



REFLECTIONS ON THE SALES TAX

Matters to consider in implementing the Sales Tax



MAY 14, 2019

SUBMITTED TO THE BUDGET COMMITTEE AND COMMITTEE ON ECONOMIC AFFAIRS, TRADE AND
LABOUR MATTERS

BY THE ZAMBIA INSTITUTE FOR POLICY ANALYSIS AND RESEARCH (ZIPAR)

1 Overview

This memorandum is in response to the request made by the Budget Committee and Committee on Economic Affairs, Trade and Labour Matters to the Zambia Institute for Policy Analysis and Research (ZIPAR). The report provides a review of the Sales Tax Bill of 2019. The introduction of the Sales Tax has been necessitated by the need to improve domestic resource mobilisation and curb the accumulation of VAT refunds. Refunds accumulated to as high as K17.9 billion in January 2019, despite administrative strategies introduced in 2017 that contributed to the improvement of VAT and helped make it a better performing tax.

The proposed solution is the reintroduction of Sales Tax. Using the 2010 Supply and Use and Input-Output Tables, we estimate that, in 2019, about K21.2 billion or 7.1% of the 2019 GDP will be raised from this tax. This is K6.3 billion higher than the projected VAT/Sales Tax collections in the 2019 Budget. Additionally, Sales Tax is expected to discontinue the accumulation of refunds as the refund mechanism will be removed. This may solve the refund problem and is likely to increase revenue collections in the short term. However, our research demonstrates that the current design of the Sales Tax will lead to several economic consequential effects, under this period of economic slowdown that will particularly arise from the following:

- a) The repeated taxing at each link in the production chain will result in punitively high effective tax rates of about 23% - up from 13% under VAT, due to the “tax-on-tax”/cascading effect which will increase the cost of goods and services for producers and Zambians;
- b) To mitigate the cascading effect, producers may change their production decisions and/or reduce the size of the supply chain (vertical integration);
- c) Authorities have come up with numerous deductions and exemptions to industries with high levels of cascading. This is likely to increase the complexity of the tax, effectively abandoning its purported simplicity which could distort production markets;
- d) The proposed differentiated rates of Sales Tax contravene the World Trade Organisations (WTO)’s principle of National Treatment 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;
- e) Unlike the VAT, the new regime lacks a self-enforcing compliance mechanism. This is likely to further exacerbate the challenges associated with compliance.

The Sales Tax therefore poses the following risks:

- *Constrained economic growth:* The Sales Tax will raise the cost of doing business, damaging Zambia’s competitiveness and business environment. The country is currently grappling with low growth. In a ministerial statement issued in early May, the Minister of Finance reported a downward revision in growth for 2019 from 4% to below 3%. Further, a recent International Monetary Fund (IMF) Article IV mission projected a slowdown in growth from 3.7% in 2018 to 2.3% in 2019. Therefore, the private sector is needed to prop up the economy given the Government’s financial constraints. Without which, there will likely be job losses and/or reduced job creation due to lower investment. Further, Small and Medium Enterprises (SME’s) which constitute about 80% of Zambia’s private sector and employ 76% of the labour force, will be hard hit. The direct impact will be from loss of business induced by higher business costs, particularly, from large companies in sectors such as Manufacturing and Mining which can easily substitute from domestic purchases to imports, or vertically integrate their production chains and therefore reduce the use of smaller intermediary firms. Subsequently, these changes in production decisions could constrain economic growth.
- *Reduced revenues and job growth:* The high effective Sales Tax rate is likely to erode the tax base, and create incentives for tax avoidance/evasion. Furthermore, if not well implemented, evasion may be rife affecting revenues negatively. Indirectly, subdued economic growth is likely to lead to job losses which will negatively impact the personal income tax base.

- *Consumers will face higher prices:* The high effective Sales Tax rates will make producers pass on a proportion of their higher business costs to consumers by increasing prices. This will lead to higher costs of living for Zambians who are already experiencing elevated consumer costs due to the depreciation of the Kwacha and inflationary pass-through effects. If compounded with job losses, then consumer spending, and thus welfare, will fall.

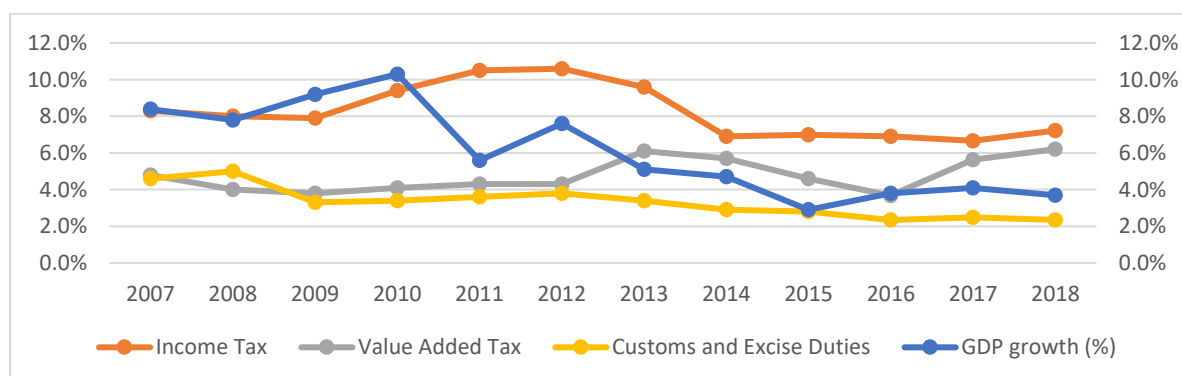
We therefore make the following recommendations to deal with the above observed consequences.

- To mitigate the risk of cascading and keep production costs lower, the Government should change the base on which the Sales Tax is charged from the selling price to the value added at each level;
- The risk of international trade disputes can be alleviated if the Government implements a single lower rate of tax. For instance, maintaining 9% both for imports and local sales;
- The risk of distorting business structures can be mitigated through an all-encompassing Sales Tax exemption regime on all critical inputs. Further, the Government should consider reducing or completely removing the final sale (output) exemptions. This is in line with international principles and best practice and will help reduce revenue leakages; and
- To further reduce business distortions, the Government should critically think about the transition period especially for businesses who will be included into the Sales Tax regime for the first time, i.e. those whose annual turnover is between K500,000 and K800,00.

