Sector Study of the Effective Tax Burden

Lesotho

June 2006

Foreign Investment Advisory Service
A joint service of the International Finance Corporation and the World Bank
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SUMMARY OF ACRONYMS

Exchange Rate: 6.9 Maloti US$

CIT  Corporate Income Tax
DFID  Department for International Development
EPZ  Export Processing Zone
FDI  Foreign Direct Investment
GDP  Gross Domestic Product
GOL  Government of Lesotho
IVCF  Import VAT Credit Facility
LDC  Least Developed Country
LRA  Lesotho Revenue Authority
M&E  Machinery and Equipment
METR  Marginal Effective Tax Rate
RA  Revenue Authority
SACU  Southern Africa Customs Union
SMMEs  Small, Medium and Micro Enterprises
VAT  Value Added Tax
This report forms part of a multi-country study of African revenue authorities FIAS are undertaking in collaboration with the United Kingdom Department for International Development (DFID). The purpose of the study series is to determine whether the tax policy and tax administration regimes are conducive to economic growth. A key focus is on the opportunities created by bringing informal firms into the tax net and appropriate tax policies for small enterprises. FIAS undertook a pilot study of Zambia, published in December 2004.1

On behalf of the Government of Lesotho, the Ministry of Finance & Development Planning, in conjunction with the Lesotho Revenue Authority, requested that FIAS conduct a similar study of the effective tax burden on five key sectors in the economy. The purpose was to investigate whether these sectors are competitive domestically and internationally, as regards the impact of the tax regime. This study provides the government with information it seeks through both quantitative and qualitative analysis. The quantitative analysis uses ‘marginal effective tax rate’ calculations carried out in each of the identified sectors. It also offers cross-country analysis allowing the assessment of international competitiveness. The qualitative analysis involves firm level interviews and secondary sources, by both a political economy specialist and sector experts. A third component built into this study is a capacity building exercise, with the group of international consultants tasked to work closely with a Ministry of Finance & Development Planning and Lesotho Revenue Authority counterpart group to transfer the knowledge and methodology underlying such an analysis.

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1 The Swedish Agency for International Development co-funded the Zambia study.
<table>
<thead>
<tr>
<th>Issues</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General Economy</strong></td>
<td>• Recent significant changes to the CIT regime need time to have effect. Focus tax policy (in terms of creating a pro business environment) on monitoring and evaluating these changes with a view to evaluating their effectiveness in driving additional investment.</td>
</tr>
<tr>
<td><strong>Agriculture Sector (METR 18%)</strong></td>
<td>• Monitor carefully impact of new 10% CIT rate.</td>
</tr>
<tr>
<td>Almost entirely subsistence and outside the tax net. Benefits from significant tax advantages; unlikely that tax acts as a break on investment in the sector.</td>
<td>• Investigate the expansion of the list of zero-rated farm inputs.</td>
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<tr>
<td>• Consider a specific self assessment form for farmers.</td>
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<tr>
<td>• Outreach and education are especially important in rural areas.</td>
<td></td>
</tr>
<tr>
<td><strong>Mining Sector (METR 26%)</strong></td>
<td>• Move away from individually negotiated agreements by standardizing all aspects of diamond mines taxation in the tax and mining code.</td>
</tr>
<tr>
<td>Growing from a very small base. Individually negotiated agreements in place, as well as CIT, royalties and surface rentals. Generous capital allowance and paper losses mean that firms are paying very little tax at present.</td>
<td>• Consider implementing a progressive formula based tax regime or a resource rent tax.</td>
</tr>
<tr>
<td>• Clear up the issues in the sector regarding the Import VAT Credit Facility and the interpretation of VAT &amp; improve the VAT rebate system.</td>
<td></td>
</tr>
<tr>
<td><strong>Manufacturing Sector (METR 11%)</strong></td>
<td>• Preferential corporate tax rates for exporters will need to be phased out in the medium term to ensure WTO compatibility.</td>
</tr>
<tr>
<td>Has benefited from significant FDI (textiles and garments), but now under threat from global trade deregulation. Following 2006 Budget exporters pay 0% CIT, 10% otherwise. Also receives other tax benefits (i.e. VAT credit facility).</td>
<td>• Increase transparency and disseminate criteria used for income tax assessments.</td>
</tr>
<tr>
<td>• Review need to provide Tax Clearance Certificate to renew sector licenses.</td>
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</tr>
<tr>
<td>• Provide VAT refunds to fully compliant claimants w/o pre-refund audits &amp; carry out post-refund audits during planned audit cycle.</td>
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<tr>
<td><strong>Tourism (METR 43%)</strong></td>
<td>• Simplify the VAT system by applying VAT to all tourism and transport services.</td>
</tr>
<tr>
<td>Fledgling industry, based on spill-over from the South Africa market. Low headline CIT rate, but low depreciation allowances also (hence high METR). Few VAT registered companies. Administration problems remain.</td>
<td>• Zero rate VAT applicable to travel agent’s commission.</td>
</tr>
<tr>
<td>• Considering increasing rates of depreciation, especially the depreciation of hotel buildings which is currently non depreciable.</td>
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<tr>
<td>• Eliminate multiple rates of VAT by converting VAT on alcohol and telecommunications to the standard rate.</td>
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</tr>
<tr>
<td><strong>Financial Sector (METR 51%)</strong></td>
<td>• Amend the VAT act to specifically address the application to the leasing sector, when the leasing legislation comes into force.</td>
</tr>
<tr>
<td>Small sector based on South African subsides. VAT exempt (as is common). Lack of appropriate legislation and institutions hinder development, rather than taxation.</td>
<td>• Following its current period of exemption, tax the Lesotho Unit Trust in the same way as any corporation.</td>
</tr>
<tr>
<td><strong>Small businesses (METR 38%-52%)</strong></td>
<td>• Examine options for the introduction of a small business tax regime.</td>
</tr>
<tr>
<td>No specific small business tax regime, but small firms may use cash accounting. VAT registration is option when turnover is &lt; M500,000. Poor record management leads to low self-assessment compliance and friction over LRA assessments.</td>
<td>• Raise the ceiling for the requirements to (a) use accrual accounting and (b) submit audited accounts.</td>
</tr>
<tr>
<td>• Shift to quarterly or bi-annual filing of returns for VAT for small taxpayers &amp; devise simplified regimes for VAT for small businesses.</td>
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<tr>
<td>• Increase outreach function of LRA to encourage compliance.</td>
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<tr>
<td><strong>Institutional and Organizational Issues.</strong> LRA has achieved much in a short period. Customs and Perceptions Survey of 2004 has still to be fully acted upon. Need to do more (e.g. outreach) to secure voluntary taxpayer compliance. Engagement with the private sector improving.</td>
<td>• Put in place new performance measures for the LRA that balance revenue targets with customer service measures.</td>
</tr>
<tr>
<td></td>
<td>• The LRA needs to devise a tax compliance strategy as a key institutional tool to impact on the implementation of tax policies.</td>
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EXECUTIVE SUMMARY

This FIAS/DFID report forms part of a series of studies designed to improve understanding of the impact of tax policy, and in particular its administration, on the business climate in southern Africa.

The study uses both quantitative and qualitative techniques to address these concerns. The quantitative component uses Marginal Effective Tax Rate (METR) techniques to investigate how the tax code, as defined in legislation, benefits certain sectors over others. The qualitative component addresses in more detail how tax administration works in practice, including a political economy analysis of the LRA and Ministry of Finance & Development Planning & Development Planning as institutions.

