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## THE POLITICAL ECONOMY OF TAXATION AND STATE RESILIENCE IN ZAMBIA SINCE 1990

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## **The Political Economy of Taxation and State Resilience in Zambia since 1990**

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This paper examines the evolution of the Zambian tax system with two aims. First, it will identify how patterns of taxation contribute to state capacity, and in particular state resilience. This follows a long line of research that links state formation and consolidation to the capacity of the state to tax (Schumpeter 1918 [1954]; Tilly 1990; Brewer 1990). Second, it will explore the political economy of taxation, and in particular the relationship between elite bargains and patterns of taxation. While there has been considerable work on the politics of taxation (Lieberman 2003; Brautigam et al. 2008), much of this literature ignores how processes of maintaining political stability affect taxation capacity and patterns. It has been argued elsewhere that elite bargains have been central to the maintenance of political stability in Zambia (Lindemann 2009; Di John 2010). The main aim here will be to suggest how taxation reflects the nature of elite bargains and, in turn, how the dynamics of elite bargains affect tax patterns and capacity. This type of analysis moves well beyond traditional economic and administrative approaches, which treat taxation as a technical exercise in optimal policy and institutional design, devoid of political economy considerations (Newberry and Stern 1987; Burgess and Stern 1993).

### **Summary of the tax-reform process in Zambia since 1990**

The tax-reform process in Zambia since the early 1990s has been well documented (DFID 2001; Von Soest 2007). The reforms can be briefly summarised as follows. Zambia undertook major tax reforms in the mid-1990s as part of a broader economic liberalisation programme. An independent taxation authority was established, tariffs were dramatically reduced and a VAT was introduced. The Zambia Revenue Authority (ZRA) was established in 1994 to collect direct taxes (income tax), indirect taxes (excise tax, VAT, property-transfer tax), customs and the mineral-royalty tax for the Zambian government. Much later, a Large Taxpayers Office (LTO) was created in 2008, while a Small and Medium Taxpayer Office (SMTO) will be set up in 2010. The LTO and SMTO administer domestic tax-revenue collection for their respective sectors, while the Customs Division collects trade taxes. Operation of all these offices is handled internally, with the majority of the funding coming from the main ZRA budget. In line with many less developed countries, taxation administration changed from departments collecting according to type of tax to one where tax departments were divided by type of taxpayer.

For revenue purposes, the major reforms were the establishment of the ZRA in 1994, the abolition of sales tax and its replacement by VAT in 1995. Trade taxes were also simplified and reduced: ‘in 1991 customs duties ranged between 0 and 100 percent, with 11 tariff bands. By 1996 duties ranged from 0 to 25 percent, with only four bands’ (World Bank 2004: 7). These changes ‘transformed the trade regime into one of the most outward oriented in the region’ (World Bank 2004: 6). The corporate tax rate was also reduced from 40 percent to 35 percent in 1993 (it remains at this rate, except for agriculture, non-traditional exports and

fertiliser, where a lower rate of 15 percent applies; and for mining, where a rate of 45 percent applies); and the property-transfer tax was reduced from 7.5 percent to 2.5 percent in 1994.

The mid-1990s also saw major changes in the mining sector. The privatisation process of Zambia Consolidated Copper Mines (ZCCM) started in 1994, with ZCCM finally being sold in 2000 after many delays in the process. Prior to its privatisation, ZCCM was losing \$1 million per day, contributing 10 percent of GDP to Zambia's quasi-fiscal deficit (World Bank 2001: xiii). As part of the privatisation process, the government instituted a very low tax regime for mining firms: royalties of 0.06 percent of gross value, 25 percent corporate income tax, 100 percent depreciation for tax purposes, zero percent withholding tax and customs-duty exemptions for capital equipment imports (IMF 2008: 7). In the 2007 budget a series of changes were made to the tax regime for new mining operations: the royalty rate was raised to 3 percent, the corporate tax rate to 30 percent (still below the rates for other sectors, with the exception of agriculture). The government is also re-negotiating the fiscal terms of current development agreements (IMF 2008: 8). The IMF states that the generous terms 'helped to promote investment in the sector when copper prices were low'. They also imply the terms were too generous, stating that the 'generous fiscal terms and write-down of large investments have limited fiscal revenues from the mining sector' and that the reforms in the 2007 budget make the mining sector fiscal regime 'more consistent with international standards' (IMF 2008: 7-8).

An additional tax was introduced in 2003 to raise additional funds for the health sector. The Medical Levy is deducted at source (i.e. by financial institutions) from interest earned on bank accounts, treasury bills and government bonds at a rate of 1 percent.<sup>1</sup>

### **Patterns of taxation and state resilience in Zambia**

There are two important senses in which the Zambian state has been resilient. The first is that there has been a lack of large-scale political violence in the postcolonial period (Burnell 2005). This is not to say that there has been no repression, no coup attempts, no labour unrest or some political violence, but these have been relatively mild compared with its neighbours (Di John 2010). The second sense in which the state has been resilient, and with which this paper deals, is the capacity of the state to mobilise tax revenues. This section will consider several ways in which the tax capacity of the state is linked to state resilience.

The first notable feature of the Zambian tax system in the post-1960 period is that the state, regardless of the level collected, has maintained a monopoly over tax collection in the country. That is, there is no record of rival non-state actors, challenging the tax collection capacity of the state (on patterns of tax collection during colonial rule, see Chipungu 1992: 74-96; and Roberts 1976: 177-230). Monopolisation of tax collection may reflect as much if not more a resilient state than the tax-collection capacity itself. This point is often missed in general discussions on the relationship between tax capacity and state capacity.

There are two main factors that have contributed to the monopolisation of tax collection. First, in colonial times, the British were successful in co-opting local chiefs/native authorities to collect tax as part of indirect rule. In fact, the colonial authorities implicitly provided incentives for native authorities to collect tax since successful tax mobilisation brought material rewards. Indeed, such tax-farming practices led to the rise of the so-called *Boma* class, which accumulated substantial amounts of capital as medium-sized and large-scale

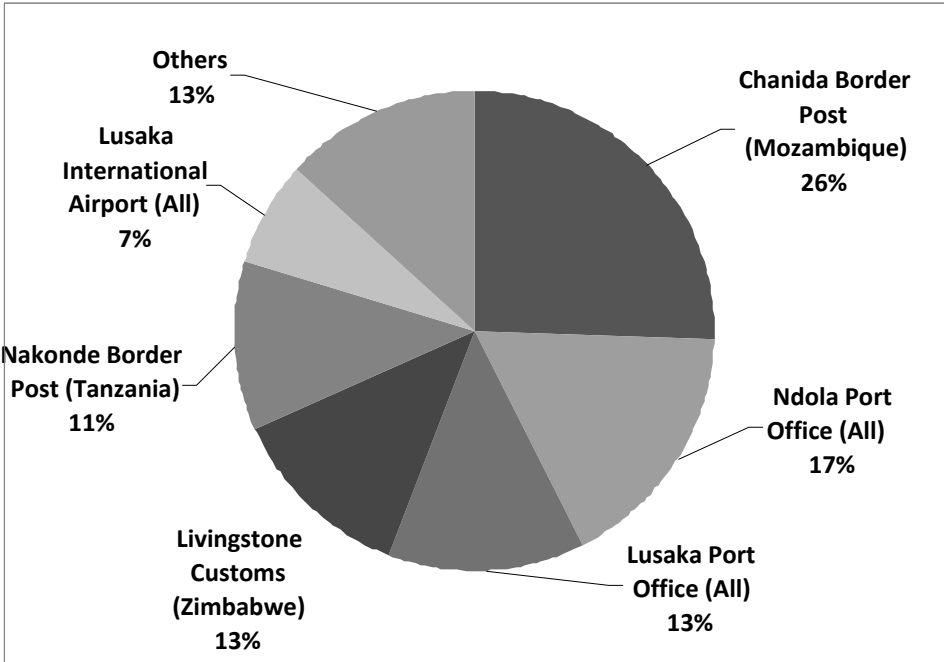
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<sup>1</sup> <http://www.zra.org.zm/MedicalLevy.php>.

farmers (Chipungu 1992). At the same time, tax farming fuelled resentment among the larger population, and was one of the focal points around resistance to colonial rule that ultimately led to the independence struggle (Chipungu 1992; Roberts 1976).<sup>2</sup>

Second, the extensive penetration of the state in nearly all sectors of the economy in the post-colonial period prevented non-state rivals from challenging the state’s authority to collect tax. This was achieved through the extensive use of marketing boards in agriculture, price controls on key agricultural products such as maize, public enterprise production in mining (principally copper), manufacturing and services, and substantial control of the financial/banking sector (Di John 2010). State control over most avenues of capital accumulation reduced the incentives for any one group challenging the tax capacity of the state.

