motivation of taxpayers that underlies both income and substitution effects is to reduce tax liability, the overall impact of these effects, if and when they are generated, is to reduce the amount of tax collected by the Zambia Revenue Authority (ZRA)<sup>58</sup>. This raises issues relating to the cost-effectiveness of a particular tax as a generator of revenue, which is further considered in the next section.

### ***Cost effectiveness in Raising Revenue***

In addition to generating significant income and substitution effects (with the net effect on Government revenue likely to be negative), the introduction of the three percent presumptive tax on turnover can also be expected to generate both tax avoidance and tax

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<sup>57</sup> Or even completely new non-agricultural economic activities e.g. selling part of the farmland so as to buy and operate a PSV.

<sup>58</sup> However, it should be observed that if an income effect raises output levels, then, by increasing overall purchasing power in the economy through the extra income earned and by providing additional demand for inputs to sustain the higher output, positive indirect effects on tax revenue collection can be generated that will mitigate any revenue losses caused directly by the income effect.

evasion behaviour on the part of taxpayers, both of which will further undermine the revenue raising objective of the tax and hence its cost-effectiveness as a measure to add resources to Government coffers.

Thus, as already noted in Chapter Four, introduction of the three percent presumptive tax on annual business turnover of less than K 200 million has been exceptionally beneficial to proprietors of “low-cost, high-profit” enterprises whose turnovers fall below this “upper threshold”. Assuming that such an enterprise was registered as a private company, income that was taxed at thirty-five percent in the 2004 charge year became liable to only the three percent presumptive tax rate in the 2005 charge year, provided that the annual turnover remained below K 200 million. This very favourable impact is likely to induce significant incentive on the part of these enterprises to adopt tax avoidance strategies so as to reduce tax liability e.g. by separating the business into two smaller tax entities (if the annual turnover is between K 200 million and K 400 million) and dividing the work between the two new businesses so that the annual turnover of each does not exceed the presumptive tax upper threshold of K 200 million<sup>59</sup>. The business turnover so split becomes liable to the three percent presumptive tax rather than a thirty five percent tax on income earned. Given that income is such a high proportion of turnover, the tax yield will inevitably fall significantly as shown in Appendix I.

Such tax avoidance manoeuvres by business are perfectly legal ways of reducing tax liability but they may of course also be induced to attempt to illegally reduce their tax

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<sup>59</sup> Such a reorganization of business for tax avoidance purposes does not raise economic efficiency in the economy as no new business is generated. It simply raises compliance costs for the reorganizing businesses that they are prepared to absorb, as they are more that offset by the lower tax burden.

liability by tax evasion e.g. under-reporting turnover levels. The negative effect of such induced tax evasion behaviour on the revenue raising capacity of the tax - i.e. its cost effectiveness - is the same as with a firm that adopts tax avoidance strategies.

### ***Transparency/Certainty/Convenience***

Projecting the income or annual turnover of any type of business, let alone its profit level, is inevitably subject to a large element of uncertainty and this is even more so for income and turnover from farm enterprises. The volume and value of a farm's output, and hence its turnover, will be affected, *inter alia*, by the vagaries of the weather, the outbreak of animal and/or plant diseases, the volatility of prices paid for agricultural produce and inputs - especially if exported or imported - and the availability and timeliness of input supplies. All these factors make it extremely difficult to predict turnover.

With this situation in mind, a small-scale farm operating around the K 200 million-turnover level may, at the end of the charge year, find its turnover either above or below the "upper threshold" for the three percent presumptive tax. This can make it difficult to ascertain tax liability during the charge tax year in question. This can be problematic as payment of tax due is done monthly during the charge year that the tax relates to under the presumptive tax and quarterly under income tax. Recalling the words of Adam Smith, "the time of payment, manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person".

Thus, for example, at the beginning of the charge year in April, a poultry farm may project an annual turnover of K 220 million and a profit margin of ten percent. On this

basis it calculates that it must pay K 3.3 million in income tax and starts to make quarterly provisional tax payments of K 825,000. However, during the third quarter of the charge year, unanticipated problems occur e.g. the hatchery cannot provide sufficient day-old chicks to maintain production at the planned level, imports of chicken from Zimbabwe lead to a collapse in prices or an outbreak of Newcastle disease halts production until the chicken housing can be fumigated.

