THE SALES TAX PROPOSAL: ARE WE BEATING A DEAD HORSE?

Preliminary results from a rapid assessment

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EXECUTIVE SUMMARY

The tribal wisdom of the Dakota tribe in the United States of America, passed on from one generation to the next, says that "*when you discover that you are riding a dead horse, the best strategy is to dismount"*. The fiscal authorities have argued that the horse – in this case, (value-added tax) VAT – is dead.

In contrast, this rapid assessment argues that the VAT may have been pronounced dead too quickly, perhaps for expediency's sake. Examples from many countries abound and show that with the right fiscal discipline to ring-fence VAT refunds and improve compliance, VAT works just fine, offering value-added incentives and avoiding cascading effects. In finding a solution for this supposedly dead horse, important questions that we need to ask are "Is the horse really dead? If it is, what killed the horse?" Without this introspection, the other horse in form of Sales Tax, which in fact died and was buried 25 years ago, might be resurrected. Without learning from previous experiences and experiences elsewhere, we are bound to make the same mistakes in trying to resuscitate a truly dead horse.

Granted, the authorities have tried to clarify that Sales Tax is not exactly the dead horse from 25 years ago. They suggest that what they have devised is a *hybrid Sales Tax* that draws from the VAT system. This hybrid reportedly includes: a self-policing mechanism through the TPIN requirement for all transactions between registered purchasers and sellers; an exemption of some businesses below the Sales Tax registration threshold from being charged the Tax; taxation at every point of value addition; and input exemptions for producers and manufactures from the tax.

It is an undeniable fact that the VAT system, like all other tax regimes in Zambia, has been dogged by low yields as evidenced by low VAT C-efficiency rate[1]. The low yields have been due to, among other things, numerous exemptions, weak tax administration, and high and unsustainable refunds. The proposed Sales Tax deals with the VAT refund issue. But removing refunds does not necessarily fix the low yield problem considering that the low yields are a result of weak tax administration and poor compliance.

Moreover, the proposed design of the Sales Tax will lead to several adverse economic effects, with the main issue being the cascading effect. This is bound to lead to higher effective tax rates across all sectors of the economy, but more so in business services, mining and manufacturing. To mitigate the cascading effect, producers, being rational economic players, will most likely change their behaviour by, among other things, consolidating the supply value chain to the extent possible, thereby cutting out smaller firms. The cascading effect will also increase the cost of production, which, turn is also likely to lead firms to cut back jobs to the estimated tune of47,000

1 The VAT C efficiency rate is defined as actual VAT collection as a share of its potential base.

direct jobs and potentially 56,000 additional job cuts in smaller firms.

Although often touted for its simplicity, the proposed numerous deductions and exemptions to industries with high levels of cascading are likely to increase the complexity of the Sales Tax as well as increase the risk of rent-seeking and corruption. Further, the proposed differentiated rates of Sales Tax contravene the World Trade Organisations (WTO) principle of national treatment. And unlike the VAT, the Sales Tax has an inherent flaw – it lacks a self-enforcing compliance mechanism. It is our understanding that the TPIN requirement for Business-to-Business transactions in the proposed hybrid system is designed to address this problem.

It will be folly to ignore all these challenges brought about by the introduction of the proposed Sales Tax hybrid. **From the reasons stated above,** we therefore offer the following recommendations:

1. **The authorities should not go ahead with the proposed implementation of the Sales Tax in 2020.** The best option that eliminates the risks to businesses, workers and consumers, and simultaneously supports a reasonable tax revenue inflow, is to make amendments to the VAT regime. Instead of establishing the Sales Tax regime, the Government should therefore deal with the refund problem first within the context of a systematic VAT system reform.

2. **Dealing with the refund problem.** It will be more reliable to look at solutions that do not involve VAT being paid on mining companies' inputs, so that the question of a refund does not arise. It is our understanding that the vast bulk of VAT refunds are paid to the mining companies. And a large proportion of these refunds are for VAT paid on the capital goods they import. Therefore, exempting these goods from VAT (i.e., VAT ineligible) at the point of entry into Zambia would help eliminate the refund problem in the future[2]. At the same time, efforts should be made to tackle frauds related to refunds.

