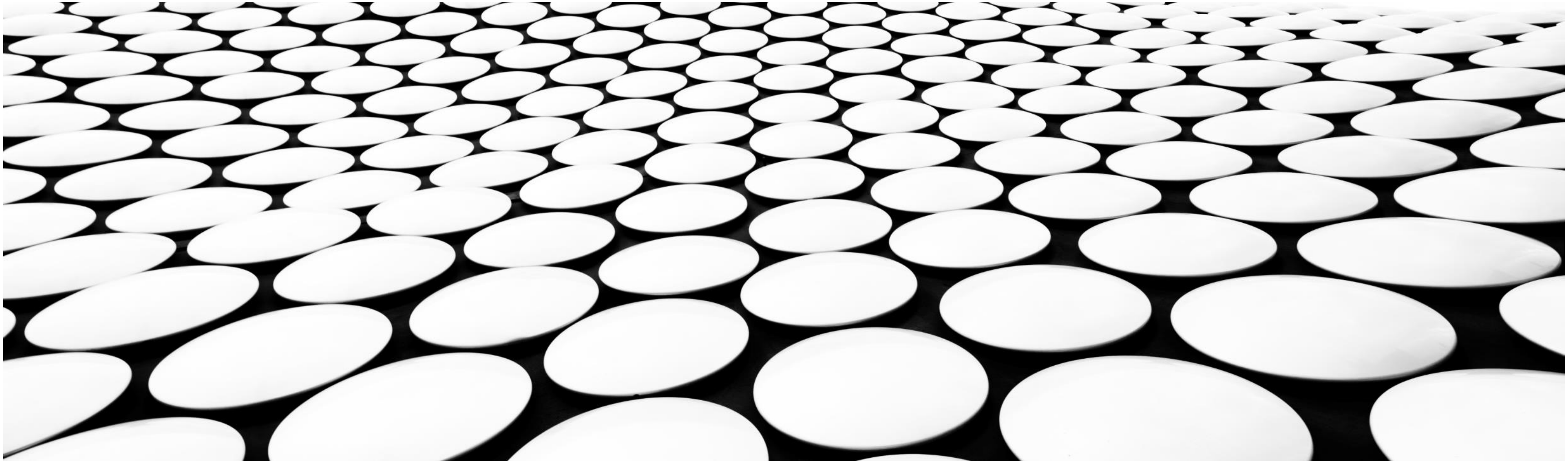
Mobilising financial resources for development in the time of COVID-19: with a focus on personal income tax