As a result of these types of developments, annual turnover projections are adjusted downward to K 180 million. In such a circumstance, the farm is no longer subject to 15 percent income tax but to the three percent presumptive tax on turnover and the tax liability for the charge year rises to K 5.4 million (despite a reduced ability to pay). Further, payment of this presumptive tax is done monthly and, on average, the farm should have been paying around K450,000 a month in presumptive tax on annual turnover of K 180 million. Two issues thus arise relating to Adam Smith (and Stiglitz's) certainty/transparency/convenience characteristics of a "good" tax.

First, a small-scale farm operating around the K 200 million annual turnover level cannot *ex-ante* predict with certainty what tax regime it will be subject to and thus it cannot predict its annual tax liability which can be very different under the presumptive tax and income tax regimes. On the basis of its farm budget projection it will identify the likely applicable regime at the beginning of the charge year - in our example income tax rather than presumptive tax - and start to make tax payments to liquidate this liability. If farm budget projections are revised so that turnover and profits are adjusted downwards and

the tax regime shifts to a presumptive tax, this may not be so serious if it leads to a fall in tax liability to reflect the lower ability to pay. However, in our example, this is not the case. As turnover and profits (in absolute terms) fall in the third quarter, liability to tax (on all income earned in the charge year) increases almost 64 percent. Even income on which provisional income tax has already been *bone fide* paid (quarterly) in the first half of the charge year will suddenly become liable to a higher effective rate of average tax, even though the ability to pay has been reduced. Not only is such regressivity in the tax treatment of such small-farms unjust, such uncertainty as to the tax regime and rates applicable on farm income can lead to cash flow problems for such farms and breach of Smith's certainty cannon of taxation. It would also breach his cannon of convenience that he summarised by saying "Every tax ought to be levied at the time or in a manner in which it is more likely to be convenient for the contributor to pay it".

Second, once it is assessed that the small-scale farm should have been paying each month a final presumptive tax on turnover at a higher absolute level than what it was paying quarterly as provisional income tax, does it become liable to pay penalties and interest on the shortfall of tax now deemed due on the turnover that produced that income? There is what Riddall labels a "penumbra of uncertainty"<sup>60</sup> in the law surrounding this issue i.e. s.3(b) of the Income Tax (Amendment) Act of 2004<sup>61</sup> "falls short" in that it does not give unambiguous guidance, indeed it is silent, as to how this issue is to be tackled by the tax authorities. By default, the ZRA has implicitly been given an increased amount of discretionary power to decide this issue. The uncertainty about how ZRA will handle this

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<sup>60</sup> Ridall J.G. "Jurisprudence" Second Edition [1999] Butterworths at p. 98.

<sup>61</sup> Quoted on pages 5 and 6.

issue will compound not only the injustice of having to pay more tax on less income but also entail a further breach of Smith's uncertainty cannon as the three percent presumptive tax is implemented, if the ZRA uses its discretion to apply interest and penalties also.

Indeed, in relation to a basic tenet of administrative law that requires adequate controls over the discretionary powers conferred on public officials, the lack of any statutory guidance as to how the ZRA would decide this issue - an issue that significantly affects the material standing of citizens and indeed the future of their livelihoods - entails a level of official arbitrariness and uncertainty as regards the citizen's rights and duties before the law, that is the antithesis of the requirement of the rule of law. It is hoped that the Revenue Appeals Tribunal<sup>62</sup> will be alive to this issue, if the ZRA does decide to impose such interest and penalties, and appeals to the Tribunal are made as a result.

