TREASURY

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PAY YOUR TAXES THE NATION NEEDS IT

The Evils of Tax Evasion

The Oxford advanced English learners' dictionary defines evasion as the act of avoiding something that is legally or morally required. Tax evasion can therefore be loosely defined as illegal and deliberate failure to pay tax. But why is tax evasion a problem?

For the sake of argument, assume there is 100 million kwacha of income tax evasion in Malawi. Why is this a problem? The answer may appear obvious and one could argue that if evasion were to vanish then the central government budget deficit would be 100 million kwacha lower than would otherwise be the case. Alternatively, government could spend an extra 100 million kwacha more to finance essential services such as health care, education and infrastructure.

These, however, are not satisfactory answers to the question. Reducing the government deficit or expanding existing government programs can be financed in a number of other ways such as raising tax rates, broadening the tax base, or introducing a new tax. The real question is whether curbing evasion is superior to alternative methods of achieving our fiscal objectives.

Consider the following hypothetical example. If all eligible taxpayers underestimate their tax liability by say, 20 percent, then the government could simply raise the tax rate by the same margin to realise the desired revenue. In this case, spending money on tax enforcement could be a waste of resources. The problem, however, is that not everyone evades taxes and, indeed, those who do evade do not evade by the same proportionate amounts. Furthermore, different people have different motives for evading taxes which include personal characteristics such as one's attitude towards government, one's willingness to gamble, etc. Secondly, others evade taxes because of opportunities and potential rewards for evasion. Therefore, as long as these differences occur, then evasion creates serious inequalities and inefficiencies in the economy. For example, evasion creates horizontal inequity because people with equal abilities to pay result in paying different amounts. Moreover, if the rich can evade taxes more easily than the poor, then evasion could defeat the vertical equity principle of progressivity. It is clear that widespread evasion endangers the fairness of the tax burden and has substantial economic cost. Therefore, it is the duty and responsibility of all citizens to pay taxes for fairness sake besides contributing the taxes for the nation's needs.

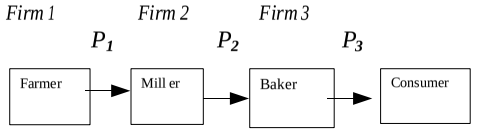
Understanding the Value Added Tax (VAT)

In the last issue, we wrote on the principles of Value Added Tax (VAT) and its characteristics. VAT is an indirect tax collected at various stages of production or distribution based on the value added at each stage. Value added is a process by a producer (manufacturer, distributor, etc.) that adds value to the raw materials or purchases that he/she is using to make a good or a service before the new or improved good or service is sold.

In this issue, we illustrate how VAT is calculated by giving an example of a bread manufacturer.

First: Although in Malawi we have Surtax, in all its characteristics and intent, it operates like a VAT system. An invoice or credit method for computing surtax or (value added tax) is used. In this method, the output is taxed and a credit is given for the taxes paid on inputs. If t_1 is the rate of tax on output and t_2 is the rate on input and tax liability is given by T, then;

$$T = t_1 * \text{output} - t_2 * \text{input}$$



P_1 is the value added at the farmer level = $WL+rK$; where W=wage rate; L=Labour hours; r=cost of capital and K=capital used;

Suppose that the price of flour sold by the miller is P_2 and the price of bread sold by the baker is P_3; then

Value added at the level of farmer = P_1
Value added at the level of miller = $P_2 - P_1$
Value added at the level of the baker = $P_3 - P_2$
Consequently total value added = P_3

Arriving at the tax base using the crediting method gives the following;

Farmer pays = TP_1
Miller pays = $TP_2 - TP_1$
Baker pays = $TP_3 - TP_2$
Total Tax Paid = TP_3

Therefore, the advantage of VAT is that it eliminates the cascading effect by removing out all input taxes paid during each transaction – no double taxation. This means that the tax is effective at the last price or last point.

If wheat per loaf of bread was MK 18 and vale added at each stage of production was MK 4 and we assume a 20 % surtax is imposed at each stage of production then tax liability would be calculated as follows:

(a) Miller = (20%)(MK 18) = MK 3.6
(b) Baker = (20%)(MK 22 + MK 3.6 - MK 3.6) = MK 4.4
(c) Retailer = (20%)(MK 26 + MK 4.4 - MK 4.4) = MK 5.2

Final price = K18 + MK 5.2 = K 23.2

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3rd and 4th Quarter Revenue Performance

In September 2000, the revised tax revenue figure projected for 2000/2001 was MK18.2 billion. In December 2000, this figure was revised and increased to MK 19.8 billion. This revision assumed a depreciation of the Kwacha against the US Dollar of a 21% and a resultant import quantum of 2.52%. It also took into account the expected petrol price increase. Following the International Monetary Fund Mission in March 2001, the tax revenue figure was adjusted slightly downwards to MK 19.7 billion and then re-adjusted downwards in May 2001 to MK 19.45 billion as the true effects of the changes in oil price and exchange rate movement were realised.