Context of the Study in Lesotho

Since 2005 the Government of Lesotho (GOL) budget has been presented in the context of a Medium Term Expenditure Framework, with the aim of linking expenditure directly to agreed priorities which, in turn, are guided by the broader objectives of the UN’s Millennium Development Goals, the National Vision 2020 and the Poverty Reduction Strategy.

The recently published Poverty Reduction Strategy 2004-07 had three interconnected goals:

- Create jobs through the establishment of an environment that facilitates private sector-led economic growth.
- Empower the poor and the vulnerable and improve their access to health care and education.
- Deepen democracy and improve public sector performance, to ensure that policies and legal frameworks facilitate the full implementation of priorities.

SACU revenues are important for Lesotho as they accounts for at least 50% of the Government’s total revenue. The GOL only have unilateral control over inland taxation. The relatively small contribution of inland taxes, (as compared to sub-Saharan African countries outside SACU) means that the Government of Lesotho has more flexibility to adjust rates without the immediate revenue impact.

This is most apparent in the 2006 Budget (based upon analysis by the Tax Task Force), which lowered corporate income tax substantially to between 0% and 25%, depending on the sector and whether the business exports outside SACU.
The business climate in Lesotho

The World Bank’s ‘Doing Business’ project provides a good starting point for assessing Lesotho’s investment climate. On taxes, Lesotho compares well to South Africa and the region in terms of the number of tax payments (19 vs. 32 and 41 respectively). However, Lesotho performs worse in terms of the time taken to complete tax forms with 564 hours, which is well above the OECD standard of 197, South Africa of 350 and the regional average of 394. This result implies that there is considerable scope for simplifying the tax administration procedures. The LRA has begun to initiate efforts in this regard.

The revenue/GDP ratio in Lesotho is estimated at 51.6% in financial year 2005/6. This is far higher than any other African nation outside of SACU, and higher than South Africa (25%) and many OECD economies. This is attributable to both the numerator (SACU income boosting revenues) and denominator (a large informal economy not captured by GDP data). The contribution from the SACU Customs and Excise pool has grown from 48% in 2002/3 to an estimated 53% in 2005/6.

Summary of METR analysis in Lesotho

Table 1 shows the METRs for large firms in Lesotho compared to those already calculated for this series of FIAS studies. The METRs highlight that the ‘headline’ rate of corporate income tax does not always reveal the true tax burden. In Lesotho, while manufacturing firms have a low METR, the same is not true for tourism and financial services. This is because of differences in factors such as interest rates, depreciation rates allowed under tax legislation and capital allowances. It is important not to use METR numbers in isolation however, as comparing like with like is difficult. The FIAS team passed on training in METR analysis, which it is hoped, will prove useful in analyzing the impact of tax changes in more detail.

Table 1: Comparison of METRs in Lesotho vs. Region

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Tanzania</th>
<th>Lesotho</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>7%</td>
<td>5.7%</td>
<td>23.1%</td>
<td>18%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>7%</td>
<td>21.3%</td>
<td>15.3%</td>
<td>11%</td>
</tr>
<tr>
<td>Tourism</td>
<td>13%</td>
<td>13.9%</td>
<td>14.9%</td>
<td>43%</td>
</tr>
<tr>
<td>Financial</td>
<td>28%</td>
<td>29.8%</td>
<td>28.9%</td>
<td>51%</td>
</tr>
</tbody>
</table>

2 For example, the METR for agriculture in Tanzania in Table 1 assumes that the 5% turnover ‘cess’ tax applies – which is not the case for all crops.
Sector Analysis

Agriculture

According to the 1999 Labor Force Survey, about 80% of the economically active rural population listed “subsistence agriculture” as the household’s main occupation. There is very little commercial agriculture.

Tax is not a major issue constraining investment in this sector. Other factors are more important in driving growth and investment, issues such as land tenure reform, skills gaps, and access to credit, soil erosion and poor rural infrastructure. However, businesses that supply and buy from farmers are assessed by the LRA and have a similar set of issues as urban enterprises.

Recommendations include:

- Monitor carefully the impact of the recently introduced 10% CIT rate.
- Investigate the expansion of the list of zero-rated farm inputs.
- Consider a specific self assessment form for farmers, which would be tailored to their specific needs and requirements.

Mining

The contribution of the mining and quarrying sector to GDP increased from 0.2% in 2003 to 2.3% in 2004. Diamond mining is the main source of large scale mining in the country while small scale and artisan operations are focused on the production of agate, clay, stone, sand and gravel mainly for local consumption.

Individually negotiated agreements are in effect in the diamond mining industry. All aspects of diamond mining leases (financial, technical and commercial) are negotiated with the Mining Board. Diamond licenses and contracts are negotiated with the Mining board in Lesotho on a project by project basis which increases subjectivity, the risk of inconsistency in their application and increases administration costs and the possibilities of corruption.

Royalties are charged at the rate of 10% for precious stones and at 3% for other mineral products. All other mining operations without an agreement or mining lease are subjected to a royalty rate of 15%. Royalty payments are based on gross turnover. A surface rental is payable by mines to the government at a rate of R 5 per/km² per year. Royalties in Lesotho are at or below the regional average. Royalties however must not be compared in isolation and should be considered in the context of the overall comparative mix of tax instruments.
The design of a mineral taxation regime is crucial to ensure that government receives short term-revenues without jeopardizing the investment potential of long-term projects. The justifications for a specific mix of instruments and a separate tax regime for the mining industry are related to economic rents associated with the extraction of a scarce and finite resource such as minerals.

Despite the fact that mining companies in Lesotho pay a low rate of corporate tax (25%), one of the lowest in the region, the impact is negligible. Diamond mines, especially, are not paying any corporate tax due to the lack of production volumes of mines (there is currently only one mine in the production phase) and due to the capital intensive nature of their investments. In addition due to investment incentives such as initial capital allowances and indefinite carry over of assessed losses, the payment of corporate tax is further delayed.

Although Lesotho offers a type of VAT deferment scheme on imports through the Import VAT Credit Facility (IVCF) none of the mines are currently using this facility effectively. As a result some mining companies have issues relating to the late payment or delays in payment of refunds which in some instances are sizeable amounts. The inclusion of mining projects in this scheme will help both government and mining operators. Although the IVCF will help to reduce the amount of refunds, refunds will still need to be paid on input credits from local purchases. Therefore, the refund system needs to be reviewed and improved.

Mining operations have experienced issues in the past and seek future clarity relating to the refunding of VAT on the costs of the construction and on-going provision of staff accommodation and related social facilities.

Recommendations include:

- Move away from individually negotiated agreements by standardizing all aspects relating specifically to diamond mines in the tax and mining code.
- Consider implementing a resource rent tax, such as a progressive formula based tax regime.
- Clear up the issues in the sector regarding the IVCF and the interpretation of VAT and make improvements to the VAT rebate system.
- Allow prospecting and exploration expenses to be expensed in the first year of production.