The second sense in which tax collection both reflected and contributed to state resilience was through the territorial reach of the state. At present this is manifested in the near total control of most border stations, which allows the state to collect most customs/trade taxes. In terms of trade-tax collection, the areas are indeed relatively evenly distributed, as indicated in Figure 1. This also shows that the border with Mozambique and the Democratic Republic of Congo (DRC) are the most important. Overall, this picture contrasts with more fragile states such as the DRC and Afghanistan, where state control over customs collection is much more limited and concentrated geographically.



**Figure 1: Geographical location of trade tax collection, 2006-8**  
 Source: ZRA and author’s calculations

The territorial presence is also reflected in the fact that the ZRA has thirty-seven collecting stations, of which twenty-three are border posts and fourteen are stations in town and cities (see Figure 2). The historical background to this territorial reach in taxation is closely related

<sup>2</sup> In the post-colonial period, the authority and legitimacy of native authorities was greatly reduced because they were seen as collaborators of colonial rule. The decline of native chiefs’ authority was further undermined when political party leaders in the post-colonial government reduced their role in the national government.

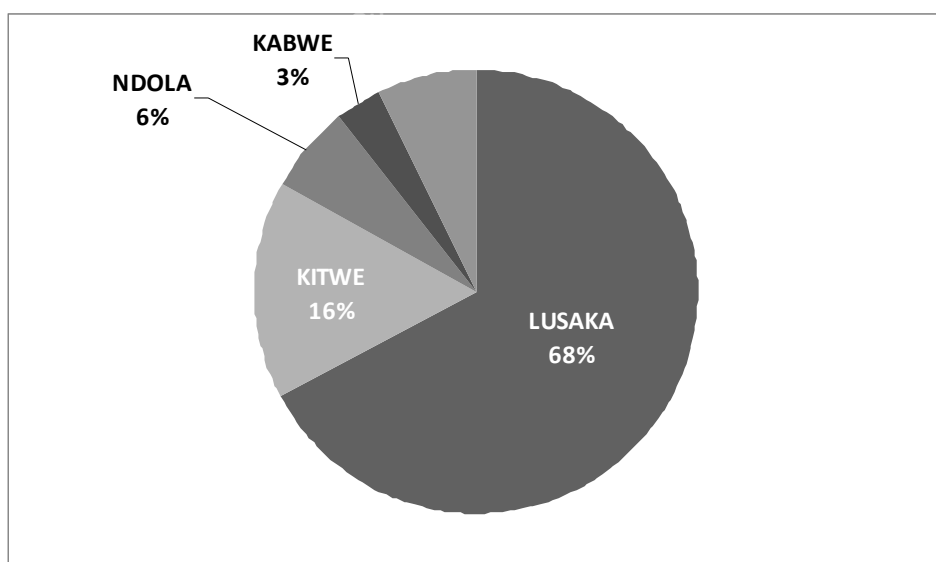
to previous agricultural policies. Since the early 1970s, a central mechanism to maintain state and political party legitimacy was to provide cheap food prices to urban residents, a main support base for the United National Independence Party, the dominant party in the Second Republic (1972-1991). This was achieved through state control of the economy in the form of marketing boards. In 1971, the Zambian government mandated uniform, trans-regional crop pricing with the intention of equalising the market position of all ethnic groups and regions. In 1973, the National Marketing Board (NAMBOARD) was designated as the sole purchaser of maize and cotton in order to ensure fair and adequate agricultural distribution.<sup>3</sup> While agricultural marketing boards were an ineffective tool to promote dynamic agricultural production, they played an important role in expanding the territorial reach of the state and in linking rural interest groups to the state (Di John 2010). Marketing boards were also an important source of state-resource mobilisation through the mechanism of monopolising the purchase of cash crops at below world-market prices and selling such crops abroad at world-market prices.



**Figure 2: ZRA Collecting Stations**  
 Source: Zambia Revenue Authority, at [http://www.zra.org.zm/ZRA\\_Presence.php](http://www.zra.org.zm/ZRA_Presence.php)

Despite the widespread reach of the tax authorities, it is important to note that the bulk of economic activity is largely concentrated around the capital city, Lusaka, and the industrial area of the Copperbelt. Figure 3 shows that the majority of domestic revenues mirror this distribution. However, in comparative perspective, it is important to note that the capital/main city is not as dominant in tax collection as some other fragile states such as Pakistan or Afghanistan, where the main city contributes at least 80 percent.

<sup>3</sup> Ultimately, NAMBOARD policies led to the dramatic decline in agricultural production, which highlights an important trade-off between the maintenance of political stability and the promotion of economic development that characterised the Second Republic.



**Figure 3: Geographical composition of domestic revenues (2009)**

Source: ZRA and Author's calculations

The third sense in which the state has been resilient is its ability to maintain relatively robust levels of tax collection. Recent evidence suggests that Zambia is a relatively high tax-collection state (Table 1). In the period 2001-2005, total tax revenue in Zambia declined slightly, but still averaged over 17.5 percent of GDP. To the extent that tax-collection efforts are not built over night, it is reasonable to assume that Zambia's relatively high tax take is not a recent creation.<sup>4</sup>

Despite its relatively high tax-collection effort, there are two important comparative and historical issues to address. The first is that there has been a general decline in tax collection as a proportion of GDP since 1973, from 20.5 percent at the beginning of the period to 15 percent in 2009 (see Figure 4). While this may seem as if the state has been losing its capacity to tax, it is important to keep in mind that the 20 percent tax of the early 1970s was quite high in comparison with other African countries at the time. Moreover, this decline was the result of both conscious fiscal policy decisions (with the onset of tax reforms in 1992) as well as actual tax-collection performance (an issue discussed below). These reforms reduced the overall tax burden on the economy, which may account for at least some of the fall in the tax revenue to GDP ratio.<sup>5</sup>

<sup>4</sup> There are several points worth considering with respect to the data in the table. First, as standard theory predicts, low tax countries tend to have much lower income per capita and tend to be much more reliant on trade taxes, which means that the fiscal consequences of trade liberalisation can be devastating if alternate forms of tax are not quickly increased. However, income per capita is not necessarily associated with higher tax takes. For instance, there are many countries with a lower income per capita than the Central African Republic and Uganda that collect a much higher share of taxes as a percentage of GDP. Second, the level of tax collection does not necessarily indicate that the state has the capacity to promote rapid economic growth. Uganda, Mozambique and Tanzania have been among the fastest growing African economies in the period 1900-2005, yet have relatively low tax capacity. South Africa and Zimbabwe have higher tax capacity but have had not had nearly as impressive growth rates over the same period. Finally, tax levels do not necessarily indicate that a state or government is legitimate. Recent episodes of political violence in Kenya and Zimbabwe, two relatively high tax states, are examples that relatively high tax collection does not preclude violent challenges to state authority. In these two cases, further research is needed to explain if high tax rates were the result of compliance/consent, administrative effectiveness, or unsustainable levels of coercion.

