THE UNIVERSITY OF ZAMBIA

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Entitled

ZAMBIA'S TAX LEGISLATION VIS-À-VIS THE SHADOW ECONOMY

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Date: 15th December 2004

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STUDENTS NAME:....................................... JIMMY M. SAKALA.

SIGNATURE:..

DATE:.. 14TH DECEMBER, 2004.

DEDICATION

To my children and family members, always strive to seek Justice at all costs

LEGISLATION

The Constitution, Cap 1 of the Laws of Zambia

The Customs and Excise Act, Cap 322 of the Laws of Zambia

The Income Tax Act, Cap 323 of the Laws of Zambia

The Income Tax Act, Cap 668 of the Laws of Zambia

The Value Added Tax Act Cap 331 of the Laws of Zambia

ABSTRACT

Taxation from time in memorial has being a source of revenue for the state to provide social goods for use by the whole citizens. States have used different tax system in order to meet revenue needs. However, some individuals and corporations have not been willing to meet their tax obligations voluntary. It is for this reason that the revenue collecting agency whether central or local government have to devise suitable mechanism for collecting taxes. Tax law operates as a legal enforcement tool to ensure tax compliance by tax payers. Like anywhere else in the world, tax payers have come up with means of evading their tax obligations or engaging in outright avoidance. This creates a 'grey economy' also known as the 'shadow economy'. The shadow economy is that part of income that is earned but can not be capture in national income or financial records. This distorts planning of a national economy as available official information is inaccurate hence the creation of a Parallel structure. A better understanding of the shadow economy will assist in the design of an optimal tax system. Tax legislation is important in that it can either encourage the formation of the shadow economy, discourage it or ultimately avoid the existence of one. Tax legislation is cardinal in tax administration as it gives the collecting agency the legal back-up to manage the collection of such taxes.

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Jimmy M. Sakala
University of Zambia, Lusaka
3rd December 2004

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CHAPTER ONE

Introduction

The year 1991 is important in Zambia's economic history. It marked the beginning of a transition from an economy in which public enterprises played a substantial role, to an economy in which private enterprises predominated. Linked to this transition were profound reforms of Zambian tax system and tax laws. It included a reduction of tax rates, scrapping of a number of exemptions, allowances and provisions and the replacement of sales tax by a values added tax.

The reforms were intended to attain a good tax system. For any economy to operate it requires a well-designed tax system which will satisfy the criteria of efficiency, equity and simplicity. Equity means the establishment of a fair relationship between the resources available to taxpayer and the amount of tax paid by that taxpayer. Efficiency refers to the costs that a complex system imposes on both taxpayer (in complying with the laws) and the government (in collecting taxes). These factors must be taken into account when designing a good tax law which is clear and simple.

The purpose of this paper is to examine Zambia's tax legislation and how it effectively captures the informal sector "shadow economy". Taxation does not only generate financial resources of a government, but also impacts the economy through its effect on production, investment, income and employment. In this regard the law must be well designed to capture all sectors of the economy.

Definition of Terms

What is Taxation

Tax may be defined as a compulsory financial contribution imposed by a government on the citizenry to raise its revenue. It is levied on the income or property of persons or organisations on the production cost or sales price of goods and services. Taxation on the other hand is the process of raising Revenue for the Central Government through taxes.[1]

Brief History of Taxation

Tax collection dates back as far as the Roman Empire, the earliest taxes collected were known as *Portoria.* During the reign of the famous Caesar Augustus as 'First Citizen' the *publicani* were virtually eliminated as tax collectors for the Central Government.

Saint Matthew of the bible was a publican (Tax collector) from Capernaum during Caesar Augustus reign in his case he was hired by the local government to collect taxes – the job he faithfully held until Jesus Christ made him a fisher of men.

In Britain, the first tax assessed was during occupation by the Roman Empire. When Rome fall, the Saxon kings imposed taxes, referred to as *Danegeld* on land and property.

In Zambia taxation has always existed even before colonization by England. Villagers paid tradition tax to the Chief. However, with the arrival of the

[1] . Mohammed M, (2003), Taxation in Zambia, Multimedia, Lusaka

Imperialist government, the model for paying tax has drastically changed. The Income tax Act was enacted soon after independence as Chapter 668 of the Laws of Zambia.

The Shadow Economy

The shadow economy has however been the most difficult to tax. Economic activities that fall outside the purview of government accounting is known by various names: shadow, informal, hidden, black, underground, gray, clandestine, illegal and parallel[2]

Implicit in each, save for informal, is that these economic activities include conscious efforts to avoid official detection. Indeed, some unrecorded activities, such as the drug trade are illicit. Some activities, such as day labour, however, are legal but may include an illicit component, such as unrecorded payments. Still others, such as household production, are wholly legal.

As these nuances indicate, simply defining the shadow economy is a challenge. Although most authors agree that it is a "fuzzy concept"[3]. Despite decades of study on the issue from an empirical and historical point of view, little agreement has been reached on fundamental constructs that underlie the shadow economy.[4]

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[2] . Thomas J, (1992), *Informal Economic Activity*, University of Michigan Press, Michigan.