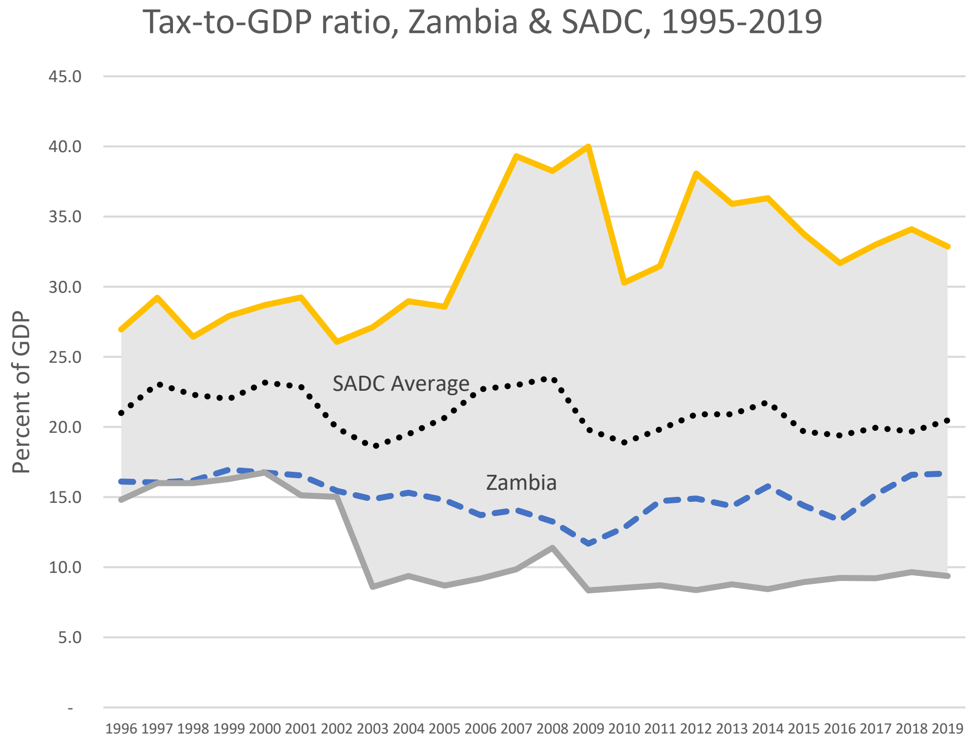
ZAMBIA | SHEBO NALISHEBO| 7 July 2022

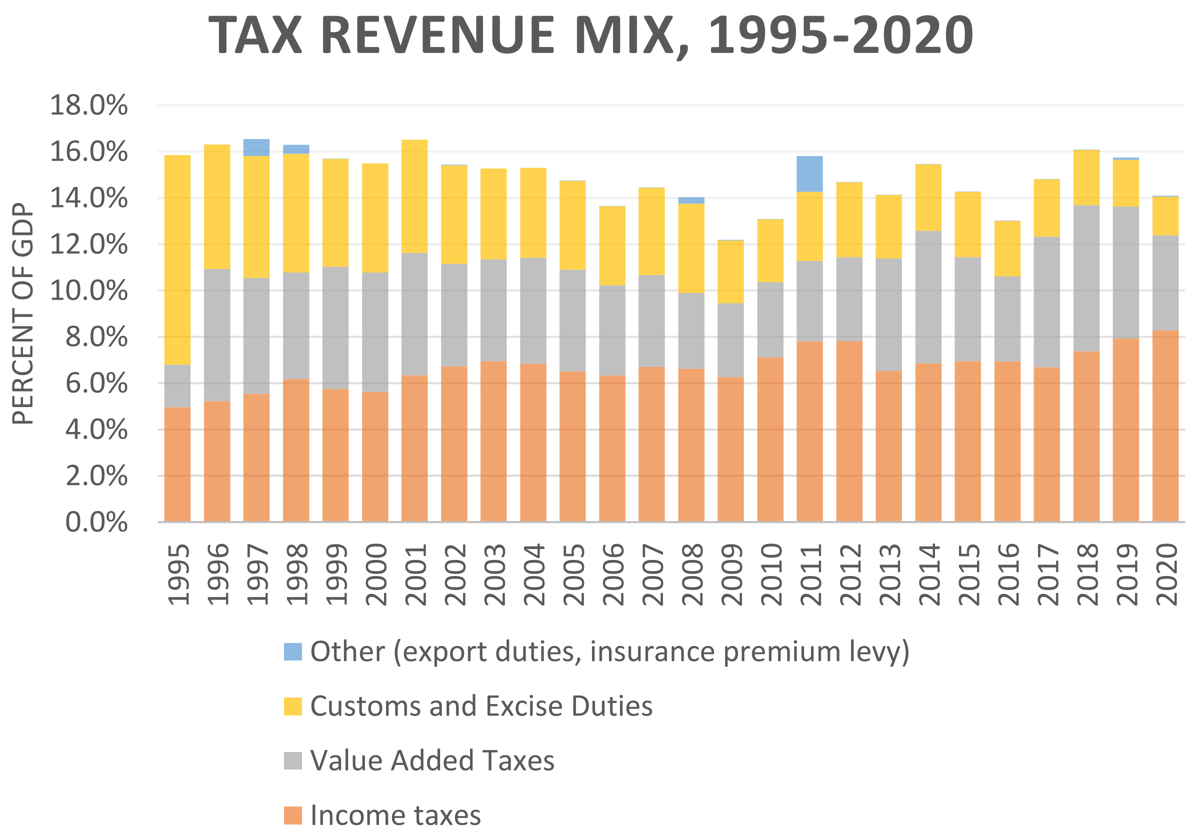


Introduction

- Zambia is presently beset with fiscal and debt challenges which require adjustments to make an economic turnaround
- With the fiscus already weakened even before the COVID-19 pandemic, challenges include lower levels of economic growth, limited growth in tax revenues, and an already high and unsustainable public debt
- A number of loans falling due within the next five years
- Further, with COVID-19 still here, it has brought new and severe pressures on the Zambian economy – fiscal deficit rose to 14.5% of GDP in 2020
- And having lost access to international capital markets following its default on several loans in 2020, Zambia would have to look within itself to generate enough resources to bring public finances on a more sustainable trajectory

Overview of Zambia's tax system





Hovering around 15% of GDP, Zambia's tax-to-GDP is lower than the SADC average of 21% of GDP; medium term target: 18% of GDP

Income taxes are the most dominant tax type; averaging 45% of total tax revenues during 1995-2020

About the review: simplified analytical framework for personal income tax

Key objective: To undertake a comprehensive and detailed review of Zambia's income tax regime, piloting UNECA's analytical framework

Tax design
- Features of the income tax system
- What the tax base ought to be

Tax Law
- How well the tax law is designed to capture the tax base

Tax administration
- The actual administration of the tax

Reforms
- Reform proposals that would not only increase revenues but reduce the efficiency costs of the tax system

Design: hypothetical middle class family …