3. **Preventing the build-up of arrears by improving forecasting and ringfencing of funds.** The Government needs to improve its refunds forecasting by diverting a matching amount of VAT revenues into a special account from which refunds are made. As long as its forecasts were reasonably accurate, such an approach would automatically vastly reduce the refund problem. Notwithstanding the Government's present liquidity constraints, this measure would also require the Government to use net VAT revenues in its tax and spending plans, and have the discipline to strictly ring-fencing and not raid the 'refund account'. During the period of VAT refund assessment, say 45 days or 90 days, the Government can lend the money to the banking sector to expand private sector credit instead of putting it in government securities. When the loans to the banks mature, the

2 Presently, capital goods imported by mining companies are on the VAT deferment scheme. To normalise VAT administration, capital items should not be on a VAT deferment scheme but on a permanent list of VAT ineligible items (or a permanent VAT exemptions list) based on value-added transformation criteria.

Government will use the refunds to pay the principal and keep the interest for fiscal spending. Given the size of the quarterly VAT amounts, the interest earnings can be quite healthy even at low interest rates. Effectively, the Government will be using fiscal policy to support monetary policy including lowering interest rates.

4. **To clear the existing arrears, the Government needs to explore the possibility of allowing firms to offset their VAT refunds against other (i.e. non-VAT) tax liabilities.** On the downside, this would still require refunds to be audited and it would also be complicated for the ZRA to administer, requiring different tax departments to collaborate. However, if the practice was limited to large mining companies, thereby minimising the administrative burden, it would be feasible to implement. In fact, this provision already exists in the current legislation – offsets are an option against approved audited refund claims.

5. **The Government needs to cut back on the number of VAT exemptions.** Zambia has too many exemptions. One of the most efficient and straightforward ways to increase revenues is to apply VAT to more goods and services. Reducing VAT exemptions may be a better way to tackle the deficit than the Sales Tax option – or something to be considered as part of a package of different measures. Using the MicroZAMOD tax-benefit microsimulation model, we simulated the removal of output VAT exemptions on disconnection and reconnection fees resulting from the non-payment of water and sewerage bills; the buying and selling of foreign currency; the sale of dwelling houses to be used for commercial purposes; telephone and telefax services; and religion. Using 2017 tax data, we found that at least K1.2 billion additional VAT revenues would have been raised in that year.

6. **Improving administrative systems can have a significant positive effect on VAT revenues.** This was demonstrated in 2017 as a result of adoption of modernisation and automation strategies. This included enhancement of technological solutions, particularly the use of electronic fiscal devices for VAT-registered suppliers to monitor transactions in real-time; the appointment of withholding agents and the introduction of external forensic audits before the disbursement of refunds. Additionally, the ZRA should encourage and incentivise consumers to ask for receipts.

7. **It will also be important to review the ZRA modernisation and automation initiatives over the years.** This is particularly so given that, during this period, the administration inefficiencies in VAT became so deep that they resulted in an attempt to abandon VAT altogether and shift to Sales Tax after years of sizable public investment in ZRA modernisation, automation and tax administration improvement programmes.

BACKGROUND

1. **The tribal wisdom of the Dakota tribe in the United States of America, passed on from one generation to the next, says that "*when you discover that you are riding a dead horse, the best strategy is to dismount*".** It can be argued, by the fiscal authorities, that the horse – in this case, VAT – is dead. But we argue that the VAT has been pronounced dead too quickly for expediency's sake. Examples from many countries abound[3] and show that with the right fiscal discipline to ring-fence VAT refunds and improve compliance, VAT works just fine, offering value-added incentives and avoiding cascading effects. In finding a solution for this seemingly dead horse, important questions that we need to ask are: "Is the horse really dead? If it is, what killed the horse?" Without this introspection, another horse in form of Sales Tax, which in fact died and was buried 25 years ago, might be resurrected. Without learning from previous experiences, we are bound to make the same mistakes in trying to resuscitate a dead horse.

2. **Granted, the authorities have come up with a *hybrid Sales Tax* that draws from the VAT system in order to preserve the perceived advantages of the VAT system.** These include a self-policing mechanism through the TPIN requirement for all transactions between registered purchasers and sellers; an exemption of some businesses below the Sales Tax registration threshold from charging Sales Tax; taxation at every point of value addition; and input exemptions for producers and manufactures from the tax.

3. **Is the horse really dead?** Following modernisation and automation strategies put in place by the Zambia Revenue Authority which included the appointment of withholding agents and the use of electronic fiscal devices for VAT registered suppliers, VAT collections improved by 44% in 2017 and 2018. It, in fact, was the best performing tax in these two years. Those cannot possibly be the last kicks of a dying horse. We contend that the decision to scrap VAT was surprising and it was pronounced dead too quickly for expediency's sake without performing CPR – unless the general public were blind-sided to the realities on the ground.