[3] . Norman Loayza, *The Economics of the Informal Sector*, The World Bank Policy Research Working Paper Series(February 1997)

[4] Gibson B and Bruce K, *A Classical Theory of the Informal Sector*, The Manchester School, 62 no. 1 (1994) pp. 81

The lack of consensus in formulating a unified theory of the shadow economy, or even a precise definition of the components that comprise it suggest that important questions remain unanswered. What is the distribution of the shadow economic behaviour between unrecorded, but legal, and illicit activities? What influence has tax legislation has on the development of the shadow economy? This paper gives an overview of the issues relating to these questions. We begin by discussing the definition of the shadow economic activities and why the study of the shadow economy is important. We then discuss the impact of Zambia's tax legislation and how it can encourage or discourage the existence of a shadow economy. We conclude with thoughts for future research.

It is evident that direct tax is the main source of revenue for developed countries. As pointed out by Musgrave,[5] developed countries depend primarily on tax on income and profits. The advantage of tax on income and profits is that it accords with the principle of vertical equity. These taxes are criticized on the grounds that all types of income are not treated uniformly. It is the income from wages and salaries that are heavily taxed: with a large scope for avoidance and evasion on incomes from interest and profits. Hence there is no horizontal equity. Thus, it has been argued that there is a greater scope for tax mix change in developed countries too. The tax net must include the informal sector. The International Labour Organisation defines the informal sector as having very

5. Musgrave, R. A (1964), The Role of Direct and Indirect Taxes in the Federal Revenue System, Princeton University Press, Princeton.

small units of production, independent self employed producers, a predominance of family labour with few outsiders hired, little capital, low technology, low productivity, irregular incomes and unstable employment.

In the Zambian case, the Central Statistics Office(CSO) defines the informal sector as including those workers who are not entitled to paid leave, not entitled to pension or other social security, and who work or run a business with five people or less. According to the Living Conditions Monitoring Survey it is estimated that 61 percent of the Zambian population earn their living through undertaking various types of activities or businesses in the informal sector. Moreover, their earnings are not subject to taxation.[6]There is currently a general tendency to associate informal activities only with poor women and children selling vegetables on the street, or small-scale marketers in high-density areas.

However, these people represent the very lowest end of the informal sector. It can be amply demonstrated that there is a healthy stock of traders and business people engaged in activities such as: Import and Export Trade, Import of second hand or used vehicles, Import of second hand or used vehicles, Real Estate Agencies, Commodity Brokerage, Trading Brokerage, Suppliers of goods and services and Consultancy.

Many of these earn well above the threshold for paying income taxes but fail to make the required contributions for various reasons some of which are outright

[6] CSO, *Living Conditions Monitoring Survey of 1996*

evasion of tax. This category of taxpayers is supposed to pay personal income tax or company tax and withholding taxes.

Tax evasion and enforcement

The standard optimal tax approach assumes that individuals and firms voluntarily pay all of their tax liabilities. This assumption is wildly inaccurate. Individuals pursue many illegal avenues to reduce their payments, such as underreporting incomes, overstating deductions and exemptions, or failing to file returns. Despite obvious measurement difficulties, there is widespread evidence that tax evasion is extensive and commonplace in nearly all countries. The government imposes several kinds of taxes for various reasons the most common types being:

- Income taxes which are used for revenue generation and equity objectives. The latter objective is not a serious consideration in Zambia.
- Value Added Tax (VAT) which is a tax on consumption and a major instrument of revenue generation.
- Import duties are used to provide protection to domestic industries or effect short-term balance of payments objectives.
- Excise (selective commodities taxes) are used to discourage consumption of certain commodities or link tax payment to special costs. Another purpose is to simply use them for revenue generation, especially in cases where demand is inelastic.

- Export taxes that can be used to tax windfall gain from devaluation or exceptional movements in world prices and to divert production to the domestic markets. Export taxes are not a part of the international standard tax system and are currently not levied in Zambia.

Zambia's tax system continues to evolve, as exemplified by the 2002 reforms. At present, Direct taxes comprise the Pay As You Earn (PAYE) – a personal income tax- and a Company tax levied on both individuals and corporation. Final withholding taxes are charged on interest and dividend income. Consumption is taxed according to excise duties and the Value Added tax. There are, furthermore, Customs tariffs and Property Transfer tax.

The law is suppose to be designed in such a way that the above mentioned taxes are adequately covering all sectors of the economy for a tax to be fair, efficient and equitable.

Statement of the Problem

Zambia's taxation has been perceived by some groups of people in society as being inequitable. Tax legislation has for many years been perceived as not adequately covering the informal sector of the economy, thereby placing the burden on a few individuals in the formal sector. Additionally, the tax legislation is perceived not to capture shadow economy. The shadow economy is considered to be more pronounced thereby creating a parallel tax structure.

Complexities in the Tax laws and legal intricacies make the interpretation or translation of policy into law results in immensely complicated tax laws that are difficult to implement. Unable to understand tax laws fully, large numbers of taxpayers make frequent mistakes, which must be corrected by tax collecting agency at considerable cost. Further, this complexity of the laws creates a fertile ground for inventing interpretations that favour tax avoidance. The tax collecting agency then gets engaged in an unending duel on legal issues. Since serious legal challenges often come from well organized large tax payers, this can mean that the tax collector is unable to collect large sums of taxes from them for long periods of time.