<sup>5</sup> Theoretically these reforms should have encouraged economic growth, and so led to long term strengthening of tax revenues. Furthermore, if we assume that the informal sector has grown alongside the formal economy, then

**Table 1: Tax collection and composition in selected sub-Saharan African countries**

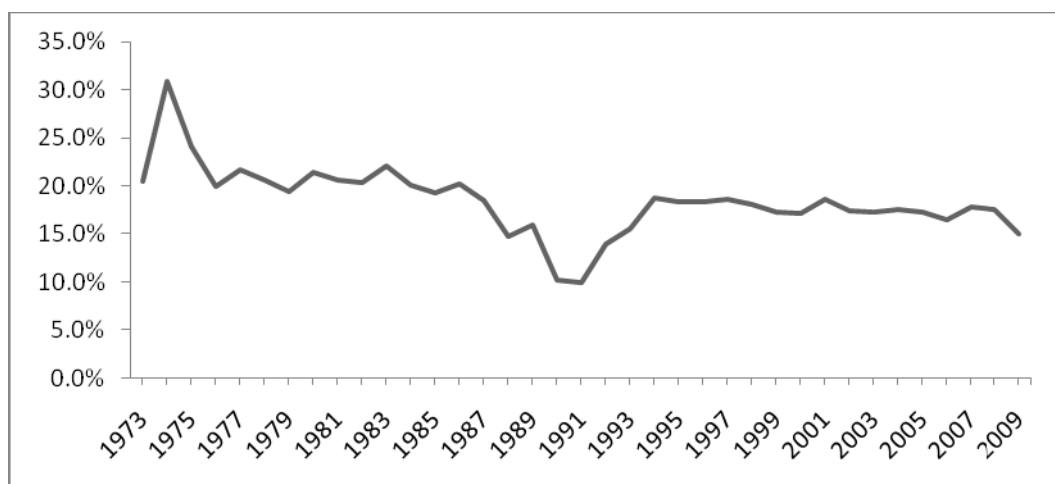
Source: IMF; Government Finance Statistics; Fox and Gurley 2005.

Note: \* at \$US 2000, market prices

<i>Lower Tax Countries</i>	Years	Tax Revenue (as % of GDP)	Trade Taxes (as % of total taxes)	GDP/cap (market prices*)
Congo (DR)	1998-2002	4.5%	32.0%	\$600
Central African Rep.	1992-96	6.1	39.0	1,055
Chad	1994-2000	6.5	34.0	801
Niger	1994-2000	7.9	57.0	678
Rwanda	1993-99	9.3	18.0	931
Tanzania	1992-99	9.6	35.0	524
Uganda	1998-2003	11.4	16.0	1,167
Mozambique	1993-99	11.4	18.0	799
Ethiopia	1993-97	12.9	40.0	814
Mali	1991-2000	12.9	30.0	784
Malawi	1993-2000	14.2	15.0	583
<b>Average</b>		<b>9.7</b>	<b>30.3</b>	<b>814</b>
<i>Higher Tax Countries</i>				
Botswana	1993-98	32.5%	18.0%	\$8,347
South Africa	1998-2002	25.5	13.0	8,764
Zimbabwe	1992-97	22.5	19.0	2,498
Kenya	1992-2001	23.1	17.0	1,033
<b>Zambia</b>	<b>1990-99</b>	<b>18.1</b>	<b>12.0</b>	<b>785</b>
Cote d'Ivoire	1991-99	18.0	40.0	1,582
Senegal	1992-98	16.0	28.0	1,427
Nigeria	1992-2000	15.2	18.0	854
<b>Average</b>		<b>21.4</b>	<b>20.6</b>	<b>2,420</b>
<b>Average (excl. Botswana, S. Africa)</b>				<b>1,363</b>

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the actual tax revenue to GDP ratio is likely to have fallen even further than these data suggest.



**Figure 4: Tax revenue to GDP ratio in Zambia (1973-2009)**

Source: Central Statistics Office and Zambia Revenue Authority

The second important caveat is that there are important historical political economy reasons behind the relatively high tax take in Zambia compared with many sub-Saharan African countries. A recent study (Mkandawire, forthcoming) has suggested that the differential impact of colonial economic development (and in particular the structure of labour markets and the historical process of the integration of indigenous populations into the colonial order) appears to have had an impact on tax-collection capacities in sub-Saharan Africa. One striking feature of African economies is the regional differences in the share of tax revenue in GDP, with southern African countries (South Africa, Zimbabwe, Botswana, Namibia, Zambia) and also Kenya generally having higher tax takes and tax-effort indicators than would be predicted on the basis of their per capita incomes. The reason for this difference owes to the greater formalisation of labour in the colonial period in the Southern African economies and Kenya compared with the rest of sub-Saharan Africa.

Amin (1972) first discussed the different patterns of formalisation of labour markets in colonial sub-Saharan Africa, classifying three patterns of labour integration in the colonial order: the labour-reserve economy, the ‘cash-crop’ economy and the Africa of concessions. ‘Labour reserve economies’ were characterised by a dualistic formal labour market and a migrant labour system that has tied vast amounts of peasants to the enclave white-owned mining industry and plantation agriculture (Mhone 2001). The labour reserves were usually within the African economies themselves (as was the case in South Africa, Namibia, Zambia and Zimbabwe) or were whole countries assigned that role by the colonial division of labour (pre-diamond Botswana, Lesotho, Swaziland, Malawi). Mkandawire (forthcoming) includes Kenya in this group because of its settler past and internal labour market, which had the characteristic of a labour-reserve economy. In these economies, self-employment by natives in the cities was not allowed and there was little encouragement of peasant production since this would have undermined the supply of labour to white farms and industry. One consequence of this is a higher level of formalisation when compared to other African countries (Mkandawire 1985). As a result, many of the small enterprises that elsewhere were in the informal sector were reserved for whites and were thus registered and subject to taxation. In all the cases a white ‘welfare state’ emerged as part of the process of giving legitimacy to the racial order. Whites paid income taxes while natives were confined to ‘poll taxes’ or to service-user charges. Since industry was predominately in ‘white areas’, the revenue from it went to whites. Revenue for native services was mostly generated from user fees on services (electricity, water, sanitation and beer halls). The consequence was that, at

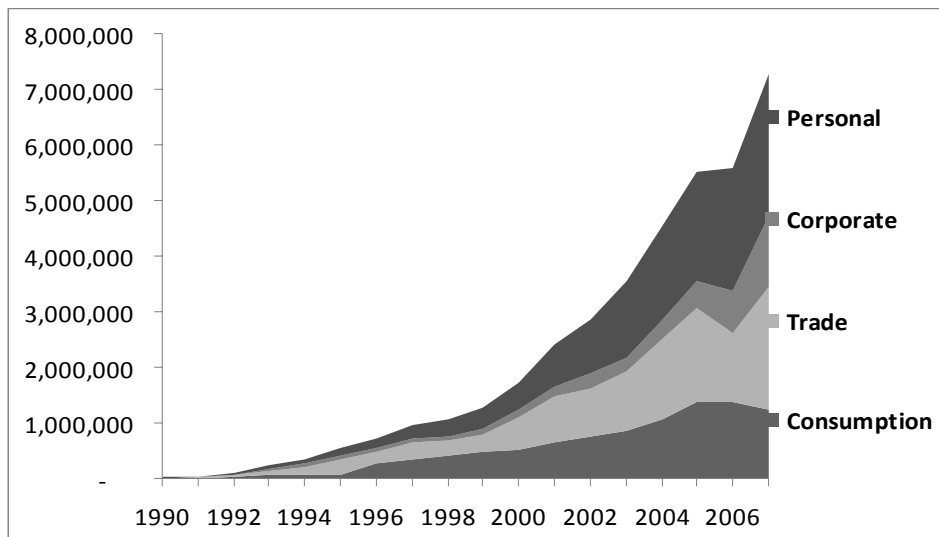


independence, relatively sophisticated tax-collection mechanisms were in existence in all these countries. Independence led to the ‘Africanisation’ of these tax systems, which led to the taxation of the new black middle class and workers in the formal sector.