**Manufacturing**

Lesotho’s economy depends heavily on export-oriented FDI in the apparel industry in terms of export revenue and employment.
The 2006 Budget provided manufacturing firms exporting outside SACU with 0% corporate income tax. However, tax incentives that are linked to export performance are WTO incompatible. Most countries have moved away from such incentives, and the grace period for least developing countries to comply with these WTO regulations will eventually expire. As such, the preferential corporate tax rate for exporters in Lesotho is not a sustainable policy and may have to be phased out ultimately in line with international and regional trade agreements (SACU, COMESA). Until such time, it would be interesting to evaluate whether the incentives yield benefits in terms of investment inflows, output and employment.

However, tax incentives that are linked to export performance are WTO incompatible. Most countries have moved away from such incentives, and the grace period for developing countries to comply with these WTO regulations will eventually expire soon. As such, the preferential corporate tax rate for exporters in Lesotho is not a sustainable policy and may have to be ultimately phased out.

The manufacturing sector, dominated by apparel exports, had contributed negligibly to revenue from income tax, payroll contributions or VAT. Textiles and garment exporters have been declaring losses in Lesotho, possibly due to difficult external market conditions or transfer of profits to the parent company by engaging in transfer pricing.

Selective incentives create pressures for granting similar concessions to other sectors. One, there is pressure to extend the preferential 0% CIT to exports within SACU. Second, domestic manufacturing firms that primarily supply exporting firms are subject to the standard regime and seeking to benefit from tax incentives.

Exports are zero-rated for VAT, and manufacturers are thereby eligible for refunds on most VAT paid on inputs. To reduce refund claims, the LRA had provided an Import VAT Credit Facility for large exporters.

VAT refund claims above a specified level trigger verification audits. VAT pre-refund audits in Lesotho are based on the amount of refund rather than risk level of the taxpayer. In countries that implement a risk-profiling based system, fully compliant claimants who make claims (of around the size expected) have their claims approved for payment (without pre-refund audit) within a few days. In addition, the LRA has introduced an Upfront VAT Refund Scheme for textile and garments exporters whose average monthly claims exceed M100,000 (US$15,000), and are compliant.

In the past, delays in refund payments discouraged the purchase of domestic inputs which were charged VAT, and thereby affected the development of local
suppliers. The above schemes have improved the refund process, and large manufacturing exporters are being paid on a monthly basis.

While the private sector acknowledges the considerable improvement in tax administration by the LRA, delays in resolving any tax issues negatively affect businesses as they cannot renew their manufacturing license without a Tax Clearance Certificate which is obtained on a quarterly basis. In particular, firms complain about the lack of clear criteria used by LRA for assessing income tax, as well as no (statutory) time limit for resolving issues. Anecdotal evidence includes tax assessments being consistently revised upwards, estimates differing depending on the tax auditor, expenses being disallowed without substantiation, and lack of clarity about expenses qualifying for Fringe Benefit Tax.

Recommendations include:

- Preferential corporate tax rates for exporters will need to be phased out in the medium term to ensure WTO compatibility.
- Increase transparency and disseminate criteria used for income tax assessments.
- Extend the period of business licenses to at least a year. Remove the requirement for a Tax Clearance Certificate to obtain a business license.
- Provide VAT refunds to fully compliant claimants without pre-refund audits, and carry out post-refund audits during planned audit cycle.

Tourism

The tourism industry in Lesotho is extremely small and is largely regionally based. True international overseas tourists make up a very small percentage of tourists to Lesotho. While there are a number of factors constraining the growth of tourism in Lesotho, tax policy and tax administration is not a major factor.

The tourism industry does not benefit from any investment incentives in Lesotho. This headline rate of corporate tax (25%) applies to the tourism sector in Lesotho and is the lowest in the region.

The standard VAT rate of 14%, applicable to certain services in the tourism industry, in Lesotho is lower than most countries in Africa and increases the price competitiveness of the product. A very small number of tourism operators are registered and pay VAT in Lesotho. The charging of a slightly higher rate of 15% VAT on the sale of alcohol and a lower rate of 10% on telecommunications in Lesotho is problematic.
Passenger transportation in Lesotho is exempt from VAT. Many countries, but not currently Lesotho, specifically exclude transportation of tourists from this exemption. As a result, tour operators face the complexity of calculating VAT on a bundled set of products (transportation, hotel accommodation etc.), only some of which are VAT-able.

Exported services, as with exported products, are zero rated for VAT in Lesotho. However, this provision is not currently being applied to the packaging and brokering services provided by tour operators in Lesotho. The charging of VAT on commissions and services associated with the packaging and brokering of international travel increases the price of the ticket and creates a competitive imbalance in the market.

Currently the corporate tax burden on the sector is very low; only a limited number of operators pay corporate income tax. The recent reduction of the corporate tax rate from 35% to 25% is unlikely to stimulate significant new foreign direct investment, but will mainly provide tax relief to existing operators.

Lesotho’s current depreciation structure follows best practice in that it is simple and consists of 3-4 major rating groups. However, the rates themselves are low and do not encourage re-investment and on-going refurbishment of capital.

Although a large proportion of the private sector indicated a definite improvement in their dealings with the LRA over the past few years, some administration issues still occur.

Recommendations include:

- Simplify the VAT system by applying VAT to all tourism related transport services and by converting VAT on alcohol and telecommunications to the standard rate.
- Apply a zero rate VAT to travel agents commissions’.
- Considering increasing rates of depreciation, especially the depreciation of hotel buildings which is currently not depreciable.

Financial Services

While access to credit is widely cited as an impediment to private sector development, improving access to credit is primarily an issue of regulation, legislation and institutional reform rather than taxation.

All financial service firms (banks, insurance companies, pension houses) pay 25% corporate income tax following the 2006 Budget. While lower than the regional average, it is also true that all financial service firms are now at an income tax...
disadvantage vis-à-vis manufacturing, agricultural or manufacturing exporting firms. This inequity of treatment is not lost on the private sector, or indeed on the GOL as the issue was acknowledged in the 2005 Tax Task Team Final Report.

Financial service firms, as in South Africa, and many other economies, are exempt from VAT. This means that financial services firms pay VAT on their inputs but are unable to charge VAT on their outputs. As a result VAT acts an implicit sales tax for this sector. Banks are aware that this VAT position disadvantages them against other sectors, but also recognize that such a practice is common in most tax regimes (though in South Africa some financial services are VAT-able). There is some debate over whether banks have been inadvertently not paying VAT on imported (non-financial) services. We are aware that LRA is cognizant of this and is investigating ways to ensure full compliance going forward.

A withholding tax is levied on interest (10%). This tax is not ‘final’ for companies in that it can be credited against corporate taxation. There are no withholding taxes on dividends but there are on superannuation funds (25%). Banks argue that the 10% withholding tax on interest payments contributes to savings being moved to South Africa.

Currently pension (‘retirement annuity fund’) contributions are deductible against income tax (up to 20% of gross income), for the employer and the employee. Pension fund income is exempt from income tax, but the annuity payments are taxed at the marginal rate. This system (the ‘Exempt/Exempt/Tax’ system) provides a positive incentive for individuals to save and for firms to contribute to employee pension schemes.

There is currently no leasing market in Lesotho (operating or capital). However, we are aware that legislation has been drafted. It is international best practice to treat capital leases equivalently to a similar transactions structured as a loan to purchase an asset (when the interest payments would not be subject to VAT). Equal treatment would help stimulate the capital leasing market in Lesotho.