The attitude of taxpayer towards compliance determines the relative ease with which the tax collecting agency such as ZRA can perform its functions. The level of sophistication of taxpayers also impacts on the ZRA because the more sophisticated the taxpayers are, the more complex is the *modus oparandi* used to avoid and evade taxes.

An understanding of the shadow economy and taxation law is important for many reasons, that it affect the efficiency of the tax system by creating misallocations in resource use as agents alter their behavior – and incur costs (or "noncompliance costs") – to cheat on their taxes. The shadow economy also has equity effects because it alters the distribution of income in unpredictable ways. Tax evasion affects the tax rates that compliant taxpayers face and the public services that all citizens receive. More broadly, it is not possible to understand the true impact of taxation without recognizing the existence of evasion. It is clearly not possible to design an optimal tax system without appropriate consideration of tax evasion and its effects on individuals and on government.[7]

Theoretical analysis of tax evasion most often builds on the economics-of-crime model as applied to tax evasion by Houston.[8] The focus of nearly all of this work is on the behavior of a representative individual who faces an individual income tax. The individual is viewed as maximizing the expected utility of the evasion gamble, weighing the benefits of successful cheating against the risky prospect of detection and punishment, and the individual pays taxes because he or she is afraid of the law such as getting caught and penalized.

The central conclusion of this approach is that an individual pays taxes only because of this fear of detection and punishment, and an increase in the fine hence increase compliance. Surprisingly, an increase in the tax rate generally has an ambiguous effect on reported income in the standard model; under plausible assumptions, compliance actually rises with higher tax rates, in contrast to the common perception that higher tax rates have contributed to evasion.

However, it is clear to a number of observers that at least some forms of compliance cannot be explained entirely by the level of enforcement.[9]The levels of audit and penalty rates are set so low that most individuals would either underreport income not subject to source withholding or over claim deductions

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[7] . Opcit, Masgrave, P.269

[8] . Houston J.K, (1990) The Policy Implication of the Underground Economy, Journal of Economics and Business, no 42 p. 27-37

[9] . Hinrichs, Harley H (1966), *A General Theory of Tax Structure Change during Economic Development*, Harvard University Press, Cambridge.

not subject to independent verification if they were purely "rational," because it is unlikely that such cheating would be caught and penalized.

In part because of this quandary, there have been numerous extensions of the basic theoretical model, to consider other factors not included in the basic theoretical model or to consider other factors not captured appropriately by the theory. These extensions include such things as government services, overweighting of low probabilities, social norms, and labor supply choices. Of particular relevance here, the theory has also expanded to include the uncertainty and complexity Individuals may not know with certainty their tax liability or the tax agency's enforcement strategy.

The presence of an active shadow economy may reflect the degree to which various existing economic policies and tax laws are inappropriate or inefficient. Oppressive tax and regulatory regimes (or increases in the tax burden or the degree and/ or complexity of regulation over time) appear to drive economic agents from the official sector into the unregulated shadow economy.[10] In this regard tax law plays an important role in determining the magnitude of the shadow economy.

Objective of the Study

The specific objective of the study is to analyse Zambia's tax legislation vis-a-visa economic activities that are not captured by economic indicators. In particular

[10] Loayza, *'Regulatory Discretion and the Official Economy' The American Economic Review, No. 88* (May 1998) pp. 3-7

the study attempts to investigate the weakness in tax legislation and the various holes in the economy that permit tax evasion.

The general objective of the study is for it to be a stating point for research in taxation vis-a`-vis the shadow economy in Zambia, an area where limited studies have been conducted in the past. This study will there for act as a references material for future research on this subject.

Scope of Study

This is a Legal study. The study will therefore focus on tax administration with specific references to tax law. However, in some cases reference will be made to economic issues. This is taking into account that there is generally a close relation between law, economics and accounts when dealing with taxation. The specific focus which must not be deviated from is that the study is a legal one.

Methodology

The study will utilize qualitative research methodologies. Qualitative research methodology is suitable for the study as opposed to quantitative approach as it will enable the researcher to obtain sufficient information. In addition to that, being a legal study, a qualitative research would be more appropriate than a quantitative approach as it will also involve participant observation.

The study will include an analysis of literature such as tax legislation, Commissioner-Generals rules/ZRA Practice notes, law journals, newspapers articles and books. In addition to that, field research will be conducted which will involve discussions with stakeholders in tax related issues.

The Revenue Appeal Tribunal cases will also be analysed on cases involving tax issues. The Revenue Appeals Tribunal was established through the Revenue Appeals Tribunal Act to hear cases involving tax disputes.

Literature Review

Little research on the Zambia's tax law vis-a`-vis the shadow economy has been conducted. The study will therefore in some cases make reference to literature on international tax law drafting in relation to the shadow economy. This study will therefore analyse tax measures that have been enacted through Budget speeches presented to Parliament in past years, articles by respectable scholars in tax matters, law journals, internet literature and regional tax system information. British tax legislation will be referred to in the paper.

CHAPTER TWO

Analysis of the Tax System

In 2002 Zambia reformed its tax system. Among the most profound changes was the replacement of a progressive personal income tax schedule, with rates increasing from 0, 10, 20, to 30 percent, to the PAYE with a flat rate of 30 percent above a K1.92 million threshold. This was further changed in 2003 with the introduction of a top rate of 40%.

