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Enhancing non-SACU Revenue in Swaziland:

Improving Tax Policy and Administration

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Summary

(i) The collapse of SACU revenue in 2009 has caused the Government to consider enhancing new sources of revenue in earnest to sustain its development policies. Existing plans that were prepared more than 5 years ago to introduce the VAT and create a new Revenue Authority focused on improved compliance are therefore more relevant than ever.

(ii) This initial preparation provides ample room to rapidly improve both the design of taxes and fees and tax administration to ensure they are in line with both Swaziland's unique policy context and sound economic principles. These principles include: (i) policy and administration harmonization with South Africa so that investors view both countries as offering the same tax benefits and to facilitate the seamless launch of the RA with the benefit of the necessary support from (and partial integration with) South Africa's operations; (ii) the ability to implement reform rapidly given the fiscal emergency; and (iii) the need for simple and resilient policy and administrative designs that are able to cope with limited administrative capacity and a history of out-of-control spending.

(iii) The key recommendations for improving tax policy are:

- The replacement of the sales tax with a VAT. It is suggested Swaziland adopt a 14% VAT to avoid arbitrage opportunities with neighboring countries, to demonstrate commitment to obligations laid out in the draft bill, and to avoid providing lobbying groups with grounds to argue for lower rates;
- Phase out the Development Order tax credit. With the exception of an exemplary investment opportunity such as Coca-Cola (Swaziland's single largest taxpayer), experience in Swaziland and abroad shows that investors who are keen on participating in Swaziland's economic growth over more than the period of the tax holiday do not count on it to be profitable;
- Set all minor fees high enough to ensure they cover the costs of administration. There is scope to double motor vehicle licenses and to raise licenses for liquor stores. The graded tax should either be abolished or transferred to local governments. The cattle fee and the dog fee should be eliminated. Where fees are considered necessary for behavioral objectives (i.e. "sin" taxes) albeit at a lower-than-cost-recovery level, there should be an explicit rationale and a statement of the broad benefits of such fees or taxes;

- Increase certain taxes to levels comparable to that prevailing in South Africa. Among these taxes are the fuel tax (by E1) and the gambling/gaming tax. The introduction of a capital gains tax on business assets is also an option;
- Introduce a thin-capitalization rule to avoid excessive perverse effects stemming from the tax-free status for interest;

(iv) Key recommendations for a successful launch of the Revenue Authority are:

- Establish a Large Taxpayer Unit able to create an institutionalized focus and match the tax engineering sophistication of the most wealthy taxpayers;
- Automate most communications with taxpayers and the selection of cases to be audited (for efficiency) and the taxpayer databases (for crosschecks);
- Enhance VAT administration with dedicated VAT accounts for accredited exporters, thus eliminating transaction-specific hassles;
- Integrate the administration of VAT systems with South Africa's. This will improve efficiency through economies of scale and significantly reduce the risk of divergences in data collection. This does not imply less oversight of data by Swaziland; rather, it is consistent with the one-stop shop approach for customs simplifications advocated in another policy note;
- Ensure the broadest application of the principle of withholding. It is easier to enforce taxes with easy-to-monitor tax subjects, and with VAT, withholding increases the incentives for self-enforcement;
- Limit discretion in the new Revenue Authority. The current lax compliance rate is a strong indication of political interference in the administration of taxes, which cannot be afforded if the RA is to be launched successfully;
- Start training tax administrators without delay. The concept of the VAT is novel and requires some adjustment for even the most qualified staff if they are not yet familiar with its administration.

(v) Expected revenues from these reforms are difficult to quantify in some cases. In any case, the Table shows some preliminary estimates.

Expected revenue from reccomendations (% of GDP)		
	Reccomendation	Additional Revenue
1	Introduction of VAT at 14% rate	1,00
2	Small Taxpayer design	0,00
3	Phase out of tax incentives	0,45
4	Abolish graded tax	-0,01
5	Increase fuel taxes in E 1 per liter	0,80
6	Increase tax on gaming to 15%	0,15
7	Increase Motor vehicle and liquor licenses	0,06
	TOTAL (excludes gains from better tax administration)	2,45

Background

1. **Decline in SACU revenues demands fiscal action.** The government of Swaziland faces a fiscal challenge due to the declining SACU revenues. For the next 3 years revenues are expected to equal 11% of GDP, about half of what they averaged during the period 2004/09. According to the Medium Term Fiscal Framework, non-SACU revenues are expected to grow a modest 0.5% of GDP during the same period. Meanwhile, spending remains a key issue as well. Expenditures increased to 43% of GDP by end FY2009/10 and are slated to remain high enough for the foreseeable future to maintain a deficit of around 10% of GDP barring any new measures. There in order for Swaziland to become financially sustainable the government must adopt both revenue raising and expenditure control measures.[1]

2. Although Swaziland's SACU revenues may rebound as SACU economies recover from the financial crisis, , there are a number of reasons to believe that relying could be very risky: a) trade liberalization agreements may impact the collections from durables that are an important source of SACU revenues (cars alone contribute about one third of the total); b) other members of SACU may increase their share on Intra-SACU trade; c) the union may be extended to other SADC countries with a likely reduction of the actual share of the five members of SACU.[2]

3. There is a second round negative effect on government revenues if SACU revenues decline. The economy would need to adjust to lower inflows of Rands and this is likely to affect the collection of income taxes and taxes on consumption. For a while, consumption will have to grow at lower rates than GDP to reduce the current account deficit that is financed by SACU revenues.

4. **Swaziland faces the challenge of increasing non-SACU revenues that are lower than in other countries of similar characteristics**. Table 1 compares the revenues obtained in 2008/09 with the collections of more than 100 countries (17 from Africa). A simple comparison shows that Swaziland collections of Taxes on Income and Profits are better than the average of countries of similar development, while it is worse in Taxes on Consumption on Goods and Services and Other Revenues (that include a large variety of fees and in some cases royalties). When SACU Revenues are excluded Swaziland collects only 15% of GDP compared to the 22% to 25% of GDP collected from countries of similar development in Africa or in the world. There is a growing literature that analyzes what are the reasons that explain why revenues differ across countries. Annex 1 includes econometric estimates of the determinants of government revenues. The conclusion is that total revenues (i.e. a proxy of the size of government) in Swaziland are higher than what is suggested by the characteristics of its economy. However, when the fraction of SACU

[1] During the past 25 years there have been 30 experiences in Advanced Economies of large fiscal adjustments and 41 experiences in Emerging Economies. The median adjustment in Advances Economies was 6.8% of GDP with revenues increases accounting for about 60% of the improvement. In Emerging Economies the median was 8.4% of GDP and only 20% was accomplished through revenue increase. See Fiscal Affairs Department, "Strategies for Fiscal Consolidation in the Post Crisis World", IMF, February 2010.

[2] Some of these threats are recognized by the Ministry of Finance in the Medium Term Budget Policy Statement 2010/11 – 2012/13.

revenues (that includes some redistribution from other members of the Union) is excluded, government revenues are about 6% of the GDP lower than what could be. Therefore, there is room to improve non-SACU revenues in Swaziland in the absence of a compelling reason to the contrary.

Table 1 : General Government Revenues
(percent of GDP)

Selected Countries	No. of countries in group	GNI pc Range in US$ 1/	Taxes on Income, Profits, & Capital Gains	Taxes on PayRoll and Work Force	Taxes on Property	Taxes on Goods and Services	Taxes on International Trade	Other Taxes	Total	Social Contributions	Grants	Other Revenue	Total Revenues	Total Revenues Excluding Taxes on Trade
High Income	44	> 11455	12,0	0,4	1,5	10,3	0,5	0,3	25,1	8,7	0,4	6,6	40,7	40,2
Upper middle Income	31	3706-11455	6,4	0,5	0,9	9,5	2,9	0,8	21,1	4,4	0,6	6,8	32,9	30,0
Lower middle Income	31	936-3705	5,2	0,1	0,6	7,8	4,1	0,6	18,4	2,1	1,7	6,5	28,7	24,6
Low Income	12	< 936	3,4	0,3	0,5	5,5	3,2	0,2	13,0	0,1	2,7	1,9	17,7	14,5
Burkina Faso	Low Income	480	2,7	0,0	0,0	6,1	2,2	0,3	11,3	0,0	5,6	0,9	17,8	15,6
Congo, Dem Rep of	Low Income	150	2,0	0,0	0,0	2,0	2,3	0,0	6,3	0,0	0,3	1,6	8,2	6,0
Congo, Rep of	Lower middle Income	1970	2,1	0,0	0,3	2,9	1,2	0,2	6,7	0,4	1,6	35,1	43,8	42,7
Côte d'Ivoire	Lower middle Income	980	2,3	1,5	0,0	2,8	7,6	0,3	14,6	1,3	0,5	2,2	18,6	11,0
Ethiopia	Low Income	280	3,0	0,0	0,0	2,4	5,2	0,1	10,7	0,9	4,6	3,4	19,6	14,4
Kenya	Low Income	770	8,1	0,0	0,0	5,6	4,9	1,7	20,3	0,0	1,5	0,0	21,8	16,9
Madagascar	Low Income	410	1,4	0,8	0,7	2,9	5,6	0,0	11,4	0,0	4,3	0,5	16,1	10,5
Mauritius	Upper middle Income	6400	3,2	0,1	1,3	9,3	2,7	0,0	16,6	1,0	0,1	2,2	20,0	17,3
Senegal	Lower middle Income	970	4,5	0,0	0,0	11,0	3,5	0,0	19,0	0,0	1,5	0,9	21,4	17,9
Seychelles	Upper middle Income	10290	7,3	0,0	0,0	19,6	9,1	0,0	35,9	11,2	1,4	9,6	58,1	49,0
Sierra Leone	Low Income	320	1,8	0,0	0,0	1,5	3,5	0,0	6,8	0,0	5,4	0,3	12,5	9,1
Uganda	Low Income	420	3,7	0,0	3,1	3,9	1,2	0,0	11,9	0,0	4,5	0,7	17,1	15,9
Zambia	Lower middle Income	950	8,4	0,0	0,0	7,5	2,0	0,0	17,9	0,0	4,6	0,7	23,2	21,2
Botswana	Upper middle Income	6470	10,7	0,0	0,0	10,3	3,5	0,3	24,8	0,0	0,7	17,0	42,5	39,0
Namibia	Upper middle Income	4200	10,8	0,0	0,2	7,5	9,4	1,0	28,9	0,0	0,1	2,8	31,7	22,3
Lesotho	Lower middle Income	1080	9,6	0,0	0,7	8,3	39,7	0,1	58,3	0,0	1,0	5,5	64,8	25,1
South Africa	Upper middle Income	5820	16,1	0,3	1,7	10,7	1,3	0,2	30,4	0,6	0,0	6,4	37,4	36,1
Swaziland	Lower middle Income	2520	8,1	0,0	0,1	4,5	25,3	0,4	38,4	0,0	0,6	1,5	40,5	15,2
In Africa Region														
Upper middle Income	5	4200- 10290	9,6	0,1	0,7	11,5	5,2	0,3	27,3	2,6	0,5	7,6	37,9	32,7
Lower middle Income	6	950- 2520	5,8	0,3	0,2	6,2	13,2	0,2	25,8	0,3	1,6	7,6	35,4	22,2
Low Income	7	150- 770	3,3	0,1	0,5	3,5	3,5	0,3	11,2	0,1	3,7	1,1	16,2	12,6