4. **If indeed the VAT was dead, what really killed the VAT?** In an earlier ZIPAR paper submitted to the Ministry of Finance in July 2019, we identified three main factors that led to the dissatisfaction with the performance of VAT: i) low yields, ii) poor administration of the tax and iii) high refunds.

   i) **Low yields due to numerous exemptions:** When the VAT was introduced in 1995, it performed relatively well until it was overrun by the discretionary granting of exemptions. These exemptions did not only reduce VAT yields

3 For example, South Africa, China and Kenya.

but also overwhelmed administration and enforcement of the tax. The IMF has estimated that Zambia's VAT revenues in 2015 were just 28% of the potential maximum, if all goods and services were taxed at the standard rate. This compared to a SADC average of 45%. Given this scenario, if Zambia kept the current set of exemptions, it would have to increase the VAT rate to 25% to reach SADC's VAT collection levels[4] Since discretionary exemptions are a fiscal policy choice of the authorities, by extension, low yields are arguably also a policy choice.

ii) **Weak administration of the VAT regime:** A number of challenges were faced in administering VAT beyond the particularly daunting VAT refunds problem (discussed below) and included fraud, false documentation, double claims and unaccounted for offsets. This implies that the Zambia Revenue Authority (ZRA) could little contend with unscrupulous tax payers, which unfortunately still persist. Some strategies were put in place at the end of 2016 to curb some of these challenges. These strategies include the introduction of withholding agents which helped to minimise fraud and double claims; acquisition of electronic fiscal devices which, to a large extent, dealt with false documentation and offsets. These were clearly strategies in the right direction that helped to increase the yields from VAT.

iii) **High refunds:** Thus, the accumulation of VAT refunds to as high as K17.9 billion, is but a symptom (and not really the disease) of weak administration of the VAT regime. Despite, the innovative initiatives introduced by the ZRA to improve administration, the accumulation of refund arrears over the years meant that VAT collections of K17.3 billion in 2018 would still not have covered the refunds bill for that year?? and if all refunds were to be paid out in 2018, negative VAT collections would have been recorded.

5. **The Government's proposed solution of the Sales Tax may deal with the symptoms of the VAT problem.** That is, it may deal with the high refunds, but gloss over the challenges of low tax yields and low administration efficiency.

The likely effects of the Sales Tax

6. **The current design of the Sales Tax (based on the Sales Tax Bill presented to Parliament in April 2019 will lead to several adverse economic effects, including higher effective tax rates**. Earlier ZIPAR research[5] demonstrates that under a Sales Tax, every item that changes hands between companies and/

4 International Monetary Fund (2017), *Zambia: Selected Issues*, Country Report No. 17/328, https://www.imf.org/en/Publications/CR/Issues/2017/10/25/Zambia-Selected-Issues-45359

5 ZIPAR (2019). Reflections on the Sales Tax: matters to consider in implementing the Sales Tax. Paper submitted to the Budget Committee and the Committee on Economic Affairs, Trade and Labour Matters.

or individual business practitioners will be taxed, regardless of whether it is a raw material or final product. As a result, in industries where products move through multiple stages of production—from raw material to manufacturing, distribution, and final consumption—the value created in early stages of production is taxed repeatedly in subsequent stages. This phenomenon is called "tax cascading". This repeated taxing at each link in the production chain will result in punitively high effective tax rates of about 22% - up from 12% under VAT. This will lead to a further rise in consumer prices, and subsequently on the cost of living. High production costs in firms will reduce firms' value added and therefore subdue economic growth even further.

7. **To mitigate the cascading effect, producers may change their behaviour - production decisions and/or reduce the size of the supply chain (vertical integration).** This is inequitable as it kills off small Zambian firms who bear the brunt as large firms cut them out of the value chain

8. **The increased cost of production may also lead firms to cut back jobs.** We estimate that the effect of the Sales Tax would possibly lead up to the loss of 47,000 direct jobs, or up to 56,000 indirect jobs across key sectors in Zambia. The sectors that may be most affected are service jobs in the administrative and support service activities (including security firms and business support services who are in the higher levels of the production/supply chain), in mining and in manufacturing (Table 1). A decision meant to "fix" one aspect of the economy will end up adversely affecting other aspects.

9. **The proposed numerous deductions and exemptions to industries with high levels of cascading are likely to increase the complexity of the tax.** Advocates of the sales tax tout its simplicity and enforceability. But the introduction of numerous exemptions to reduce the cascading effect effectively abandons its purported simplicity which could distort production markets. It also opens up the system to risks of rent-seeking and corruption – two age-old problems that are likely to remain unaddressed.