### ***Socio-economic Policy Facilitation***

The principal overarching policy document guiding Government decisions and action as the 2004 Budget was being formulated in the second half of 2003 was the 2001-2004 Poverty Reduction Strategy Paper (PRSP)<sup>63</sup>. The PRSP's executive summary states,

“...agriculture in Zambia combines the virtues of growth and equity and it is in this regard that enhanced agricultural productivity is being given the highest priority ... On equity, it is noted that the poor ... are predominantly in agriculture. If the sector grows and measures are put in place to include the poor in this growth, poverty will be reduced. The creation of conditions that enhance long-term innovative

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<sup>62</sup> The Revenue Appeals Tribunal replaced the earlier Revenue Appeals Court established under s 107 of the Income Tax Act, Cap. 323 of the Laws of Zambia.

<sup>63</sup> The President, Mr. Levy Patrick Mwanawasa S.C. officially launched the PRSP in July 2002.

improvement of the productivity of agricultural resources, particularly smallholder farmer's land and labour, is therefore considered crucial"<sup>64</sup>

The PRSP clearly lays great emphasis on agriculture, and particularly agricultural activity undertaken by the smallholder sub-sector i.e. peasant farmers and small-scale commercial farmers. In this respect, as small-scale commercial farmers fall in the tax net, one would expect Government's fiscal arrangements to be so structured so as to provide particular tax incentives to this priority sub-sector under the PRSP so creating "conditions that enhance long-term innovative improvement of the productivity of agricultural resources, particularly smallholder farmer's land and labour".

However, in terms of both vertical and horizontal equity considerations between smallholders and other tax entities like PSV operators, employees and high-income, low-cost businesses and as regards the inter-temporal tax burden on smallholders themselves (which, as shown in Chapter Four, worsened considerably for those whose profit levels were under twenty percent), the 2004 Budget did not offer a tax regime that would enhance the productive capacity of the smallholder agricultural sector. For small-scale farms operating at, or just above, break-even point, one can infer from the analysis in Chapter Five that the likely impact of the three percent presumptive tax on turnover is to shift them back into subsistence farming. Indeed, the incentive to make this shift is further reinforced by making unprocessed agricultural produce exempt from VAT in the 2004 Budget, so making all farms producing this produce unable to claim back their input VAT and so, concomitantly, weakening further their cash flow and profitability positions.

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<sup>64</sup> "Zambia: Poverty Reduction Strategy Paper", Ministry of Finance & National Planning, May 2002, p 13.

## Chapter Seven

### Conclusion

In the light of the analysis made in this study on the impact of the 2004 tax legislation on small farms, can one conclude that the 2004 Budget's tax legislation was primarily motivated by the need to raise more revenue under the SMP programme, and ultimately reach the HIPC "completion point", than by any consideration of "justice" as regards its impact on taxpayers? More specifically, when the Minister was balancing "the revenue needs of Government against the need to provide tax relief to citizens and businesses", as far as small scale farms were concerned, was the balance clearly in favour of raising revenue to the detriment of being "just" to the majority of small-scale farms?

Of course, an appeal to "justice" is an emotive and subjective undertaking. Perelman states, "...for thousands of years protagonists, in public and private conflicts, in wars, in revolutions, in lawsuits, in clashes of interest have always done their best to prove that justice is on their side".<sup>65</sup> In more colourful language Ross says that to "invoke justice is like banging on the table."<sup>66</sup> In short, to use "justice" as a yardstick to objectively assess any act, decision, situation or law is highly problematic, it being a concept that is vested, often subconsciously, with subjective value judgements. This being said however, we have analysed the 2004 tax legislation in relation to widely accepted standards, laid down by Smith over two centuries ago. Indeed, echoing the views of Lord Kaldor and John Rawls<sup>67</sup> in relation to proportional expenditure taxes, the Minister, when justifying his

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<sup>65</sup> C. H. Perelman "The Idea of Justice and the Problem of Argument" [1963] p.2

<sup>66</sup> A. Ross, "On Law and Justice" p. 274.

<sup>67</sup> John Rawls ("A Theory of Justice" [1972] Oxford University Press at p. 278) comments with approval Lord Kaldor's view ("An Expenditure Tax" [1955] George Allen & Unwin) that a proportional expenditure

decision to zero-rate unprocessed agricultural goods (and medical supplies)<sup>68</sup>, explicitly appealed to these same standards. The reason he gave in the 2004 Budget Address for this measure was that “by virtue of VAT being a consumption tax, the zero-rating mainly favoured the high-income groups compared with the low-income groups through their ability to consume more of the affected items.”<sup>69</sup> In effect, the Minister was, to paraphrase Ross, “banging on the table” by appealing to our sense of justice (and Smith’s first cannon of equity) that those who are in a better position to pay more tax should be taxed more.