Notes: 1/ Per capita Gross National Income measured according to Athlas Method. World Development Indicators.
Source: Own based on IMF GFS and Article IV Revisions.

5. Since 1999 non-SACU revenues (excluding grants) have averaged 13.3% of GDP and reached 14.7% of GDP in FY2009/10. Most of the increase is explained by the income tax falling on individuals, the withholding on non-residents and the collection of the sales tax (see Figures 1 and 2). Taxes on income generate 7.6% of GDP, the sales tax 4% of GDP, taxes on the transfer of property account for a meager 0.1% of GDP, taxes on fuels and road levies for only 0.3% of GDP and fees and fines account for about 0.6% of GDP.[3] SACU revenues were in FY 2009/10 2.4% of GDP lower than the average received during the previous 5 years. The Government was able to partially offset this reduction with an increase of tax revenues that added 1.5% of GDP with income and sales taxes contributing the most[4] (See Annex Table 1). But the fiscal challenge is projected to be more severe in the next years. Budgeted SACU revenues for the next 3 years are only 11% of GDP, about half of the average obtained during 2004/09. Additional resources may come from tax policy decisions (larger tax bases or higher tax rates), improvements in tax administration or from a more generalized use of cost-recovery fees.

[3] The value quoted in the text excludes interest income, Central Bank profits and low repayments to focus on those revenues that government policies may influence.

[4] Collections from fuels tax, taxes on property and the road and sugar levies were lower in FY 2009/10 than in the previous 5 years.

Figure 1: Non SACU revenues (% of GDP)

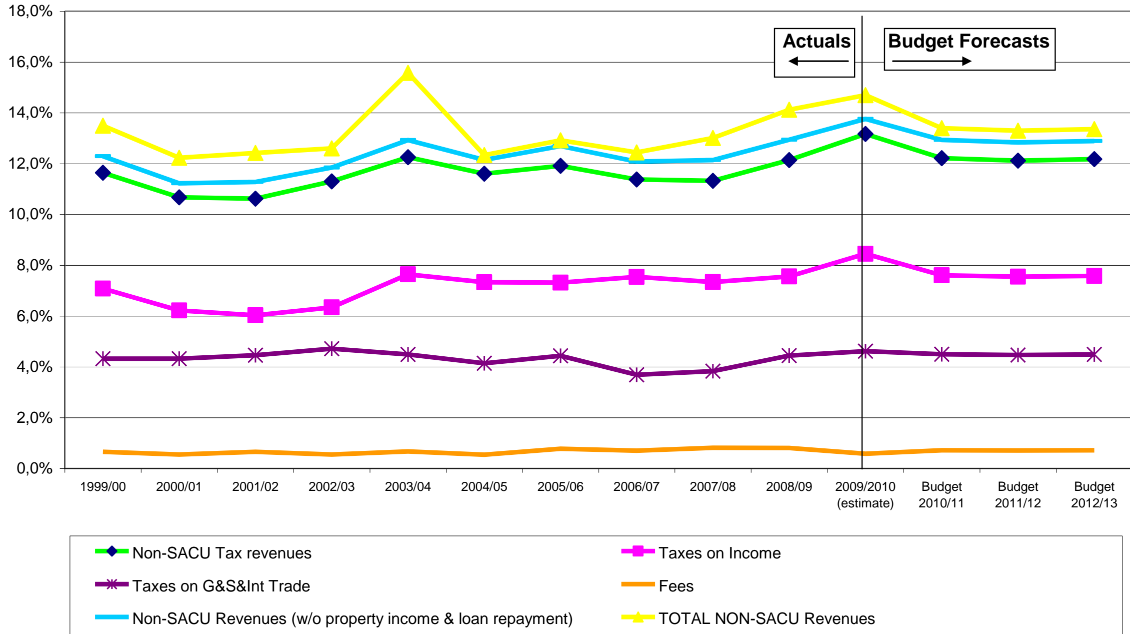

Figure 2: Revenues from taxes on income and on consumtion (% of GDP)

Tax policy Issues

6. **Swaziland has some unique characteristics that create specific constraints on its tax policy.** Due to the country's small size, border trade is more important than in countries of larger size. Therefore, it has been a good decision to have not only the same tariffs on imports as South Africa in the context of the Customs Union, but also to have the same excise taxes that are collected at the first port of entry (usually South Africa) and allocated to the Excise Revenue Pool. This reduces the opportunities for round tripping of exports and smuggling. The same logic applies for VAT/Sales tax rates. With the exception of goods and services that are difficult to be traded across borders (e.g. electricity) different tax rates on the same goods and services would create opportunities for tax avoidance and fraud. With most goods and some services taxed at 14% (the same rate that South Africa applies) Swaziland reduced the incentives for tax avoidance. However, this reveals an additional limitation to its ability to modify tax rates. Given its small size, Swaziland has less space than most countries to vary its tax rates. This also puts some limits on the income tax rate and income tax base. Different rates with neighbor countries would encourage firms either to incorporate in the other country or to use transfer pricing.

7. *Income tax*. In theory, this tax falls not only on consumption but also on savings and investment, this makes it a tax on capital accumulation and the ability to build wealth. Most countries apply separate tax structures for individuals and companies. At the individual level, the tax falls on labor earnings (usually with a progressive structure) and on earnings from returns on capital (interest on financial assets, dividends, rent). As individuals are the owners of firms it would be possible to avoid a tax on companies' profits. However, most countries opt to tax firms for at least two reasons: (i) it is easier to collect taxes from firms than from individuals; in this case the company tax acts as a withholding on the tax that the individual should have paid; (ii) for foreign firms, the company income tax allows the countries to receive part of the return on capital invested that would otherwise be transferred to foreign treasuries.

8. **In adopting its income tax structure, Swaziland opted for an approach that features a dual income tax, but also includes a lower flat rate on income from capital.** Individuals face a progressive structure with a top marginal rate of 33% and a minimum exempt level of about one per capita GDP. There are some rules characteristic of a "dual income" tax (e.g. dividends to residents were taxed at a final rate of 10% until this was repealed in 2008); although the same rule does not apply for profit earned by firms (a withholding of 10% that is not final).[5] The definition of the personal income tax base is rather stringent including most benefits in kind that have to be valued at market prices. There are some deductions allowed but with a cap, and this puts a limit to a potential abuse by the taxpayers.

[5] The dual income tax is applied by some Nordic countries and by Uruguay. The idea is that in a world of high capital mobility it is better to tax separately, at a lower flat rate, capital income accruing to individuals like interest, rents and dividends. This is considered a final tax. A simpler system like this may help to reduce elusion and evasion but leaves the progressivity only for labor income.

9. **Swaziland's income tax has a debt-financing bias.** A well-designed income tax should be neutral with regards to the choice of investment financing (debt, new equity, or reinvested earnings). When a firm finances its investment with equity in Swaziland, it pays the statutory rate of 30% (some sectors pay a lower rate, see below) and dividends pay an additional tax.[6] For residents the combined tax is 37% while foreign investors have a combined tax rate of 38.7% for SACU and 40.5% for all other countries.[7] On the other hand, when the investment is financed with debt, the savers do not face any withholding, while firms deduct the interest paid in full. [8] Therefore, the overall tax burden on the debt-financed investment is reduced to 0% (plus the 30% tax paid by the bank on its spread of intermediation). For interest paid abroad there is a 10% withholding tax and the debt-financed investment will still pay a lower tax than when equity is used.