10. **The proposed differentiated rates of Sales Tax contravene the World Trade Organisations (WTO) principle of *national treatment*.** This is enshrined in the General Agreement on Tariffs and Trade (GATT), General Agreement on Trade in Services (GATS) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) which risk retribution from trading partners and international penalties.

11. **The principle of National Treatment prohibits discrimination between imported and domestically produced goods with respect to internal taxation or other government regulation.** At the multilateral level, this can result in a trading partner lodging a complaint and show burden of proof to the WTO Dispute Settlement Body (DSB) that the Sales Tax is discriminatory in

nature to specific product lines. Upon establishment that a Member State is contravening the GATT Article III- National Treatment on Internal Taxation and Regulation, the Member State will have to compensate the aggrieved trading partner(s) or any other mechanism as deemed fit by the Dispute settlement schemes; essentially Sales Tax would take the country back into a situation of tax refunds of a sort. Similarly, breaching National Treatment may evoke retaliatory measures such as trade wars between the trading partners concerned and overtime impede the establishment of foreign firms.

12. **Unlike the VAT system, the new regime lacks a self-enforcing compliance mechanism.** This is likely to further exacerbate the challenges associated with compliance and opportunities for tax evasion. Income where taxes are withheld and reported to the Government by a third party has lower evasion rates than incomes where taxes are not withheld and there is no cross-reporting. Since the Sales Tax would feature no withholding and no cross-reporting, the possibility of high evasion rates needs to be taken very seriously. Suffice to say, under the proposed hybrid Sales Tax, the withholding agents system under the VAT is expected to continue. We get back to this issue later in this note.

13. **The best option that eliminates the risks to businesses, workers and consumers is amendments to the VAT regime.** The Government needs to solve the refund issue, as well as reducing leakages through exemptions and the hitherto poor administration of the tax leading to low compliance. The VAT system has taken time and money to design. The rest of this paper offers policy options for dealing with the proposed VAT reforms.

Table 1: Possible employment effects of the implementation of the Sales Tax

	Number of persons employed (2018 Labour Force Survey)	Value added 2019 (K 'million)	Estimated Sales tax 2019 (assuming Jan-Dec implementation)	Adjusted VAT 2019 (K 'million)	Pure Sales Tax (K 'million)	Direct job losses	Indirect job losses	Total job losses
Agriculture, forestry and fishing	830,858	22,611	435	381	53	1,070	1,136	2,206
Mining and quarrying	85,111	39,280	10,454	6,368	4,085	10,097	6,126	16,222
Manufacturing	242,779	22,916	2,419	1,510	909	6,552	24,399	30,951
Electricity, gas, steam, and air conditioning supply	13,275	9,939	1,119	561	558	376	136	512
Water supply; sewerage, waste management and remediation activities	8,615	768	13	(15)	27	308	40	347
Construction	174,009	31,688	332	355	(24)	(133)	(104)	(237)
Wholesale and retail trade; repair of motor vehicles and motorcycles	690,666	55,870	2,421	2,356	65	820	653	1,473
Transport and storage	111,911	21,898	429	368	61	324	264	588
Accommodation and food service activities	67,887	4,473	197	158	39	299	75	374
Information and communication	17,949	6,132	1,219	1,449	(230)	(717)	(231)	(948)
Financial and insurance activities	25,600	11,217	627	501	127	326	191	517
Real estate activities	10,343	14,622	70	93	(23)	(17)	(8)	(25)
Professional, scientific and technical activities	14,734	3,622	344	9	335	1,414	1,110	2,524
Administrative and support service activities	112,354	2,962	767	(415)	1,182	45,784	24,445	70,229
Public administration and defence; compulsory social security	61,023	12,665	3	3	0	1	0	1
Education	166,024	21,047	429	445	(16)	(124)	(42)	(166)
Human health and social work activities	79,073	3,726	88	88	(1)	(19)	(1)	(20)
Arts, entertainment and recreation	6,208	835	39	48	(9)	(68)	(2)	(70)
Other service activities	128,498	1,308	410	598	(188)	(19,272)	(2,247)	
Activities of households as employers	92,659	-	-	-	-	-	-	-
Activities of extraterritorial organizations and bodies	9,395	-	-	-	-	-	-	-
Total	**2,948,971**	**300,420**	**21,813**	**14,862**	**6,951**	**47,020**	**55,940**	

Source: Central Statistical Office and authors' own calculation using input-output analysis

REFLECTING ON THE VAT REGIME IN MORE DETAIL

14. **There are two particular problems with VAT in Zambia.** First, the zero-rating of exports means that exporters – and large mining companies in particular - pay very little or no output VAT on their export goods but are due large refunds for the VAT paid on their inputs. Second, revenues are held down by a wide range of goods and services through zero-rating for VAT and other deferment and by non-compliance.

