

## Bridging the PAYE Tax Revenue Gap

Based on the Report “Uncovering the Unknown: An analysis of Tax Evasion in Zambia” by Shebo Nalishebo and Albert Halwampa

Zambia’s tax revenue-to-GDP ratio dropped to a record low of 13% in the early 1990s from a peak of 30% in the 1970s. To address the problem, Government embarked on a wide range of tax reforms that included the formation of the Zambia Revenue Authority (ZRA) in order to increase revenue collection through efficient tax administration. Despite these reforms, tax revenues have remained low, averaging only 17% of GDP. The low tax revenues can be partly attributed to tax evasion. The current legal and administrative measures to address this problem are inadequate. This is evidenced by the underperformance of taxes such as PAYE with a significant proportion remaining uncollected. The estimated PAYE tax gap as a percent of GDP is 6.7% or 40.3% of total tax revenues in 2010. Government should embark on comprehensive legal and administrative tax reforms in order to minimise the tax gap, thereby combating tax evasion.

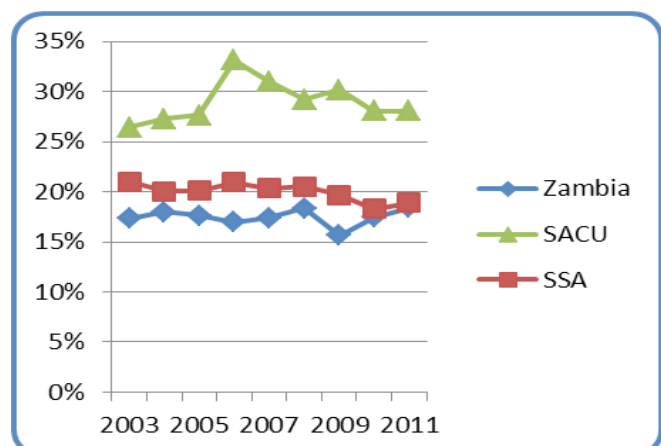
Zambia is currently grappling with issues of reducing high budget deficits. The country recorded a deficit amounting to 6.6% of GDP in 2013. This is due, in part, to the huge infrastructure projects in the transport and energy sectors that Government has embarked on and salary hikes for public sector workers, coupled with lower than expected revenues. Government intends to contain this deficit to no more than 5.2% of GDP in 2014. As a first step in reducing the deficit, Government has to continue improving the efficiency of public expenditure and enhance revenue mobilisation. One way to increase revenue is through a reduction in tax evasion. There is therefore need to recognise the extent of evasion and impose corrective measures.

### Tax revenue performance in Zambia

Compared to countries in the Southern Africa Customs Union (SACU) and the rest of Sub-Sahara Africa (SSA), Zambia is under performing in tax

revenue collection. The percentage difference in revenue collection ranges from 2.5% to 10 % of GDP between 2003 and 2011. Consequently a cumulative variance in taxes amounting to K52 billion relative to SACU, and K10 billion relative to other SSA countries is estimated. This low revenue performance can be explained in part due to tax evasion among other reasons.

Revenue to GDP ratio, 2003-2011



Tax audits conducted by ZRA reveal the existence of tax evasion in Zambia. In 2011, of the total amount of K1, 957.6 million assessed through tax audits, additional tax revenue in the amount of K597.7 million was collected, while penalties amounting to K370.3 million were charged for non-compliance with tax regulations.

The contribution to total tax revenue in Zambia is mainly through Pay-As -You-Earn (PAYE), Company Income Tax (CIT) and Import VAT. Of these tax types PAYE can be said to be the most efficiently collected as it is largely withheld at source. However evidence from our study suggest that PAYE is also susceptible to tax evasion.

### PAYE is under-performing

On the analysis based on data from LCMS 2010, using income of earners, both in wage employment and self-employment, above the PAYE exempt threshold, it is evident that there is a gap in PAYE between what is currently being collected and what could be collected. PAYE as one of the major income taxes collected by ZRA, contributes 26% to total tax revenue on average. ZRA would have collected an additional K800 million from wage earners even before taxing the 10% self-employed who were above tax threshold in 2010. Based on the study's estimates for 2010, the PAYE potential from both the self-employed and the wage employed was estimated at K8, 886 million compared to the actual PAYE collected of K3, 683.5 million. This gives a K5, 203 million PAYE tax gap equivalent to 6.7% of GDP or 40.3% of tax revenue.

#### Estimated PAYE Gap, 2010

	Total (K'million)
Est. PAYE	8,886
PAYE Revenue 2010	3,683
Tax Gap	5,203
GDP 2010	77,667
Tax Gap as % of GDP	6.70%
Tax Gap as % Tax Revenue	40.3 %
self-employed > tax threshold	<b>10%</b>
Uncollected PAYE-wage earners	<b>800</b>

With more than 80% of expenditure dependent on domestic revenue collection through taxes, closing up such tax gaps by addressing their causes such as tax evasion would create more fiscal space for undertaking development programmes.