10. **This debt financing bias augments when there is inflation**. Although inflation penalizes investment by increasing the net present value of the tax given that depreciation allowances are not adjusted by inflation, it reduces even more the tax burden on debt when firms are allowed to deduct nominal interest. In this case, they deduct more than the real cost of capital. The net effect is that inflation aggravates the debt financing bias.[9] Furthermore, as Swaziland has no thin capitalization rules, there is a risk of excessive interest deduction.[10]

11. There is no limit on the amount of losses that can be carried forward although the statute of limitations is 5 years. There are other withholdings to payments abroad that attempt to ensure some collection for rents generated inside Swaziland (the most important for revenues are the 15% withholding to royalties, management fees, and contractors). Both individuals and companies have to pay a provisional tax which reduces the average collection lag (a correct decision when inflation is high).

12. **There is no tax on capital gains**. Based on principles capital gains should be taxed at normal rates. However, there are some practical issues that have encouraged some countries to either use lower rates or exempt capital gains obtained by individuals. For example, only real capital gains should be taxed and this requires some adjustment by inflation, capital losses should be deducted from the tax base but the control of capital losses is not easy, and it is necessary to avoid double taxation (e.g. taxing the increase in value of stock at the individual level when that increase in value is likely to reflect higher – already taxed- gains at the firm level). Some countries opt to tax only those capital gains obtained by business.

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[6] Dividends distributed to residents pay an additional tax of 10% (12.5% if dividends are distributed to non-residents from other SACU countries and 15% for other non-residents). The "double taxation" of dividends also happens in other countries. One example is the United States.

[7] The highest marginal rate for individuals at 33% is lower than the combined rate for company and dividends and this may discourage the creation of companies to save in some taxes.

[8] The exemption of interest earned is frequent in developing countries that are afraid that including interest into the tax base would encourage capital flight to those developed countries where non-residents are exempt (like the US). This happens because the tax authorities cannot observe the assets held abroad.

[9] For a proof see Atkinson A. and J. Stiglitz Lectures on Public Economics. McGraw Hill, 1980.

[10] For example Lesotho has a thin capitalization rule of 3:1. Firms are allowed to deduct only a proportion of the interest paid when the debt/equity ratio exceeds that limit.

13. **Tax incentives for certain types of investment reduce Swaziland's effective marginal tax to one of the lowest in the SADC region.** Although a 5-year tax holiday was repealed in 2004, the Ministry of Finance can reduce the company income tax rate to 10% for any firm that qualifies for a Development Approval Order.[11] Moreover, manufacturing and hotels enjoy a 50% initial allowance for most of their investments and a similar benefit applies to investments in infrastructure. Farmers can also expense some of their investments. The same applies to expenses in training and research and development and to promotional expenses for export promotion (133% and 150% deduction). The expensing rule is equivalent to a reduction of the company income tax rate. For example a 50% initial allowance reduces the effective rate to 15%. This is a generous incentive but it is less distortionary than investment tax credits because firms cannot deduct more than 100% of the investment cost, a factor that may encourage the approval of projects with negative social rates of return.[12] Bolnick (2004) estimated the Effective Marginal Tax Rates to invest in SADC countries taking into account the statutory tax rates and the effects of the different tax incentives while assuming different financing patterns for the investment. Based on tax data from 2003 the study concluded:[13] a) Swaziland had a combined tax rate (company and dividend tax to residents) that was somewhat lower than the 40% average for SADC; b) When incentives were allowed, the Effective Marginal Tax Rate, between 4 and 8%, was close to the lowest in the region. For example, in South Africa the Effective Rates were 13% to 20%, in Lesotho 14% to 19% and in Botswana 9% to 16%. There were 5 countries with lower rates in 2003 (Namibia, Zimbabwe, Malawi, Tanzania and Zambia). The benefit of tax incentives to the economy—especially in terms of employment and investment—is highly questionable.[14]

14. **There is too much discretion in the enforcement of penalties.** Penalties for non-compliance are relatively high but the Act allows the Commissioner to reduce them. There is also more discretion than in other countries for the Minister of Finance (e.g. he can change the tax rates every year or grant the reduced 10% rate). There is a trade-off with

[11] Currently there are about 12 companies that either enjoy the lower rate or are about to get it. It is remarkable than in the case of Conco the special regime was extended several times since 1988 when the company received the benefit for 5 years. The last renewal was from 2009 to 2019. This is a typical example of temporary benefits that become permanent.

[12] A 100% initial allowance (expensing) would eliminate the tax but no project will be approved with a return below the net of tax opportunity cost of capital. Investment tax credits do not have that lower bound. For a proof see A. C. Harberger "Tax Neutrality and Investment Incentives" in H. Aaron and M. Boskin (Eds.) The Economics of Taxation. The Brookings Institution.

[13] Bolnick, Bruce. *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*. Study prepared for AID by the Nathan-MSI Group. February 2004. The only difference between the actual tax system in Swaziland and the 2003 system used by Bolnick is the elimination of the 5 year holiday. This change does not affect Bolnick's estimates of the Effective Marginal Tax Rate because he used the 10% reduced rate combined with the 50% initial allowance.

[14] Bolnick (2004) reached to this conclusion in his analysis of SADC countries. H. Zee, J. Stotsky and E. Ley. "Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries". World Development. 2002. Pp. 1497-1516, confirm this finding in their review of several studies across the world. It is important to note that the advocates of New Industrial Policies do not support tax incentives; they recommend coordination among public and private sector. See R. Haussman and D. Rodrik *Doom to choose*. Kennedy School of Government, Harvard University, September 2006.

discretion: while it allows for greater flexibility in implementing policies, it can also be co-opted for political purposes. While this trade-off might be tilted in favor of the greater good when there is a highly efficient tax administration, this is not the case today in Swaziland.

15. **Information collected from a sample of firms suggests that there are not many abuses on the income tax. Firms may opt directly to evade a fraction of their activities and report properly the other fraction.** Table No. 2 aggregates the information of the income tax forms of a sample of 85 firms done at the request of the World Bank. There is information on turnover, cost of sales, and expenditures, and also of some categories of expenditures like depreciation and interest paid. The sample accounts for about half of company income tax revenues of Fiscal Year 2008/09. There is also information on taxes paid by about 60% of the firms in the sample. It follows from these figures that:

a. In spite of the absence of thin capitalization rules the interest deducted by the firms is largely insignificant (about 1% of turnover).

b. Depreciation used for tax purposes is somewhat smaller than true economic depreciation. This would raise the effective tax rate, although its effect may be offset by the initial allowance.

c. The fiscal loss of the initial allowances is relatively modest. Extending the results of the sample to all firms yields an estimated loss of around E 10-15 million a year.[15]

d. The average tax rate is not much different from the statutory tax rate. This may be because firms favored with lower tax rates (i.e. the 10% Development Tax Order) are not included in the sample.

e. Overall, the figures suggest that there are not many abuses in the income tax. However, this may be simply because firms decide to evade recording a fraction of their income and not to abuse on what is the reported.

Table No. 2. Information on Company Income Tax (FY 2008/09). In Rands.

No. of firms	Turnover	Cost of Sales	Expenditures	Depreciation 1/	Interest Paid	Net temporal differences	Legal Wear & Tear 2/	Initial Allowance	Taxable Income	Tax Paid 3/
53	5.381.686.902	3.365.595.239	1.387.364.138	162.219.302	40.815.017	(26.929)	109.650.810	33.023.677	793.781.148	238.980.536
% of turnover		62,5%	25,8%	3,0%	0,8%	0,0%	2,0%	0,6%	14,7%	4,4%
85	8.376.599.053	4.649.054.119	2.364.584.003	215.366.477	100.541.882	(23.092.353)	138.835.672	51.755.183	1.092.614.352	n.a.
% of turnover		55,5%	28,2%	2,6%	1,2%	-0,3%	1,7%	0,6%	13,0%	n.a.

Notes: 1/ Depreciation used in accounting
2/ Depreciation allowed in the tax code
3/ Memo item. Income tax revenues collected from companies during FY 2008/09 was 608.000.000

16. **In conclusion, Swaziland's income tax has some distortions: its legal design favors debt financing and investments in farming, manufacturing and hotels. For other activities the income tax is well designed with a few loopholes. Paradoxically, labor intensive activities are taxed more heavily than some capital intensive activities. The income tax is also strict at the individual level with fringe benefits included in the**

[15] Assuming that the sample in revenue terms is about half of the total, the initial allowance deducted would be around 100 million. The initial allowance is 50%, i.e. about five times higher than the normal depreciation. At a 30% income tax rate the fiscal cost would be around 12 million a year (0,3 x 0,4 x 100 million).

tax base (in other countries there are some limits to payments in kind but some are allowed) and a partial attempt to introduce dual taxation.

17. ***Sales Tax* departs from good practice on the taxation of consumption**. Swaziland has a general consumption tax that differs from the Value Added Tax that is used in most countries. A wholesale sales tax is applied to goods because imports are taxed at customs, while domestic production is taxed at manufacturing. As a result, the value added by retail is left untouched. At the same time, a retail sales tax is applied to taxed services with some cascade if the buyer is not a family member.[16] The Sales Tax Act departs from a well-designed tax on consumption for the following reasons:

a. relative prices to end users are distorted because the value added by the retail stage differs across goods, or because there are cascade effects with some inputs taxed;[17]

b. the tax policy secretly shields domestic production from imports coming from outside SACU that enter Swaziland on bond by arbitrarily increasing the base sales tax on such imports by 10%;[18]

c. although exports are exempt, there is no guarantee that all the sales tax paid in previous stages is exempt (e.g. some professional services are taxed);

d. alcoholic beverages and tobacco products are taxed at 25% (which may be justified given the negative externalities of their consumption) but traditional beer is taxed at 14% favoring its consumption;

e. there is a long list of exemptions that in many cases are difficult to control (leaks to undesired consumers). Although some may have a rationale to favor the poor (like foodstuffs, medical supplies and scholastic materials, bottled and piped water, kerosene)[19] part of their consumption is also enjoyed by the rich. Others like electricity are more questionable on distributional grounds, at least based on the experiences of other countries in the region where the share of total consumption of electricity by richer families is higher than for the average taxed

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[16] Taxed services are: hotels and restaurants, photographic, printing and publishing, commissions of auctioneers and real estate agents, administration and management, accounting and audit, data processing, legal services (except for individuals), architecture and engineering, secretarial and advertising.