The average monthly collection for the 3rd and 4th quarters of 2000/2001 was MK 1.76 billion. The 2000/2001 outturn, however, put overall annual collections at MK 19.852 billion, MK 366 million above the May 2001 target. This was, among other factors, due to an increase in collection effort by Malawi Revenue Authority.

Government funded MRA an additional sum of MK 20 million to assist with tax enforcement. In addition, tobacco prices were relatively favourable in the 2000/2001 fiscal year than in the 1999/2000 fiscal year.

	January	February	March	April	May
Total Revenue	2255.14	1609.31	1509.79	2001.39	1925.81
Total Tax Revenue	2131.38	1499.51	1392.29	1854.60	1732.84
PAYE	366.77	283.65	304.32	302.73	354.10
Assessments	55.36	52.85	90.75	109.76	110.40
Provisional	473.93	113.93	114.72	451.90	51.38
Withholding	164.66	121.72	94.24	107.87	203.44
Import Duty	189.11	201.76	154.37	221.93	216.56
Miscellaneous	110.29	30.90	92.75	2.53	87.10
Import Surtax	284.65	305.89	144.84	250.88	336.26
Local Surtax	209.98	210.08	180.66	226.73	193.02
Excise Duty	241.21	210.69	246.80	132.42	204.94
Other Taxes	75.42	8.04	8.84	87.86	15.65
Tax Refunds	-40.00	-40.00	-40.00	-40.00	-40.00
Non tax revenue	123.75	109.80	117.50	146.79	192.97

Tax Buoyancy

Any tax system should be adequately stable and buoyant in order to enable a country to meet its increasing financial commitments as its gross domestic product (GDP) grows. If the tax revenue of a country is stable and buoyant, there is a high probability that its public expenditure needs will be adequately met over time.

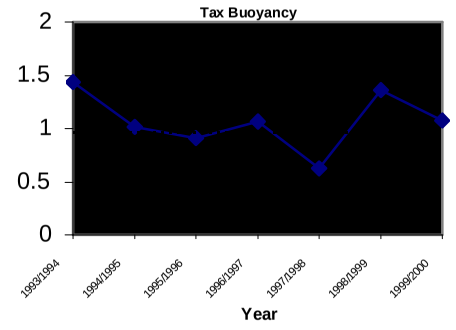
We define tax buoyancy and tax elasticity as the indicators which are used to estimate the change in tax revenue with change in GDP. These provide good revenue performance indicators because it is easy to tell how well a country is doing based on movements in GDP. If GDP is growing more than tax revenues then it could be one policy indicator that the tax structure needs reform.

Tax buoyancy is the ratio of the percentage change in tax revenue, including changes in tax collection due to changes in the tax base or tax rates or both, to the percentage change in GDP. To calculate the tax buoyancy, *ex-post* percentage changes in tax revenue are used.

So, if T_i ? Tax revenue in year *i*

Y_i ? GDP in year *i*

(*continued on page 2*)



Inside this issue:

Tax Reform: Bridging the Budget Deficit

Since the mid 1980s, Malawi has been implementing a comprehensive tax reform program aimed at improving the efficiency and equity of the tax system. A key objective of the program has been to widen the tax base so as to allow a reduction in tax rates and to ensure sustainable financing of public expenditure programs.

Although there are other options of financing the budget deficit, such as borrowing internally or seniorage revenues, extending the tax base is seen as the best option considering the negative effects on the economy which may be caused by the other options. For instance, internal borrowing may crowd out the private sector and, as a result, may slow down private investment. External borrowing may increase the public debt burden, while deficit financing may lead to inflation.

Recent studies show that perpetually large budget deficits are bad for growth (Fischer, 1993). Fischer finds from the analysis run on data across regions and over time, that there is a negative correlation between growth and inflation and, also, between growth and budget deficits. As noted above, budget deficits financed through borrowing from the central bank may lead to inflation. Economists are wary of rising inflation because high inflation, which is inconsistent with overall macroeconomic parameters on growth, employment and the balance of payments negatively the entire economy. Mindful of this fact economic reform programs being implemented in most developing countries, including Malawi, have emphasised the need to control budget deficits through austere expenditure management measures, or to increase tax revenues or a combination of both of these strategies. However, both of these strategies by their nature are not easy. It is usually difficult to cut expenditures because in developing countries growth is largely spearheaded by the public sector that has a duty to politically deliver. Tax rates, themselves, are not easily adjusted upwards because it is economically and politically undesirable.