The 2002 change was criticized by certain members of society as it was perceived that primarily the reform shifted the tax burden from the rich to poor. Although the flat rate would have reduced the distortions of labour supply and education decisions – wage and salary earners may have become more inclined to look for jobs and invest in their skills – the high income inequality in Zambia makes the reform indeed questionable. Clearly, inequality in Zambia is high by any standard. The 2003 tax legislation was criticized by certain members of society such as the Trade Unions as being too high.

This section focuses on the PAYE, on final withholding taxes, on taxation of small businesses insofar as it impacts directly on individuals, how certain tax payers are not captured in the tax net. It leaves other taxes, such as import duties and the Property Transfer Tax (PTT) out of the analysis. Nevertheless, it does give some tentative directions for reform of the entire tax code.

Zambia's tax system continues to evolve, as exemplified by the 2002 and 2003 reform. At present, direct taxes comprise the PAYE – a personal income tax – and a Company Tax, levied on individuals and corporations respectively. Final withholding taxes are charged on interest and dividend income. Consumption is taxed according to excise duties and the value added tax. There are, furthermore, customs tariffs, and a property transfer tax.

Direct Taxes

The Income Tax Act applies to both individuals and companies. All persons are liable to Zambian tax on income that springs from a Zambian source. Income includes business profits and emoluments, i.e. salaries, wages, overtime or leave pay, commission, fees, bonuses, gratuities, (inducement) allowances, and pensions or annuities.[11] There are, however, exemptions for foreign source dividends, for farming dividends, for income of any person designated as an enterprise under the Investment Act 1993,[12]. The Income tax Act also provides for tax exemption for charitable institutions involved in humanitarian work under section 41.[13] Other exemptions include for civic society, registered trade unions, approved fund, or medical aid societies, for contributions to approved savings schemes, for political parties[14]. The Income Tax Act, the following:

1. The emoluments of the President.

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[11] .Laws of Zambia, Income Tax Act, CAP.323, Section 17
[12] . I bid, Part 4 of the second schedule
[13] . I bid, Section 41
[14] . I bid, Second schedule, Part 3, 5(1)

2. The income of the Litunga of the Western Province as Litunga and the income of any Chief received as a Chief from the Government.[15]

Part 4 of the second schedule, Section 7 covers exemptions for war disability or war widow's pensions, for alimonies, for commencement and terminal passages made by employees, for scholarships, for the first ZMK 3 million of any amount received by employees for the loss of office, for *ex gratia* payments to the spouse and dependants. There are, furthermore, deductible expenses such as contributions to approved pension funds, and premiums under approved annuity contracts.[16] This in the long run contributes to the creation of a grey economy which cannot captured in the tax net.

The standard rate for Company Tax is 35%. In an attempt to diversify away from copper, Zambia has an array of reduced rates for specific sectors. Income from farming, for example, is subject to 15%. It should, however, be noted that a rush for privatization of state owned mining companies prompted the Zambian government to give discretionary concessions to (foreign) investors in this sector. Banking income, on the other hand, is taxed at an increased rate of 45% above ZMK 250 million in order to cream off some of the economic rent associated with excessively high interest rates.

[15]. I bid, Second schedule, Part 1, Section 1

[16]. Opcit, Part 4 of the second schedule, Section 7

Pay As You Earn

Under the Zambia Revenue Authority tax measures for 2004, the PAYE was changed by increasing the threshold of exempt income from K1, 920,000 to K3,120, 000 per annum and introduction of a graduated four band-system of 0, 30, 35 and 40 percent so as to tax income between K3, 120, 000 and K11, 760, 000 per annum at 30 percent, income between K11, 760, 000 and K60,000, 000 at 35 percent and income above K60, 000, 000 per annum at 40 percent. The measure was intended to provide some relief to the majority of workers who are in the low and medium income brackets in order to compensate for the relief given, there was an increase in tax for highly paid groups.[17]

2003/4 Income tax year (Per annum)	**2004/5 Income tax year (Per annum)**
First K1, 920, 000 @ 0%	First 260,000 0%
Above K1, 920, 000 @ 0%	Next 720,000 30%
	Next 4, 020, 000 35%
	Above 5,000, 000

It is however, important to note that not all income from employees is captured under the PAYE as some organisations and companies pay their employees minimual salaries while the rest is paid in form of allowances which may not be captured as income earned. In addition to that, some companies pay their

[17] . ZRA, Tax measure Highlights, 2004

employees fringe benefits that may not be capture under the income brackets. This results into the development of a shadow economy as some income is not captured.

Company Tax

Business Income		**Rate (%)**
Standard		35
Farming		15
Chemical Fertilizers		15
Non traditional exports		15
Rural enterprises		30
Companies listed on Lusaka stock exchange		33
Banks	≤ ZMK 250 million	35
	> ZMK 250 million	45
S/ scale Presumptive tax	≤200 million	3

Final withholding taxes

Capital income		Rate (%)
Dividend		15
Interest	≤ ZMK 300 thousand	0
	> ZMK 300 thousand	25
		1 (Medical Levy)