The relatively high level of formalisation of labour did not extend to countries outside southern Africa and Kenya. In the other two types of colonial economies identified by Amin – the cash-crop economy and the Africa of concessions – higher levels of informalisation prevailed. In the cash-crop economies natives produced most of the export crops while the colonial authorities concentrated on mercantile activities. Colonial merchant houses or marketing boards enjoyed a monopsonistic position in the economy and taxation took place largely through the marketing channels. There were few restrictions on the movement of native labour and informal activities in the urban areas. Most of the countries of West Africa fall in this category. In the Africa of concessions, the colonial power gave private companies concessions on vast tracts of land to produce crops on large plantations or exploit minerals. The Belgian Congo was the classical example of such an economy.

Patterns of colonisation have thus turned out to have produced institutional arrangements and practices that have proved remarkably resilient. Mkandawire’s brief application of Amin’s analysis of the colonial economy to its effect on subsequent tax capacity in post-colonial sub-Saharan Africa represents an important insight into the historical origins of the differences in processes of state formation and consolidation. It can help explain why Zambia has a relatively high tax take and relatively high personal income-tax collection on labour (see below), but cannot explain adequately why Zambia today has a relatively low tax-collection rate among the high tax southern African countries (see Table 1).

The fourth characteristic of the Zambian tax system has been the diversity of the revenue base, particularly impressive for a country at a low income per capita level. All four major types of taxes (trade, personal income, corporate and consumption) make some contribution to tax collection, which, along with the tax level, indicates broadly the extent of state control over resource mobilisation (see Figure 5). Unlike for almost every other sub-Saharan country, personal income taxes brought one of the largest shares of revenue in Zambia (Weeks et al. 2004). This indicates a relatively high level of taxation from labour income, the implications of which will be discussed later. Given the tariff reductions during the 1990s, trade taxes held remarkably steady in their contribution, suggesting there to be limited scope for increased revenue from this source, but also that trade liberalisation does not necessarily weaken the fiscal base of the state in a low income country – as has been argued, for example, by Baunsgaard and Keen (2005). Finally, the Zambian case corroborates recent evidence that suggests increasing the diversity of the tax base, and not just relying on VAT, has been central to keeping tax revenues from collapsing in the face of trade liberalisation (IMF 2005).



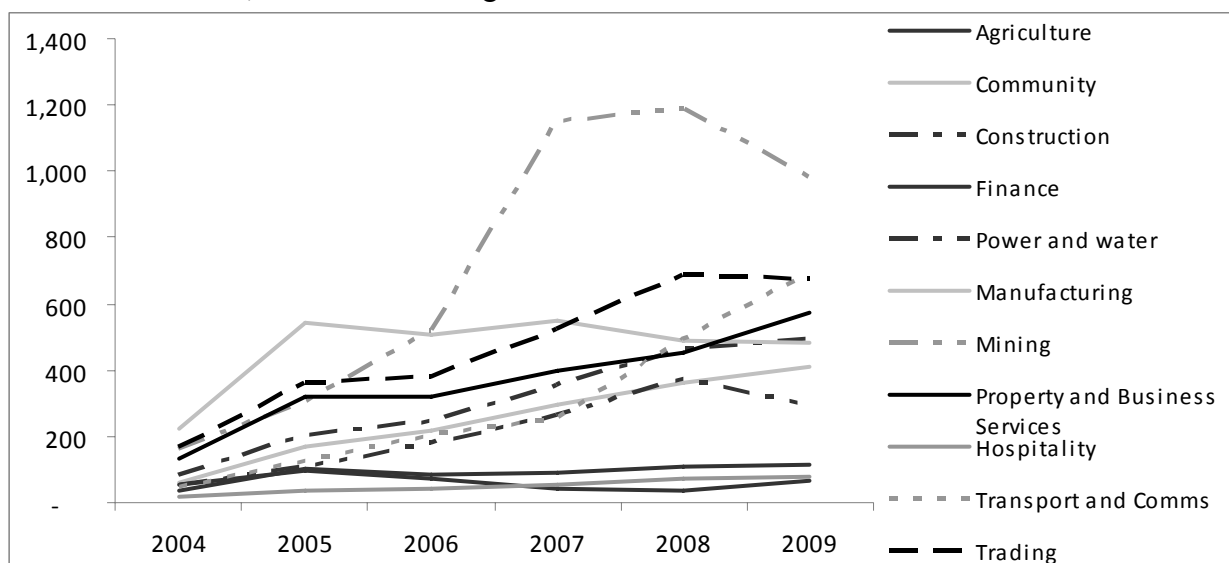
**Figure 5: Composition of tax revenues by tax types (Kwacha millions), 1993-2007**

Notes: Categorisation of tax types – Consumption (Excise Duties, Domestic VAT); Trade (VAT on Imports, Import Tariffs, Export Duty); Corporate (Company Income Tax, Mineral Royalty); Personal (PAYE, Withholding tax)

Figure 5 reveals a number of characteristics of the nature of tax revenue in Zambia:

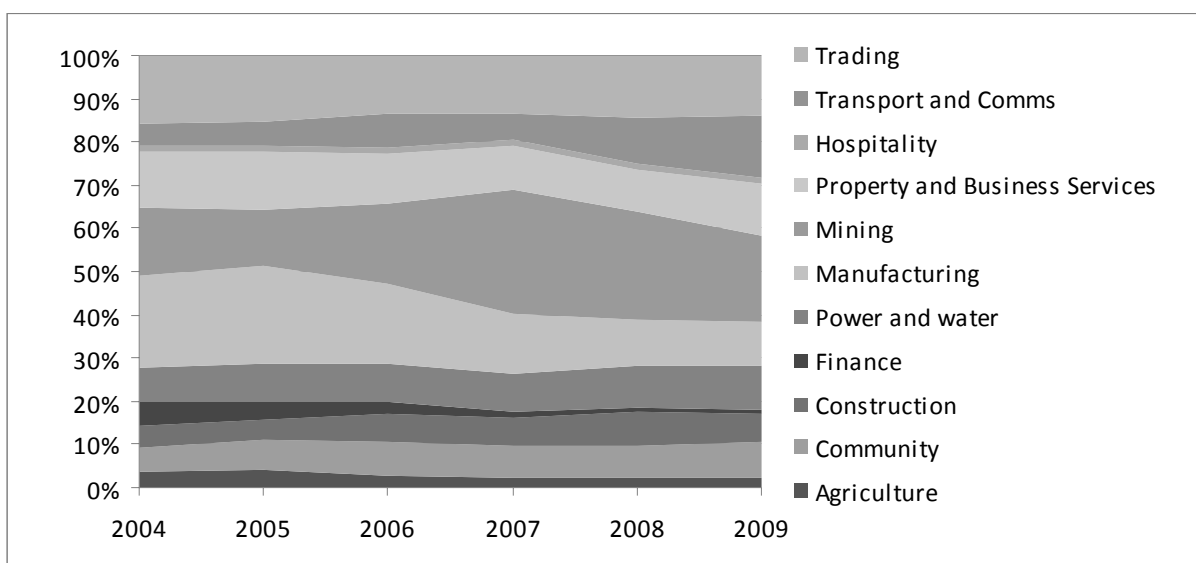
- The relative burden on businesses has been low for most of the period, although there has been a notable increase since 2005. This is likely to be driven by the increase in the profitability of the mining sector.
- Consumption taxes made the largest contributions in the late 1990s. However, this has dramatically declined throughout the past decade. It is likely that this is due to a widening of the tax gap in VAT and similar taxes.
- The dominant tax types throughout most of this period have been trade and personal taxes, although PAYE has fallen slightly as a proportion of total revenues since 2004 as a result of relief measures outlined in the national budget.

The diversity of the tax base is further seen in the ability of the state to tax a wide range of economic activities, as indicated in Figures 6a and 6b.