To illustrate how taxes can decrease the budget deficit let us assume that the total government budget deficit is denoted by *def*, total government expenditure is expressed as *g*, total government revenue is expressed as *t*, and interest payments on local and external borrowing is expressed as *id*. Then, the total budget deficit a government faces may be expressed as $def=(g-t)+id$ where *id* is assumed to be given. An increase in *t* will lead to a decrease in *def*, at given levels of *g* and *id*.

Considering the equation above, most governments strive to implement reforms that minimalise further increases in *def* and avoid resorting to options of printing money to finance primary deficits *(g-t)*. Another possible way of controlling *def* is to control the growth of *g*. Reductions in *g*, however, may have adverse equity effects and a negative impact on growth. For example, direct reductions in expenditure levels may lead to a reduction in employment and, therefore, aggregate demand. This may lead to recession. This leaves small open economies, like Malawi, with little room to manoeuvre and reduce budget deficits, which implies improvements in *t*. Tax reforms, therefore, provide an efficient anchor for reduction of budget deficits through increased revenue collection and structural changes to improve, for example, efficiency in resource allocation.

Tax Buoyancy

$\%\Delta T = \frac{T_{i+1} - T_i}{T_i} \times 100$ is the percentage change in tax revenue between year *i* and year *i*+1

$\%\Delta Y = \frac{Y_{i+1} - Y_i}{Y_i} \times 100$ is the percentage change in GDP between year *i* and year *i*+1

then:

Tax buoyancy $t = \frac{\%\Delta T}{\%\Delta Y}$

which can be written as $\frac{\%\Delta T}{\%\Delta taxbase} \times \frac{\%\Delta taxbase}{\%\Delta Y}$

This means that for every one percent increase in GDP, tax revenue increases by *t*%.

The tax base is represented by the goods and services or income streams that are taxed. Tax buoyancy is adversely affected by exemptions given in the tax base. If the tax base has been eroded due to exemptions then tax collection will not increase proportionally with an increase in GDP. Alternatively, if governments improve the structure of their tax systems through time, the buoyancy of the tax system will be increased.

Tax Buoyancy			1993/1994	1994/1995	1995/1996	1996/1997	1997/1998	1998/1999	1999/2000
Tax revenue			1.44	1.01	0.91	1.06	0.62	1.36	1.08
	PAYE		1.76	1.10	0.61	1.38	1.88	1.59	1.27
	Company Tax		0.88	0.89	1.70	0.76	0.13	1.58	0.78
		Company Assessments	2.31	0.86	2.06	0.61	-0.96	1.08	1.34
		Provisional	0.11	0.91	1.45	0.89	1.02	1.82	0.55
	Withholding tax		0.88	0.75	1.60	1.79	1.69	1.48	0.96
	Import duty		1.26	1.06	0.69	1.15	0.48	0.99	0.76
	Surtax		2.07	0.87	0.87	0.94	0.71	1.79	1.23
		Import surtax	2.39	1.24	0.89	1.07	0.63	2.13	1.48
		Domestic surtax	1.77	0.50	0.84	0.76	0.83	1.28	0.78
	Misc. Duties		-4.18	8.88	3.66	-0.79	1.36	1.23	1.07
	Excise duties		3.56	1.15	0.93	1.59	0.32	0.73	1.32
	Export duties		-6.25	-	5.74	-0.19	-1.30	-2.51	-
	Other Taxes		-0.34	0.71	-0.62	1.64	0.57	1.67	0.96

WITHHOLDING TAX ON DIVIDENDS

In the 2001/2002 fiscal year, Government introduced a 10 percent withholding tax on dividends as a replacement of Dividend Tax Account (DTA) method which the private sector tirelessly fought to be removed because it was regarded as a disincentive to private investment.

Under the DTA method, companies were required to maintain a record that registered the amount of taxes paid on profits of the company. In the record, companies were being required to offset the income tax paid by the company against the imputed tax on the amount of dividend distributed. If the result was that the imputed tax on the net dividend was higher than the actual tax paid, then the company would be required to make up that difference before distributing the dividends. Such difference would arise because there is often a difference between commercial profits and taxable income. The difference may be due to deductions for incentives which are made against profits before arriving at taxable income.