2 Sources of the VAT refund problem

Until 2017, the performance of Zambia’s Value Added Tax (VAT) was poor. Despite strong economic growth registered at an average of 6.1% of GDP during 2007-2018, VAT did not grow in tandem with economic growth, contrary to expectations. The VAT system was dogged by low tax yields particularly on domestic VAT and poor administration of the tax which resulted in the authorities’ inability to pay-out refunds. Figure 1.1 shows the trends in the various tax types.

Figure 2.1: Zambia’s VAT Performance as a percentage of GDP, 2007-2018



2.1 Low, but improving, VAT yields

Though Zambia’s VAT rate of 16% is higher than the rate for Botswana (12%), Lesotho (14%), Seychelles (15%), and South Africa (14%), VAT’s contribution as a share of GDP in 2015 in comparison to the said countries, remained much lower as shown in Table 2-1.

The IMF (2017) estimated that in 2015, Zambia had a relative low VAT Collection (C)-efficiency ratio (defined as the actual VAT collections as a share of its potential base). Estimated at 0.28, Zambia fared poorly compared to the average of 0.45 for SADC members. Zambia only collected 28% of what it could have potentially collected from VAT in 2015, when its counterparts were close to 50%.

Table 2-1: Revenue Levels for SADC Countries, as a percentage of GDP, 2015

	Total Revenue	Tax Revenue	Taxes on goods & Services	Income Tax	Taxes on International trade
Zambia	18.8	14.4	6.3	7.0	1.1
Angola	27.3	14.4	1.4	21.0	1.1
Botswana	32.5	24.7	3.8	8.3	10.8
Congo DR	15.9	23.2	4.1	3.2	2.0
Lesotho	51.7	44.0	9.3	12.1	0.8
Madagascar	11.8	10.1	2.5	2.5	5.1
Malawi	21.9	16.2	6.3	8.3	1.5
Mauritius	21.9	19.4	11.6	5.7	0.3
Mozambique	28.0	21.0	9.1	9.0	2.1
Namibia	35.2	33.0	8.1	12.8	12.0
Seychelles	34.7	30.7	15.3	10.1	18.8
South Africa	29.6	24.8	9.1	14.8	0.1
Swaziland	29.2	27.8	6.3	7.6	13.8
Zimbabwe	27.5	26.4	11.8	8.7	2.8
Average SADC	27.6	23.2	7.5	9.4	4.0
Median SADC	27.8	24.0	7.2	8.5	1.9

Source: World Economic Outlook

The low yields from VAT were attributed to low compliance, evasion and the many exemptions on output VAT that served to narrow the tax base (e.g. on kerosene, health, education, rental income, water, transport, some financial services, life insurance, food and agriculture). Further, books, medicines and medical equipment are zero-rated. Under international best practice and modern VAT regimes, zero-rating is mostly limited to exports. The IMF further estimated that if current exemptions were kept, Zambia would need to increase its VAT tax rate to 25% to reach SADC's VAT collections levels (IMF, 2017).

ZIPAR used the MicroZAMOD¹ to simulate 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, the model found that at the minimum, an additional K1.2 billion would have been raised in VAT in that year, if these output exemptions were removed (ZIPAR, 2019).

VAT collections have been on the increase in the last two years. In 2016, VAT collections stood at K8.0 billion or 3.7% of GDP, missing the projected target of K9.9 billion. Nonetheless, VAT collections improved to 5.6% of GDP in 2017 (K13.9 billion) and 6.2% of GDP in 2018 (K17.4 billion). This was, in part, due to modernisation and automation strategies adopted in 2017. The strategies included enhancement of information technology solutions, particularly the use of electronic fiscal devices for VAT registered suppliers to monitor transactions in real-time. Other measures were the appointment of withholding agents and the introduction of audits before disbursement of refunds which were enhanced by external forensic audits and use of refund analytics.

2.2 Poor tax administration and slow pay-out of VAT refunds

A lack of strict adherence to the provisions in the law on refunds resulted into the accumulation of VAT refunds. The VAT refund challenge also arose from a number of systemic and endemic administrative problems. These included fraud, false documentation, double claims of refunds and unaccounted for offsets which led to the rise in the VAT refund amounts. The Government's inability to pay off the refunds in a timely manner led to cash flow inconveniences for the business community.

¹ The MicroZAMOD is a tax-benefit microsimulation model developed by ZIPAR in conjunction with SASPRI, UNU-WIDER and the University of Essex. The 2015 Living Conditions Monitoring Survey (LCMS) data is the underlying database and simulations can only be done on micro-units.

While strategies to strengthen VAT administration and thus collections led to increased VAT collections and supposedly made VAT the best performing tax in 2017 and 2018, they did little to resolve the VAT refund issue. VAT refunds rose to K17.9 billion in January 2019 – an amount almost equal to the K17.4 billion collected in VAT in 2018. This entails that if the refunds were all paid out, VAT in 2018 would have actually been negative. Delayed audits led to large accumulations of VAT arrears such that it has become unsustainable to pay off the refunds. Therefore, to curtail further accumulation of refunds, a different form of consumption tax – Sales Tax - has been proposed and is to be implemented starting in the second half of 2019.

3 Can Sales Tax be the answer?

While the soon-to-be-introduced Sales Tax may be seen as the solution to the problem of VAT refunds, and may increase revenues in the short term, it may not address the low yields from the consumption tax, especially that the issue of numerous exemptions has not been dealt with decisively. Sales Tax will introduce some unintentional problems that arise from the design of the tax. The issues that require consideration before implementation of the tax include: the multiple taxation points amidst the removal of the input-output mechanism which will lead to tax cascading, the introduction of two different tax rates on imports and domestic supplies, and the exemption regime.

Without due consideration of these matters, a poorly designed and implemented Sales Tax may not deliver the higher anticipated revenues due to erosion of the tax base, especially if businesses close down and/or the economy faces heightened non-compliance as tax payers devise ways to evade the new tax.

The rest of this section discusses these issues.