[17] Although the Sales Tax Act attempts to reduce the cascade effect of turnover taxes by exempting from the tax the inputs used by taxed activities, it does not eliminate all of them.

[18] With a sales tax of 14% on the import price plus customs duties the price would be 1,14 x (1+tm) where tm is the tariff on imports. Under Swaziland Sales Tax Act this becomes 1,14 x (1+t) x 1,1. The equivalent tm that will match the Swazi rule is tm = 0,1 + 1,1 x t. In other words a 10% tariff becomes 21% protection given the extra sales tax that the importer has to pay at Customs. However, importers have an incentive to clear the goods in South Africa and avoid the extra charge.

[19] Foodstuffs exempt, both if imported or locally produced, are: dairy products, eggs, milk, maize, plain bread, meat, fresh fruit, vegetables, sugar, salt and enahewin. Surprisingly, dried fruits are exempt only if they are produced locally resulting in a hidden subsidy to local manufacturing.

good. Most inputs for farming are also exempt. Finally, the purchases made by foreign diplomats and the King are exempt;[20]

f. the Act allows the Minister of Finance to exercise a high level discretion over the sales tax. For example, he can allow exemptions at will (Section 8 f), which has cost the government a loss of revenues of about E 1.5 to 2 million a year;[21]

g. some investment decisions may be taxed;

h. some importers have the option to pay the sales tax later (the deferred option), which departs from the standard practice of collecting the tax at the border and provides them with financing at zero cost.

18. **About 90% of sales tax is collected at Customs**. Table 3 shows the composition of domestic collections (the other 10% of total sales tax revenues), with manufacturing accounting for more than half and a meager collection from taxable services and hotels and restaurants.

Table No. 3. Revenue Collections from Sales Tax (Domestic)

	Domestic Sales Tax	MANUFACTURERS - LOCAL SALES (A)	Share in Total Domestic Sales Tax	TAXABLE SERVICES (C)	Share in Total Domestic Sales Tax	RESTAURANTS/ HOTELS/ ACCOMMODATION (D)	Share in Total Domestic Sales Tax
2008	97.465.538	53.500.402	55%	25.401.311	26%	18.563.825	19%
2009	114.401.310	64.771.688	57%	29.737.467	26%	19.892.154	17%
2010	17.260.223	7.375.447	43%	7.515.493	44%	2.369.283	14%

Source: World Bank based on Customs and Excise Department.

19. **Swaziland's sales tax is less efficient than other SACU countries (i.e. either exemptions are larger or evasion is more pervasive).** Efficiency of sales tax collection have be estimated by comparing the yield to an ideal scenario that assumes no exceptions and no evasion. This comparison is usually done using the Consumption or GDP of the economy as an estimate of the VAT/Sales tax base.[22] Table 4 shows that Swaziland is the least effective SACU country for tax collection. Swaziland's tax collection equals 30% of GDP, while the average for SACU countries is 46.3%. Similarly, tax collection equals 28.8% of consumption, while the SACU average is 57.5%. The revenue yield is only 30%

[20] There is also a relatively high threshold of E 1000 exempt for purchases abroad that, given the proximity of most citizens to the borders, may be abused.

[21] The King's office can also grant some exemptions in the Sales tax.

[22] If all countries in SACU had a VAT and all estimate GDP and consumption in the same way it would be better to use Aggregate (or private) Consumption as a proxy of the tax base. However, this is not the case (e.g. Swaziland includes SACU revenues in its GDP' estimates and has Sales Tax). Therefore, the estimate is done using both Consumption and GDP.

of the potential tax base, compared with an average of about 50%. Thus, Swaziland is more generous with the exemptions, has more tax evasion, or both.

Table 4. Estimate of the "efficiency" of the collection of VAT/Sales tax in SACU region					
				Efficiency Ratio	
Country	Fiscal Year	Collections % of GDP	Tax rate	Consumption Based	GDP based
Lesotho	2007/08	7,0%	14%	37,4%	49,6%
South Africa	2007/08	7,2%	14%	63,8%	51,4%
Bostwana	2007/08	3,8%	10%	68,7%	38,0%
Namibia	2007/08	6,9%	15%	60,0%	46,0%
Average of other SACU		6,2%	13,3%	57,5%	46,3%
Swaziland	2009/10	4,2%	14%	28,8%	30,0%

20. The value added tax is a generalized tax on consumption when all goods and services are taxed at a uniform rate and all VAT paid to suppliers (including capital goods) is allowed to be deducted. There is no country that has a "pure" VAT for several reasons including: the difficulty of taxing certain sectors (e.g. financial services and insurance), distributional considerations that lead to zero-rating, and exemptions for goods deemed critical for poor families.

21. Taxes on consumption do not affect the process of capital accumulation, but there is a common belief that they are regressive because poorer families consume a larger proportion of their income than richer families. However, taking into account that richer families will consume their savings in the future and pay the VAT, the present value of the tax paid will be proportional to each family's income on an intertemporal basis. Besides, with a special rate on some food items, the VAT may be even progressive.

22. **The Government has drafted a VAT Bill with a proper design for the tax.** The proposed tax is of the consumption type with zero-rating of exports and refunds of excess credit, with a list of exemptions and zero-rate of foodstuffs and farm inputs. Exempted products will absorb the input VAT as a cost while zero rating will allow for the recovery of the input VAT from the government. Therefore, the VAT in Swaziland will affect relative prices, sometimes as desired by policy (e.g. to reduce the cost of food for the poor or the cost of inputs for subsistence farming that, in any case, will not be registered in the VAT) and other times because of the inherent difficulties of taxing some sectors properly (e.g. the financial sector and insurance companies).

23. The proposal improves the sales tax by addressing many of the problems mentioned above. The surtax of 10% on bonded imports is eliminated, the distortions in relative prices are reduced because the value added by retail will be taxed and the list of exemptions or zero rated goods is somewhat less generous (e.g. electricity will be taxed which may

increase revenues in about E 14 million).[23] The annual registration threshold is E 500.000 but a simplified tax regime is not included in the bill.[24]

24. **It is important that the tax rate be 14% to avoid creating arbitrage opportunities or leaks to the well-off.** There is no definition about the tax rate. Adopting a rate different than 14% will create lots of problems for the administration of the tax given the fluid transit across the border with South Africa. It is possible to have a different rate on non-traded services like those provided by utilities but this will be a mistake. Evidence from other countries in the region suggests that the well-off families account for a large fraction of the consumption of electricity and telecommunications (at least compared with the average taxed good). Therefore a lower rate for these services would create a fiscal loss with no positive effect on income distribution.

25. ***Fuel Taxes and Road Levy* are low**. Swaziland taxes the consumption of gasoline and diesel with a fuel tax of E 0.40 per liter, a fuel levy of E 0.20 per liter and 14% sales tax on the import parity plus customs and excise duty (E 0.04). As of March 2010, the total tax on gasoline and diesel was E 1.31 per liter (equivalent to US$ 17.5 cents per liter); paraffin was tax free. Road tolls are only charged on foreign vehicles at the border (E 50 for light vehicles and E 80 for commercial vehicles).

26. The taxation of fuels above general consumption taxes and the use of tolls have been justified to provide adequate signals to road users (to internalize congestion and environmental externalities) and to provide revenues from goods with an inelastic demand. Even though it is beyond the scope of this note to estimate the value of the negative externalities in Swaziland, the US$ 8.5 cents per liter above sales tax is very low.[25] More importantly, taxes on gasoline and diesel in South Africa in April 2010 were E 1,1 higher per liter of gasoline and E 0,98 higher per liter of diesel, suggesting there is ample room to increase them in Swaziland without raising problems of smuggling at the border.

27. **Road tolls are low, especially for heavy vehicles and are not charged to locals.** There are several problems with road tolls: a) they are charged only to foreigners when residents' vehicles also deteriorate the infrastructure; b) the difference between the charge on light vehicles and heavy vehicles is only 1.6 times. In the past it was 2.5 times. Since

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[23] It also introduces some limits to deductions to the input tax that are used in other countries to avoid abuses. However, it might be better to allow the deduction up to a lump sum (especially for mobile telephone services with a 50% limit).

[24] The project also allows firms with a taxable turnover below E 3.000.000 to use cash accounting for tax purposes. It is important to keep a lower threshold for this option because it usually delays the collection for the government. The project also shortens the collection lag from an average of 52 days to an average of 35 days.

