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REFORMING THE VALUE ADDED TAX IN ZAMBIA

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ABSTRACT

This study analyses the reform of value added tax (VAT) in Zambia. It does so by firstly, empirically establishing who pays VAT and secondly by investigating the economic impact of broadening the VAT base. Two options on reforms to broaden the VAT base are considered using a computable general equilibrium model which specifies a VAT with rebates. These are: (a) broadening the VAT base to all sectors and (b) broadening the VAT base to the agricultural sectors except the maize sector which is the source of the country's staple.

The results in general suggest that VAT is mildly regressive. However, the VAT burden is borne more heavily by urban households compared to rural households. In particular, VAT paid on food is borne more heavily by urban households. The results also suggest that in the short-run broadening the VAT base to all sectors has the ability to raise additional revenue but has adverse effects on the economy, particularly on household welfare. Nevertheless, the adverse effects are muted if VAT broadening is accompanied by reduction in the VAT rate. Furthermore, results on the reform that extends the VAT base to the agricultural sectors except the maize sector, has minimal effects on the macro economy, raises some additional revenue and adversely affects the welfare of urban households compared to rural households.

At sectoral level, results reveal that in the short-run broadening the VAT base engenders a resource allocation within value-added that is beneficial to the mobile factor, labour due to the impact of rebates on relative prices of intermediate inputs. In addition to this, results show the importance of a well functioning rebate system on the economy. The imperfections in the rebate system are likely to affect the welfare implications of changes to VAT. Results suggest that welfare losses from broadening the VAT base fall with an improvement in the functioning of the rebate system.

The conclusions and recommendations from the foregoing are as follows. Given that that the burden of VAT is largely borne by urban households who are relatively better off compared to the rural households, VAT can be extended to cover some of the currently exempted items at low welfare cost. This would create fiscal space to undertake more activities as envisaged in the Fifth National Development Plan. Secondly, extending the VAT coverage to all sectors with very minimal or no exclusions should be accompanied with reductions in the VAT rate. Furthermore, contrary to the widely held view in the debate on VAT reform in Zambia, extending the VAT coverage to agricultural sectors apart from maize sector is not likely to hurt the worse-off socio-economic groups. The short-run welfare losses of such a reform appear to be more disproportionately borne by the urban households whose incidence of poverty is low compared to the rural households. Therefore, bringing more agricultural commodities under VAT coverage provides one of the viable options to reforming VAT in Zambia.