**Figure 6a: Sector composition of domestic revenue, 2004-9 (Kwacha billion)**

Source: ZRA and Author's calculations



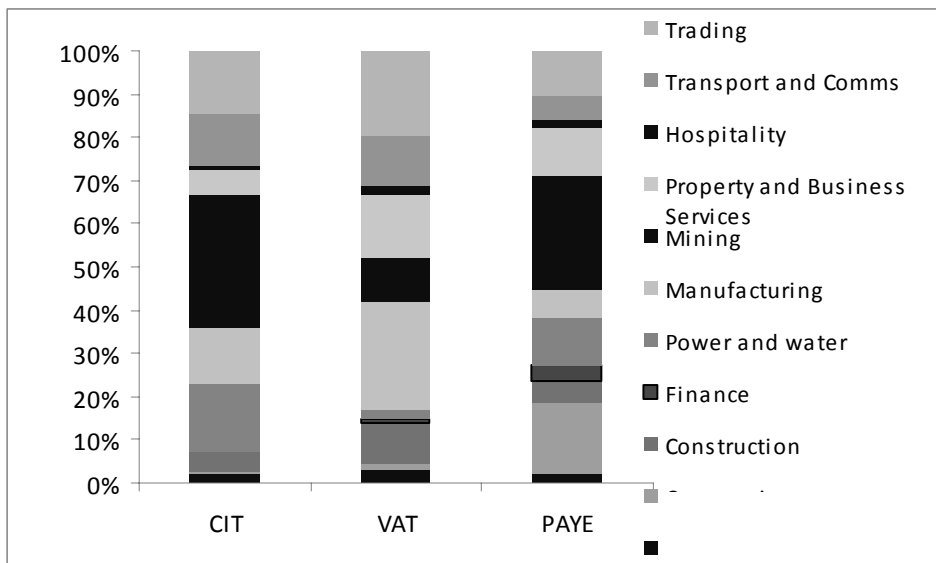
**Figure 6b: Sector composition of domestic revenues, 2004-9 (percent)**

Source: ZRA and Author's calculations

The relatively small burden of corporate taxes in more recent times will be discussed later. However, there are several issues worth noting here. First, manufacturing was strong in the first two years of the period but has since stagnated with other sectors such as retail trading and transport, storage and communications overtaking this sector. Second, the community sector includes government institutions, and the relative high position of this sector is a function of this – in particular through government employees' PAYE contributions (see Figure 7).

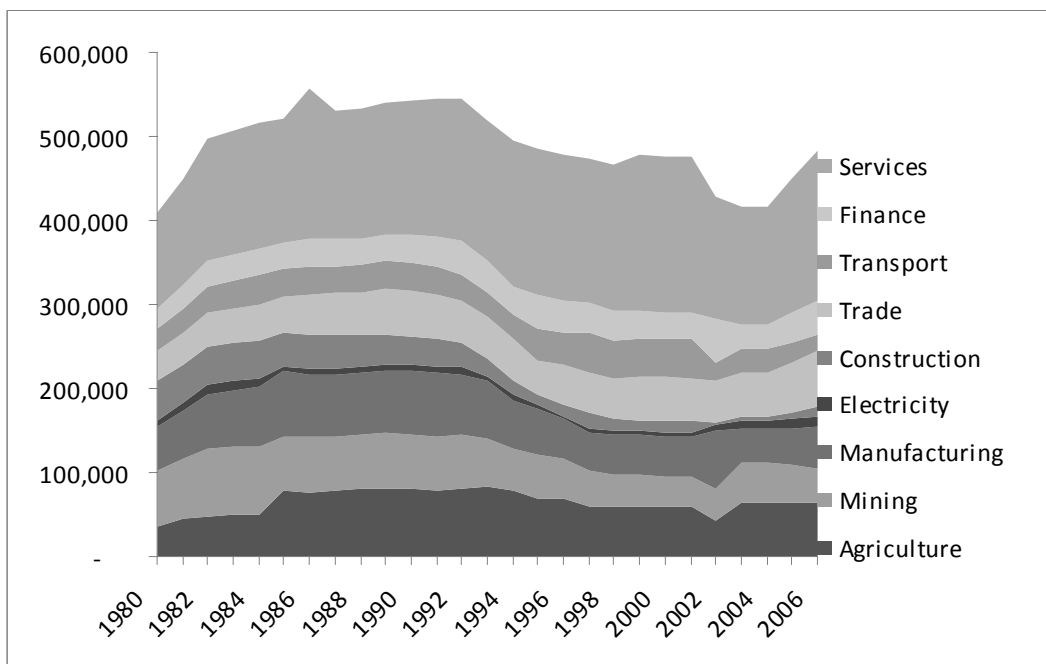
The role of copper mining in tax-revenue collection is much less than expected for an economy where, up until the early 1990s, copper taxes contributed on average nearly 60 percent of government revenues (Weeks et al. 2004). While the case of copper taxation will be discussed in more depth in the next section, it is worth noting that while the copper industry contributes substantial amounts through collecting personal income tax and company tax, its small share is due in large part to the the large investment incentives and the fact that major capital expenditure has occurred. The losses the mines have made due to this expenditure has been carried forward over the years reducing taxable profits.<sup>6</sup> In the period 2007-9, of the top ten recipients over this period, firms from the mining sector received 67 percent of total VAT refunds, in value terms. Utilities and manufacturing received 13 percent between them.

<sup>6</sup> As discussed below, the surprisingly small share of taxes from copper is also due to investment incentives (such as long tax holidays) and the negligible royalty tax levied on the sector.



**Figure 7: Composition of domestic taxes by sector, 2004-2009 (annual average)**

Source: ZRA and Author's calculations



**Figure 8: Formal employment by sector (number of workers)**

Source: ZRA and Author's calculations

Fifth, the relatively robust personal income-tax collection in Zambia has important consequences for state resilience since it is a direct tax that is particularly effective in institutionalising state-citizen relations. This is because direct taxes tend to be most effective activating 'voice' among citizens (Lieberman 2002). What is notable in Zambia is that a substantial number of employees in the formal sector are registered with the tax authority. Figure 8 shows formal employment figures from 1980 to 2006 have varied between 400,000 and 550,000.

One of the main reasons behind the high income-tax collection is the large share of public employees among employees. In 2006, approximately 36 percent of formal employment was in the public sector with 25 percent working in central government. Moreover, government

wages and salaries have represented around 30 percent of total expenditure for most of the 2000s with the public wage bill averaging around 8 percent of GDP in the period 2006-8 (IMF 2010: 25), which is one of the highest ratios in sub-Saharan Africa (Interview, IMF resident representative, Zambia, 8 March, 2010).

It is not currently possible to fully analyse PAYE taxpayers at the employee level. ZRA systems only capture PAYE at the firm level – i.e. ZRA records PAYE payments by firms, which aggregate the PAYE contributions of individuals. However, it has been possible to utilise a database that contains a sample for 2006 only. This database contains information on the number of employees and the total wage bill for each firm in the sample. From this it is possible to estimate the amount of tax that each employee would pay (see Table 2).<sup>7</sup> It shows that out of the 477,580 employees in formal employment, an estimated 73 percent paid a non-zero amount of PAYE in 2006.

**Table 2: Estimated number of PAYE taxpayers in 2006**

Source: CSO, Patrick Chileshe (Senior Economist, ZRA) and Author’s calculations

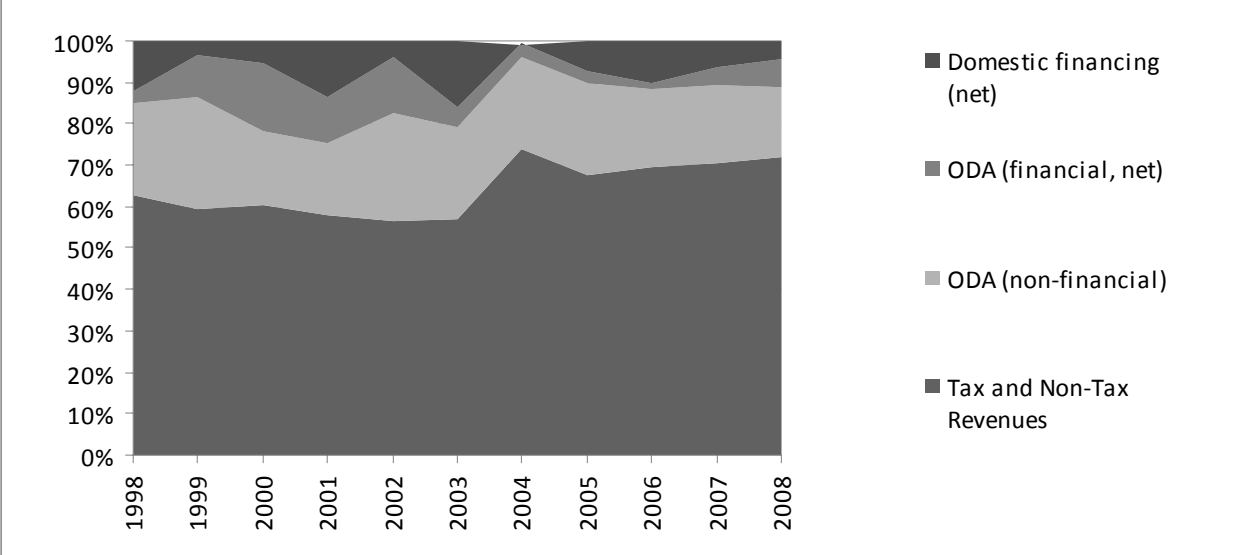
Total formal employment in 2006	477,580
Employees that paid PAYE	350,168
No. paying PAYE, threshold 1	240,999
No. paying PAYE, threshold 2	70,228
No. paying PAYE, threshold 3	38,941