3.1 Multiple taxation points

According to the Sales Tax Bill, Sales Tax is to be charged on manufacturers, producers, distributors, wholesalers and retailers as well as on importers of goods into the country. It is also to be imposed on services supplied from within and imported into the country. By implication, this means that Zambia will now adopt a non-refundable, multi-stage Sales Tax, across all businesses. The multiple-stage taxation adopts similar taxation points as in the VAT. This is good in the sense that the Sales Tax maintains some aspects of the in-built control mechanism embedded in the VAT and thus may work to counter evasion.

Under a multi-stage Sales Tax, and in contrast to the VAT, Sales Tax will not be charged on the values added to the business activities like the input-output credit mechanism used in the VAT – i.e., collection of tax at all points after allowing credit for the inputs – because this will be removed. In the current VAT system, VAT is collected at input stage and on final output. Registered suppliers would at the time of paying tax on output, reduce their tax liability by deducting the amount already paid on inputs in line with the principle of the input credit mechanism. But this will no longer be the case in the Sales Tax system. So, while VAT is only levied on total value added in the production-distribution chain, the Sales Tax will be charged on the full production costs or selling price of registered businesses in the value chain.

With Sales Tax applied on final prices at all stages, every item that changes hands between companies will be taxed, regardless of whether it is a raw material or final product with no consideration for inputs. 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 the early stages of production will be taxed repeatedly in subsequent stages. This phenomenon is called “tax pyramiding” or “tax cascading” or simply “tax on tax”. This repeated taxing at each link in the production chain results in punitively high effective tax rates on complex products produced in stages by more than one company.

This will increase the production costs of registered businesses since the input tax they pay to their suppliers will no longer be offset. Rational actors will naturally pass on the Sales Tax cost to buyers of their goods and

services, who in turn will pass on the added cost to the next players in the value chain until the cost is finally passed on to the final consumer.

The issue of cascading will further be exacerbated by the introduction of an additional higher Sales Tax rate on imports. With the VAT, the claim of the credit input VAT essentially meant that all inputs were not VAT chargeable. But in the Sales Tax, if some inputs will be imported using the higher Sales Tax rate, the manufacturer will then bear the burden of taxes from the point of entry and will then pass on the costs to the retailer and finally to the consumer. The direct and immediate impact of the Sales Tax will be a higher new effective tax rate on goods and services. This may worsen transfer pricing, introduce value shifting as well as have inflationary effects.

3.1.1 Investigating the Cascading Effect of Sales Tax

We employ the **2010 Supply, Use and Input-Output tables** (CSO, 2017) which is a form of macroeconomic analysis that describes the structure of the economy and the interdependencies between economic sectors or industries. It is commonly used for estimating the impacts of positive or negative economic shocks and analysing the ripple effects throughout the economy. The illustration assumes 16% Sales Tax on imports and 9% Sales Tax on domestic products and assumed to be fully passed forward onto buyers at subsequent stages of production. As products pass from one company to the next, and as they move through production stages, we assume the full value of each business-to-business sale will be taxed as illustrated in Figure 3.1.

Figure 3.1: The various stages of production

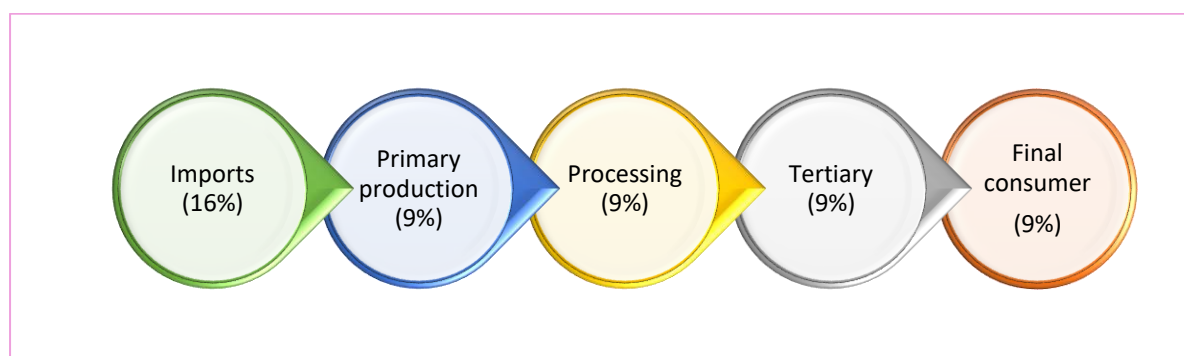


Table 3.1 provides an illustration of how cascading effects will affect the economy. If the Sales Tax were to be collected in a “perfect” economy, i.e. a tax system without exemptions on imports or domestic products, no zero-rating, and assuming full compliance, etc., the tax would amount to K53.5 billion, an amount almost equivalent to the whole 2019 domestic revenue target of K56 billion. To take into consideration the existing system of exemptions, zero ratings and all the frailties of the current collection system, we adjust the ideal Sales Tax to be collected by a three-year average of the industry share of tax revenues to GDP.

Adjusting for the afore-mentioned real-life situations, the Sales Tax is expected to raise about K21.2 billion or 7.1% of 2019 GDP. This is K6.3 billion higher than the projected VAT/Sales Tax collections of K14.9 billion for 2019.

However, these revenues come at a cost to the economy. The repeated taxation of input costs plus values added at each stage results into an economy-wide effective tax rate of 23%, which is about two-and-half times the statutory domestic rate of 9%. In the different sectors, the effective tax rates vary from 16% for real estate activities and 29% for manufacturing, to 30% for mining and 30% for professional, scientific and technical activities. Generally, the primary industries are expected to have an average effective tax rate of 25%, while the secondary industries will average 24%. The tertiary (services) sector is expected to have an effective tax rate of 21%.