15. **Neither of these problems is unique to Zambia**. The way VAT regimes are implemented in most countries is, to varying degrees, far from the ideal, resulting in revenues falling far short of the theoretical maximum.

16. **From the point of view of the Zambia Revenue Authority (ZRA) and the Ministry of Finance, the refund problem was the overwhelming flaw in VAT and the reason to drop it and replace it with a Sales Tax.** Therefore, no argument to drop the Sales Tax proposal and retain VAT will be persuasive if it does not provide a way of avoiding, or at least minimising, refunds in the future. Ideas around increasing revenues through fewer exemptions and better administration are necessary, but of second-order importance.

The refund problem

17. **VAT is a tax on the value-added at each stage of the production process through to the final sale.** It is collected by charging the rate of VAT on the price of goods and services sold at each stage of production and allowing the company to claim back the VAT paid on the goods and services it has bought. So, for example, when a car retail company sells a new car in the domestic market, it charges VAT on the price the car is sold for, and claims back the VAT paid when it bought the car from a wholesaler. It, therefore, pays tax only on the proportion of the final sales price that represents its value-added. This process is repeated all the way up the supply chain, so that the wholesaler, manufacturers and suppliers of raw materials all pay tax only on the value they added to the final price.

18. **It is the convention that countries with VAT systems do not charge VAT on exports.** Instead, VAT is charged in the importing country. This avoids the double taxation of traded goods and ensures that exported goods and services compete on a level playing field with goods and services sold in their home market. However, exporters are still allowed to reclaim the VAT paid on their

inputs, a root problem of which rests in the definition of inputs. As a result, exporting companies may be in a position where they can reclaim more VAT than they pay, resulting in a refund. In Zambia, large companies in the copper mining sector export the bulk of their output, so they pay little VAT on their sales. But they are able to reclaim large sums of VAT that they pay on the plant and machinery used in their production processes, even though, strictly speaking, these items are not inputs that undergo actual value-added transformation during the production process. The exporting firms are, nonetheless, entitled to net VAT refunds on this account.

19. **However, in recent years there have been considerable delays in auditing and processing refunds.** This has artificially boosted net government revenues in the short-term, masking to some extent the parlous state of the public finances, but at the cost of creating future liabilities for the Government. It has also negatively affected the cash flow of mining companies, which may act as a disincentive to investment in the industry.

20. **Notwithstanding the net VAT refund problem, it is important to understand that refunds to the mining sector should not be a drain on the Treasury and the Government does not have to raise money from other taxes to pay them.** Refunds, as the name suggests, are VAT revenues that the Government receives and then pays out again. Most of the capital goods used in the mining sector are imported, and the Government will be collecting VAT at the full rate on them when they come into Zambia. Only if there is fraud in the system – companies recording domestic sales as exports to avoiding paying VAT or over-recording the cost of inputs to boost VAT refunds – would there be a net loss of revenue.

21. **It is also important to understand that VAT refunds are not a problem unique to Zambia.** As far back as 2005, the IMF published a report on VAT refunds that described them as the 'Achilles Heel' of VAT systems. This report's description of how delays in paying refunds, especially in low- and middle-income countries, could be the result of a high level of fraudulent claims and pressure on the public finances reads like a clairvoyant forecast of what has happened in Zambia.[6]

Solutions to the refund problem

22. **Solutions to the refund problem, unless they are directed at the reduction of fraud, are not principally concerned with increasing revenue.** Instead, they are designed to either reduce or eliminate the need for refunds or to

6 Graham Harrison and Russell Krelov (2005) *VAT refunds: a review of country experience*, Working Paper WP/05/218, https://www.imf.org/en/Publications/WP/Issues/2016/12/31/VAT-Refunds-A-Review-of-Country-Experience-18646

improve the administration of them. It would be helpful, therefore, to correct the popularly-held view that the mining sector in Zambia typically uses refunds to avoid paying its fair share of tax. The appropriate level of taxation for the sector is a separate question, but, if it is agreed that it should be higher, other means of increasing revenues should be used, rather than changes to the VAT system. Similarly, refunds should not be described as lost revenues. And the focus, in projections of the public finances for example, should be on net, rather than gross, VAT receipts.