INDIRECT TAXES

(A) Value Added Tax

Zambia introduced a Value Added Tax on 1st July 1995 under the VAT Act.[18] It replaced the notoriously distorting Sales Tax, which led to excessive cascading. The majority of goods and services are taxed at the standard rate of 17.5%. A number of goods and services are, however, zero rated. Their producers do not charge VAT on their output, and are entitled to claim VAT paid over their input. The list of zero rated goods and services include items within the groups such as foods and agriculture, exports, supplies to privileged persons, and medical supplies and drugs. Some other goods and services are exempt. Their producers do not charge VAT on their output, but are *not* entitled to claim VAT paid over their input. The list of exempt goods and services include water supply services, health supply services, educational services, books and newspapers, transport

[18] .Laws of Zambia, Cap 331

services, conveyance of real property, financial services, metals, funeral services, gaming and betting supplies, relief at importation, domestic kerosene (paraffin), and trade union subscriptions.[19]

Principals of VAT

VAT is a multi-step tax on final consumption. It is a sales tax of choice (operates in 125 countries in the world). The central feature of this tax is that firms can offset or credit the tax they pay on purchases for other firms against the tax they charge on sales they provide to other firms and consumers. VAT in this regard is the difference between what the firm sales and what it purchases from other firms. All the VAT paid during the system of production are concealed until at the last level of final consumer. All VAT paid by the firm is offset by the crediting system. Another type of tax similar to VAT is the retail sales tax which is however, sales tax is inferior to VAT because it does not have the same strength as the VAT.

Effects of Exemption

VAT exemptions means that one is out of the VAT system, this may be by not registering. Therefore, one is not suppose to claim input VAT because he or she is not registered. The effect of exemption is that the effective tax rate will diverge and will be different from the statutory rate. This has the effect of distorting the economy as it distorts inputs choices made by firms. This can also

[19] For a comprehensive list, see ZRA (2003).

have the effect of loss of productive efficiency in the economy such as one firm would avoid doing business with another firm. In addition to that VAT exemptions act as an incentive to self supply while exports are harmed. Exports are harmed in that imports with competing industries is distorted favouring imports.

In the Zambian case the exemption on the Agriculture sector meant that exports of agriculture produce could not claim input VAT credit because they were not registered. This breeds exemption creep as there is proliferation of exemptions in the system.

The increase of the registration to K200 million also meant that small businesses were unable to be captured in that tax net as they were not able to do business with bigger companies or government as they required VAT registration.

Ideally the exemption follows the general rule of the thumb, exemption should be put on the following:

- Hard-to-tax sectors for administrative reasons such as small businesses.
- Public sector output (health and education) such as zero rating the public sector.
- Financial sector(Banks, Insurance companies) because it is difficult to determine their value added.
- Housing such as owned and rented.

Risks of Value Added Tax

I. Non –registration: This tax faces the risk of tax payers not reporting the transactions.
II. In cases where reporting has been done, there is a risk of under reporting of sales (output vs. Input VAT comparison)
III. There is also a danger of non-remittance of tax: tax may be collected but not remitted to the collecting agency.
IV. Tax payer also tend to false invoice, this is the dark side of VAT
V. Tax payers also tend to false export claims.

Is VAT regressive?

The regressive nature of VAT is country specific. To adhere to a non-regressive VAT an economy has to use the multiple rates. For instance food may be zero rated (while it is true that poor households spend much of their incomes on food, it is also true that it's the rich households that spend more income on food. In the same vain rich households spend most of their income abroad than poor households. The ratio of consumption to disposable income falls as disposable income increases. In the longer term, VAT is essentially a proportionate tax. Empirically, the share of VAT is less than their share of total consumption.

The major weakness of VAT is that it is difficult to refund in some cases, authorities face difficulties on administration as they accumulate arrears. In most cases the authorities lack audit capacity to clear refunds. This may in the emergence of the shadow economy as taxes funds are not captured in the tax net. The solution to this problem is to carry forward excess credits and to zero rate export suppliers.

(B) IMPORT DUTIES

There are ad valorem customs tariffs to all imports, except those originating in the Common Market for Eastern and Southern Africa (COMESA), which are duty free on a reciprocal basis. The rates are 0% or 5% for raw materials, 15% for intermediate goods, and 25% for finished products.

<u>Consumption tax</u>

Consumption		**Rate (%)**
VAT		17.5
Customs tariffs	Raw materials	0-5
	Intermediate goods	15
	Finished products	25
Excise duties	Electricity	5
	Selected motor vehicles	10
	Kerosene, light oils, and fuel oils	15
	Cosmetics	20
	Diesel fuel, and petroleum gas	30
	Opaque beer	35
	Gasoline	60
	Clear beer	70

Source: ZRA, Budget Highlights 2003

(C) OTHER TAXES

The Zambian tax system comprises a small number of other taxes. Examples are the Property Transfer Tax levied on the market price of transferred property and shares, and a Mineral Resource Levy charged on the market value of the natural resources of mining companies. There are, apart from unsubstantial fees for fishing licenses or levies for the right to market goods, no genuine local taxes.