How will this family be taxed?

Self-employed: runs small business selling fruits & veggies at nearby market

Joint dividend income from investment in brother's company in South Africa

.Joint interest income from government securities.

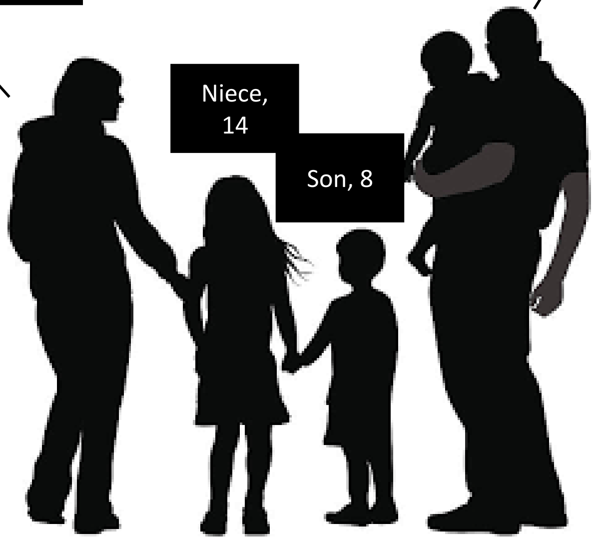
Wife, 40

Infant, 2

Man, 45

Niece, 14

Son, 8



School-going children

Employed: permanent & pensionable

Employer-provided housing & medical cover

Joint investment in government securities

Joint dividend income from investment in brother-in-law's company in South Africa

Key considerations for taxing persons in this family

- What types of income can be gleaned from this household/family that is subject to tax?
- Should the income be taxed as a family or separately for each individual? *Unit of taxation*
- Should taxes be imposed on each source of income separately or should a single tax be imposed on all income regardless of its nature? *Global or schedular basis of taxation*
- What is the source of income and where are the tax payers resident? *Source and residence principles*
- How then is taxable income determined? Are there any exemptions that need to be excluded from gross income? Are there deductions, allowances and credits?
- What tax schedule should be applied?

All these aspects are covered in the UNECA analytical framework

1. What types of income can be gleaned from this household/family that are subject to tax?

2. Unincorporated business income

Self-employed: runs small business selling fruits & veggies at nearby market

3. Investment income (dividends, interest)

Joint dividend income from investment in brother’s company in South Africa

.Joint investment income from government securities.