Recommendations include:

- Amend the VAT act to specifically address the application to the leasing sector, when the leasing legislation comes into force.
- Following its current period of exemption, tax the Lesotho Unit Trust in the same way as any corporation.
Small Business Sector

Lesotho does not have a special tax regime for small businesses, in contrast to most tax regimes in Africa. Small businesses which are incorporated are subject to CIT, rather than given the choice to opt for a simplified tax regime. Most small businesses are sole proprietors, and are in effect taxable under the personal income tax regime. The rates of tax since April 1, 2006 are different for companies and sole proprietors. The personal income tax is 25% on annual income up to M33,075 (US$4,793) and 35% above. There is also a tax credit of M2,772 (US$401). As a result, sole proprietors incur a higher tax burden than companies of a similar size. These higher rates could be an incentive for incorporation.

Small businesses consider the high compliance cost imposed by the tax systems as onerous. Small firms find it difficult to prepare self-assessments for income tax since they are unable to keep proper books. As a result, they are often forced to use accountant services which add significant expense.

Under the Income Tax Act the threshold for the requirement to use accrual rather than cash accounting for calculating tax payable is only M150,000 (US$21,740). This threshold has not been adjusted since 1993, and therefore excludes a large number of small businesses that would benefit from cash accounting. Accrual accounting particularly affects the cash flow of small growing enterprises that carry significant inventories (e.g. manufacturing).

In practice, the LRA raises assessments on an estimated basis when taxpayers fail to keep adequate records. Anecdotal evidence suggests that the closure of some retail businesses was precipitated by excessively high tax pre-assessments, which businesses were unable to pay and which led to the non-renewal of business licenses. A Customer Satisfaction Survey of the LRA (2004) found that as much as 44% of those interviewed believed that the LRA was responsible for causing the closure of businesses (of all sizes).

In Lesotho the VAT registration threshold is quite high and, although voluntary registrations are permitted below the threshold, this threshold effectively excludes small business from the VAT requirements. However, businesses that are not registered cannot claim back VAT on inputs, resulting in breaks in the VAT chain. For example, for small manufacturers, the METR for non-registrants is 52% compared to 38% for registered firms, indicating the high burden from staying out of the VAT net. However, those businesses that are registered must submit VAT returns on a monthly basis, significantly adding to their administrative burden.
The absence of a small business tax regime is an exception to the practice in the region and there are many options that could be explored that would positively encourage voluntary compliance from this vital sector.

**Small businesses complain about the lack of information on tax compliance and reporting requirements.** Education programs and seminars organized by LRA have not specifically targeted this sector. The lack of proper tax education was evident in the Customer Satisfaction Survey of the LRA (2004), in particular in rural areas.

Recommendations include:

- Examine options for the introduction of a small business tax regime.
- Raise threshold for the requirement to use accrual accounting and for the requirement to submit audited accounts.
- Shift to quarterly or bi-annual filing of returns for VAT for small taxpayers.
- Devise simplified regimes for VAT for small businesses.
- Increase outreach function of revenue administration to encourage voluntary compliance.

**Organizational and Institutional Issues**

As well as the quantitative (METR) component, this project explores the political and institutional dimensions (qualitative component) to tax policy and its administration with the aim of providing governments with an international, national and sector perspective.

The project aims also to understand how the private sector and its representative bodies engage in the taxation process, with what objectives, degree of coordination and potential influence over both process and sustainable outcomes.

The Lesotho Revenue Authority is an operationally autonomous body that was established by an Act of Parliament in 2001 to be the “main body responsible for the assessment and collection, on behalf of the Government, of specified revenue; for the administration and enforcement of laws relating to such revenue and for related matters.”

The Governing Board maintains a strategic oversight across the LRA and businesses believe that the LRA is operating in a transparent manner – some believe that the transparency reveals the sole focus on securing revenue. The LRA does not have discretionary powers beyond those relating to administrative processes.
In devising tax policies the views of both business and the tax administration must be considered. Businesses in general in Lesotho are not, however, well organized; small businesses especially do not have a particularly strong political ‘voice’. This makes it difficult to harness the views of business when tax changes are being designed.

FIAS discussions with business and their representatives indicated that they did not think that they were involved enough in the formulation of tax policies. There is a perception that some tax changes are proposed by other Ministries and that these do not seem to go through an examination process (by the Ministry of Finance and Development Planning and the Lesotho Revenue Authority) that is as rigorous as was conducted by the Task Force. It was also reported that small lobby groups (e.g. textile manufacturers) are regularly seeking exemptions and favorable treatment from Ministers and that when concessionary treatment was given it gave rise to other groups seeking similar treatment.

The LRA commissioned a Customer Perceptions Survey in late 2004 – the team conducting the survey recommended that, in the light of the findings, the following issues needed to be addressed:

- The existing Corporate Plan of the Organization needed to be reviewed and updated.
- A comprehensive Communications Strategy needed to be formulated whereby clear guidelines are provided on communications, client handling and all public relations activities.
- A performance program was required to improve the LRA service delivery and enable LRA to become a true customer orientated organization. An integrated and holistic approach was required and the LRA leadership should address the outcome of the survey.

The business community was appreciative of the caliber of the LRA staff and how approachable they are. They were, however, critical that their manner and approach frequently appeared driven by pressures to meet revenue targets. The feedback FIAS received was consistent with the ‘perception survey’. If the new Corporate Plan can strike a balance between revenue and service targets we would expect that there will be an impact on staff attitudes. In addition, however, the performance management system will need to be modified to incorporate service measures (i.e. marry together quantitative revenue targets with qualitative measures, particularly customer service).

The LRA has succeeded in improving revenue collection during the short time of its operations. The authority has been innovative and introduced measures that made tax payment easier; provided public tax education and established a tax
a large degree of harmonization of the VAT with South Africa (at 14%) and capacity building at border posts has helped remove long queues.

Securing voluntary taxpayer compliance

There is clearly a need to strike a balance between revenue and customer service targets to influence the behavior of LRA staff. However, if a tax compliance strategy were in place, this would also influence the behavior of taxpayers. There are many examples of such compliance strategies. A taxpayer charter, such as that of the LRA, can be used in a complementary manner, to reassure taxpayers as regards their rights and legitimate entitlements, including fair and equitable treatment, as well as informing them of their obligations.

The task for the future is to build on this sound base and intensify the taxpayer education effort so that new businesses and those who want to comply are helped. Compliant businesses should see the benefit through less intrusive controls being exercised by the LRA and reduced compliance costs. The LRA has in place a number of excellent initiatives, including the up front VAT refund scheme, that demonstrate willingness to try new ideas.

Recommendations include:

• Put in place new performance measures for the LRA that balance revenue targets with customer service measures.
• The LRA needs to devise a tax compliance strategy as a key institutional tool to impact on the implementation of tax policies.
1. INTRODUCTION

Background

This FIAS/DFID report forms part of a series of studies designed to improve understanding of the impact of tax policy, and in particular its administration, on the business climate in southern Africa. ³

The success over the last decade in establishing semi-autonomous revenue authorities (RAs) in various countries in the region has achieved increased tax collection. An unforeseen consequence of creating RAs may have been to strengthen RA incentives to maximize revenue generation while weakening the authority of ministries of finance to formulate tax policy for broader national needs - especially business development, investment and growth for sustainable poverty reduction. There has been little focus on the possible business and growth impacts of revenue targets and internal performance incentives.