[25] I. Parry and K. Small *Does Britain or the United States have the right gasoline ta.x* Resources for the Future (2002, revised on 2004) estimate that a US$ 0.05 per liter charge in the consumption of diesel and petrol in the UK or the US is needed to pay only for the impact of fuel consumption on global warming. Even though there is no agreed common solution for global warming, this estimate suggests that a minimum tax for fuels in all countries should be US$ 0.05 per liter. The congestion and local pollution components of an optimal tax on fuels will vary depending on the economic and traffic problems of each country. For example the authors estimate that the optimal tax on gasoline in the US should be US$ 1 per liter and in the UK US$ 1.34 per liter, several times higher than the actual tax in Swaziland.

trucks impose damage greater than 1.6 times road compared to cars the difference should be priced accordingly.[26]

28. ***Other taxes* offer not only some scope for raising additional revenues, but also for simplification**. The government collects other taxes that account for only 0.24% of GDP but they are projected to decline to 0.19% of GDP in the next 3 years because of the recent decision to eliminate the sugar levy. Transfers of property (0.09% of GDP) and taxes on gaming (0.08% of GDP) are the main sources of revenue. Taxes on property fall on the transaction of real estate at very high rates (a sliding scale that has a maximum rate of 6% of the value of the property). Other countries rely on taxes on the stock of property (a larger base at much lower rates) but this requires an updated register of the value at least of urban residences and commercial property, a task that has proved to be elusive in many emerging economies.[27] Besides some licenses, gaming pays a 4.5% on the net value of the bets less the prizes paid. This is a very low rate on an activity with negative externalities. There is a proposal by the Ministry of Finance to increase this rate to 15%.[28] Finally, the government still collects the graded tax (0.01% of GDP) which is a poll tax that increases with income and is very costly to administer.

29. ***Non-tax revenues***. These include fees for services provided by the government, revenues obtained from sale of goods and services produced by a government agency, dividends obtained from parastatals, loan repayments or government equity participation in private firms and rents. In FY 2009/10 they contributed with about 10% of non-SACU revenues (excluding grants) or about 1.5% of GDP. However, the government has less room to influence interest earned or Central Bank profits. Most of the rest are fees, fines and sales of goods and services that account for 0.6% of GDP. Business licenses, motor vehicle and driver licenses, immigration and travel, and rentals (most are charged to public employees for housing), each account for about 10% of the total.

30. **There are no studies in Swaziland that estimate the economic cost of providing these government services**. As most fees are collected by the Treasury and allocated to the government general account, each department has no incentive to raise their value (they will incur the cost without receiving any compensation). However, the alternative may tempt them to charge monopoly prices to end users.

31. **Most fees are likely to be lower than economic costs.** Some fees may have another rationale. For example, those charged for health services are about 1.5% of the budget of the Ministry of Health. Clearly there is no cost-recovery attempt with these fees. If the government tries to charge a minimum fee to reduce excessive demand, the fees should at least cover the operating costs for charging them (i.e. the cost of the clerks who sit and collect them are different from the cost of doctors, nurses, and hospital equipment)

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[26] In South Africa there is a large variance of tolls according to the road. But the heaviest vehicles pay a toll that is at least 3 times more than that paid by light vehicles, and in many cases the difference is of 5 times.

[27] Some local governments in Swaziland collect taxes on urban property, but apparently without obtaining much income from them.

[28] In Nevada in the United States the tax is 6.75% on gross revenues, while in Colorado the average rate is 12.2% also on gross revenues. In the case of Nevada public information shows the amount paid to employees. The tax collected on the "net" revenue of payroll was 31% in 2008. In South Africa taxes paid in 2008/09 were 9.7% of the turnover, net of prizes paid.

while those with ability to pay should be charged full economic cost. That is, departures from sound economic principles (fees equal to economic costs that include all costs, including those accruing to capital) are only justified for social purposes if there are no alternative instruments in place to fight poverty.[29]

32. Business licenses are another example. They range from E 50 for peddlers to E 5000 for large construction companies. There is no single criterion for these fees; some of them vary by firm size, and in some cases the license restricts the goods that can be sold.

Tax Administration Issues

33. **In 2007 the IMF concluded that Swaziland's tax administration was performing poorly. Most of the problems still exist.**[30] "…Tax administration is split between the Department of Taxes and the Customs and Excise Department for sales tax, with inappropriate organizational structures, a lack of strategic or even short-term planning, and very little staff development. Many core revenue administration functions are inoperative or under-developed, such as filing and debt enforcement. With taxpayer audit producing few assessments, any deterrent effect has dissipated, and the onus to pay taxes has effectively become optional…IT support is rudimentary for sales tax and…system for income tax is so unreliable that… must be replaced…" The mission also mentioned the absence of a Large Taxpayer Unit, the cost of administering the graded tax and issuing tax clearance certificates, the lack of integration of the administration of domestic taxes. The creation of an independent Revenue Authority was seen as a positive step but insufficient to improve tax administration. Most of these problems still exist today.

34. **There are three collection agencies in Swaziland. This is likely to complicate tax administration**. Two departments are responsible for the collection of most taxes: the Customs and Excise Department (CED) that is not only responsible for collections of taxes at the border but also collects the domestic sales tax, and the Department of Taxes (DT) that is responsible for the collection of the income tax, the graded tax, the gaming tax and other small taxes. The treasury collects some fees that are set by different ministries. This split in the collection of domestic taxes is rare and is likely to complicate tax administration. A positive development is the creation of a Joint Task Tax Team that may even audit some sectors jointly (e.g. hotels), but as of April 2010 no joint audits have been done yet. This problem is easier to solve with the creation of the Revenue Authority.

35. **There is some risk of politicization in the staffing of the collecting agencies.** CED has 224 staff and 107 support staff. Although all receive a fixed salary there is no problem of wage compression (the ratio of the top to the lowest wage is about 10/11 times). Over the past two years the staff at DT apparently has increased from 200 to around 275

[29] The actual fees are so low that the extra charge to non-residents (they have to pay three times the fee to residents) and the possibility to waive them in cases of inability to pay are not relevant. Just as an example the cost for a tooth extraction is E 3 (less than US$ 0.50).

[30] D. Kloeden, G. Reid, B. Russell and B. Msiska "*Swaziland. Strategy to Modernize Revenue Administration*". FAD May 2007.

today (200 staff and 75 support staff). All staff at CED and DT is recruited by the Government Central Civil Service Office and firings also have to go through that office. This creates some risk of politicization and delays the removal of corrupt or inept officials.

36. **The Departments responsible for the collection of taxes do not face a shortage of funds to operate.** The budget for 2010/11 for CED and DT is E 83 million. This represents about 1.5% of the collections of the taxes that are supervised by both departments and 2.4% when SACU revenues are excluded. Given that a large fraction of SACU revenues accruing to Swaziland was collected by other revenue authorities, the higher number is better used to compare with other countries. In the US the IRS has a budget of about 0.5% of the revenues. In some emerging countries the number oscillates between 1 and 2% and in Lesotho is 1.6%. Therefore, the conclusion is that there is no shortage of funds. However, the departments have faced problems financing investment, training, and in loading the data in a timely manner. This suggests that there might be some excesses in payrolls of non-qualified staff.

37. **Some examples of critical issues are the de facto manual operation of most activities and the unnecessary delays created by a formal process of assessment by both departments of the returns and support information**. For example, firms file a tax return for sales tax and have to accompany the invoices. CED has a backlog of 5 months to issue statements and this allows firms to delay (at zero interest) the day of payment. The IT system does not issue automatic letters to non-filers of the income tax. There is no risk-based approach to select the cases to be audited and DT rarely requests information from external sources. Given that neither department can file the tax returns on time, external information would add to their problems. However, modern tax administration request information from banks, credit cards, real estate transactions that is loaded into the IT system to detect inconsistencies in the individual tax returns. Summing up, CED and DT spend precious time in manually entering information and issuing assessments instead of using that time to check self assessed tax returns that were filed electronically by the taxpayer.[31]

38. **Neither of the Departments has an updated database of taxpayers**. DT could provide the number of taxpayers (about 86,000 individuals, 20,000 companies, and 8,000 non-residents) and information that shows that about 80% of the returns are not filed. However, it is likely that some of the non-filers simply do not exist anymore. CED is working to update its taxpayer database. According to FAD (2007) there were 1,234 active sales taxpayers (about half importers that qualify for the deferred option) and 377 inactive taxpayers.

39. **The absence of a Large Taxpayer unit and unnecessary administrative burdens are other examples of inefficiencies.** Other issues include: a) Although tax evader may base unusually stringent penalties including fines and prison, the laws are rarely enforced properly which has lead to few convictions for tax offenses; b) there are different tax numbers for the same taxpayers and invoices in the sales tax may not be numbered. This adds unnecessary complexity for the auditors; c) neither CED nor DT conduct tax evasion estimates nor do they do not prepare annual reports on time as they are mandated to under

[31] Only recently taxes can be paid electronically.

the Income Tax Order); d) the income tax form not only requires unnecessary information[32] but also requires firms to attach a version of the financial statements in the format used by the firm, which complicates the analysis of the returns; e) DT faces an unnecessary burden when it processes every year 150,000 graded tax transactions and 24,000 tax clearance certificates that are issued without ensuring that they cannot be forged. Both activities may involve about 20% of the staff of the department; f) neither CED nor DT have Large Taxpayers Units. Most tax administrations have these to ensure a closer look at those taxpayers that account for most of tax revenues.

40. **However, there are some improvements in the past two years like the increase in the number and efficacy of audits and a better profile of the aged tax debt.** According to FAD (2007) in 2005 and 2006 the number of annual sales tax audits was a meager 16 audits and 18 audits, respectively. The combined additional revenue resulting from these audits came about E 1 million. In the 15 months from January 2009 to March 2010, 15 staff from CED made 130 audits that produced E 16.5 million of additional revenues. In addition, Table 5 compares the Aged Income Tax Debt as of March 2007 and September 2009. Even though the total debt is still around 10% of income tax collections, the share of debts with more than one year has declined from 99% to 34%, and those debts below 90 days have increased to around 9% of the total.