Table 3.1: Illustrating economy-wide effects of cascading using Input-Output Analysis, Zambia (in billions of Kwacha)

	Imports		Primary Producer				Secondary Producer (Processing)					Tertiary input				Final consumer				2019		2019	
	Cost of business inputs (imports)	Sales Tax (16%)	Cost of business inputs (domestic)	Value added	Sales value to next prod. stage	Sales Tax (9%)	Cost of business inputs	Value added	Sales value to next prod. stage	Sales Tax (9%)	Cost of business inputs	Value added	Sales value to next prod. stage	Sales Tax (9%)	Cost of business inputs	Value added	Final sales value	Sales Tax (9%)	Total Sales Tax	Effective tax rate, Sales Tax	Overall tax/GDP ratio 2015-2017	Adjusted total Sales Tax	Share (%)
Agriculture, forestry and fishing product	0.08	0.01	1.64	3.50	5.23	0.47	5.70	17.32	23.02	2.07	25.10	2.29	27.38	2.46	29.85	12.74	42.59	3.83	8.9	21%	5%	0.4	2%
Agriculture, forestry and fishing product (green)	0.02	0.00	1.44	-0.13	1.33	0.12	1.45	-0.45	1.00	0.09	1.09	-0.01	1.08	0.10	1.18	0.68	1.86	0.17	0.5	26%	5%	0.0	0%
Mining and quarrying	12.95	2.07	4.29	29.25	48.56	4.37	52.93	38.87	91.80	8.26	100.06	0.36	100.42	9.04	109.46	6.14	115.60	10.40	34.1	30%	30%	10.2	48%
Manufactured product	11.09	1.77	3.98	5.44	22.29	2.01	24.29	9.40	33.69	3.03	36.73	11.57	48.30	4.35	52.64	3.15	55.80	5.02	16.2	29%	14%	2.2	10%
Manufacturing products (green)	0.34	0.05	4.46	-1.08	3.78	0.34	4.12	-2.61	1.51	0.14	1.65	-1.82	-0.17	-0.02	-0.19	7.00	6.81	0.61	1.1	17%	14%	0.2	1%
Electricity, gas, steam and air conditioning supply	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.16	0.16	0.01	0.18	0.00	0.18	0.02	0.19	0.12	0.31	0.03	0.1	19%	23%	0.0	0%
Electricity, gas, steam and air conditioning supply (green)	0.00	0.00	4.33	5.22	9.55	0.86	10.41	1.99	12.40	1.12	13.52	0.83	14.35	1.29	15.65	0.67	16.31	1.47	4.7	29%	23%	1.1	5%
Water supply; sewerage, waste management and remediation activities	0.00	0.00	1.17	-0.62	0.55	0.05	0.60	-0.26	0.34	0.03	0.38	-0.28	0.09	0.01	0.10	0.26	0.37	0.03	0.1	33%	10%	0.0	0%
Construction work	0.76	0.12	1.85	7.88	10.61	0.95	11.56	4.90	16.46	1.48	17.95	30.33	48.28	4.35	52.63	0.51	53.14	4.78	11.7	22%	3%	0.3	2%
Wholesale and retail trade; repair of motor vehicles and motorcycles	0.86	0.14	3.18	17.96	22.14	1.99	24.14	27.20	51.34	4.62	55.96	18.19	74.15	6.67	80.82	44.46	125.28	11.28	24.7	20%	10%	2.4	11%
Transportation and storage services	0.39	0.06	3.02	6.09	9.56	0.86	10.42	7.11	17.53	1.58	19.11	8.52	27.63	2.49	30.12	6.50	36.62	3.30	8.3	23%	5%	0.4	2%
Accommodation and food services	0.50	0.08	0.51	1.32	2.42	0.22	2.64	1.51	4.15	0.37	4.52	1.90	6.42	0.58	7.00	0.77	7.77	0.70	1.9	25%	7%	0.1	1%
Accommodation and food service services (green)	0.00	0.00	0.22	0.67	0.89	0.08	0.97	0.54	1.51	0.14	1.64	0.69	2.33	0.21	2.55	0.49	3.04	0.27	0.7	23%	7%	0.1	0%
Information and communication services	0.16	0.03	0.91	1.66	2.76	0.25	3.00	1.67	4.68	0.42	5.10	7.63	12.72	1.15	13.87	8.20	22.07	1.99	3.8	17%	31%	1.2	6%
Financial and insurance services	0.02	0.00	1.96	0.60	2.59	0.23	2.82	1.30	4.12	0.37	4.49	1.74	6.23	0.56	6.79	2.88	9.67	0.87	2.0	21%	30%	0.6	3%
Real estate services	0.03	0.00	0.82	1.24	2.09	0.19	2.28	2.39	4.67	0.42	5.10	9.98	15.07	1.36	16.43	13.51	29.94	2.69	4.7	16%	1%	0.1	0%
Professional, scientific and technical services	0.11	0.02	3.54	-0.60	3.07	0.28	3.35	-0.32	3.03	0.27	3.30	-0.88	2.43	0.22	2.65	1.09	3.74	0.34	1.1	30%	30%	0.3	2%
Administrative and support service	0.21	0.03	7.86	-4.43	3.67	0.33	4.00	-1.04	2.97	0.27	3.23	-0.77	2.46	0.22	2.68	0.68	3.36	0.30	1.2	34%	65%	0.7	4%
Public administration and defense; compulsory social security	0.06	0.01	0.00	0.00	0.07	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.0		19%	0.0	0%
Education	0.00	0.00	1.14	5.73	6.87	0.62	7.48	7.46	14.94	1.34	16.29	8.56	24.85	2.24	27.08	15.12	42.20	3.80	8.0	19%	5%	0.4	2%
Human health and social work services	0.00	0.00	0.38	2.09	2.47	0.22	2.69	1.64	4.33	0.39	4.72	2.52	7.25	0.65	7.90	4.58	12.48	1.12	2.4	19%	4%	0.1	0%
Arts, entertainment and recreation	0.03	0.00	0.00	0.00	0.03	0.00	0.03	0.65	0.68	0.06	0.74	0.47	1.22	0.11	1.33	1.00	2.33	0.21	0.4	17%	10%	0.0	0%
Other services	0.03	0.01	0.00	0.00	0.04	0.00	0.04	0.25	0.30	0.03	0.32	2.06	2.38	0.21	0.00	0.00	0.00	0.26	0.5	18%	78%	0.4	2%
Gross Value Added at basic prices	27.66	4.42	46.70	81.78	160.56	14.44	174.93	119.71	294.64	26.52	321.16	103.90	425.05	38.25	463.31	130.86	594.17	53.48	137.1	23%	13%	21.2	100%

To illustrate why the effective tax rates are high, let us consider firms in Agriculture, for instance, whose effective tax rate is estimated at 21%. They absorb outputs from many sectors as inputs required in their production process, such as fertilisers, pesticides, machinery, fuel, electricity and they will be required to pay taxes on these products unless the products are exempt. Similarly, the outputs from agriculture provide inputs for many industries such as grain millers, sugar producers, etc. and different services such as trade, transport and communication, banking and insurance, hotels and restaurants, will also face the Sales Tax. Given the many VAT tax concessions and high informality of the sector, Table 3.1 shows that Agriculture's contribution to taxes remained relatively low at 5% over 2015 to 2017. This is likely to continue with Sales Tax if the same exemption regime is adopted.