This project therefore aims explicitly to develop a deeper understanding of African RAs’ impact on business. ‘Doing Business 2006’⁴ showed that countries that tax highly and have complex regulations (and hence provide strong incentives to evade), generally receive lower tax revenues than countries with low rates, broader tax bases and less onerous administrative burdens. Reflecting on examples of successful policy reform, this series of studies will suggest reforms in both tax policy and administration that may stimulate savings, investment and growth – such as through selectivity/disciplining of rents/security of rents, and tax exemptions.

The study uses both quantitative and qualitative techniques to address these concerns. The quantitative component uses Marginal Effective Tax Rate (METR) techniques to investigate how the tax code, as defined in legislation, benefits certain sectors over others. The qualitative component addresses in more detail how tax administration works in practice, including a political economy analysis of the Lesotho Revenue Authority (LRA) and Ministry of Finance & Development Planning as institutions.

³ “Tax administration is tax policy”, M. C. de Jantscher: Administering the VAT: in Value Added Taxation in Developing Countries: World Bank 1990, p.179.

⁴ See www.doingbusiness.org, The World Bank’s Doing Business database provides objective measure of business regulations and their enforcement.
Tax impact on business in the wider context

This study recognizes that maintaining revenue for necessary government expenditures is critical, and that any tax policy or administration reforms (including those in this report) need to take into account the revenue implications. However, ‘investment friendly’ tax reforms need not threaten the fiscal base and may indeed enhance it. Simpler tax systems encourage compliance and discourage evasion and avoidance; lower tax rates can spur growth leading to increased revenue collection in the medium to long term; and the elimination of expensive incentives can boost revenue in the short term.

In many cases sub-national taxation or customs may have a larger impact on businesses than national taxes. Surprisingly little information is available on what percentage and kind of taxes are being paid by what type or size of business in sub-Saharan Africa – not only at the national level (the focus of this project), but also at sub-national level and on international trade. This data is necessary for a complete picture of where the burden of taxes and compliance costs falls most heavily and what distortions to growth patterns may result. These broader issues are beyond the scope of this project, but it is hoped that they will be explored in due course, perhaps through the Investment Climate Facility for Africa currently being established.

This project appreciates that tax may be only a small part of the wider picture of what affects the incentives to invest. Other factors may include economic governance, trade tariffs, security etc.

Context of the Study in Lesotho

Since 2005 the GOL budget has been presented in the context of a Medium Term Expenditure Framework, with the aim of linking expenditure directly to agreed priorities which, in turn, are guided by the broader objectives of the UN’s Millennium Development Goals, the National Vision 2020 and the Poverty Reduction Strategy.

For 2006/07 the identified budget priorities are:

- Infrastructure development: to cover urban and rural roads, water, electricity and communications. For rural areas, the development of “clusters”, where service provision is concentrated on a single place, will be encouraged.
- Health service delivery: at both the clinic and hospital levels. The government has been encouraging public-private partnerships as a way to develop the health sector.
• Food production: assistance to improve output and encourage commercialization will be achieved through more intensive support in specified target areas, including poultry, diary and vegetables, with an emphasis on the efficient use of irrigation.

• Service delivery: covering all levels of government, including developing the capacity of the new local authorities to manage services for their communities.

The recently published Poverty Reduction Strategy 2004-07 had three interconnected goals:

• Create jobs through the establishment of an environment that facilitates private sector-led economic growth.

• Empower the poor and the vulnerable and improve their access to health care and education.

• Deepen democracy and improve public sector performance, to ensure that policies and legal frameworks facilitate the full implementation of priorities.

The PRS acknowledges that enhanced efforts are needed to stimulate employment creation and income generation, particularly in such areas as infrastructure, access to the financial sector, improving the business environment and governance.
Box 1: Key Strategies & Activities for Employment Creation & Income Generation in PRS

- Create a conductive environment for attracting domestic and foreign direct investment.
- Increase support to Small Medium and Micro Enterprises (SMMEs) in a targeted manner in line with the SMME policy in order to meet their most basic needs, such as access to credit, appropriate technology and markets and create viable linkages between SMMEs and large scale enterprises.
- Develop sustainable market opportunities for locally produced products and improve their quality and price competitiveness through demand-driven capacity building activities targeted at trade negotiators, entrepreneurs and the workforce.
- Provide basic infrastructure such as factory shells where needed, develop the Maseru terminal depot and the four new industrial estates in Tikoe, Mafeteng, Mohale’s Hoek and Butha-Buthe in a phased manner depending on established financial and economic viability.
- Facilitate international trade e.g. by improving customs efficiency.
- Intensify investment promotion measures by strengthening the capacity of the Investment Promotion Centre of Lesotho National Development Corporation and the foreign missions in strategic countries in order to improve efficiency in attracting foreign and local investment.
- Establish a sound industrial relationship through tripartite economic forum or National Employment Council.
- Make optimal use of natural resources by developing agro-business, tourism and mining in a manner that is anchored in community participation and private sector development.

Source: Government of Lesotho

Impact of SACU Revenues

The Southern African Customs Union (SACU) links South Africa, Botswana, Lesotho, Namibia and Swaziland. Historically South Africa administered the union, which gathered excise duties on local production and customs duties on member states’ imports from outside the SACU area. These were then paid to all the member states in quarterly installments, using an agreed revenue-sharing formula. SACU revenues are important for Lesotho as they accounts for at least 50 per cent of the Government’s total revenue. This means that the Government of Lesotho has more flexibility available for its own domestic taxation structure.

Negotiations to reform SACU began in 1994, and a new agreement was signed in October 2002 and came into effect in July 2004. As well as decentralizing the implementation of the new agreement onto the hands of all member states, the new formula aims to ensure that revenue flows to each country are stable. However, reductions in external tariffs on many imports under the EU-South
Africa free-trade agreement, alongside progressive global trade deregulation, are likely to result in declining customs revenue.5

Lesotho’s dependence on revenue from SACU has been gradually reduced from over 75% of total revenue in the early to mid-1980s to just under 50% in recent years. However, in 2005 the budget benefited from a large SACU windfall arising from the transition to the new SACU agreement, under which payments will be boosted to reflect the low level of income per head in Lesotho compared with other SACU member countries.

The GOL is committed to further strengthening tax administration. The LRA was officially launched in September 2002, despite some delays arising from shortages of suitably qualified staff. The LRA amalgamates the income tax, indirect tax and customs and excise administrations into an autonomous body that is intended to be self-financing. The LRA has been credited with substantially improving the efficiency of revenue collection.

**Lesotho: Economic Background**

**Growth and performance in the past**

Table 2 shows that Lesotho has achieved strong growth over the last five years. Although growth has slowed more recently, it remains above the average for sub-Saharan Africa.