The idea of DTA was one of trying to integrate company taxes with personal taxes (that is, shareholder and limited company) in order to avoid double taxation and high effective tax rates on company earnings which create disincentives to investment. However, it was also recouping tax on incentives which were statutorily granted. The understanding was that incentives are granted to enable companies to expand their businesses, not for consumption by shareholders. Many companies in different fora, including the Pre-Budget consultations meetings which Government arranged with the private sector, complained that the DTA was 'clawing back' investment incentives which did not make any sense as the benefits of the incentives then did not flow through to the shareholder. After what seemed to be never-ending discussions on the matter, Government in 2001/2002 fiscal year abolished the DTA. In its place, however, as a compromise, a 10 percent withholding tax on dividends was introduced.

In one the National Bank's Economic Newsletters, there is an article that suggests that even if the corporate income tax rate has been so drastically reduced, the effective tax rate for corporate companies has in fact gone up in some cases by more that 47 percent owing to the introduction of withholding tax on dividends!. This, the Newsletter says, are corporations with subsidiary companies. At each stage when a subsidiary company declares dividends to its share holding company there will be a 10 percent tax which will be paid to Government. In this instance, the corporation as a going concern with its all subsidiary companies would be in a multiple taxation situation and the effective tax could finally cascade to higher levels. This is a matter of perception.

One of the misunderstandings between Government and the private sector has been one of failing to disassociate a limited company from its shareholders. Even though taxes on declared dividends are collected at source because of administrative simplicity, the Income tax Act recognises that a company is by itself an independent legal entity which can sue or be sued and that a shareholder is also a different legal entity. As such, both of them having earned income in Malawi were differently liable to tax on income based on their sources of incomes earned. The incidence of the tax on dividends falls on the shareholders and not the company. DTA and the withholding tax were and have been introduced to ensure that distributed dividends were tax like any other income i.e. interest from savings, rents or income from any other business venture. Therefore, the newly introduced tax on dividend has a reasonable economic justification. However, if it is agreed that a limited company is just a conduit for conducting the business of its shareholders and that the company and shareholders are one and the same, then what could indeed be a problem is the issue of cascading where there is a chain of companies under one group. The question could still be how many of such kind of structured corporations exit in Malawi? Is the complaint over exaggerated?

One way of dealing with such a problem would be to make a policy which provides for group relief or credit and this is perhaps what Government could consider for the future.

Revenue Collections...which way?

Although the Malawi Revenue Authority (MRA) collected US$ 290,917,885.19 during the first twelve months of its existence (March 2000 to February 2001) compared to US$ 297,505,513.62 collected by its predecessor institutions, the Income and Customs and Excise Departments, over a similar period in the previous year, collection performance in constant prices (nominal revenue collections divided by inflation) has been positive. See Table 1. MK615.5 million, measured in constant prices, was collected compared to MK343.3 million collected over the period of review. During this period, however, MRA collected on average MK64.59 for every MK1.00 they spent from the 1.65% retention whereas the two old revenue departments were collecting MK104.55 for every MK1.00 they spent from budgetary allocations.

Worldwide, the establishment of revenue authorities has led to more revenue collections. In Zambia, Kenya and Tanzania, revenue figures doubled or tripled as a percentage of GDP following the setting –up of revenue authorities. Perhaps, the reason for such increase in revenue as a share of GDP in these countries could be that the initial revenue collection figures as a share of GDP were quite low. Their initial revenues were as low as 9 – 11% of GDP. The setting up of revenue authorities pushed the revenues to 18 -20% of GDP. A range of 18 -21% revenue collection to GDP is an optimal range. Compared with Malawi case, the scenario may be different since Malawi is coming from a high revenue collection performance. Government has been implementing tax reforms in order to improve the efficiency and effectiveness of the tax system. Development oriented tax policy formulation and improved tax administration has been the focus areas in the reform program. With these reforms, Malawi has been collecting about 16% of GDP.

Considering Malawi's tax base, this figure is indeed quite high. Because of the small tax base, characterised by the relatively small market economy, in time to come revenues may modestly increase mainly from increasing tax compliance. From the Pre-Budget consultations, it was clear that one of the contributing reasons for low tax compliance was the less-than-adequate taxpayer education in Malawi.

MK million in constant prices	Revenue for 1999	Revenue for 2000
March	16.1	40.5
April	20.0	49.7
May	18.2	53.4
June	20.9	58.2
July	26.4	67.2
August	27.4	46.8
September	30.7	47.9
October	38.8	51.3
November	32.0	43.5
December	35.3	40.5
January	42.5	64.9
February	35.0	51.5