1. Employment income

Employed: permanent & pensionable

Joint dividend income from investment in brother’s company in South Africa

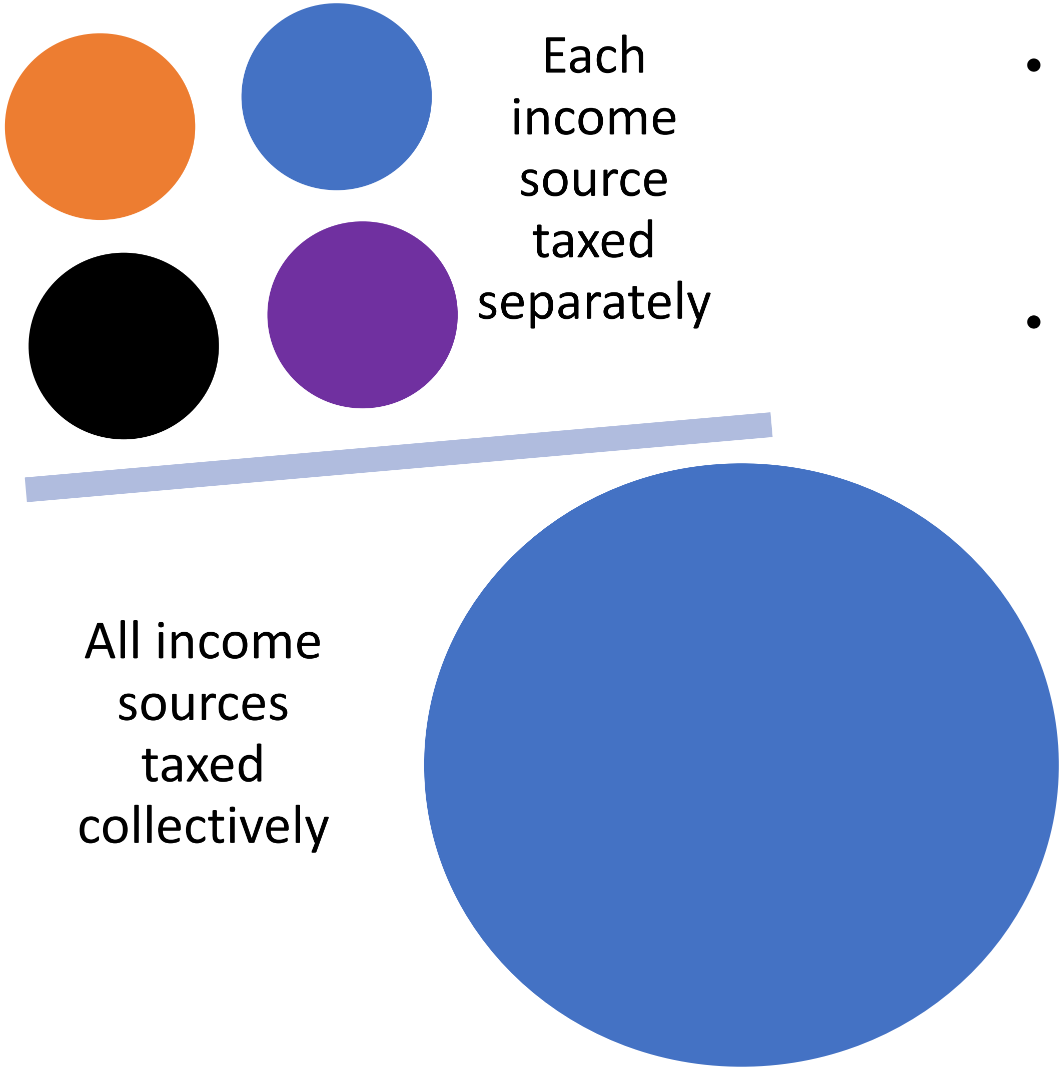
Employer-provided housing & medical cover