23. **From this follows the first suggestion for solving the refund problem.** This involves the Government forecasting the level of refunds in the future and diverting a matching amount of VAT revenues into a special account from which refunds are made. As far as we are aware, this already happens and by law there is a requirement to set aside refunds into that special account. Thus, for example, if a mining company imports a piece of equipment and pays a certain amount of VAT on it, then the Government should set this money aside into the separate account in anticipation of the mining company claiming a refund. In practice, of course, the Government would be forecasting refunds, rather than knowing about them in advance. But, as long as its forecasts were reasonably accurate, such an approach would automatically vastly reduce the refund problem. It would also require the Government to use net VAT revenues in its tax and spending plans.

24. **However, while this approach is sound in principle, it will only work in practice if the Government has discipline.** The Government needs to have the discipline not to raid the 'refund account' or to delay the processing of refunds so that they are held in the account for a long time and still effectively being used to finance its spending. This discipline may not be present in Zambia, so other solutions that reduce or eliminate the need for refunds in the first place are worth considering.

25. **One suggestion is to allow firms to offset their VAT refunds against other (i.e. non-VAT) tax liabilities.** Indeed, the Zambia Chamber of Mines has suggested this option. On the downside, this would still require refunds to be audited and it would also be complicated for the ZRA to administer, requiring different tax departments to collaborate. However, if the practice was limited to large mining companies, so minimising the administrative burden, it might be feasible.

26. **Instead, it is better to look at solutions that do not involve VAT being paid on mining companies' inputs, so that the question of a refund does not arise.** At one extreme would be a comprehensive system that exempted all supplies to exporters from VAT. However, under this system, domestic suppliers to exporters would now be able to claim refunds because they would still be paying VAT when they purchase from their own suppliers, but not charging it

when selling to an exporter. To an extent, the problem is simply shifted one step up the production chain. And the administration of the system would be far more complicated. Exporters tend to be large companies; their suppliers smaller. So, there will be more refunds to process. Suppliers to exporters would have to show that their products were being used to produce exports. This may be difficult when the firm they are selling to is producing goods for the domestic and export markets and using the same plant and equipment for both. As well as creating difficulties for honest firms, this would increase the scope for avoidance and evasion.

27. **A better idea, which avoids most of these administrative problems, would be to exempt from VAT only the capital goods imports of the mining companies.** Normally, economists would be reluctant to propose a system that treated imports more favourably than domestically-produced goods, because it would create a bias in favour of imports. However, Zambia has very little domestic capacity to produce the type of capital goods imported by the mining companies so the problem of favouring domestically-produced goods is not really a consideration. The problem of refunds being pushed up the supply chain in Zambia is avoided because only imports are taken into account.

28. **It is our understanding that the vast bulk of VAT refunds are paid to the mining companies**. And a large proportion of these refunds are for VAT paid on the capital goods they import. The relatively simple step of exempting these goods from VAT at the point of entry into Zambia would, therefore, go a long way to eliminating the refund problem in the future.

29. **The ZRA has a VAT deferment scheme which is used by mining companies importing capital goods.** To normalize VAT administration, capital items should not be on a VAT deferment scheme but on a permanent list of VAT ineligible items (or a permanent VAT exemption list) based on value-added transformation criteria based on the Rules of Origin approach used in international trade. Under the Rules of Origin approach, only items that are, by definition, inputs or intermediate goods into the production process should be eligible for VAT and thus VAT refunds. The responsibility would therefore be on the importer or buyer of a local input to show certified proof that they have sufficiently transformed an input in order to get a refund. So for example, if firms A and B import flour (or buy domestic flour) and Firm A sufficiently transforms the flour into a cake or bread, it gets a refund upon certification by ZRA; and if, on the other hand, Firm B, packages the same flour into new packets for sale in a retail outlet, implying insufficient transformation, then Firm B cannot claim any VAT because it did not add value. In the same way, a tractor or excavator that is not transformed in production of copper cannot attract VAT. But copper concentrate from DRC can be "VAT-able" if the mine house can prove sufficient transformation into copper sheets.

The revenue loss problem

30. **Zero and reduced rates of VAT are applied to 'essential' goods and services in many countries though definitions of 'essential' vary.** This makes VAT progressive, because poorer families spend proportionately more on these items. However, zero-rating adds complexity to the system and distorts spending patterns; and critics have argued that it is not a good way to target the rich and the poor.[7] Other taxes and benefits can be used to target both groups more directly. However, such moves have their own problems. Increases in means-tested benefits, for example, are likely to reduce incentives to work. They are also more attractive to high-income countries with well-developed public services and benefit systems, than for countries like Zambia where there are fewer, less effective, levers to pull.