However, using the same yardstick to assess the measure, this reasoning turns out to be flawed and, to take a cynical view, was disingenuously advanced. It is flawed as it did not take into account the fact that, as income rises, the proportion spent on food falls, a phenomenon widely recognized by economists and which holds in Zambia as evidenced by the higher weighting that the Central Statistical Office (CSO) gives to food in the index of consumer prices for low income households as compared to high income households<sup>70</sup>. Thus, any rise in the price of unprocessed agricultural products due to the inability of producers to reclaim their input VAT will disproportionately affect low-income households who spend a higher proportion of their income on such items. This is clearly contrary to any Aristotelian notion of justice or Smith’s cannon of equity.

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tax may be the best basis for a “just” tax system. However, nowhere has a State based its taxation regime purely on an expenditure tax, and tax on income inevitably figures prominently in all taxation systems.

<sup>68</sup> That adversely affected the cash flow of farming (and pharmaceutical) enterprises by the estimated revenue gain of K 95.3 billion

<sup>69</sup> 2004 Budget Address, paragraph 133.

<sup>70</sup> The CSO’s April 2004 Consumer Price Index gave food, beverages and tobacco a weight of 67.9% for the “metropolitan low income group” but only 42.9% for the “metropolitan high income group”.

Thus, despite appeals to accepted standards of justice and equity, measured against those same standards the analysis in this study has shown that the impact of the 2004 tax legislation on small farm enterprises has been inequitable and unjust. This injustice is not simply in terms of the sometimes-considerable vertical and horizontal inequity between small farms and other tax entities, but is also unjust in a broader sense e.g. by placing the small-scale farms in an uncertain position as regards their eventual tax liability (and their possible liability to interest and penalties) and exposing them to arbitrary discretionary power by the ZRA, contrary to the basic tenets of the rule of law.

Further, contrary to Smith's fourth cannon of cost effectiveness, the revenue gains from introducing the three percent presumptive tax, estimated by the Minister at only K 7.3 billion<sup>71</sup>, was negligible in comparison to the size of the 2004 Budget (K 8,328.6 billion<sup>72</sup>), the additional revenue to be raised by increasing the revenue/GDP ratio to 19 percent of GDP under the SMP (about K250 billion) and in relation to the economic/financial dislocation caused to many small-scale enterprises - an important sub-sector of the economy in relation to Government's over-arching objective of reducing poverty. Indeed, this study has advanced the argument that the tax treatment of the small-scale farming sector in the 2004 Budget's tax legislation runs counter to society's wider "growth with equity" objectives of promoting the productivity of the small-scale farming sector, as expressed in the PRSP.

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<sup>71</sup> 2004 Budget Address, paragraph 116

<sup>72</sup> 2004 Budget Address, paragraph 88.

These inequities and policy conflicts could have been overcome, or at least mitigated, by the presumptive tax being designed differently. For example, a presumptive tax rate of 1.5 percent of turnover rather than 3 percent<sup>73</sup> would have reduced the number of small-scale farms adversely affected by the tax, as only farms with profit margins of 10 percent or less would have been negatively affected (and the horizontal inequities as between PSV operators and small farms would have been narrowed). Also, having a “lower threshold” (set at a level comparable to the exempt portion of earned income) would have reduced the inequity between low-profit small farms and lowly paid wage earners.

In fact, there are a myriad of ways a presumptive tax can be designed. Thus, bases other than turnover could have been used. Internationally, the most common base is income rather than turnover. However, from an equity point of view, probably the fairest way of introducing presumptive taxation on small businesses is to employ a method, described by Bulutoglu<sup>74</sup>, of presumptive cost deduction, where the small business declares revenues/turnover but not costs. Costs are then estimated on a presumptive basis to arrive at presumed income on which the presumptive tax rate is based. However, in order to avoid any gross inequity from arising, the small business is given the option to deduct actual costs so that a small business with high costs and a low profit margin (or a loss) can avoid paying presumptive tax on actual income at very high *de facto* effective rates (as with small farmers with profit margins of under 10 percent under the 2004 tax legislation) or avoid it altogether if losses, rather than profits, are made.