Table No. 5. Aged Income Tax Debt

Tax Debt (as of September 2009)							
Taxpayer	Number of taxpayers (estimated)	30 to 60 days	60 to 90 days	90 to 120 days	120 days to 1 year	more than 1 year	Total
Individuals (Private sector)	870	4.416.878	290.780	816.641	2.705.400	6.560.223	14.789.922
Individuals (Government)	280	764.364	33.269	65.760	540.687	1.333.342	2.737.422
Companies	840	9.793.580	4.620.390	88.921.893	23.791.576	63.260.457	190.387.896
TOTAL	1990	14.974.822	4.944.439	89.804.294	27.037.663	71.154.022	207.915.240
Shares		7%	2%	43%	13%	34%	100%
Tax Debt (as of March 2007)							
		30 to 60 days	60 to 90 days	90 to 120 days	120 days to 1 year	more than 1 year	Total
Individuals		57.789	776.073	19.440	59.058	44.870.932	45.783.292
Companies		312.780		40.832	192.174	103.142.118	103.687.904
TOTAL		370.569	776.073	60.272	251.232	148.013.050	149.471.196
Shares		0%	1%	0%	0%	99%	100%

Sources: FAD (2007) for 2007 and Department of Taxes for 2009

Tax Policy and Tax Administration Options

41. **An efficient tax administration and an enlargement of the tax bases, tax rates, and fees based on sound economic principles are crucial elements of a legitimate tax reform.** There is a range of principles to ponder when raising revenues. Importantly,

[32] Some examples are explanations about the decrease in gross profit, details about the valuation of trading stock, purpose, duration and cost of business trips, etc.

governments have to be careful not to rely excessively upon taxes or fees that create growth-deterring distortions or increase income inequality. For example, export taxes and financial transactions are easy to collect and are likely to produce large amounts of revenues, but they are damaging for the economy. Therefore, a well-designed reform agenda will include: a) a focus on improving the efficiency of tax administration, because evasion is both negative for income distribution and reduces the efficiency of the economy; b) an enlargement of tax bases because the international evidence suggests that most tax incentives are deleterious for the overall performance of the economy; c) an improvement of the performance of those taxes that are below what is the norm in neighboring countries or below the levels that are justified by sound economic principles (e.g. correcting for negative externalities); d) the introduction of cost-recovery fees for the services provided by government. There is ample room in Swaziland to move into any of these directions. Some options are discussed below.

42. **Some proposals discussed in Swaziland are likely to improve the tax design, but others are not.** There are some proposals to increase tax revenues being discussed at technical levels. Some of them are justified from economic principles like: a) raising the tax on gaming to 15% on the revenues net of prizes paid, b) raising the road toll, c) eliminating the graded tax, and d) taxing capital gains on business assets. Other proposals are problematic. For example, an educational levy will act like a tax on human capital besides what is the usual case with the income tax (assuming that more education leads to higher income as it is the case in other countries). Also, introducing a minimum income tax of 3% of taxable income will create a higher increase for those close to the exempt level, probably reducing vertical equity.[33]

43. **The replacement of the Sales Tax with a VAT expected for 2011/12 is a much needed improvement in the tax system of Swaziland**. A VAT at a rate of 14% together with a better administration should be able to produce a substantial increase in revenue if the VAT is kept simple and general (i.e. a single rate for taxed products, with few exemptions) and similar to that used in neighboring countries. The GOZ has drafted a VAT Bill in this direction. If approved it would replace the sales tax with a well-designed VAT of the consumption type with: i) zero-rating of exports (allowing them to exit the country free of indirect taxes as permitted by the WTO); ii) refunds of excess credit within two months or an offset against future VAT liabilities; and with a list of exemptions and zero-rate of foodstuffs and farm inputs. Firms would be allowed to deduct the VAT paid on purchases for inputs and capital goods. Exempt products would absorb the input VAT as a cost while zero rating would allow recovery of the input VAT from the government. It is important to stick to the draft bill and not give in to lobbies that will argue for lower rates. In the case of goods this will create negative arbitrage opportunities, and in the case of services like electricity or telecommunications an important loss of revenues with no positive impact on income distribution. The exceptions to the general rate of 14% should be kept to a minimum and based on distributional considerations (e.g. zero-rating of basic foodstuffs that are important in the consumption of the poor) or technical reasons (e.g.

33 Minimum taxes are justified when there are many exemptions that erode the tax base. This is not the case of Swaziland that taxes many fringe benefits. Besides the objective of the minimum tax is not to ensure that exemptions cannot erode completely the tax base, but to obtain more revenues from those taxpayers that have incomes that barely surpass the exempt level.

exemption to insurance and financial services) or revenue needs (e.g. maintaining the 25% tax on alcoholic beverages and tobacco products that adds to domestic revenues).

44. **Following the experience of other SACU countries there is room to simplify the administration of the VAT.** Lesotho has made two improvements that are likely to be positive for Swaziland as well. First, it eliminated for large exporters the financial cost of delays in the reimbursement of the VAT through an upfront payment system that allows exporters to receive a monthly reimbursement based on their past activities with virtually no lag as well as a quarterly settlement of the accounts with the tax administration. This is an improvement compared to other countries where the reimbursements of VAT for exporters are delayed, either because the government is strapped for funds or because it is afraid of "ghost" exports (the exporter collects a VAT refund that was never paid to the government). Second, Lesotho Revenue Authority (LRA) has an agreement with SARS to facilitate the processing of transactions at the border. Given that many individuals and firms cross the border to buy goods in South Africa and pay VAT there that has to be reimbursed at the border by SARS and taxed by LRA, both revenue authorities agreed that LRA will now tax those transactions with an invoice, collect those invoices from the consumer and remit them to SARS. SARS then reimburses LRA.

45. **There are other possible simplifications that are likely to generate additional revenues.** Another simplification, which can be applied even with the existing sales tax, is the tax of foreign providers of services to Swazi firms, which has to be withheld by the firm who receives the service. This allows collecting from firms that provide services but do not register in the sales tax and disappear before the authorities in Swaziland can collect from them. If the provider incorporates in Swaziland he can be exempt from the withholding. It is also advisable to eliminate the deferred tax system in the sales tax.

46. **A special tax regime for small taxpayers would simplify the tax system although it is unlikely to generate additional revenues.** A special regime for small taxpayers (e.g. with turnover below E 500.000 a year) will expand the tax net.[34] Firms and individuals can be asked to pay a quarterly amount based on their turnover (around 2%) that will satisfy their duties under the new VAT and under the income tax. Unfortunately, this breaks the VAT chain, but there is no easy alternative to this.[35] The taxpayers who opt for this simplified regime will not get the right to claim the Input VAT (which provides the incentive to advance one step forward and register as a standard VAT taxpayer). Although a system like this would be a positive development if carefully designed, it is unlikely to generate substantial sources of revenue.

47. **The Development Order reduced tax rate and the initial allowance should be phased out. Tax incentives should be coordinated in SACU to avoid a "race to the bottom."** In the income tax there are some problems to be fixed. It is better to have the same top marginal rate for individuals and firms but unification at 30% will only reduce tax revenues of the richest families. Different tax rates on manufacturing and hotels are not

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[34] The Department of Taxes is working on a similar proposal.

[35] The VAT Draft has a threshold of E 500.000 but does not exempt the firms from complying with the income tax. A special regime for small taxpayers would allow the beneficiaries to get rid of the normal duties in both taxes for a monthly payment.

good instruments to foster investment. The potential problems for investing in Swaziland appear to be related to protecting investors, enforcing contracts, and the costs of creating new business rather than tax issues. Bolnick (2004) concludes that tax incentives may have an impact on investment decisions only in countries facing similar problems and opportunities.[36] Therefore, it is advisable to phase out the Development Order reduced tax rate and the initial allowance. Tax incentives, if any, should be coordinated with other SACU countries to avoid a "race to the bottom" where firms extract high concessions from governments to locate their investments. If some incentives are going to exist it is better to keep the initial allowance, but reduced (for example to 25% of the cost of the assets) and extended to all sectors to include labor intensive activities (like most services).

48. **It is advisable to introduce thin-capitalization rules and avoid partial indexation of the income tax.** There is no indexation of the income tax. Many countries have formal procedures for indexing the brackets and the minimum taxable income in the personal income tax. This avoids fiscal drag but reduces the flexibility to increase tax revenues, if needed. At the company level the lack of indexation aggravates the debt-financing bias. If there is going to be some form of indexation at the company level it is better to adopt full indexation (as some Latin American countries do).[37] As full indexation is not a standard practice in African countries, it might be better to leave it aside. However, the government should resist any partial indexation that usually is requested only for depreciation allowances (it creates a fiscal loss for the government) while firms continue deducting all interest paid. Also, thin capitalization rules should be introduced allowing the full deduction of interest only if the debt/equity ratio is lower than 3:1.

49. **Some withholding rules need to be reintroduced.** There is not much space to increase income tax rates, especially for companies. When tax administration is weak, like in Swaziland, most countries rely on withholdings to ensure some revenue from third parties that are easy to monitor. This was probably the rationale of the withholding on interest paid to residents that, unfortunately, was abolished in 2008. There is room to improve collections of self-employed income tax. This requires reintroducing the withholding on interest and better enforcement of the withholding on rentals until tax administration improves.

50. **The graded tax should be abolished or transferred to local governments.** The tax clearance certificate can be replaced by an automatic check in the webpage of the RA, eliminating paper work.