Table 3.1 also shows that about K12.9 billion of the Mining industry's input costs are imported, but input costs incurred at final (K109 billion), tertiary (100 billion) and secondary levels (K52 billion) are even higher. Because, the cascading effect will result in a tax burden of 30%, some large firms especially, may choose to change their production structures. The mines may vertically integrate their production chains and increase their direct importation from source, to substitute some of their domestic purchases. This will adversely impact smaller intermediary firms who are likely to lose the lucrative business of supplying to the mines. Since most, if not all, of the mines' VAT payments resulted into refunds, to curb refunds, it would have been prudent to exempt mining inputs from VAT instead of requesting them to pay input VAT against zero-rated outputs. Adopting a similar strategy in Sales Tax will help reduce the mines production costs.

Manufacturing, the one sector mostly associated with value addition, has been dwarfed in the size of value added by Wholesale and Retail and Construction sectors. However, the Wholesale and Retail trade industry as well as the Construction sector are highly informal and do not generate as much tax revenue as they potentially should. The average tax to their generated GDP stood at 10% and 3% for Wholesale and Retail Trade and Construction, respectively, between 2015 and 2017. Without much enforcement, informality in these sectors will continue even in the Sales Tax era. However, it is hoped that companies in these sectors will be covered by the lower Sales Tax threshold of K500,000 and increase their contribution to GDP given that their effective tax rates will be much lower.

To boost growth in the Manufacturing sector, it will be important to support the agro-processing (food and beverages) subsector and secondary processing of metals, including refining and smelting of copper. These two sub-industries collectively account for about 60% of the total output in the sector. These industries depend strongly on inputs from agriculture and the mining and quarrying sectors. They also require electricity, financial and transport services. The output from these industries are disposed of in construction, wholesale and retail trade, real estate and business services. For Manufacturing and other sectors, the input exemption regime will be an extremely cardinal consideration to boost private-sector-led growth. If all critical inputs will not be exempt, the proposed Sales Tax may further increase the sector's already high production costs.

3.1.1 Differentiated tax rates can result in international disputes

Section 10 of the Sales Tax Bill prescribes two differentiated tax rates with 9% adopted on locally produced products while 16% is to be charged on imported finished products. Notwithstanding this commendable action aimed at protecting locally produced goods and services, the proposed rates contravene the World Trade Organisation (WTO)'s principle of National Treatment (World Trade Organisation, 1994) enshrined in the General Agreement on Tariffs and Trade (GATT), General Agreement on Trade in Services (GATS) (World Trade Organisation, 1994) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

National Treatment implies that imported and locally produced goods, services and intellectual property should be treated equally after the foreign goods have entered the domestic market. A point of contention has arisen regarding the definition of *National Treatment*. Zambia Revenue Authority (2019) contends that "National Treatment only applies once a product, service or item of intellectual property has entered the

market". Arguably, if the Sales Tax is being imposed on the imported goods at the point of entry or even before the goods are shipped, then this is before the goods have entered the Zambian market and therefore is not in violation of the National Treatment principle. But the definition of National Treatment cannot be interpreted casually and must be read in its entirety with other accompanying legal texts of the WTO, for it to be fully and accurately interpreted.

Under part II of the GATT, Article III National Treatment on Internal Taxation and Regulation, paragraph 1 states that member countries "recognise that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, should not be applied to imported or domestic products so as to afford protection to domestic production".

Paragraph 2 stipulates that imported goods "shall not be subject directly or indirectly to internal taxes or other internal charges in excess of those applied, directly or indirectly, to similar domestic products". And in paragraph 4, imported goods "shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use". These principles are also embedded in the GATS Article XVII on National Treatment and the TRIPS.

In addition to these paragraphs, the Interpretative Note of the GATT III categorically states that: "Any internal tax or other internal charge, or any law, regulation or requirement of the kind referred to in paragraph 1 which applies to an imported product and to the like domestic product and is collected or enforced in the case of the imported product at the time or point of importation, is nevertheless to be regarded as an internal tax or other internal charge, or a law, regulation or requirement of the kind referred to in paragraph 1, and is accordingly subject to the provisions of Article III".

This implies that the Sales Tax, an internal tax, applied to both imports and domestic goods and services, is subject to this principle irrespective of whether the tax is collected at the point of importation. The Sales Tax therefore stands to violate the principle of National Treatment because it will tax all 'like' imports of goods and services 7 percentage points in excess of locally produced goods and services to be consumed.

Notwithstanding Zambia's sovereign right to determine its internal taxes, the WTO rules on National Treatment seek to prevent countries from using internal taxes as a means of protecting locally produced goods and services. This is simply because internal taxes can have the same distortionary effects on trade as tariffs, quotas, subsidies and other regulations and thus have the potential to counter trade liberalisation efforts by discouraging imports. As a signatory to the WTO rules (including rules on national treatment), Zambia therefore cannot impose a higher Sales Tax on 'like' imported goods and services. The country has an obligation to conform to these principles or at best, risk having a dispute brought against the country and at worst, risk retaliation from other countries.