Joint investment in government securities

4. Fringe benefits

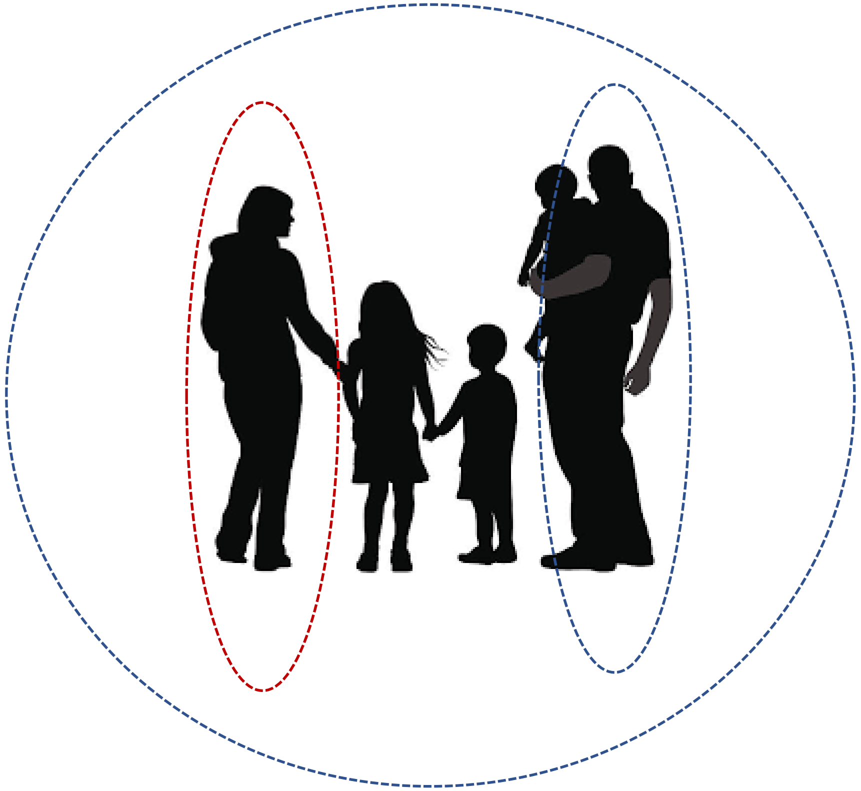
3. Investment income (dividends, interest)

2. Should taxes be imposed on each source of income separately or should a single tax be imposed on all income regardless of its nature?



- The Zambian tax system is considered global, achieving vertical equity more easily since the tax is based on an aggregate measure of income
- But, like many other countries, it has strong schedular features
  - The different types of income are treated differently when determining the taxable income
  - Has heavy reliance on withholding and a few taxpayers filing final returns or being assessed on global income

3. Should the income be taxed as a family or separately for each individual?



- Section 14(1)(a) of the ITA specifies that an **individual** is subject to tax on income
- The choice of taxable unit at individual level has important equity and efficiency implications
- **Equity:** Individual taxation seems neutral with respect to marital status - it avoids inequalities in taxation between married and unmarried couples and individuals with the same income
- **Efficiency**: It also avoids the efficiency problem that result from joint taxation (trying to determine what a household is, marital status, etc.)

4. What is the source of income and where are the tax payers resident?

- **A person's liability for tax in Zambia is determined by the source of the person's income as well as their residency status**
- In our example, all income is assumed to be from Zambian sources except the dividend income from South Africa; the taxpayers are assumed to be resident
- **Section 14(1)(a) of the ITA** specifies that an individual, whether resident or non-resident, is subject to tax on income within or deemed to be from within Zambia - **territorial**

- **Section 4 of the ITA** defines a resident – " … an individual who is physically present or who exercises an employment in Zambia for 183 days or more in any charge year…"
- However, there are exceptions:
  - Foreign-sourced income received by a resident individual is subject to income tax on interest and dividends, as specified in **Section 14(1) (b)** – *in this case, dividend income from South Africa*
  - Where a Double Taxation Treaty exists between Zambia and other jurisdictions, the interest and dividends are subject to the provisions of the treaty
    - South Africa is one of the 22 countries with a DTT with Zambia

5. How is taxable income determined? (1)

Gross Income

Tax on personal or individual income is defined as the taxes levied on the net income (gross income *minus* allowable tax reliefs) on individuals