### Legal and Administrative framework and Tax Evasion

Despite the tax reforms in the early 1990s, legal and administrative framework remains weak to sufficiently tackle cases of tax evasion.

- **The Income Tax Act in its current form is not adequate to tackle tax evasion.** Currently the law provides for penalties for late filing, non-filing, non-payment of tax and fraud. While tax fraud or evasion receives the stiffest penalty at 52.5% of the amount involved plus interest at Bank of Zambia rate of 5%, the jail sentence provided for in the Act is rarely applied; the monetary fine is the most applied penalty and appears not sufficient as deterrence for tax evasion

The Act is clearer in addressing issues of tax avoidance than it is with tax evasion. For instance, issues relating to profit shifting using techniques such as thin capitalisation and transfer pricing, though also inadequate in many respects, have been given greater attention than tax evasion.

The Act provides for Double Taxation Agreements (DTA) mostly entered into with Multinational Corporations. However it is important that such provisions in the law are reviewed regularly to seal any loopholes of potential abuse.

- **Significant strides in improving efficiency in tax administration made but a lot needs to be done to address tax evasion.**

**Structural Changes.** ZRA has continued to make improvements in tax administration over the years. Notable is the creation of the Tax Audit and Investigations units to address issues of tax evasion. However these two departments require further operational

improvements to squarely address tax evasion. The number of officials in both departments is below optimal levels required to frequently carry out audits and investigations. Tax evasion is sophisticated and therefore officials in the audit and investigations departments require specialised skills to tackle tax evasion in addition to minimum education requirements.

**Taxpayer Education.** Initiatives such as the Taxpayer Education and Advisory Services (TEAS) and the Tax Payer Charter have been rolled out to improve tax payers' knowledge of taxes, obligations and rights. However there is need for a continuous programme of educating tax payers and the general public on the rationale of paying taxes.

**Upgrading of Information Systems.** The ZRA website contains good information on taxes in Zambia. Recently ZRA rolled out the Tax Online programme aimed at improving compliance and efficiency in tax administration through e-registration, e-returns and e-payments. However, more needs to be done to sensitize the public on the new measures and their advantages.

### **Taxpayers' perception of the Causes of Tax Evasion in Zambia**

#### ● **High Tax Rates**

Two thirds of the firms surveyed linked tax evasion to high tax rates in Zambia. Firms surveyed admitted that high tax rates encourage firms to evade tax by using techniques such as under valuing of invoices, overstating expenses, declaring part of turnover as capital allowances in order to reduce taxable gross value.

The tax types that are perceived to be high are import duties, PAYE, Company Income Tax (CIT) and VAT. Firms paying the standard CIT rate of 35% strongly felt that CIT is low for non-traditional exports and agriculture at 15% and 10% respectively.

#### ● **Complicated tax codes**

Two thirds of the respondents found the tax codes to be complicated, with most respondents citing CIT as the most complicated and therefore the most vulnerable to tax evasion.

#### ● **Limited Knowledge of taxes and the tax system in Zambia**

Two thirds of the respondents had a fair knowledge of taxes and the tax system in Zambia. Tax literacy has the potential to increase compliance.

#### ● **Limited knowledge of the existence of penalties for tax evasion**

Only two out of every five respondents interviewed had knowledge of penalties for tax evasion. Knowledge of penalties and their severity have the potential to discourage tax evasion. If tax payers do not know how harsh the penalties are, it is likely that they could engage in tax evasion.

### **Policy Recommendations**

Government should undertake comprehensive tax reforms that should include the following:

#### **1. Review the law in order to strengthen it to address tax evasion. This must include among others:**

- Simplification of tax laws. Simple tax laws are easy to understand and comply with.
- Stiffer Penalties: Charge interest at above market rate, strengthening enforcement on jail sentences, revocation of operating licenses and blacklisting the directors of companies involved in tax evasion.
- The law on Double Taxation Agreements should be strengthened to prevent Multinational Corporations evading tax.
- Include filing of personal income returns by the self-employed and wage earning employees.

## 2. Review the administrative measures used to address tax evasion to include among others:

- Restructure the Audit and Investigations departments by increasing the number of officers and equipping them with skills to combat tax evasion.
- Continuous upgrade of the information systems to accommodate changes in the economy. Significant resources are required to constantly update the information system capable for tracing evasion transactions.
- Increase compliance through embarking on taxpayer education to improve tax literacy. This can be done by establishing call centres in each provincial centre alongside the presence of ZRA for the purpose of taking tax literacy closer to the people.

## 3. Streamline Tax incentives.

Tax incentives should be reviewed continuously to ensure those which no longer serve or have served their purpose are phased out. Maintaining incentives which appear to be disproportionately favouring a sector of the economy at the expense of tax revenue deters tax morality in the country as a whole and therefore encourages tax evasion. Tax incentives should only be awarded to firms or sectors that add value in terms of employment creation, skills transfer and foreign exchange earnings.

**Note:** For more detail, references and sources refer to full-length report, cited above

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