For example, in 1995, Canada, the European Communities and the US initiated a dispute against Japan regarding Japan's lower specific and *ad valorem* taxes on domestically produced spirits compared to imports. The WTO Dispute Settlement Body found Japan in violation of the WTO GATT Article on national treatment specifically, in violation of the use of internal taxes to offer protection to domestic production. Japan was subsequently required to amend its Liquor Tax Law to allow for the reduction in taxes on imported spirits and bring the law in conformity with the National Treatment principle under the GATT. Similarly, Indonesia was found in contravention of the national treatment principle in 1996 regarding its National Car Programme that granted Sales Tax exemptions or reductions to domestic companies producing luxury cars. Consequently, Indonesia was required to remove all the elements of its programme and associated taxation policy that were at variance with the WTO rules on National Treatment.

In the WTO Analytical Index of the GATT 1994 –Article III, a differentiated tax is considered discriminatory and an infringement of Article III: 2 if the effective tax burden imposed on imported products is higher than

the effective tax burden on domestic products. As shown under Section 3, the multiple taxation method on raw materials and other production processes increases the effective tax rates for both imports and domestically produced goods above 16% and 9%, respectively, subject to the length of the production-distribution-supply chain. Clearly, the effective tax burden is relatively higher in those sectors – Mining and Manufacturing - that import in larger quantities (Table 3.1).

3.1.2 Exemptions regime

The Ministry of Finance and the Zambia Revenue Authority are well aware of the tax cascading issue. To mitigate the cascading effect, the authorities have come up with numerous deductions and exemptions to industries with high levels of cascading. The Zambia Revenue Authority (2019) shows that exemptions will be provided on selected goods and services including:

- a) Capital goods as identified from the Customs Tariff Guide and selected items from the current VAT deferment schedule.
- b) Some supplies prescribed in the current VAT Zero rated schedule, for example, exports and supplies to privileged persons.
- c) Some supplies prescribed in the current VAT Exemption Order, for example, food, health services and educational services.
- d) Approved inputs (imports and locally supplied) for manufacturers/producers in all sectors except for service providers.

Exemption certificates will be provided to ensure that the Authority identifies exempt persons. Additionally, the Sales Tax exemption schedule shall be outside the principal Sales Tax Act in order to allow for a flexible amendment process.

The criteria adopted was motivated by a combination of factors such as: rationality surrounding the current items exempted so as not to depart from existing government policies and declarations which the Government is party to, priority sectors identified under the Seventh National Development Plan and cannons or principles of taxation.

However, what needs to be very clear is the treatment of inputs versus outputs exemptions. In as much as the exemption regime has resulted from valid policy rationale, as is the case with the Sales Tax where there are industrial and redistribution policy objective considerations, it is important to be cautious with the exemptions regime. This is because exemptions can result into unintended effects on revenue mobilisation such as the direct loss in tax revenue from exempt firms and reduced production efficiency (Gerard & Naritomi, 2018).

It has been shown by the World Bank (2009) that exemptions can erode a country's duty and tax base and their widespread use can result in abuse, fraud, and revenue leakage, particularly where there is broad discretion granted to particular ministries or agencies to grant such exemptions. This distortion is a particular risk for SMEs who do not have the same lobbying power as larger businesses. Ideally, duty and tax exemptions should be kept to a minimum of inputs and include those items required by international agreements and conventions or non-commercial exemptions such as goods for exhibitions. Even in this case, exemptions should be clearly established in legislation and contain transparent administrative procedures.

With exempt firms at all stages of the supply chain (retail, wholesale and manufacturing), any lack of enforcement at any stage may result in spill over effects with exemptions resulting into further losses in tax revenues especially if the exempt firms are important trade partners for many other firms. Additionally, the exemptions scheme has the effect of affecting a firm's choice of trade partners. These unintended consequences may actually undermine the rationale behind the initiation of the exemption scheme in the first place as it may lead to increased complexity of the tax, effectively abandoning the purported simplicity of the tax and may end up reducing revenues. If final sale exemptions will remain as was in the VAT **then, rationalising the output VAT exemptions list is worthwhile for the proposed Sales Tax for 2019.**

3.1.3 Tax Erosion

Sales Tax does not have the sort of self-enforcing mechanism exhibited in VAT, where purchasers help enforce VAT as they insist on correct invoices from suppliers to claim input VAT. Since the real incentive to be truthful in the VAT system – the credit refund mechanism - will be removed under the Sales Tax system, tax erosion is likely to occur. Under the VAT, the tax liability at risk in any given transaction is only some fraction of the total tax on the good, since a claim is made on the input VAT. This reduces both the incentive to cheat and the revenue lost if any, with successful cheating at any given stage of the production process. Since the audit and invoice trail is poorer under the Sales Tax, the revenue might not be secured especially from the last stage – the retailer. Additionally, the reduced threshold of K500,000 implies that the Sales Tax will cover a larger base, to include those that make sales of about K2,000 a day from about K3,000². However, this may introduce tedious procedures and requirements for smaller businesses that may not have the systems like cash registers, no access to online requirements and other requisite procedures. Thus, it may further increase the cost of doing business for registered dealers as well as the cost of providing the costly fiscal devices to all but still not produce the expected revenue from the tax.

3.1.4 Value Shifting

Producers may also change their production decisions and/or reduce the size of the supply chain. During the transition period and market readjustment to the Sales Tax, all business entities involved in the production and distribution of the standard-rated goods and services will have to experience some contraction of demand for their output. This will entail that business entities will experience some temporary reduction of profits, or a temporary conversion of small profits to a loss.

Overall over time, variations in the effective tax rate caused by cascading have the potential to distort investment patterns in the economy for the worst, altering the industrial landscape. Large companies facing high effective tax rates such as those in mining (28%) and manufacturing (21%), are likely to cut the number of production stages for products by bypassing intermediate suppliers, thereby cutting out the middle man, who are usually small and medium enterprises. This economic distortion is likely to shrink the overall output of the economy. This is especially because the SMEs which constitute about 80% of Zambia's private sector and employ 76% of Zambia's labour force, will be hard hit. The direct impact on them will be in form loss of business induced by higher business costs as well as loss of jobs.

The Government needs to take keen consideration into these matters in order to lower the effective tax burden, without which, businesses will be given a powerful incentive to cut the number of production stages for products. The alteration of company structures for tax reasons may result in efficiency losses and adoption of poor organisational structures for tax reasons. This will eventually result in revenue losses on the part of the Government and loss of jobs for many Zambians.