Zambian tax compared to International tax standards

There is a general perception that the income tax structure imposes a heavy burden on the wage and salary earners. In this regard there is a widespread feeling that the overall burden of taxation in Zambia is high. Many people in the country would like to see the VAT rate reduced from its current level of 17.5% so as to make them consistent with the rates prevailing in some of the other countries in the region. This begs the question whether the Zambian tax burden is indeed high by international standards. These expressions have being aired by Trade Unions and the public in general in the media.[20]

Statutory tax rates

A first step in comparing tax burdens on wage and salary earners across countries is to look at differences between statutory tax rates. A precautionary note is, however, imperative here. There is no reason why statutory tax rates should be the same across countries. For one thing, a high rate may offset a

[20] .The Post, 21st July 2004

narrow base, and a low rate a broad base. For another, a high rate may reflect a national preference for public expenditure, and a low rate a preference for private expenditure. Finally, countries in different stages of their development set different tax rates as tax rates tend to increase with GDP per capita. Only in case of strong international spillovers – capital flight comes readily to mind – is there a theoretical case for tax coordination. Nevertheless, even in the absence of spillovers, benchmarking and following best practices may make an international comparison meaningful. In order to prevent comparing apples with oranges the set of countries under consideration must, however, be similar in economic structure. Hence we concentrate on the twenty COMESA countries.[21]

The top statutory tax rates on different types of personal income, taken from the loose leaflet service of the International Bureau of Fiscal Documentation (2003). Most updates have been made in 2002 and 2003. Some leaflets date, however, from the 1990s. For example, the Zambian top rate for income from wages and salaries is 40%. The top statutory tax rates on dividend, interest, royalties, and fees are either final withholding taxes, or, if a country has a classical personal income tax system – in which no distinction is made between different income sources – the top personal income tax rate. If there are differences between the taxation of residents and non-residents, we list the rate that applies to residents. Similarly, if there is a difference between the taxation of domestic and foreign source dividends. Is the Zambian tax burden high by international standards?

[21] Tanzania left the COMESA in 2001. We do nevertheless include in the analysis.

Compared to other COMESA countries, Zambia qualifies to be considered as being amongst the average category.

The structure of the Zambian PAYE – a relatively low rate and bracket implies that it is relatively harsh for persons at the bottom of the labour market, and relatively mild for persons at the top end. Zambian wage and salary earners at the bottom end of the labour market are worse off in terms of disposable income compared to their counterparts in, for example, Namibia. However, as gross income increases, the picture reverses as the progressivity of Namibian taxation starts to dominate. How does Zambian taxation of other personal income compare to that of other COMESA countries? Relatively low intermediate tax burden adds to the inequity of the Zambian tax system.

The discussion above suggests that PAYE is relatively harsh on wage and salary earners at the bottom end, and mild to wage and salary earners at the top end of the labour market. This suggests that the main problem with Zambian taxation does not lie in an average burden that is too high, but in a lack of redistribution.

Taxation of the Household

Taxation of a household is an important one as far back as the Roman empire. In practice some households do, of course, avoid taxes. A single household may have more income earners. This implies that, in case of wages and salaries and interest income, the tax exemption of the first income brackets are enjoyed more than once. The results of the exercise are striking. First, there is for each level of income, a large variation in effective tax rates.

This indicates that the Zambian tax system suffers from a lack of horizontal equity. This is compounded by the fact that Zambia, like most African countries has a large informal sector that does not pay income taxes at all.[22]

Equally important is that the effective tax rates do not increase in gross income. The reason for the distortion is the preferential treatment of income from rent, interest, and dividend. Even under effective consumption taxes, there is a grey economy of a category which is not captured in the tax net. Effective consumption tax are basically the total household consumption tax bill (excise duties and VAT) divided by total household expenditure. The results show that Zambian consumption taxation is, like income taxation, characterized by a lack of horizontal equity: for a given level of expenditure there is a wide variety of effective consumption tax rates. Hence Zambian consumption taxation, unlike Zambian income taxation, is progressive, and is coherent with the objective of vertical equity. The reason is that poor households spend the bulk of their income on primary food which is zero rated under the VAT.

The previous sections have brought home a number of points. First, income is more unequally distributed in Zambia. Second, the average Zambian income tax burden is intermediate by COMESA standards, but it is carried disproportionately

[22] There are no published estimates of the relative size of the Zambian informal economy. Extrapolation of estimates for Malawi (Chipeta, 2002) suggest, however, that it is at least one third of GDP, and even more in terms of employment

by the poor. Third, the effective income tax burden decreases in total income. Hence Zambian income taxation is regressive.

Taxation of Small-businesses

Legislation regarding taxation of small-businesses has contributed to the creation of a grey economy. Small businesses are those that do not meet the established threshold for tax returns.

While this group may be considered under the Presumptive tax regimes, the challenge would be on how to improve the method of presumptive taxation without necessarily being in conflict with the law. Another problem would be the enforcement mechanism of strengthening the collection of such a tax. Also included in this category are the self employed individuals who's income does not reflect on the tax returns. Another category that has to be considered is that of small agriculture holdings. This category of tax payers is unique in that:

- There are too numerous therefore only a small fraction can be audited;
- Some of the tax payers in this category are also below the poverty level;
- The law does not compel them to maintain books of accounts;
- They sell largely for cash so withholding tax is not practicable and;
- They can early conceal their income in the case of professional and consultants

Principals of Presumptive Taxation

This is generally an indirect means to ascertain tax liability which differs from the usual rule based on taxpayer's accounts.

Rebuttable vs. Irrebuttable: The rebuttable approach requires adherence to accounting rules by keeping books which may be used for appeals. While under the Irrebutable approach there cannot be appeal, however, there is need to include it in the tax statutes.