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5 The Economist Intelligence Unit, Lesotho Country Profile 2006.
Lesotho: Sector Study of the Effective Tax Burden

1. Introduction

Table 2: Lesotho: Economic Data 2001 - 2005

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP at market prices (TSh bn)</td>
<td>6.5</td>
<td>7.6</td>
<td>8.3</td>
<td>8.6</td>
<td>9.5</td>
</tr>
<tr>
<td>GDP (US$ bn)</td>
<td>0.8</td>
<td>0.7</td>
<td>1.1</td>
<td>1.3</td>
<td>1.5</td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>3.2</td>
<td>3.8</td>
<td>3.3</td>
<td>3.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Consumer price inflation (av; %)</td>
<td>-9.7</td>
<td>33.9</td>
<td>6.7</td>
<td>5.1</td>
<td>3.5</td>
</tr>
<tr>
<td>Population (m)</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
</tr>
<tr>
<td>Exports of goods fob (US$ m)</td>
<td>278.6</td>
<td>357.3</td>
<td>475.0</td>
<td>707.3</td>
<td>733.1</td>
</tr>
<tr>
<td>Imports of goods fob (US$ m)</td>
<td>678.6</td>
<td>762.7</td>
<td>994.4</td>
<td>1,302.0</td>
<td>1,358.3</td>
</tr>
<tr>
<td>Current-account balance (US$ m)</td>
<td>-95.1</td>
<td>-126.7</td>
<td>-134.7</td>
<td>-76.0</td>
<td>-67.3</td>
</tr>
<tr>
<td>Foreign-exchange reserves excl gold (US$ m)</td>
<td>386.1</td>
<td>406.4</td>
<td>460.3</td>
<td>502.8</td>
<td>520.4</td>
</tr>
<tr>
<td>Exchange rate (av) TSh:US$</td>
<td>8.6</td>
<td>10.5</td>
<td>7.6</td>
<td>6.5</td>
<td>6.4</td>
</tr>
</tbody>
</table>

^a Actual. ^b Economist Intelligence Unit estimates. ^c Official estimate
Source: Economist Intelligence Unit 2005

Sector contributions to growth

This study gives priority to five sectors, chosen because of their important contribution to current output and production and for their potential for growth and new investment. These are: agriculture, mining, manufacturing, tourism and financial services. Table 3 illustrates the various component contributions to Lesotho’s (formal) GDP.

Table 3. Lesotho: Sector contribution to total GDP, 2000-2004 (in % of total GDP)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, Forestry, Fisheries and Hunting</td>
<td>18.6%</td>
<td>18.2%</td>
<td>17.6%</td>
<td>17.8%</td>
<td>17.1%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>16.8%</td>
<td>17.7%</td>
<td>20.4%</td>
<td>19.6%</td>
<td>19.8%</td>
</tr>
<tr>
<td>Mining</td>
<td>0.1%</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Electricity &amp; Water</td>
<td>5.9%</td>
<td>6.1%</td>
<td>5.2%</td>
<td>4.9%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Building &amp; Construction</td>
<td>18.2%</td>
<td>17.7%</td>
<td>16.5%</td>
<td>16.6%</td>
<td>16.6%</td>
</tr>
<tr>
<td>Wholesale &amp; Retail Trade</td>
<td>9.1%</td>
<td>9.1%</td>
<td>9.6%</td>
<td>10.5%</td>
<td>10.7%</td>
</tr>
<tr>
<td>Government Services</td>
<td>31.3%</td>
<td>31.0%</td>
<td>30.4%</td>
<td>30.4%</td>
<td>30.4%</td>
</tr>
<tr>
<td>Total GDP at factor cost</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Central Bank of Lesotho; Economist Intelligence Unit, Lesotho Country Profile 2005

Lesotho is predominantly an agriculturally based economy, but the vast majority of agricultural production is subsistence (not reflected in Table 3). Notable from
Table 3 is the increased contribution from manufacturing (predominantly textiles) and the decrease in building and construction (following the completion of the Lesotho Highlands Water Project).

Table 4. Lesotho: Sector Growth, 2000-2004

<table>
<thead>
<tr>
<th>Sector</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, Forestry, Fisheries and Hunting</td>
<td>7.8%</td>
<td>6.7%</td>
<td>10.9%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>13.8%</td>
<td>22.1%</td>
<td>5.5%</td>
<td>9.5%</td>
</tr>
<tr>
<td>Mining</td>
<td>16.5%</td>
<td>9.0%</td>
<td>14.5%</td>
<td>62.0%</td>
</tr>
<tr>
<td>Electricity &amp; Water</td>
<td>13.5%</td>
<td>-5.8%</td>
<td>3.8%</td>
<td>8.8%</td>
</tr>
<tr>
<td>Building &amp; Construction</td>
<td>6.8%</td>
<td>3.2%</td>
<td>10.2%</td>
<td>8.6%</td>
</tr>
<tr>
<td>Wholesale &amp; Retail Trade</td>
<td>10.1%</td>
<td>14.4%</td>
<td>17.4%</td>
<td>9.5%</td>
</tr>
<tr>
<td>Government Services</td>
<td>8.6%</td>
<td>8.1%</td>
<td>9.6%</td>
<td>8.3%</td>
</tr>
<tr>
<td>Total GDP at factor cost</td>
<td>9.5%</td>
<td>9.8%</td>
<td>9.7%</td>
<td>8.2%</td>
</tr>
</tbody>
</table>

Source: Central Bank of Lesotho; Economist Intelligence Unit, *Lesotho Country Profile 2005*

Table 4 shows that all sectors have shown positive growth in nominal terms. The highest growth has been in the mining sector (although the large increase are based on small absolute figures involved). The manufacturing sector’s growth has slowed, while that from wholesale and retail has increased faster than overall growth.

Provisional estimates for Lesotho show real GDP growth in 2005 at 1.2%, held back by an 8.3% contraction in manufacturing. Employment in the textile sub-sector, hit by the removal of quotas on exports from low-cost Asian producers and the continued strength of the South African rand, fell by more than one-fifth. The situation stabilized somewhat in the second half of the year, with indications that the importers in the US would prefer to maintain a diversified supply base. But the remaining textile businesses are reported to be struggling and the government, while pointedly not joining calls for renewed restrictions on Asian exports, has announced special support measures, including the removal of all taxes for exports of manufactures outside of SACU (more detail below).
**Foreign direct investment in Lesotho**

**Figure 1. FDI Flows into Lesotho 1995-2004**

![Graph showing FDI Flows](image)

Source: UNCTAD

Between 1995 and 1998 FDI in Lesotho was at its highest level over the past decade, but following the civil unrest after the 1998 elections, FDI fell markedly until the successful elections of 2002. Following the 2002 elections FDI began to increase moderately, much of which came from the textile sector.

**The business climate in Lesotho**

The World Bank’s ‘Doing Business’ project provides a good starting point for assessing Lesotho’s investment climate. In nearly every category of the survey, Lesotho performance was in line with or better than the African regional average. Even so Lesotho’s overall ranking was only 97th out of 155. Table 5 shows whether Lesotho improved on its overall performance ranking across the various sections of Doing Business.
Table 5: Doing Business 2006 – Lesotho’s Performance

<table>
<thead>
<tr>
<th>Section</th>
<th>Position vs. 2005</th>
<th>Ranking Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Starting a business</td>
<td>Worsened</td>
<td>111th</td>
</tr>
<tr>
<td>Dealing with Licenses</td>
<td>Improved</td>
<td>56th</td>
</tr>
<tr>
<td>Hiring and Firing</td>
<td>Improved</td>
<td>51th</td>
</tr>
<tr>
<td>Registering Property</td>
<td>Worsened</td>
<td>117th</td>
</tr>
<tr>
<td>Getting Credit</td>
<td>Worsened</td>
<td>118th</td>
</tr>
<tr>
<td>Protecting Investors</td>
<td>Worsened</td>
<td>116th</td>
</tr>
<tr>
<td>Paying Taxes</td>
<td>Improved</td>
<td>62th</td>
</tr>
<tr>
<td>Trading Across Borders</td>
<td>Worsened</td>
<td>101th</td>
</tr>
<tr>
<td>Enforcing Contracts</td>
<td>No Change</td>
<td>97th</td>
</tr>
<tr>
<td>Closing a Business</td>
<td>Improved</td>
<td>49th</td>
</tr>
</tbody>
</table>

Tables 5 and 6 show that in dealing with licenses\(^6\), Lesotho came in 56\(^{th}\) in the world, with it taking an estimated 12 procedures (less than the OECD average of 14, South Africa figure of 18 and the regional average of 20.1), 254 days and costs 134.2\% of income per capita to complete the process. These figures compare favorably with the regional averages.