4 Experiences of other countries

The Zambia Revenue Authority (2019) contends that VAT is suitable in economies with a high degree of formality or, conversely, economies with low degree of informality, and that Zambia is not that advanced to adequately handle VAT as most value addition occurs in the informal sector. They further argue that the inherent informality in the structure of our economy makes it challenging to efficiently and effectively implement VAT. Yet in the same paper, they give examples of three countries that are neither underdeveloped nor do they have informality in their system – Canada, Malaysia and the US. Additionally, very few countries use a Sales Tax – and none in the way that Zambia is proposing – the trend is towards VAT. Through the VAT, they seek to minimise the risk of cascading by targeting, at the least, exempting inputs

² This is calculated on the basis of about 250 working days in a year.

and at the most levying a retail tax on the final value of the goods. To undertake comparison in this paper, we study the countries using a Sales Tax as stated by ZRA to learn some lessons.

4.1 Malaysia switches to SST

Malaysia abolished its Goods and Services Tax (GST) on 1st September 2018, and replaced it with a Sales and Service Tax (SST). It was estimated that the transition would cost about US\$ 6 billion or 2% of GDP in lost revenue. Under the SST, Sales Tax is charged on taxable goods that are manufactured in, or imported into, Malaysia. Manufactured goods that are exported are not subject to the SST. The rates charged on both manufacturing and imports are 5%, 10% or a specific rate, or exempt depending on the category of the goods. The Sales Tax is a single tax and it is only charged at one stage in the supply chain i.e. at the import or the manufacturers' level. On the other hand, the service tax is charged at 6% on the provision of a taxable service by a registered person in Malaysia. The SST that was implemented in Malaysia does not have the mechanism for businesses to claim the input tax credits.

This mechanism of charging the Sales Tax at one stage in the supply chain was put in place to reduce the effect of cascading. In addition, to further reduce the cascading effect, registered manufacturers are eligible to import and acquire raw materials, components and packaging materials on a tax-free basis. Specific exemptions are also applicable to sub-contractors so that the Sales Tax is not imposed more than once in the manufacturing supply chain.

The Malaysian SST system shows that the country moved from a multi-stage tax system to single point because the cascading effect was higher in the multi-stage system and that all inputs have now been made tax free so as to ensure that production costs are lower.

4.2 Canada

Canada has quite a different Sales Tax system that is charged on both the retail value and the value added of goods and services that are being sold. The Sales Tax that is implemented in Canada is an interesting one, because it is differentiated and levied in three different ways. Firstly, there is a Provincial Sales Tax (PST) which is a retail Sales Tax levied by some provinces in the country which ranges between 6% and 8%, and does provide for input credits since it is charged only on value added. Secondly, there is a Goods and Services Tax (GST) which is also a Value-added tax and it is levied by the Government at a rate of 5%. Thirdly, is the Harmonised Sales Tax (HST) which is a combination of the PST and GST which is a pure retail tax, charged on the sales value and does not provide for input credits, and it is charged between 9% to 15%. It is thus quite difficult to learn any lessons from a significantly different regime.

4.3 United States of America

Sales Tax in the United States of America (USA) is administered in 45 states. The Federal Government does not implement the Sales Tax, instead each state makes its own Sales Tax law. This means there are about 45 different sets of Sales Tax rules and regulations in the USA, and the rates range between 2.9% to 8.25%. To mitigate the possible risk of cascading, some states have a reduced tax rate on certain goods which are considered to be necessities, such as food and prescription drugs, while other states exempt some necessities from taxation entirely. Unlike the VAT, which has the self-policing mechanism by use of the credit invoice, the Sales Tax utilises resale certificates which it uses to identify exempt transactions. The resale certificates are meant to relieve the seller of its obligation to collect Sales Tax. Therefore, use of resale certificates in Zambia will help to identify exempt transactions.

5 Mitigating the risks of the Sales Tax

It is very important to get the proposed Sales Tax right because a system that businesses will perceive as costly will threaten business production, economic growth and revenues. A well balanced Sales Tax can support both the Government's need for increased revenues and an economic growth rate of above 4%. But

the two are dependent on the growth and production of Zambia’s businesses which appears to be highly unlikely with the current Sales Tax proposal. ZIPAR therefore proposes some solutions to help implement a Sales Tax that balances the need for revenue, production and growth.

We therefore propose the following:

- i) To mitigate the risk of cascading and keep production costs lower, the Government should change the base on which the Sales Tax is charged from the selling price to the value added at each level. This will exclude the input tax paid from the selling price and avoid tax on tax;
- ii) The risk of international trade disputes can be alleviated if the Government implements a single lower rate of tax. For instance, maintaining 9% both for imports and local sales;
- iii) The risk of distorting business structures can be mitigated through an all-encompassing Sales Tax exemption regime on all critical inputs. On the other hand, reducing to minimal or no final sale (output) exemptions, in line with international principles and best practice and thus reduce the revenue leakages; and
- iv) Government should critically think about the transition period especially for those being included into the Sales Tax regime for the first time, to further reduce business distortions.

5.1 Change the base from which Sales Tax is charged

In Table 5.1 below, we illustrate how the Government would manage to reduce the production costs for businesses and minimise on the cascading effect.

Scenario 1 assumes the proposed multi-stage Sales Tax which could result into the collection of K6.4 billion additional revenue. However, input costs will become more expensive in relation to outputs (from 41.5% shown in Scenario 6 in Table 5.1 to 78%) and this has the effect of reducing value addition and consequentially may shrink GDP.