Defined in **Section 17 of ITA** and **First Schedule**

Though not explicitly called "gross income", includes emoluments; annuities; dividends; interest, charges and discounts; royalties; and income from letting of property

Exempt persons

Specified in **Section 15 of ITA** & Second Schedule

emoluments of the President, the income of the *Litunga* of Western Province and income of any chief received as a chief from government

emoluments for officials of any foreign government, any international organisation, any foreign foundation or organisation as approved by the Minister by order in the Gazette

Exempt income

Includes:

a pension received from an approved fund

Approved death, disability, injury or sickness benefits

Capital gains

Non-monetary fringe benefits

5. How is taxable income determined? (2)

Deductions

Defined in **Section 29-44 of ITA**

Include:

non-capital expenditure incurred wholly and exclusively in the production of the income from that source;

interest on money borrowed by any person where the Commissioner-General is satisfied that the loan or advance was obtained for capital employed wholly and exclusively in the production of income.

Allowances

Refunds of actual medical expenses incurred by an employee

accommodation provided by employer

Personal-to-holder vehicles

emoluments of former Presidents of the Republic;

Funeral expenses paid or incurred by an employer on behalf of an employee are exempt

Sitting allowances for Councillors in Local Authorities (paragraph 7(s) Second Schedule, Income Tax Act);

Labour Day Awards paid to employees either in cash or in kind are non-taxable

Credits

Specified in the Charging Schedule

Disability Credit

Taxes paid in a foreign jurisdiction

6. What tax schedule should be applied?

Once the taxable income is determined, Part II of the Charging Schedule of the ITA specifies the rate structure for personal income tax

A key issue in the design of the income tax rate structure is the progressivity, if any, to be incorporated into the tax rate scale.

Band	Taxable Income (ZMW) per month	Rate of Income Tax (%)
Band 1	0 – 4,000 (2021); {0-4,500 (2022)}	0
Band 2	4,001 – 4,800 (2021); (4,501-4,800 [2022])	25
Band 3	4,801 – 6,900	30
Band 4	Above 6,900	37.5

With different tax bands depending on the level of income, personal income tax is considered a progressive tax type.

Administration of personal income tax

- We established that one tax payer in our hypothetical example has a **salary** and gets **fringe benefits**, while the other runs a **small unincorporated business**. They jointly get **interest and dividend income**. How would they be taxed in practice?
- Administratively, several methods of collecting personal income taxes to make income tax more effective as a fiscal policy instrument are applied in Zambia
- The main techniques used are:
  (1) withholding on wages and salaries,
  (2) withholding on interest and dividends; and
  (3) presumptive taxation for hard-to-tax self-employment incomes
  (4) Treatment of fringe benefits

1. Withholding on wages and salaries

- Withholding on wages and salaries represents a major source of revenue in Zambia
- The withholding system is applied in the form of pay-as-you-earn (PAYE), which is final
- This has two main advantages:
  - (1) It frees taxpayers from filing an annual tax return; and
  - (2) reduces administrative and compliance costs
- However, it is fraught with a number of challenges:
  - Steep marginal rate from exempt threshold (from 0% to 25%)
  - Irregular adjustment of exempt bracket
- **This introduces a “bracket creep” particularly for low-income earners who are just above the exempt threshold, thereby increasing their tax burden (reducing their disposable income) and reducing progressivity**

1. Withholding on wages and salaries: “Bracket creep”

- There were no adjustments in the tax brackets during 2017-2020
- As a result, there was a marked increase in the number of taxpayers in the bracket just above the exempt threshold and the top marginal rate bracket, particularly in 2020

Band		2017	2018	2019	2020	**Change: 2020/2017**
		Number	Number	Number	Number	**Number**
0%	0 – 4,000	456,558	440,074	439,726	498,959	**42,401**
25%	4,001 – 4,800	20,926	23,770	29,315	38,439	**17,513**
30%	4,801 – 6,900	38,681	40,474	45,971	49,745	**11,064**
37.5%	Above 6,900	117,944	138,125	151,239	166,571	**48,627**
Total number of taxpayers		634,109	642,444	666,252	753,714	**119,605**