However, it should be noted that the vast majority of PAYE revenue comes from a relatively small number of employees. From data provided by the ZRA, the top two deciles of highest earners pay most of the overall PAYE revenue collected in 2006, around 84 percent of total PAYE revenues. In particular, the top decile, representing around 48,000 employees, contributed around 68 percent of total PAYE revenues. In terms of total tax revenue collected in 2006, the top decile of earners contributed around 21 percent. This concentration of tax collection is also mirrored among corporate taxpayers, with the top 350 firms in terms of sales responsible (through VAT, PAYE and corporate income tax) for 77 percent of tax collection over the period 2007-2009 (author’s calculation based on ZRA data). This concentration is not unusual for low-income countries, but the fact that mining firms – the largest export sector in the country – contributes very little to overall tax revenues (because of various tax holidays) suggests that the Zambian state relies on a more diverse set of tax sources and firms than most low-income African economies.

A sixth indication of the performance of the tax system is that substantial foreign aid has not dented the domestic tax effort. Figure 9 shows that in the period 1998-2007, 60 percent of the government’s budget is funded by the taxation system each year, with the rest mostly coming

<sup>7</sup> With thanks to Patrick Chileshe (Senior Economist, Zambia Revenue Authority) for the use of this database. We believe the sample is fairly representative: it contains around 10% of total formal employees and 14% of economy-wide PAYE revenues. We make two strong assumptions: all employees are paid the same, average wage in each firm and firms are fully compliant in paying PAYE contributions. The first assumption means that the estimated number of people paying positive PAYE contributions is likely to be upwardly biased. The assumption says that everyone in the firm is paid the mean wage. It is more likely that the wage profile of each firm is negatively skewed, with the majority paid below the mean. This is likely to mean a larger number of employees fall below the PAYE threshold than the following estimates show. The second assumption is currently being tested at ZRA.

from foreign assistance. However, the proportion of the budget funded by tax revenues rose over this period from 56 percent to 66 percent. While there was a dip during the recession around 2001, which was taken up by foreign assistance, tax collection rates have since recovered.



**Figure 9: Composition of government revenues**

Source: Ministry of Finance

Finally, the manner in which tax is collected and the degree of participation in the budgeting process also indicate that the Zambian state has relatively well-performing tax system. The first indicator is that there have been very few large-scale protests over tax collection in the past decade, although there was substantial rebellion over the first introduction of VAT in the mid-1980s. This is not to say that the tax regime is considered wholly legitimate. In fact, the very low tax on foreign copper-mining firms dominates much domestic policy discussion (as will be discussed in the next section). Second, tax has been generally collected in a non-coercive manner as there have been no significant episodes of tax raids involving the police or military as has been the case in some countries such as Uganda. The extent to which tax is collected through quasi-voluntary compliance is a sign that the tax regime has at least a broad passive legitimacy among the population (Levi 1988). Finally, the government began to invite budget-policy proposals from non-state actors and began to publish submissions of these proposals (and the decision made regarding each) on an annual basis in 2008. This has both increased access of interest groups and organisations in the budget process and has made the process more transparent (Bwalya et al. 2009).

**Taxation, state resilience and the elite bargain**

Beyond being a means for establishing administrative reach and authority, a given tax regime, particularly in less developed countries, is also embedded in patterns of state-created rent allocation. The creation and deployment of economic rents and privileges to relevant elites is the essence of elite bargains. In turn, exploring tax patterns can illuminate important insights into the shape and character of the elite bargain, which has been argued to be important in generating state resilience in general (North et al. 2007) and in the Zambian case in particular (Lindeman 2009; Di John 2010). At the same time, the nature of elite bargains provides a window into the political limits of expanding tax capacity. The most general case is that

increasing taxes and/or enforcing tax collection may become difficult if it substantially reduces the income flows of elite and allied upper-income groups.

As discussed in Di John (2010), the period 1964-2008 is marked by the purposeful creation of economic and political privileges for regional elites as a way of maintaining political peace. However, substantial economic liberalisation in the mid-1990s changed the way rents were distributed in the polity (Rakner 2003). Prior to liberalisation, the state was able to create rents through a series of interventions that included posts in public enterprises and parastatals, infant industry protection via trade barriers, subsidised credit through control of the banking system among others. With economic liberalisation – which was promoted both domestically by the Movement for Multi-Party democracy (MMD), the dominant party since 1991, and demanded as part of the structural adjustment loans provided by the IMF and World Bank – the levers of state patronage were reduced. Thus, while privileged positions in government remained important, the tax system became an ever growing source of dispensing patronage and privilege.

There are several ways in which tax patterns and policy contributed to the creation of rents for elites. First, consider tax evasion. A tolerance for tax evasion – particularly in personal and corporate income tax, but also in customs collection – has been a constant feature of post-independence Zambia, but has seemed to have steadily increased over time. This has principally benefited political and economic elites. Referring to the era of the Second Republic (1972-1991) under one-party rule, Von Soest (2007: 630) notes:

‘According to a former tax officer, “some people had better treatment, the big shots. It depended on who you are” (14.4.2004 int.). This assertion is also valid for the Department of Customs and Excise. In his 1979 annual report, the head of the department openly articulated his frustration : ”The number of senior people in the Party and its Government who apparently feel they have immunity to Customs formalities continued to soar... Officers are now working under constant fear of being victimised if they stumble across these officials”.

Such evasion continued in the beginning of the Third Republic (1991- ) during the transition to multi-party electoral competition. In 1992, the minister of finance stated that the tax administration only tapped one-third of formal sector incomes (Von Soest 2007: 631). As the government refrained from capturing ‘difficult’ taxpayer groups with intimate connections to the ruling elite, the revenue authority struggled to significantly broaden the tax base.<sup>8</sup> Indeed, it was common knowledge that, prominent MMD politicians and their businesses were not controlled through tax audits (Von Soest 2007: 635-6). A common phrase employees heard from their managers in these cases was ‘don’t go to this man, this man is difficult’. Respondents mentioned several politician-owned companies that allegedly have never paid tax.

Evasion of income tax among the highest income earners is also a feature of the period since 2000 (Interview, ZRA official, March 9, 2010). If one includes the substantial amount of assets held abroad by economic elites, a common feature in sub-Saharan African economies (Collier et al. 2004), then the level of income-tax evasion rises further. One of the main reasons behind continued evasion has been the only recent creation of a Large Taxpayers Office (LTO) in 1998. It still remains to be seen if it will address high evasion as its auditing

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<sup>8</sup> Moreover, self-employed individuals such as physicians and lawyers, many of whom had close connections with the ruling party, remained largely outside the tax net (Von Soest 2007).

capacity is still considered weak. Moreover, there is some evidence that customs evasion among well connected government officials (and supposedly their business allies) has been prevalent in the post-2000 period. The ZRA was apparently told not to control ‘special’ government members for dutiable goods at border posts (Von Soest 2007). A customs officer working at the Chirundu border post maintained: ‘That’s how the system is – they make an independent ZRA and [then] break the rules’ (Von Soest 2007: 636).<sup>9</sup> In the post-2000 period, there also seems to have been widespread VAT tax evasion, though this seems to be prevalent beyond big business groups. Indeed, the decline in Zambia’s tax take in the early 2000s from 18-19 percent to 16-17 percent by 2008 has been the result by disappointing revenue collection on goods and services and trade taxes. The IMF (2008: 5) argues that there has been a likely increase in VAT evasion.