51. **Aligning fuel taxes with those in South Africa will help correct negative externalities and generate revenue**. The revenue yield of raising fuel taxes to about E 1.0 per liter is around 0.8% of GDP. Road tolls are charged at the point of entry regardless of the number of days the driver uses the roads and locals do not pay the charge.

[36]It is not surprising that recent studies have found a more important effect on taxes on the location decision of firms inside the European Community.

[37] Depreciation is calculated on the cost of the asset adjusted by inflation, but the firm has to add to its taxable income an amount equal to the inflation rate times the difference between current liabilities and current assets. The logic for full indexation is that firms suffer a loss because inflation erodes the value of its current assets and have a gain because inflation erodes the value of their liabilities.

52. **Fees should be based on the full economic costs of providing the service**. This is unlikely to be the case with motor vehicle licenses that cost only US$ 15 a year for medium-sized cars (This amount is about half of what South Africa charges for domestic motor vehicle licenses). Since domestic vehicles pay low fuel taxes and no road tolls, motor vehicle license costs can be raised to reflect more properly the damage to infrastructure and to the environment.[38]

53. **There are many small fees (dog levy, cattle levy, attestation fees) that either should be abolished or collected at proper rates**. For example, there are about 600 shops with a liquor license and the government collects close to E 1 million a year from them, a relatively small amount for the provision of alcoholic beverages. These fees can be raised substantially. If such small fees and taxes are deemed necessary to effect a change in behavior, albeit at a low level, this rationale would need to be made explicit, and the benefits broadly quantified (e.g. "sin" taxes keep people healthier).

54. **The creation of the Revenue Authority in 2008 was a positive step to improve tax administration in Swaziland but needs to be put in practice as soon as possible**. **However, this is only one first positive step in the reform path.** When implemented, it will be more independent than DT and CED and it will be able to recruit staff based on their experience and knowledge, with less political interference. However, there are many immediate challenges: a) there is anxiety and tension among the staff of CED and DT about who will be recruited by RA. The recruitment process is expected to end in July for the 22 higher posts and in September for the rest of the staff. It is important not to delay this process because it might affect the collection of taxes; b) improving tax administration is far more complex than creating an RA and investing in new IT systems. It requires an adequate organization with well-paid professional staff, internal controls, risk-based selection of cases to audit, no politicization of decisions, simplification of tasks, the creation of a Large Taxpayers Unit with specialized staff in complex issues like transfer pricing, etc. Basically, it is a change from a manual and dispersed operation to an integrated approach where most activities are performed by the IT system (risk-based selection of cases to audit, letters to non-filers, letters to urge for the payment of tax debts, checks for tax compliance certificates, etc.) but with skilled staff designing the overall plans and carrying the controls in the field of those cases spot by the IT system. A medium term plan to move towards an integrated approach, which includes detection of evasion with automatic control of filings and collections, is also necessary. Without an adequate computerized system it is not possible to administer a database with information from banks, credit card companies, or transactions of property that other countries load. It is also impossible to conduct consistency checks on income declared by taxpayers. Moreover, with a manually-operated database it is very time-consuming to develop all the performance indicators that RA will need for internal control of its performance.

55. **It is necessary to train tax auditors to inspect VAT and income tax jointly**. Most auditors in Swaziland do not have an educational background in accounting. To overcome this shortage of skills it is necessary to run periodic training courses with back office

[38] There is no instrument that allows a perfect match with the externality. Environmental damage is not proportional to consumption of fuels and motor vehicle licenses, if used as a substitute of road tolls, will collect also from owners that do not use the car.

support to the auditors. Other countries have a small group of experts in the most relevant economic activities to provide auditors with a general view of the characteristics of the sectors that they audit.

56. **Discretion in the application of penalties should be restrained.** According to the VAT draft bill and the Act the Commissioner and the Ministry have significant discretion to graduate fines. This discretion might not be used properly and might encourage political pressures. Therefore, it is advisable to introduce procedures to limit the Commissioner's discretion. One way to approach this problem is to impose the same penalty for similar offences while taking into account the past performance of the taxpayer.

57. **RA should produce an estimate of the tax gap in the VAT, income taxes and the fiscal cost of tax expenditures**. Many revenue authorities produce estimates of the VAT (although only few estimate the tax gap in the income tax). Used on a consistent basis, the evolution of the tax gap might be used as another element to assess the performance of RA. Similarly, RA should estimate the fiscal cost of tax expenditures. For any special tax regime every year RA can provide an estimate of tax expenditures (the tax forgone because of exemptions, zero rating, lower tax rates) and include this estimate in the budget. It is important to do this to inform the public and to facilitate the evaluation of the fiscal cost caused by special tax treatment. Reductions in taxes to encourage one activity or a specific consumption are equivalent to favoring the same activities through a subsidy in the budget. Both the IMF and OECD recommend including tax expenditures in the budget.[39] Exemptions should also only be obtained by an amendment of the law rather than at the behest of the Minister of Finance.

58. **Experience in other countries, indicates that the following reforms are likely to improve the efficiency of RA**: a) A fully-computerized customs system should reduce costs for the private sector, control fraud more efficiently, and improve the accuracy of intra-SACU imports, thereby minimizing the unnecessary discussions with other country members. Therefore, it is important that the ASYCUDA project be finished on time; b) Gradual introduction of e-filing for tax returns will reduce the cost of creating a computerized tax base for all taxes and will eliminate any source of differences between data submitted by the taxpayer and that loaded by RA staff in the database; c) After all the returns have been computerized, RA will be in a position to request original source data be sent from banks, credit card companies, and real estate companies to validate taxpayers activities and increase chances of detecting tax avoidance; and d) All invoices and books should be numbered sequentially to avoid the possibility of using more than one book concurrently.

[39] There are several alternatives to estimate tax expenditures that range from the fiscal cost (adjusted by evasion) to the money transferred to the taxpayer that is different than the fiscal potential revenues because of the reaction of the taxpayer to the tax.

Box 1: Policy Options to Improve Non-SACU Revenue

Box 2: Administrative Options to Enhance Non-SACU Revenue

Annex 1: Swaziland Revenue and Grants

Annex Table 1	Average 1999/04	Average 2004/09	2009/2010 (estimate)	Average Bu 2010/13	2009/10 vs Ave 2004/09	2010/13 vs Ave 2004/09
TOTAL REVENUES & GRANTS	27,098%	35,214%	34,414%	25,151%	-0,800%	-10,062%
Tax Revenue	23,971%	33,229%	32,352%	23,222%	-0,877%	-10,007%
SACU	12,673%	21,556%	19,180%	11,051%	-2,376%	-10,505%
Non-SACU Tax Revenues	11,298%	11,673%	13,172%	12,171%	1,499%	0,498%
Taxes on Income	6,665%	7,420%	8,455%	7,581%	1,035%	0,161%
Individuals	4,022%	4,580%	5,067%	4,972%	0,487%	0,392%
PAYE	3,907%	4,265%	4,911%	4,534%	0,646%	0,269%
Taxes on interest and Dividend to locals	0,055%	0,064%	0,052%	0,051%	-0,013%	-0,014%
Self Employed	0,029%	0,008%	0,003%	0,002%	-0,005%	-0,006%
Directors (provisional)	0,031%	0,206%	0,044%	0,343%	-0,162%	0,138%
Trusts	0,000%	0,001%	0,005%	0,000%	0,004%	-0,001%
Withholdings Rents by Estate agents	0,000%	0,002%	0,005%	0,001%	0,004%	-0,001%
Taxes on in kind Benefits	0,000%	0,033%	0,047%	0,040%	0,014%	0,007%
Companies	2,246%	2,228%	2,476%	2,152%	0,248%	-0,076%
General and provisional	2,246%	2,115%	2,473%	2,152%	0,358%	0,037%
Withholdings	0,000%	0,113%	0,003%	0,000%	-0,110%	-0,113%
Withholdings on Foreign	0,387%	0,611%	0,912%	0,457%	0,301%	-0,154%
Interest and Dividends	0,172%	0,124%	0,056%	0,070%	-0,067%	-0,054%
Contractors	0,054%	0,067%	0,077%	0,098%	0,010%	0,032%
Royalties and management fees	0,149%	0,340%	0,497%	0,274%	0,157%	-0,066%
Other	0,012%	0,081%	0,281%	0,015%	0,200%	-0,066%
Other	0,010%	0,001%	0,000%	0,000%	-0,001%	-0,001%
Graded Tax	0,023%	0,015%	0,011%	0,012%	-0,004%	-0,004%
Taxes on Property	0,108%	0,128%	0,088%	0,092%	-0,040%	-0,036%
Transfer of Property	0,072%	0,076%	0,055%	0,042%	-0,021%	-0,034%
Stamp tax	0,036%	0,052%	0,033%	0,050%	-0,019%	-0,002%
Taxes on Goods, Services and International Trade	4,465%	4,109%	4,617%	4,486%	0,509%	0,377%
Sales Tax	3,612%	3,473%	4,154%	3,998%	0,681%	0,525%
Sugar Export Levy	0,138%	0,134%	0,065%	0,000%	-0,070%	-0,134%
Hotel and gaming taxes	0,028%	0,053%	0,076%	0,084%	0,023%	0,031%
Road Levy and fuel tax	0,687%	0,448%	0,323%	0,404%	-0,126%	-0,045%
Other taxes	0,037%	0,001%	0,001%	0,000%	0,000%	0,000%
Non-Tax Revenues	1,966%	1,294%	1,526%	1,181%	0,232%	-0,114%
Property Income	1,270%	0,493%	0,876%	0,377%	0,382%	-0,116%
Loan repayment	0,079%	0,072%	0,066%	0,089%	-0,006%	0,017%
Fees, fines and nonindustrial sales	0,618%	0,729%	0,585%	0,715%	-0,144%	-0,014%
TOTAL REVENUES	25,938%	34,523%	33,878%	24,402%	-0,645%	-10,121%
GRANTS	1,160%	0,691%	0,536%	0,749%	-0,155%	0,058%