31. **Zambia collects less revenue from VAT than it might because many goods and services are exempt.** This is testimony to the success of lobbying efforts on behalf of various industries. As earlier mentioned, the IMF estimated that Zambia's VAT C-efficiency was just 28% in 2015. This compared to a SADC average of 45%. These exemptions include 'kerosene, health, education, rental income, water, transport, some financial services, life insurance, food and agriculture'. In addition, books, medicines and medical equipment are zero-rated.[8]

32. **VAT systems are, by their nature, less prone to non-compliance than Sales Tax systems.** This is because VAT is collected in stages throughout the production process with firms paying VAT on their sales and claiming back VAT on their purchases. This provides an automatic check. When Firm A claims back the VAT it paid on a purchase from Firm B, it should be claiming the same amount that Firm B says was paid. Sales tax regimes do not have this check and for this reason experts recommend that countries where tax evasion may be relatively high and/or administration might be relatively weak, VAT is to be strongly preferred over a Sales Tax.

33. **In practice, though, all VAT regimes suffer from some non-compliance, due to a mixture of fraud (under-recording sales and over-recording purchases) and error.** In particular, the automatic check in VAT systems can break down at the final stage when a good or service is sold to a consumer, the so-called 'last mile' problem. If the consumer does not demand a receipt, there is no record of the transaction. This can lead to evasion. Unscrupulous retailers might even

7 Laura Abramovsky, David Phillips and Ross Warwick (2012) *Redistribution, efficiency and the design of VAT: a review of the theory and literature*, IFS Briefing Note BN212, https://www.ifs.org.uk/uploads/publications/bns/BN212.pdf

8 International Monetary Fund (2017), *Zambia: Selected Issues*, Country Report No. 17/328, https://www.imf.org/en/Publications/CR/Issues/2017/10/25/Zambia-Selected-Issues-45359

offer consumers a discount (that is smaller than the potential VAT bill) to not request for a receipt. And very unscrupulous retailers might even collude with their suppliers to push non-compliance up the supply chain.

Solutions to the revenue loss problem

34. **Generally speaking, economists favour VAT systems that have as broad a base as possible and as low a rate as possible**. Broadening the base means there is less scope for the misclassification of trades, whether accidental or deliberate. It also reduces the need for refunds. Meanwhile, lowering the rate means less tax is due as a result of any individual transaction, so reducing the incentive to fraud.

35. **It follows that, particularly in a country like Zambia where there are many exemptions, one of the most efficient and straightforward ways to increase revenues is to apply VAT to more goods and services**. In a paper on domestic resource mobilisation, we have simulated, using our in-house "MicroZAMOD" tax-benefit microsimulation model, the removal of output VAT exemptions on disconnection and reconnection fees resulting from the non-payment of water and sewerage bills; the buying and selling of foreign currency; the sale of dwelling houses to be used for commercial purposes; telephone and telefax services; and religion. Using 2017 tax data, we found that at least K1.2 billion additional VAT revenues would have been raised in that year.[9]

36. **But reducing the number of goods and services that are exempt from VAT would, in isolation, push up prices and the inflation rate.** If there was no offsetting increase in wages, then living standards would be hit; but if wages do increase by more than they would otherwise have done, there is a risk that higher inflation becomes stuck in the system. These are important considerations. On the other hand, it is now widely accepted that Zambia has a serious fiscal problem and that tough steps are needed to reduce the deficit and put government debt onto a sustainable path. Cutting back on VAT exemptions may be a better way to tackle the deficit than other options – or something to be considered as part of a package of different measures - if the Government is prepared to take on the various industries and lobbyists that demand exemptions.

37. **Improving administrative systems can have a significant effect on VAT revenues**. In Zambia, VAT collections in 2016 were K8.0 billion, or 2.7% of GDP. This increased to K13.9 billion (5.6% of GDP) in 2017 and K17.4 billion (6.2% of GDP) in 2018. This was the result of modernisation and automation strategies adopted in 2017. These included enhancement of IT solutions, particularly the use

9 ZIPAR (2019), *Looking within: the promise of public revenue mobilisation*

of electronic fiscal devices for VAT-registered suppliers to monitor transactions in real-time; the appointment of withholding agents and the introduction of external forensic audits before the disbursement of refunds.