Second, the tax regime in copper mining (the economy’s leading sector) has also evolved in ways that both reflect the elite bargain and the capacity of the state to appropriate mineral revenues. The industry has gone through three distinct phases in post-independence Zambia in terms of its tax regime. The period 1964-72 is perhaps the most successful as the state maintained a nearly 50 percent equity share with foreign firms, a period that coincided with the highest tax take in the country’s history (between 25 and 30 percent of GDP). The period 1972-1998 saw the complete nationalisation of the industry, which while increasing the state’s tax take also coincided with substantial politicisation of the industry (and massive mismanagement) and a slow but dramatic decline in tax revenues as production plummeted (by 1990, the overall tax take declined to around 19 percent of GDP). However, the period 1985-1990 still saw a relatively high corporate tax share of 5.5 percent of GDP, mostly due to the copper industry’s contribution. The copper industry was one of the main sources of patronage, but its dreadful performance meant that the rents to share among elites were becoming smaller. It is important to note that by the late 1990s, however, the copper industry had ceased to contribute to net government revenues as it was, for example, losing nearly \$1 million a day in the year prior to privatisation.

Structural adjustment loans became conditional on the privatisation of the industry, which was undertaken in the context of desperation: namely historically low world copper prices, declining copper production and an unsustainable debt burden. With the privatisation of the copper industry in the period 1998-2000, there was a substantial change in the tax regime, which reflected the desperate macroeconomic situation of the country and the copper industry itself.<sup>10</sup>

The basic outcome of privatisation (discussed by Sardanis 2003) was the instalment of one of the most investment-friendly mining deals known. In return for assuming the industry’s debt and reviving deteriorating mines, the foreign mining companies received: a reduction in the corporate tax rate from 35 to 25 percent; exemption from customs duty on inputs up to US\$15 million; reduction of the mineral royalty from 2 percent to 0.6 percent; exoneration from excise duty on electricity; an increase from ten to twenty years in the period for which losses

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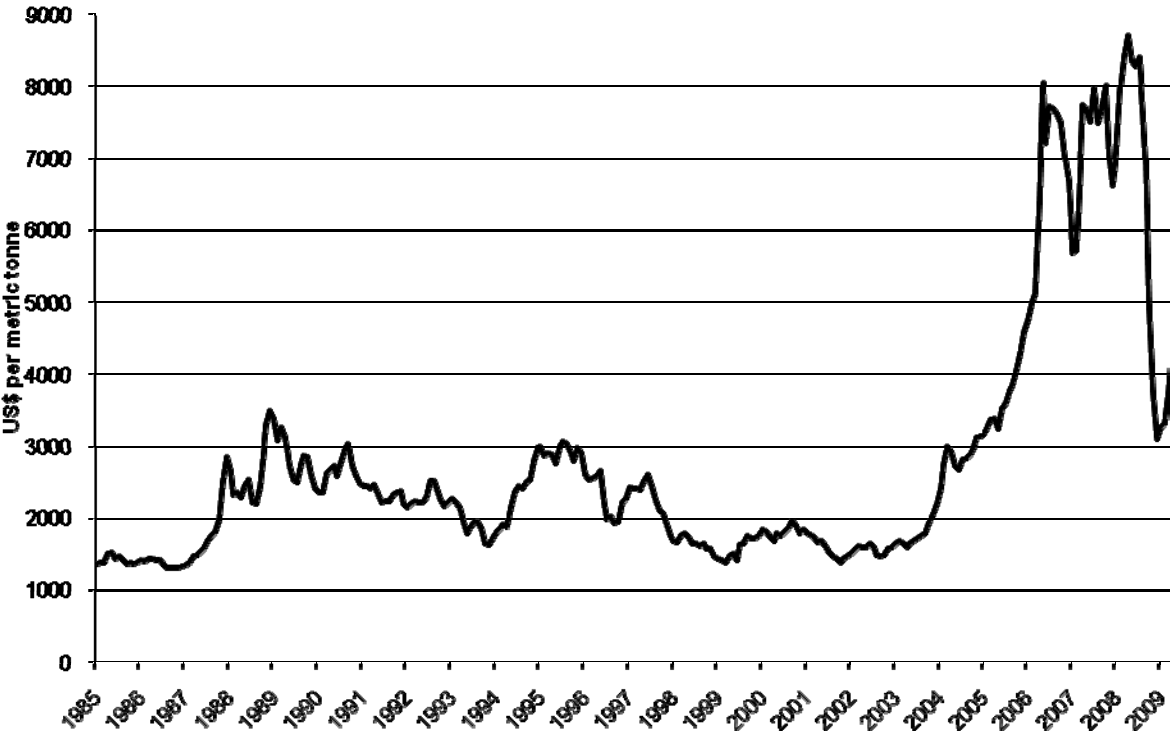
<sup>9</sup> Interviews with ZRA and IMF staff also indicated that there is widespread VAT evasion, though this seems to be prevalent beyond big business groups. See below for discussion of suspected widespread evasion in the gemstone sector.

<sup>10</sup> The reasons for the decline in Zambian economic performance are complex, but include a combination of the disruption of regional trading routes, the nationalisation of the copper industry before the development of skilled workers and managers emerged on the domestic scene, and mismanagement of the state-owned copper industry (see Weeks et al. 2004). Copper production declined from 600,000 tons in the 1960s to just over 300,000 tons by the end of the 1990s.



could be carried; and exemption from tax on interest, dividends, royalties and management fees (Fraser and Lungu 2007). Moreover, the mining contracts stipulated that companies were exempt from VAT payments. This meant that the sector had the lowest tax burden in the economy and were thus creating large rents for the companies.<sup>11</sup>

In sum, the mining companies effectively paid almost no income taxes in the period 2000-2006. In the period 2001-2008, the copper-mining sector paid around 5 percent of total tax revenues despite being the leading sector in the economy and despite positive trends in copper export prices (Figure 10). The effect of these so-called incentives was that it would be decades before the government received substantial revenue from the new mining companies. There is no doubt, however, that the tax incentives, whether overly generous or not, have had a positive effect on production, which increased from 250,000 tons in 1998 to well over 600,000 tons by 2008.



**Figure 10: Copper prices 1985-2009**

Source: International Finance Statistics

While the government in 2008 considered raising the royalty rate to 2.5 percent with the support of the IMF, this rate is still low by the standards of Zambia’s neighbours – an IMF survey of tax and royalty rates in developing countries found no other African country charging royalties 2 percent, and some have royalties as high as 20 percent (Baunsgaard,2001). As a result, taxes as a percentage of GDP declined from 18.4 percent in 1996 to 17 percent in 2005. In 2006, the government received just \$25 million in copper

<sup>11</sup> Tax exemptions can create rents for particular companies, public or private. However, this can be considered a rent only if there are no tax exemptions in most of the sectors of the economy and/or if there are not high levels of tax evasion in non-exempted sectors. If neither of these conditions holds, then the tax exemption is not potentially creating a super-profit and therefore a rent for the enterprise in question since the exemption does not necessarily create a greater profit rate compared to other sectors or companies.

royalties out of a \$US2 billion turnover in copper sales.<sup>12</sup> This substantially hampers the extent to which the government can finance improvements in physical infrastructure, which are essential for reviving productive capacity and growth in non-copper agricultural and light manufacturing sectors.