Source: World Bank Estimates based on IMF Article IV. GDP of the FY is estimated as 75% of the GDP of the first year and 25% of the GDP of the second year

Annex 2: Why government revenues differ across countries?[40]

There is a growing body of literature on the factors that explain why government revenues differ across countries.[41] There is some consensus that tax revenues will depend on the following variables:

a) Per capita income is considered a good proxy of the level of development of the economies, the sophistication of their economic structures or because the demand for public goods has an income elasticity higher than one, with citizens more willing to pay for them.

b) The composition of economic activity. As there are some sectors that are more difficult to tax than others (e.g. agriculture) those economies with a larger participation of those activities in the total are likely to have a lower tax burden.

c) The economy's degree of openness (measured by the sum of exports and imports). Since taxes are easier to collect at customs and more open economies are more likely to replace non-tariff barriers for tariffs, economic openness would tend to produce higher revenues. However, if trade liberalization was achieved through a reduction of tariffs, its effect on tax revenues might be the opposite.

d) Better institutions, more transparency, and more educated citizens are expected to lead to higher tax revenues.

e) The level of monetization of the economy. More financial deepening is likely to favor tax collections to the extent that more transactions are done through the financial system.

f) Macroeconomic variables may favor tax revenues. High growth usually creates an environment more prone for taxpayers to comply with their duties without arrears and low inflation improves revenues because the Tanzi effect is minimal.

Available empirical studies have some limitations. They focus on tax revenues while governments have other sources of revenues like fees, social security contributions, and grants. They also use central government data which is a limitation for federal countries where subnational governments may have their own important revenues. In the empirical analysis below we opted to use the revenues of the general government as shown in the GFS (Government Finance Statistics of the IMF) complemented with IMF Article IV

[40] This section is based on a work in process by D. Artana and I. Templado.

[41] See for example, M. Keen and A. Simone. "Tax Policy in Developing Countries: Some Lessons from the 1990s and Some Challenges Ahead" in S. Gupta, B. Clements and G. Inchauspe (eds) Helping Countries Develop: The Role of Fiscal Policy. International Monetary Fund. Washington DC 2004. R. Bird, J. Martínez Vazquez and B. Togler "*Societal Institutions and Tax Effort in Developing Countries*". CREMA Working Paper No. 21 (2004). A. Sen Gupta "*Determinants of Tax Revenue Efforts in Developing Countries*". IMF Working Paper No. 184 (2007) or studies done for some countries like H. Davoodi and G. Grigorian "*Tax Potential vs. Tax Effort: A Cross-Country Analysis of Armenia's Stubbornly Low Tax Collection*". IMF Working Paper No. 106 (2007), N. Farjan "*Sao Tomé and Príncipe: Domestic Tax System and Tax Revenue Potential*". IMF Working Paper No. 215 (2009) and C. Josz "*Madagascar-Tax Policy Reform Priorities to Improve Revenue Performance*" in IMF "Republic of Madagascar. Selected Issues. IMF Country Report No. 239 (2007).

reports. We also analyze total revenues and their composition.[42] To group revenues we follow economic principles as follows:

(vi) Taxes on income, profits, and capital gains include taxes on the flows of labor and capital income and are grouped together with taxes on property (on the capital stock).[43] Social Security contributions belong to this category unless each worker receives a compensation that matches his contribution to the system. As we do not have enough information on the characteristics of the social security system of all countries we opted to try both scenarios (include them in this category or exclude them).

(vii) General taxes on consumption are grouped together with excises and taxes on trade. Taxes on import are a tax on consumption that is used in part to subsidize local production. Export taxes are different and should better be classified as taxes on income. It is not easy to solve this classification problem but as most countries have abandoned taxation on exports there should not be a major problem.

(viii) Other minor taxes, grants, and non tax revenues are classified as in the GFS.

The econometric evaluation of the tax effort is done for different dependent variables:

TR_G: Total Revenues with Grants

TR: Total Revenues without Grants

Tax: Tax Revenues

Ty_SS: Income taxes plus Social Security Contributions

Ty: Income Taxes

Tc: Taxes on Consumption

And the explanatory variables are:

Agric: Agriculture and Farming share in total GDP

M2: Money and Quasi Money as % of GDP

Trade: Exports plus imports of goods (% of GDP)

Transpa: Transparency Index as measured by Transparency International

XFuels: Share of exports of fuels and mining in total exports

GNI: Per Capita Gross National Income (Athlas method)

Alfabet: Literacy index.

[42] In some low-income African countries we used data for Central Government that is likely to cover most (if not all) General Government revenues.

[43] There are some problems with taxes on property. The GFS classification includes in this category taxes on financial transactions that should better be included as turnover sales taxes.

Inflat: Average inflation rate of the year

Growth: Average growth rate of 5 years

Latam: Dummy variable that takes a value of 1 for Latin-American countries

Const: Constant intercept.

In all regressions, growth and inflation were statistically equal to zero and were dropped from the results shown in the Annex Table No. 2. The sample is a cross section for 105 countries with information on revenues of general government. Given the presence of some outliers the regressions were done using MM regression (robust) with the algorithm developed by Verardy and Croux[44] that assigns a lower weight to the outliers. To ensure that the forecasted values of tax effort stay in a range between 0 and 1, we used a classic GLM.[45]

The variable agriculture is generally significant and with the expected negative sign; M2 is significant in some regressions but with a negative sign, opposite of what the literature suggests, all other variables have the expected signs (when they are significant) with tax revenues increasing in those countries of higher development, lower corruption, more openness to trade, with a more educated labor force and higher exports of fuels and mining. The dummy variable for Latin America has also the expected negative sign which reveals chronic problems with raising revenues in this region.

It is possible to use the regressions to forecast the tax effort of Swaziland using the actual values for the explanatory variables. A summary of the results is shown in Annex Table 3. Basically the estimates say that Swaziland has a relatively larger participation of the government in the economy (approximated by total revenues). When only part of SACU revenues is counted as normal revenues total revenues are about 6% of GDP, which is lower than predicted by the regression of total revenues without grants. However, the actual collections of consumption taxes including what is collected by other SACU members (and also income taxes) is relatively adequate suggesting that there is some room to improve the collection of other taxes and non-tax revenues. Therefore, this exercise suggests first that lower government expenditures should contribute the most to the needed fiscal tightening and second that there is some room to improve the general taxes (like introducing the VAT) but that other sources of revenue are relatively not exploited in Swaziland. Note, however, that other low-middle income economies may obtain those revenues from taxing the producers of exhaustible resources and this is an option that depends on the availability of rich deposits.

[44] Verardi and Croux. *Robust Regression in Stata.* The Stata Journal Volume 9 No.3. 2009.

[45] For SACU countries there is an implicit grant in the distribution of revenues. We estimated what actual revenues would have been absent that redistribution, using each country's share in total imports of the region (as of 2005).

Annex Table No. 2. Estimates of the tax effort

	Dependent Variable											
	TR		TR_G		Tax		Ty_SS		Ty		Tc	
Agric	-0,3484	**	-0,4305	***	-0,1154	*	-0,0269	***	-0,0138		-0,006	
M2	-0,0413	***	-0,0426	***	-0,0106		-0,0003		0,0001		0,0014	
Trade	0,0116		0,0174		-0,0057		-0,0104		-0,0024		0,0021	*
Transpa	1,0466		0,956		1,6467	***	0,05236		0,1318	***	0,059	
Alfab	0,1192	*	0,0517		0,1012	**	0,02021	***	0,0071		0,006	
Xfuels	0,0009		-0,0076		0,0602	**	-0,0050	**	0,0010		-0,004	
GNI	0,0002	***	0,0002	***	0,0000		0,0000		0,0000		-0,00002	
Latam	-6,9238	***	-8,5221	***	-5,2337	***	-0,4055	***	-0,4046	***	-0,1552	
Const	18,608	**	27,754	***	6,297		-3,5272	***	-3,3216	***	-2,7277	
R2	0,478		0,432		0,353							
Method of estimation	Robust Regression (MM)		Robust Regression (MM)		Robust Regression (MM)		Classic GLM		Classic GLM		Classic GLM	

* Significant at 10%

** Significant at 5%

*** Significant at 1%

Annex Table No. 3 Forecasts for different measures of tax effort for Swaziland (% of GDP)

	Observed	Estimated	Forecasting Range	
			Lower	Upper
Total Revenues	40,5	33,1	26,3	39,8
Total Revenues without grants	22,3	28,7	22,6	34,9
Tax Revenues	20,8	16,7	12,7	20,7
Income Tax plus Social Security Contributions	8,2	8,9	6,3	12,5
Income Tax	8,2	5,6	4,1	7,7
Taxes on Consumption	12,2	13,1	10,0	17,0

Notes:

1/ Total revenues w/o grants excludes the estimated redistribution from other SACU countries

2/ Tax revenues include the share of SACU revenues that Swaziland would have obtained absent the redistribution.

3/ Taxes on Consumption include the share of SACU revenues that Swaziland would have obtained absent the redistribution.