The challenges facing the investment climate in Lesotho are summed up by the poor rankings for starting a business (111\(^{th}\)), registering property (117\(^{th}\)) getting Credit (118\(^{th}\)), protecting investors (116\(^{th}\)), trading across borders (101\(^{st}\)).

Table 6 shows that on taxes, Lesotho compares well to South Africa and the region in terms of the number of tax payments (19 vs. 32 and 41 respectively). However, Lesotho performs worse in terms of the time taken to complete tax forms with 564 hours, which is well above the OECD standard of 197, South Africa of 350 and the regional average of 394. This result implies that there is considerable scope for simplifying the tax administration procedures. The LRA has begun to initiate efforts in this regard.

Finally, the total tax payable as a percentage of gross profit (37.7\%) is lower than both the regional average (58.1\%) and the OECD average (45.4\%). This statistic however, uses ‘headline’ tax rates – the METR methodology used in this report provides a more comprehensive picture.

\(^6\) Doing Business analyze building permits as a proxy for the license regime as a whole.
Table 6: Doing Business in Lesotho

<table>
<thead>
<tr>
<th></th>
<th>Lesotho</th>
<th>South Africa</th>
<th>Region</th>
<th>OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Starting a business Procedures</td>
<td>9</td>
<td>9</td>
<td>11</td>
<td>6.5</td>
</tr>
<tr>
<td>Time (days)</td>
<td>92</td>
<td>38</td>
<td>63.8</td>
<td>19.5</td>
</tr>
<tr>
<td>Cost (% of income per cap)</td>
<td>56.1</td>
<td>8.6</td>
<td>215</td>
<td>6.8</td>
</tr>
<tr>
<td>Minimum capital (% income per cap)</td>
<td>16.4</td>
<td>0.0</td>
<td>297</td>
<td>41</td>
</tr>
<tr>
<td>Dealing with licenses Procedures</td>
<td>12</td>
<td>18</td>
<td>20.1</td>
<td>14.1</td>
</tr>
<tr>
<td>Time (days)</td>
<td>254</td>
<td>176</td>
<td>251.5</td>
<td>14.1</td>
</tr>
<tr>
<td>Cost (% of income per cap)</td>
<td>134.2</td>
<td>37.5</td>
<td>1597.3</td>
<td>75.1</td>
</tr>
<tr>
<td>Paying taxes Payment Number</td>
<td>19</td>
<td>32</td>
<td>41</td>
<td>16.9</td>
</tr>
<tr>
<td>Time (hours)</td>
<td>564</td>
<td>350</td>
<td>394</td>
<td>197</td>
</tr>
<tr>
<td>Total tax payable (% gross profit)</td>
<td>37.7</td>
<td>43.8</td>
<td>58</td>
<td>45</td>
</tr>
</tbody>
</table>


A number of analytical studies have been undertaken recently to identify the investment climate constraints in Lesotho. These studies (including the World Bank’s Investment Climate Assessment for Lesotho, which has yet to be, show that tax rates and tax administration are raised as a serious impediments to doing business in Lesotho.

However, these findings should not necessarily be taken at face value. Many surveys (including for the Investment Climate Assessment) were undertaken soon after the LRA was set up. This meant that many businesses, which had previously only paid tax sporadically, now had to do so on a consistent basis when faced with a more professional and well resourced tax collection authority. In such a situation it would seem plausible that the issue of tax could have been overstated as a constraint. One should be cautious therefore as to whether tax is such an important issue in the investment climate. More detailed analysis, such as this study, is required to provide a more comprehensive picture.

**Tax Policy in Lesotho**

Tax and incentive policies are key parameters in defining a business climate. Taxes are essential for the financing of government activities, but at the same time, they should be set and administered to be as growth enabling as possible. Revenue raising authorities therefore, (in the Lesotho case it is the Ministry of Finance & Development Planning that sets tax policy and the Lesotho Revenue Authority that administers it) must strive to set a tax policy that meets both needs.

**Foundations and Background**

Existing legislation
- Constitution of Lesotho, 1993
- Value Added tax Act 2001 (amended 2003)

Lesotho has also concluded Double Taxation Treaties with South Africa and the UK. An agreement with Mauritius is pending.

**Description of tax instruments and rates used in this study**

This study will concentrate on taxation whose burden falls on the corporate sector. The primary taxes are:
- Corporate and personal income tax
- Value Added Tax (VAT)

In addition, companies may have to pay the following taxes during their operations, depending on the type of business:
- Customs duty
- Excise tax
- Withholding tax
- Capital gains tax
The 2006 Budget introduced some significant changes to Corporate Income Tax (CIT), which is now levied on companies at a rate of 25% of Income. Manufacturing and Farming sectors are taxed at a reduced rate of 10%. A recent development is the complete exemption for the Manufacturers that export outside SACU from corporate tax.

Sole Proprietors are levied tax at a marginal rate of 25% for the first 33,075 M (a threshold which is inflation adjusted) and 35% above that. Individuals are entitled to a tax credit of 2,911 M which is also inflation adjusted. Partnership firms are not taxed but partners are taxed at individual rates on their share of the partnership income. Tax on Interest is deducted at source at 10% while Dividends are exempt from withholding.

In the case of Non-residents the Income tax rate on corporate profits is 25%. Income tax on Interest income, dividends, Royalty and Management charge accruing to a non-resident is withheld at the rate of 25%. Non-Resident individuals are taxed at a flat rate of 25%.

The Depreciation schedule is divided into four asset groups with rates of 25%, 20%, 10% and 5%. For the purposes of the METR analysis, the depreciation rate for Equipment is taken at 20%, that for industrial building at 5% and for other building 0%. Depreciation is calculated using the declining balance method.

Lesotho collects VAT at three broad rates with 14% being the standard rate. Basic commodities, agriculture inputs and exports are zero rated. In general the VAT should not affect the METR if tax paid on capital inputs is entitled to credit. On the other hand, firms that are exempt for the purpose of VAT cannot claim credit for tax paid and hence VAT has real consequences for the METR. There is a 15% rate specifically for alcohol and 10% for telecommunications.