Since 2000, copper privatisation and the copper-mining tax regime have had several implications for tax capacity and the elite bargain. First, changes in tax regulation have decimated the contribution of corporate income tax in the economy, which since 2002 has been below 2 percent of GDP (compared with over 5 percent in 1990). Second, the tax capacity of the state operates well below potential, which is one of the reasons the government is attempting to renegotiate contracts. Third, it has brought substantial economic rents to a new and important partner of the MMD government, namely foreign copper firms from Europe, Canada, India and, increasingly, China. Indeed, privatisation has reduced the patronage possibilities of the MMD to place high-level party cadres in managerial posts. Fourth, the privatisation process has brought some benefits (and therefore some rents) to the executive and close MMD party allies. The privatisation contracts were not disclosed publicly and there were allegations that substantial bribes were passed to the Chiluba administration (Interviews, Revenue Authority and Finance Ministry officials, 5-7 March, 2010). The state also still maintains a share of between 10 and 15 percent in most of the privatised mining companies, which are managed by Zambia Consolidated Copper Mines – Investment Holding. While this holding company also ‘inherited’ large amounts of debt from the privatised companies as part of the privatisation deal, they represent a potentially valuable asset as the industry rebounds. Most interesting is that these equity shares remain off-budget; that is, they are not systematically or routinely reported to the Ministry of Finance, further indication that they are valuable and represent a substantial rent income for MMD party leaders and the executive.

A third mechanism through which elites may be earning substantial rents is through the almost complete lack of taxation of the gemstone sector. At present, the government keeps unreliable production and sales statistics and has limited capacity for tracing gemstone trade, let alone monitoring production on major sites (which is the main way it would be able to estimate the taxable base for gemstones such as emeralds and amethyst).<sup>13</sup> Because of massive under-reporting of production, and the generally secretive nature of this sector, the evidence of this claim is difficult to verify; but interviews with ZRA officials and other experts on mining in the country suggest both that the sums involved are vast and that very high level politicians, state officials and allied businessmen are involved. Mpande (2009) estimates that the value of Zambian gemstones sold abroad in the 2000s was between \$US10 and 15 billion, yet the highest export values reported by the Zambian government was only US\$40 million in 2002. He further estimates that nearly 60 percent of gemstones mined in Zambia are stolen, most of which is smuggled.<sup>14</sup> Formally licensed export companies comprise around 30 percent of production, and even here it seems that the taxation of the such exports is well below potential due to transfer-pricing mechanisms on the part of companies.

While it may be the case that ineffective tax administrative capacity is behind the lack of taxation in the gemstone sector, the potentially large sums involved suggest that there may be

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<sup>12</sup> In the 2000s, as little as 2-5% of the total export value accrued to the government in the form of tax and direct ownership (minority), whereas best performers like Botswana, Chile and Norway ensured a government take of between 50-75% (Norwegian Embassy in Zambia 2008).

<sup>13</sup> Most of the gemstones are mined by small-scale artisan miners with about eight highly mechanised mines.

<sup>14</sup> Much of the smuggling goes through Katanga into the Democratic Republic of Congo (DRC).

a purposeful decision not to tax the sector. This would particularly be the case if it is benefiting political and economic elites. Moreover, because economic liberalisation, and particularly the privatisation of the copper mines, has reduced the scope for rent creation, the purposeful neglect of the seemingly lucrative gemstone industry may be providing an alternative path of rent creation to help finance the elite bargain. The fact that the industry seems to benefit particular individuals and not broader groups is consistent with the more targeted/particularistic nature of patronage in the post-1991 period (Levy and Palale 2007: 8). Fourth, the relatively low rates of taxation on agriculture can also be seen to benefit elite landowners and particularly large farmers and agro-processors.<sup>15</sup> The income-tax rate on agricultural businesses is 15 percent compared with a rate of 30 percent nationwide. Fertiliser subsidies and historically low tax rates on agriculture have been mainstays of promoting production in the sector. However, since economic liberalisation, large farmers have benefited considerably more from low taxes as they have technological capacity, the most fertile soil, and access to infrastructure (along the ‘line of rail’) to benefit from growth opportunities (Pletcher 2000; Thurlow and Wobst 2004).

Fifth, elites benefit from negligible taxes on property. While this tax (which is collected by municipal governments) is small in general, it tends to be a regressive tax since wealthy urban elites and rural landowners pay similar nominal rates as do less wealthy households. In the period 2001-2005, property taxes averaged 32 percent of local government revenues, which is a minuscule since local revenues as a percentage of GDP averaged 0.4 percent of GDP. Thus property taxes comprised a mere 0.13 percent of GDP. This low property-tax collection both limits the degree to which local governments can fund public goods and social spending, but also reflects the highly centralised revenue system in Zambia.<sup>16</sup> This in turn is consistent with the highly centralised nature of patronage throughout the polity (Di John 2010).

## Conclusion

This paper has developed two main points: first, it has analysed how patterns of taxation contribute to state capacity and especially state resilience in Zambia in the post-independence era, but particularly since 1990; and second, it has examined how taxation reflects the nature of elite bargains and, in turn, how the dynamics of elite bargains affect tax patterns and capacity. Neither of these issues has been explored systematically in the literature. The paper suggests that, while the Zambian tax system is relatively effective, the demands of accommodating elites have constrained the ability of the state to develop a more robust tax system. This problem is compounded by what appears to be substantial amounts for informal business activities among elites. Indeed, informal business can be a site of elite activity: it can give rise to a rival taxations system if it becomes particularly lucrative and there is informal protection operating (as appears to be the case in the gemstones sector). There may also be many informal activities within elite-owned formal sector firms; and, given the high levels of tax evasion, this is not a trivial issue.

At the same time, the above mentioned features of the tax system contribute to maintaining elite ‘buy-in’ and therefore state resilience in the era of economic liberalisation. It is important to remember that while in the period 1980-2005 Zambia’s tax take has declined by

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<sup>15</sup> Such as Zambia Sugar plc and Zambeef Products plc

<sup>16</sup> It is important to consider that there has been a general resistance to property taxes since they are associated with exploitative colonial rule (Roberts 1976: 177-193). In particular, the protest around the colonial ‘hut’ tax has created a legacy of resistance to property taxation.

nearly 5 percentage points of GDP (Keen and Mansour 2010: 56), this decline began from a relatively high and diversified tax base.

Indeed, the decline in revenue generation calls into question Von Soest's (2007) argument that revenue performance in Zambia improved since the establishment of the ZRA in 1994, despite the existence of what he calls 'patrimonial politics'. Rather, a combination of an excessively investor-friendly copper-mining tax regime, persistent and even tolerated tax evasion among very high income earners, a low corporate tax take generally, and the suspected purposeful neglect of taxing the gemstone sector (all of which contributed to providing rents for elites) have diminished state tax-revenue mobilisation since the creation of the ZRA.

However, there are two other areas less linked to elite bargains that may have important long-run implications for the fiscal and tax system and for state-society relations. The first concerns aid expenditure. In the period 2000-2008, between 65 and 70 percent of aid was spent on project aid with the rest comprised of direct budget support. Apart from problems of coordinating aid inflows, much of the project aid is in effect off-budget; that is, not reported to the Ministry of Finance. In recent years, there are rumours to have been thousands of unaccounted for bank accounts pertaining to project aid floating in the domestic banking system (Interviews, Ministry of Finance officials, 6-7 March, 2010). This may be one of the factors behind the country's poor record in the misuse of state resources, problems of budget control and project execution (Von Soest, 2007: 628). While it is possible to suppose that some of this money winds up in the hands of line ministers (and therefore a form of rent deployment), a big problem is that a significant portion of fiscal spending is not accountable to parliament and therefore democratic processes. One big challenge for the polity is to bring more of aid on-budget, which would help deepen the 'fiscal social contract'.<sup>17</sup> The second concerns the lack of much progress in formalising small-scale informal sector activities. Before 2005, there were virtually no initiatives to register informal firms. As with many low-income countries, this was due to administrative constraints and the high cost of collection. However, the political imperative of the MMD to ensure votes among the urban and rural poor also limits the political commitment to make inroads in this area.

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<sup>17</sup> It could also be argued that off-budget items provide another avenue for elites to appropriate some income in an era where economic liberalisation limits state patronage.

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