Minimal tax vs. Exclusive: Under this approach, the minimal is such that tax liability will not be higher than what presumptive tax apply. While under the exclusive it excludes other rules of taxing.

Mechanical vs. Discretionary: Under mechanical approach, there is the use of mechanical formulas to compute the gross receipt. Presumptive tax has the advantage of being simple in its calculation for the tax administer. In addition to threats, this mode of taxation combats tax avoidance or evasion. This approach to taxation is more equitable and distributes the tax burden.

Legally, it is against the rule of law to force people to maintain books of accounts. It is however, important to note that Presumptive tax should not be used in cases of traders who rent property neither those that own property as may not be an efficient tool for collection of tax in this section.

Another method that can be used to collect Presumptive tax can be the Fortait method. This method is appealing in theory as it provides for flexibility. However it requires good information from taxpayers, honesty and competence on the part of the tax inspectors. However, this method may not be considered as being suitable for developing countries such as Zambia. The use of this approach may enhance the development of a shadow economy.

Legislation is also not clear when considering the definition of agriculture for the purpose of collection of Presumptive tax. The definition of Agriculture for example is difficult to ascertain, whether it is based on subsistence scale or income earned from game farming. It is for this reason that legislation should be amended so as to provide a detailed definition of agriculture under the income taxes category.

Zambia's Presumptive tax Legislation

Tax legislation was changed with the introduction of a presumptive tax of 3 percent on annual business turnover of K200 million and below.

"Introducing a presumptive tax creates benefits for both tax administration and taxpayers. For tax administration the benefit is that a presumptive tax reduces enforcement effort and costs through simplification of the income tax process, attracting those businesses and individuals who find the current system complex. On the part of the taxpayers, especially small or medium sized businesses; the cost of compliance is greatly reduced, as they do not need to keep detailed books of account in order to comply with income tax requirements. This measure will also greatly improve voluntary compliance." [23]

This legislation is likely to result into the growth of the shadow economy by way of certain categories of tax payers shifting into this bracket despite them earning

[23] . ZRA , Tax measure highlights, 2004

income that could have been taxed. This includes supplies of services to government and professionals involved in consultation.

The other Presumptive tax is on buses and taxis, since this category of business does not usually maintain books of accounts no file returns.

Type of Vehicle (Sitting Capacity)	Tax per Vehicle (per year)
64+ seater	K7.2 million
50-63 seater	K6.0 million
36-49 seater	K4.8 million
22-35 seater	K3.6 million
18-21 seater	K2.4 million
12-17 seater	K1.2 million
Below 12 seater	K0.6 million

Revenue Appeals Tribunal

The Tribunal has also contributed greatly with respect to tax legislation. It was established by the Revenue Tribunals Act[24] to hear appeals under the Customs and Excise Act, Income Tax and Value Added Tax. The philosophy underlying the creation of the Tribunal is to provide a specialized and speedy forum to resolve disputes between taxpayers and Zambia Revenue Authority.

[24] . Revenue Appeals Tribunal Act, NO. 11 of 1998

The Tribunal is important when considering the shadow economy its verdicts put to rest some of cases that would otherwise have created a hope in the collection of tax. The Tribunal also interprets tax legislation in cases were Statutory Instruments may be conflicting. In the case of *Konkola Deep Mining Project Vs. ZRA,*[25] Tribunal interpreted the issue of claim on input tax on hire of motor vehicle whether it was claimable or not under Statutory Instrument No. 78 of 1995 as amended by Statutory Instrument No. 12 of 1998.

The Tribunal has also determined cases of investors who do not agree with tax measures in place. In the case of *Marasa Holdings Limited vs. ZRA*[26], issue was whether withholding Tax is chargeable to the appellants in respect of non resident contractors and consultants engaged by the appellant.

Withholding Tax

In 2004 the exempt portion of withholding tax was raised to K750, 000 per year (from K300, 000 per year). This tax is supposed to be withheld when a tenant is paying rental. The measure was intended to provide relief to small savers and encourage savings, which are critical for investment and economic growth. This measure is how ever difficult to administer as most landlords how are the beneficiaries of the sale of government and council houses neither register not file any returns with the ZRA. Tenants are unable to withhold tax at source thereby distorting the whole tax system.

[25] .*Konkola Deep Mining Project vs. ZRA /1999/RAT/130*
[26] . *Marasa Holdings Ltd vs. ZRA 2000/RAT/49*

Legislation in this regard has to be enhanced so as to capture the property owners current not in the tax net. A grey economy is created when income is earned on a property but tax is not remitted to the collecting agency.

Tax Law Drafting

The operation of a tax system requires rules and regulations. These rules and regulations essentially constitute what is commonly known as tax law. Tax law makes make policy legally enforceable. The tax laws define the powers that a tax collecting agency such as Zambia Revenue Authority can excise to enforce the law.

Under Article 80 Statutory Instruments can be issued as delegated subordinate law to any person or department within the Republic to make law.