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<sup>73</sup> The IMF Fiscal Affairs Division (unpublished) report on “Zambia: Report of the Tax System” [August 2001] indicates that the range of presumptive tax rates applied on turnover typically range from 1-3 percent

<sup>74</sup> K. Bulutoglu “Presumptive Taxation” p. 260 in “The Tax Policy Handbook” [1995] Fiscal Affairs Division of the IMF, Edited by Parthasarathi Shome

This design (or similar) for a presumptive tax on small businesses would have better balanced “the revenue needs of Government against the need to provide tax relief to citizens and businesses”. The often-gross inter-temporal and inter-entity, vertical and horizontal, inequities that arose would have been mitigated, the *ex ante* uncertainty about small business tax liability and exposure to penalties could have been avoided (and so the rule of law upheld and arbitrary discretionary power conferred by default on the ZRA contained), the incentive for tax avoidance and evasion could have been minimised and the economic distortions caused by the, on-balance negative, income and substitution effects would have been curbed. Further, its introduction would have been made in a way that it did not conflict with Government’s wider PRSP “growth with equity” policy objective for the small-scale agriculture sector, as an important element achieving the Millennium Development Goal (MDG) of halving the number living in poverty by 2015.

To conclude, the negative impact on the majority of small-scale farmers of the three percent presumptive tax on turnover (made worse by the zero-rating of unprocessed agricultural produce) violated accepted criteria for a fair and just tax. In this context it would appear that the 2004 Budget’s tax legislation was indeed primarily motivated by the need to raise more revenue under the SMP programme, and ultimately reach the HIPC “completion point”, rather than by any consideration of justice as regards its impact on taxpayers. This in turn raises wider questions of national sovereignty as regards the control over national economic policy in an increasingly globalised world, policed by powerful international financial institutions like the IMF and World Trade Organisation (WTO). However, this must be the subject of another study.