38. **The ZRA should be given the resources to do more, focusing its efforts on firms where the risk of fraud is relatively high.** These are likely to be newly-registered firms, which may have been set up as part of a fraud or may honestly struggle with compliance; and unlisted and smaller firms (because listed and larger firms are more likely to be more concerned about the reputational risk of being caught acting fraudulently. Other countries have had similar successes. Requiring retailers to use Electronic Fiscal Devices (EFDs) makes tampering with receipts harder and their roll-out in Rwanda led to an increase in VAT compliance.

39. **A report published by the International Growth Centre (IGC) in 2018 contains a number of ideas for tackling the problem of VAT fraud.**[10] It argues, for example, that technology is allowing better monitoring of business-to-business (B2B) transactions. Countries such as Uganda require business taxpayers to file their VAT returns electronically – this is also the case in Zambia for VAT returns. This makes it easier to cross-check the reports of buyers and sellers. In Brazil, electronic invoices are sent in real-time to the tax authorities.

40. **It is likely that further technological advances in the future will offer more solutions to tax authorities looking to improve the recording of transactions.** And as the vast majority of countries have VAT, rather than Sales Tax systems, it is more likely that Zambia will find solutions to its VAT collection problem than it would to any revenues problems with a Sales Tax.

41. **While awaiting such solutions, tax authorities have been looking at ways to encourage and incentivise consumers to ask for receipts.** Encouragement often comes in the form of an appeal to social duty – highlighting the benefits of paying tax for better public services. While there is little evidence to suggest that such an approach is highly effective, there could be a role for a concerted information campaign that pushed for consumers to help enforce VAT, as part of any effort to boost VAT revenues in Zambia.

42. **Generally speaking, incentives may be more effective than encouragement, though the IGC report says that experience has been mixed.** It does, however, highlight the apparently successful case of the state of Sao Paulo in Brazil. Consumers were given the opportunity to record their tax payer identification number on receipts which the retailer was required to send to the tax authorities. Consumers who did so were then entered into a lottery and earned tax rebates. They were also encouraged to report retailers who would not participate in the

10 Francois Gerard and Joana Naritomi (2018) Value Added Tax in developing countries: Lessons from recent research, IGC growth brief, https://www.theigc.org/wp-content/uploads/2018/06/IGCJ6046-VAT-Tax-180521_WEB.pdf

scheme. Millions of consumers participated; tax revenues increased; and non-compliance was reduced.[11]

43. **At the same time, efforts should be made to tackle frauds related to refunds.** According to the IMF report cited earlier, the most prevalent frauds related to refunds are inflated refund claims, underreported sales, fictitious traders and domestic sales being disguised as exports.[12] To the extent that these are a problem in Zambia, they can only be tackled by a determined effort on the part of the ZRA, which needs the resources and technology to do so. Unfortunately, it is sometimes necessary to bear higher administration costs to boost tax revenues.

44. **Now will be a good time to review the ZRA modernisation and automation initiatives.** Given the funding that has gone into the ZRA modernisation and automation initiatives over the years, it will be important to review progress and gauge the value-for-money of this exercise. This is particularly given that, during this period, the administration inefficiencies in VAT have become so deep, resulting in an attempt to abandon VAT altogether and shift to Sales Tax.

45. **Zambia is far from unique in having compliance problems with VAT.** However, other countries are developing approaches that lead to increased compliance and boost revenues. If Zambia retains the VAT system, there are, and will be in the future, plenty of opportunities for Zambia to learn from these experiences and to adapt the most successful solutions to its particular circumstances.

CONCLUSION

46. **If the VAT system is to be made to work in Zambia, the priority is to eliminate, as far as possible, the refund problem.** Because refunds are concentrated in the mining sector and arise largely because of VAT paid on imports (of capital goods) by large mining companies, it should be relatively simple to make these goods exempt. If no VAT is paid on them in the future, then there will be no refunds.

47. **Once this change has been made, efforts could focus on increasing VAT revenues as part of the steps needed to reduce the Government's persistently high fiscal deficit.** The success of the changes to VAT regulations made in 2017 in increasing revenues shows what could be achieved. In addition,

11 Francois Gerard and Joana Naritomi (2018) Value Added Tax in developing countries: Lessons from recent research, IGC growth brief, https://www.theigc.org/wp-content/uploads/2018/06/IGCJ6046-VAT-Tax-180521_WEB.pdf

12 Graham Harrison and Russell Krelov (2005) *VAT refunds: a review of country experience*, Working Paper WP/05/218, https://www.imf.org/en/Publications/WP/Issues/2016/12/31/VAT-Refunds-A-Review-of-Country-Experience-18646

revenues could be enhanced even further if the Government was prepared to reduce the number of goods and services that are currently exempt from VAT.

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