> "(1) Nothing in Article 62 shall prevent Parliament from conferring on any person or authority power to make statutory instruments.
>
> (2) Every statutory instrument shall be published in the Gazette not later than twenty-eight days after it is made or, in the case of a statutory instrument which will not have the force of law unless it is approved by some person or authority other than the person or authority by which it was made, not later than twenty-eight days after it is so approved, and if it is not so published it shall be void from the date on which it was made." [27]

[27] .Laws of Zambia, Constitution, Cap 1

In this regard Statutory Instruments may be issued on tax matters while the Zambia Revenue Authority issues what is commonly is known as Practice nopte" that broadly state how the ZRA views the Tax treatment. However the Income tax Act is the principal Act form the taxation.

The Income tax Act does not for instance give a proper definition of a tax payer. The Act only gives the definition of "taxpayer identification number" means the National Registration Card Number or such other number as may be designated by the Minister[28]. Clear terminology should be used consistently throughout legislation to refer to persons with tax obligation. Tax laws often refer to 'person' or 'taxpayer', but there is sometimes uncertainity about what these terms refer to in certain situations. For instance there may be a derivation of an amount by some person other than the taxpayer, but the circumstances may be such that the amount derived does not have the character off income in the hands of that person. For example, if part of an employee's salary is paid to his spouse, the amount derived by the spouse will not be employment income of the spouse because the spouse provided no services to the payer. This amount is a gift. A taxpayer may be required to file a return and provide other information to tax authorities even though the person did not have any taxable income for the year. The definition of taxpayer should be drafted to broader and all inclusive, similarly a person other than a taxpayer may be required to satisfy that taxpayer's tax liability.

It should not only connote a person obliged to pay tax in a particular year.

[28] .Opcit, Income Tax Act , Part I

A person other than a taxpayer may be required to satisfy that taxpayer's liability. For instance where a tax liability is met by withholding at source. If the payer of gross income who is obliged to collect withholding tax from the payment is not a tax in respect of that income, then alternative appropriate terminology should be used to apply to that person. Terms such as 'withholding agent' or 'representative taxpayer'.[29]

Given that taxable income is an algebraic concept determined periodically, it is appropriate to use a term such as 'has' to describe the requirement relationship between a person and taxable income. Terms such as 'derived', 'earned', accrued', or received are not appropriate for this purpose because they describe the required relationship between a person and individual items of gross income.

[29] .Opcit, Thuronyi, p. 538.

CHAPTER THREE

Conclusion

In the light of what has been discussed above it may be said that tax legislation has a great impact on the creation of the shadow economy. For every economy to function well it requires tax so as to provide social goods that the public can enjoy. The very existence of government is highly dependant on tax collected so as to enable it to operate smoothly. Tax law dates back as far as the Roman empire, as revenue was need to maintain a civil service and the military to conquer other territories. Tax collection has even been cited in the Bible as one of the most infamous occupation.

Taxation was introduced to the England through the Romanian empire and it is from the British tax laws that the Zambian tax system has its roots. Tax was introduced in the then Northern Rhodesia as a way of maintaining the civil service.

Like any where else in the world individuals and corporation have been involved in tax evasion or avoidance in one way or another. It is therefore, important that the tax legislation is designed in such a way that it captures all tax payers in the tax net.

The presence of an active shadow economy in an economy reflects the degree to which various existing economic policies are inappropriate or inefficient. Oppressive tax and administration mechanism may drive potential tax payers from the official sector into the unregulated shadow economy as a means of escaping the high entry costs to legality, such as license fees and registration requirements, and the high costs of remaining legal, such as taxes, red tape, labour and or environmental regulations.

The shadow economic activities escape taxation, and as a result, tax revenue is lost which is intended to provide resources for the development of a nation through the provision of public goods. The dilemma is that as provision of public goods suffers, fewer tax payers will have the incentive to continue paying tax as the benefit is not seen. Those that comply with tax payment will in the long run be overburdened thereby driving more tax payers into the shadow economy. This will in the long run shrink the base for public resources base there by affecting even the maintance of the rule of law.

Tax laws should be easy to understand by every member of society.

In developing a countries tax laws, the international dimension plays an increasingly important role that significantly restricts the rules that might be adopted if regard were had only to domestic considerations. The increasing role of international factors is mainly attributable to the globalization of the world economy. In the Zambia case taxation must be in line with the protocols that the country has entered into such as with regional bodies. A case in point is the SADC trade protocol. Zambia's customs taxes are greatly influenced by such treaties. Other include regional grouping such as the COMESA. However, it is important that a country designs a tax laws based on its own characteristics. Every country has different characteristics which may render a tax structure difficult to administer.

Recommendations

In the light of the above discussion, it has been observed that Zambia's tax system is basically British. However, it is important to re-draft some of the tax legislation so that it is in line with the prevailing conditions. Pieces of legislation must be drafted in such a way that they capture any developments in the economy.

It is important that further studies move into a detailed analysis of the impact of the shadow economy on a specific tax type such as Direct taxes, Customs and Excise or Value Added Tax. Specific measures should be critically analysed in detail as this will help us seal the holes that may be existing in the economy. A detailed study will reveal the insights on where tax legislation has contribute into the creation of the shadow economy. This will in the long run assist us in designing tax law which can contribute toward economic growth and improvement in the quality of life for the poor population.

There is need to enhance tax legislation in the informal sectors as this is one of the most difficult sectors to capture in the tax net. In this regard the definition of the informal sector must also be re-visited. The current definition is not broad enough to include small businesses which deal in transactions involving huge sums money above the tax threshold. Transactions such as those professionals involved in consultancy work.

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