# Appendix I: Inter-Entity Matrix of Absolute Tax Liabilities and Effective Tax Rates (Kwacha figures in K m)

Tax Model	2004 Charge Year			2005 Charge Year		
	Income	Tax Liability	Tax rate	Income	Tax liability	Tax rate
<b>Small scale farm with:</b>						
K 25m turnover and 0% profit margin	-	-	15%	-	0.7500	infinite
K 25m turnover and 5% profit margin	1.2500	0.1875	15%	1.2500	0.7500	60.0%
K 25m turnover and 10% profit margin	2.5000	0.3750	15%	2.5000	0.7500	30.0%
K 25m turnover and 15% profit margin	3.7500	0.5625	15%	3.7500	0.7500	20.0%
K 25m turnover and 20% profit margin	5.0000	0.7500	15%	5.0000	0.7500	15.0%
K 25m turnover and 25% profit margin	6.2500	0.9375	15%	6.2500	0.7500	12.0%
<b>Small scale farm with:</b>						
K 100m turnover and 0% profit margin	-	-	15%	-	3.0000	infinite
K 100m turnover and 5% profit margin	5.0000	0.7500	15%	5.0000	3.0000	60.0%
K 100m turnover and 10% profit margin	10.0000	1.5000	15%	10.0000	3.0000	30.0%
K 100m turnover and 15% profit margin	15.0000	2.2500	15%	15.0000	3.0000	20.0%
K 100m turnover and 20% profit margin	20.0000	3.0000	15%	20.0000	3.0000	15.0%
K 100m turnover and 25% profit margin	25.0000	3.7500	15%	25.0000	3.0000	12.0%
<b>Small scale farm with:</b>						
K 180m turnover and 0% profit margin	-	-	15%	-	5.4000	infinite
K 180m turnover and 5% profit margin	9.0000	1.3500	15%	9.0000	5.4000	60.0%
K 180m turnover and 10% profit margin	18.0000	2.7000	15%	18.0000	5.4000	30.0%
K 180m turnover and 15% profit margin	27.0000	4.0500	15%	27.0000	5.4000	20.0%
K 180m turnover and 20% profit margin	36.0000	5.4000	15%	36.0000	5.4000	15.0%
K 180m turnover and 25% profit margin	45.0000	6.7500	15%	45.0000	5.4000	12.0%
<b>Small scale farm with:</b>						
K 220m turnover and 0% profit margin	-	-	15%	-	-	15%
K 220m turnover and 5% profit margin	11.0000	1.6500	15%	11.0000	1.6500	15%
K 220m turnover and 10% profit margin	22.0000	3.3000	15%	22.0000	3.3000	15%
K 220m turnover and 15% profit margin	33.0000	4.9500	15%	33.0000	4.9500	15%
K 220m turnover and 20% profit margin	44.0000	6.6000	15%	44.0000	6.6000	15%
K 220m turnover and 25% profit margin	55.0000	8.2500	15%	55.0000	8.2500	15%
<b>Employee earning a gross income of:</b>						
K 3 m per annum	3.0000	0.2790	9.30%	3.0000	0.0000	0.00%
K 6 m per annum	6.0000	1.1700	19.50%	6.0000	0.8100	13.50%
K 9 m per annum	9.0000	2.0700	23.00%	9.0000	1.7100	19.00%
K 12 m per annum	12.0000	2.9700	24.75%	12.0000	2.6130	21.78%
K 18 m per annum	18.0000	4.7700	26.50%	18.0000	4.7130	26.18%
K 24 m per annum	24.0000	6.5700	27.38%	24.0000	6.8130	28.39%
<b>15-seat PSV operator with:</b>						
K 100 m turnover and 10 % profit	10.0000	1.2000	12%	10.0000	1.2000	12%
K 100 m turnover and 20 % profit	20.0000	1.2000	6%	20.0000	1.2000	6%
K 180 m turnover and 10 % profit	18.0000	1.2000	7%	18.0000	1.2000	7%
K 180 m turnover and 20 % profit	36.0000	1.2000	3%	36.0000	1.2000	3%
K 220 m turnover and 10 % profit	22.0000	1.2000	5%	22.0000	1.2000	5%
K 220 m turnover and 20 % profit	44.0000	1.2000	3%	44.0000	1.2000	3%
<b>20-seat PSV operator with:</b>						
K 100 m turnover and 10 % profit	10.0000	2.400	24%	10.0000	2.400	24%
K 100 m turnover and 20 % profit	20.0000	2.400	12%	20.0000	2.400	12%
K 180 m turnover and 10 % profit	18.0000	2.400	13%	18.0000	2.400	13%
K 180 m turnover and 20 % profit	36.0000	2.400	7%	36.0000	2.400	7%
K 220 m turnover and 10 % profit	22.0000	2.400	11%	22.0000	2.400	11%
K 220 m turnover and 20 % profit	44.0000	2.400	5%	44.0000	2.400	5%
<b>25-seat PSV operator with:</b>						
K 100 m turnover and 10 % profit	10.0000	3.600	36%	10.0000	3.600	36%
K 100 m turnover and 20 % profit	20.0000	3.600	18%	20.0000	3.600	18%
K 180 m turnover and 10 % profit	18.0000	3.600	20%	18.0000	3.600	20%
K 180 m turnover and 20 % profit	36.0000	3.600	10%	36.0000	3.600	10%
K 220 m turnover and 10 % profit	22.0000	3.600	16%	22.0000	3.600	16%
K 220 m turnover and 20 % profit	44.0000	3.600	8%	44.0000	3.600	8%
<b>High profit low cost enterprise with:</b>						
K 100 m turnover and profit margin of 80%	80.0000	28.000	35%	80.0000	3.000	3.75%
K 180 m turnover and profit margin of 80%	144.0000	50.400	35%	144.0000	5.400	3.75%
K 220 m turnover and profit margin of 80%	176.0000	61.600	35%	176.0000	61.600	35%

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