Individuals not only pay a higher *amount* of tax, but a higher *proportion* of their income in tax as well

This has implications on disposable income, consumption demand and ultimately affects collection of taxes

2. Presumptive taxation

- Given the dual structure of the economy, with a large size of the informal sector, there are inherent deficiencies in the administration of personal income tax
- To counter these deficiencies, presumptive methods of taxation are used as a proxy for an income tax on often hard-to-tax small, largely informal sector businesses
- “presumptive tax on passenger transport”, stipulated in the Ninth Schedule of the ITA.
- *A base tax* of K365 per charge year (or K1 per day) generally levied on small traders such as marketeers; stipulated in Section 64(2) of the ITA
- Thus, the woman in our example would be subjected to *base tax*
- ***But the sectors to which presumptive tax is applied is limited***

3. Withholding on interest and dividends

- The couple has joint investments in a five-year government bond and occasionally receive dividends from their shareholding in a company in South Africa
- It is not immediately clear how the joint investment income is to be apportioned between the two since taxes are charged at individual level
- Coupon interest income on government bonds is subjected to 15% withholding tax in Zambia
- Tax withholding on dividends is charged at the rate of 20 percent and is a final tax for both residents and non-residents
- **The lower marginal rates compared to employment income (37.5%) may create some distortions**

4. Treatment of fringe benefits

- We established that the man enjoys employer-provided housing and medical insurance for the whole family
- It seems logical to tax fringe benefits, as it would achieve horizontal equity between taxpayers who are wholly remunerated in cash and taxpayers remunerated partly through fringe benefits
- It would also ensure neutrality between those employers able to provide fringe benefits and those not able to do so
- It’d also be important to protect the tax base
- But non-monetary fringe benefits are difficult to tax due to complexities of market valuation of non-money benefits
- **Therefore, non-monetary benefits are not taxed in the Zambian system; however, some fringe benefits could be reformed**

Proposals for reforming the personal income tax base

1

The Government should reduce the graduation of the marginal rate schedule, and possibly index the threshold to inflation

- A less steep rate after the exempt bracket, such as 15 percent, will minimize the tax burden faced by low-income earners who are most prone to bracket creep
- Along with the change in the rate structure, the government should possibly index the threshold to inflation to minimize bracket creep
- If it cannot be indexed to inflation, the changes to the exempt threshold should be better planned and done more frequently than the current *ad hoc* system of revisions

2

Broaden the scope of presumptive taxes in order to ensure horizontal equity

Presently, presumptive taxes only applied to marketeers and small business owners in the transport sector

This should be extended to other sectors with substantial informal sector activity

These include: agriculture, construction, real estate activities and activities of households as employers

3

Harmonise marginal rates between employment income and personal capital income

- The differences in the marginal rates between employment income (37.5%) and personal capital income (15-20%) may create some economic distortions
- In the case of management and consultancy fees, this may create an incentive for businesses to pay consultancy fees charged at 15% or 20% depending on whether the payee is resident or non-resident, instead of hiring workers to do the same job
- In the case of interest, a business may make interest-free loans to employees as opposed to paying wages

4

Reduce motor vehicle fringe benefits

- Personal-to-holder vehicles allowances are very widespread and are based on how big the car you drive (engine capacity)
- In the public sector, over 500 senior government officials and institutional heads enjoy this fringe benefit; number is even higher for the private sector
- They are not progressive as they are generally disproportionately provided to highly compensated employees
- Expensed on the company income account
- Given that it is partly for personal use, a fixed portion of the value of benefits, say 50%, should be taxed to the employee

Conclusion

- While the hypothetical illustration used is by no means exhaustive, it makes it easier for policy makers and analysts to cover different aspects and cover many bases and angles of their tax systems
- Though only covering personal income tax in this presentation, **this framework was also applied to *corporate income tax* and *mineral royalty***
- *Ex ante* assessment should then be applied to determine the impact of these proposals

Thank you!