Table 5.1: Simulation of Different Policy Options, (in millions of Kwacha)

	Potential revenue	Actual revenue	Effective tax rate	Actual Revenue (% of GDP)	Additional revenue	Additional revenue (% GDP)	Output	Input costs	Input - Output ratio
Scenario 1: Sales Tax, cascading	137,122	21,210	15.5%	7.1%	6,347	2.1%	594,167	463,306	78.0%
Scenario 2: Sales Tax less inputs	123,433	18,856	15.3%	6.3%	3,993	1.3%	510,599	379,737	74.4%
Scenario 3: Sales Tax, same rate	134,391	20,633	15.4%	6.9%	5,770	1.9%	591,666	460,804	77.9%
Scenario 4: Sales Tax, less input, same rate	121,497	18,447	15.2%	6.1%	3,584	1.2%	510,599	379,737	74.4%
Scenario 5: VAT simulated	108,561	14,064	13.0%	4.7%	(798)	-0.3%	402,192	271,330	67.5%
Scenario 6: Government VAT Projections - 2019	108,561	14,863	13.7%	4.9%	-	0.0%	491,530	203,950	41.5%
2019 Projected GDP	300,420								

Due to the foregoing, we propose Scenario 2 which reduces the risk of cascading and keeps production costs lower. If the Government should change the base on which the Sales Tax is charged from the selling price to the value added at each level, this will exclude the input tax paid from the selling price and avoid tax on tax.

While the actual revenue reduces to K18.8 billion, it is not only K3.3 billion above the target but also has a lower input-output ratio of 74.4%. This has the effect of increasing value addition and consequently may raise GDP.

5.2 Introduce a single rate of tax to prevent trade disputes

Going by the National Treatment argument, the Sales Tax cannot be used to accord undue favour to domestically produced goods and services over imports of 'like' goods and services. Zambia has at its disposal, trade remedies that it can implement to insulate domestically produced goods and services from a surge of imports, protect infant industries or address dumping concerns. These are encapsulated in the Customs and Excise Act as well many other trade protocols such as COMESA and SADC and the WTO. There is a real risk that Zambia will be subjected to a trade dispute.

5.3 The risk of distortion of business structure can be mitigated through exemption of all critical inputs

The exemption regime is essential in reducing the cascading effect of Sales Tax, as well as its potentially distortive effect on the market. The proposed exemptions list does not capture all critical inputs for different producers and the exemptions list may serve to limit different companies' scope for innovation as times change. Therefore, getting the exemption regime right will be important. Exemptions should be concentrated at input stages where it will be ensured that there are eventual VAT-registered buyers.

A number of options exist.

For instance, in Canada, all inputs are exempt. This is similar with what is in the VAT input-output mechanism in which companies offset their input VAT costs. This model would curtail cascading but will require ZRA to have a sense of what companies use as inputs and ensure that they make use of both their import and domestic tax input data to show which companies use what inputs. It will also require undertaking audits of sector inputs required in production, and differentiated company inputs to ensure that companies are left with little room to cheat or add consumption goods as inputs. This would help to get compliance right.

The second option would be to continue with the current consultation process, where businesses draw up a list of their critical inputs. ZRA would still need to check the lists but to ensure conformity to exemption rules. Unfortunately, this process may not be all inclusive and risks sacrificing growth for revenue.

The third option would be to grant exemptions to priority sectors. However, this may work to distort markets, distort production, as it does not uphold or reflects that opportunities may exist in the future for businesses to innovate or adopt efficient practices.

It is imperative that industrial and tax policies should target boosting the key sectors and ensure maximum multiplier effects. Interventions in these sectors will help propel the economy faster. It is also important to understand that some non-key sectors are essential for the long run including education, health and water and sanitation. Thus, interventions should be put in place to strengthen the linkages with other sectors and the exemption regime will be the best tool to achieve this.

To strengthen the exemption system further, it may be imperative to include exemption and resale certificates for those registered producers who would previously claim a VAT refund. This will make the administration of the tax easier largely because it will help identify those requiring input exemptions. But once incorporated, the certificate mechanism will work well with the multiple collection points as those who are purchasing inputs can demonstrate to the seller that they are not eligible for Sales Tax.

Certificates need not be in paper form, but can be linked to the TPIN of producers. Once this is done, there will be no need for an approved input (both local and imports) list for firms in the manufacturing, mining and quarrying sectors only but will be able to cover all sectors. The allowance of certificates that are

electronically embedded will entail that the tax proposal is not only revenue-focused but will take the growth of industry, commerce and other services into consideration and result in less distortion of trade as cascading will be reduced across all sectors of the business community.

Additionally, it will be important to minimise output exemptions. Therefore, the exemption list needs to be rationalised on final consumption as the lower rate of 9% and the reduced cascading effect through exemption and resale certificates will mitigate against the rise in prices and thus the consumer's disposable income as proposed by the IMF. This will further increase the base.

5.4 Government should consider a 6-month transition period for new businesses

To effectively and seamlessly implement the Sales Tax, the July start date should be implemented for those currently on the VAT with turnover of K800,000 and above. For the new businesses to be added, either those in the K500,000 to K800,000 bracket or those above K800,000, a 6-month transition period for businesses will be required. This is to allow them more time to get themselves abreast with the return and payment systems of the Sales Tax which will be alien to them and to give them time to purchase a number of required items like cash registers and accountancy packages, etc.

6 References

CSO, 2017. *Supply, Use and input-Output Tables*, Lusaka: Central Statistical Office.

Gerard, F. & Naritomi, J., 2018. *Value Added Tax in Developing Countries: Lessons from Recent Research*, s.l.: International Growth Centre.

Hirschmann, A. O., 1959. *The Strategy of Economic Development*, New Haven (1959): Yale University Press.

IMF, 2017. *Zambia: Selected Issues*, Washington, D.C.: IMF Country Report No. 17/328.

International Bureau of Fiscal Studies, n.d. *VAT/GST Double (Non-)Taxation*. [Online] Available at: https://www.ibfd.org/sites/ibfd.org/files/content/pdf/VAT_GST_sample.pdf [Accessed 05 March 2019].

World Trade Organisation, 1994. *WTO, General Agreement on Tariffs and Trade, Article III National Treatment on Internal Taxation and Regulation*. [Online] Available at: https://www.wto.org/english/res_e/booksp_e/gatt_ai_e/art3_e.pdf [Accessed 18 April 2019].

World Trade Organisation, 1994. *WTO, General Agreement on Trade in Services, Article XXVI National Treatment*. [Online] Available at: https://www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm [Accessed 18 April 2019].

Zambia Revenue Authority, 2019. *Frequently Asked Questions: Sales Tax*, Lusaka: ZRA.

ZIPAR, 2019. *Looking within: the promise of public revenue mobilisation*, Lusaka: Zambia Institute for Policy Analysis and Research.