Tables 7, 8 and 9 provide data on Lesotho’s customs duties and VAT rates – with a comparison to other countries in the region.
### Table 7: VAT rates in SADC countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Date VAT Introduced</th>
<th>No of Positive rates</th>
<th>Rates (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Botswana</td>
<td>2001</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>DRC</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lesotho</td>
<td>2001</td>
<td>3</td>
<td>8, 14, 15</td>
</tr>
<tr>
<td>Madagascar</td>
<td>1994</td>
<td>2</td>
<td>5, 20</td>
</tr>
<tr>
<td>Mauritius</td>
<td>1998</td>
<td>1</td>
<td>15</td>
</tr>
<tr>
<td>Malawi</td>
<td>2002</td>
<td>1</td>
<td>17.5</td>
</tr>
<tr>
<td>Mozambique</td>
<td>1999</td>
<td>1</td>
<td>17</td>
</tr>
<tr>
<td>Namibia</td>
<td>2000</td>
<td>2</td>
<td>15, 30</td>
</tr>
<tr>
<td>South Africa</td>
<td>1991</td>
<td>1</td>
<td>14</td>
</tr>
<tr>
<td>Swaziland</td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tanzania</td>
<td>1998</td>
<td>1</td>
<td>20</td>
</tr>
<tr>
<td>Zambia</td>
<td>1995</td>
<td>1</td>
<td>17.5</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>2002</td>
<td>1</td>
<td>15</td>
</tr>
</tbody>
</table>

### Table 8: VAT rates in other African Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Date VAT Introduced</th>
<th>No of Positive rates</th>
<th>Rates (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>1992</td>
<td>2</td>
<td>7, 17</td>
</tr>
<tr>
<td>Benin</td>
<td>1991</td>
<td>1</td>
<td>18</td>
</tr>
<tr>
<td>Burkina Faso</td>
<td>1993</td>
<td>1</td>
<td>18</td>
</tr>
<tr>
<td>Cameroon</td>
<td>1999</td>
<td>1</td>
<td>19.25</td>
</tr>
<tr>
<td>Chad</td>
<td>2000</td>
<td>1</td>
<td>18</td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>1960</td>
<td>2</td>
<td>11.1, 20</td>
</tr>
<tr>
<td>Egypt</td>
<td>1991</td>
<td>5</td>
<td>5, 10, 15, 25, 45</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>2003</td>
<td>1</td>
<td>15</td>
</tr>
<tr>
<td>Gabon</td>
<td>1995</td>
<td>1</td>
<td>18</td>
</tr>
<tr>
<td>Ghana</td>
<td>1998</td>
<td>1</td>
<td>12.5</td>
</tr>
<tr>
<td>Kenya</td>
<td>1990</td>
<td>1</td>
<td>16, 18</td>
</tr>
<tr>
<td>Mali</td>
<td>1991</td>
<td>1</td>
<td>18</td>
</tr>
<tr>
<td>Mauritania</td>
<td>1995</td>
<td>2</td>
<td>5, 14</td>
</tr>
<tr>
<td>Morocco</td>
<td>1986</td>
<td>4</td>
<td>7, 10, 14, 20</td>
</tr>
<tr>
<td>Niger</td>
<td>1986</td>
<td>1</td>
<td>17</td>
</tr>
<tr>
<td>Nigeria</td>
<td>1994</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Rwanda</td>
<td>2001</td>
<td>1</td>
<td>18</td>
</tr>
<tr>
<td>Senegal</td>
<td>1979</td>
<td>2</td>
<td>10, 18</td>
</tr>
<tr>
<td>Sudan</td>
<td>2000</td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td>Togo</td>
<td>1995</td>
<td>1</td>
<td>18</td>
</tr>
<tr>
<td>Tunisia</td>
<td>1988</td>
<td>4</td>
<td>6, 10, 18, 29</td>
</tr>
<tr>
<td>Uganda</td>
<td>1996</td>
<td>1</td>
<td>18</td>
</tr>
</tbody>
</table>
### Table 9: Regional (Nominal) Tariff Rates

<table>
<thead>
<tr>
<th>Goods</th>
<th>Capital goods</th>
<th>Raw materials</th>
<th>Semi-finished goods</th>
<th>Finished goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rwanda</td>
<td>0%</td>
<td>5%</td>
<td>15%</td>
<td>30%</td>
</tr>
<tr>
<td>Uganda</td>
<td>0%</td>
<td>0%-7%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>Kenya</td>
<td>0%</td>
<td>0%-3%</td>
<td>5%-15%</td>
<td>20%-35%</td>
</tr>
<tr>
<td><strong>Lesotho /SACU</strong></td>
<td>0%</td>
<td>0%</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>Zambia</td>
<td>0%</td>
<td>0%-5%</td>
<td>15%</td>
<td>25%</td>
</tr>
</tbody>
</table>

*Source: PWC Lesotho Datacard 2005/2006*

### Tax revenue performance

From a macroeconomic perspective, tax policy in Lesotho has been increasingly effective at raising revenues, as measured by tax/GDP ratios. The current revenue/GDP is 51.6%, up from 40.1% in 2002/3.⁸

The revenue/GDP ratio is far higher than any other African nation outside of SACU (and higher than South Africa (25%) and many OECD economies). This is attributable to both the numerator (SACU income boosting revenues) and denominator (a large informal economy not captured by GDP data). The contribution from the SACU Customs and Excise pool to total revenue has grown from 44% in 2002/3 to an estimated 50% in 2005/6.

Grants also play a role in augmenting tax and non-tax revenue. In 2005/6 they are estimated to be 6% of total revenue.

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The combination of external grants and revenues from the SACU provide Lesotho with ‘fiscal space’ with which to undertake substantial tax reforms (such as the in the 2006 budget, discussed below).
2. ANALYSIS OF THE EFFECTIVE TAX BURDEN IN LESOTHO

Assessing the effective tax burden - an introduction

A quantitative assessment of the effective tax burden in Lesotho requires a standardized metric, which takes all provisions of the tax code and incentives scheme in place to look at what a hypothetical new entrepreneur would face if he or she were to invest today in that sector. At the same time, qualitative analysis is also needed to determine how the tax/incentives scheme is applied in practice. This section presents both the qualitative and quantitative analyses of five key sectors in the economy—agriculture, manufacturing, tourism, mining, and finance—to present a comprehensive picture the absolute and relative tax burden.

Quantitative analysis of the effective tax burden

The Marginal Effective Tax Rate (METR) is the effective tax on an incremental investment by a business. It encapsulates the effect of the complicated tax code to an incremental investment. As a result it is a very useful parameter that summarizes the impact of the tax system on the decision of an investor to infuse capital into his or her business. The METR calculated for this study uses all the parameters of the tax system that affects the return on capital. Other factors that affect business but do not affect the rate of return on capital are not reflected in this calculation.

The calculation of the METR is based on what a rational investor faces in the market. If for example, the rate of return from the market as given by alternative investment opportunities is 10%, then any investment into the business is carried out if the rate of return from that investment just meets or exceeds this rate known as the required rate of return. The tax system distorts the rate of return accruing to the investor from this investment in various ways. Corporate tax, depreciation allowances, investment tax credits, and other aspects of the tax code, changes this rate of return of the investment. As a result, an investment is carried out only if it’s after-tax rate of return matches or exceeds the returns from alternate investment opportunities. In the equilibrium, investors invest up to the point that the after-tax rate of return just matches the market rate of return.

The METR is defined as the proportion of the pre-tax rate of return that is accounted for by the tax code. If for example, the tax system reduces the after-tax rate of return on an investment such that only a pre-tax rate of return of 15% could generate a post-tax rate of return of 10% (the required rate of return), the
METR is given by, (15%-10%)÷15% or 33.3%. As a result the METR gives us one number that describes the overall burden that the tax system imposes on the investment.

The METR provides different information from the commonly used measure of the burden of the tax system on business, the average effective tax rate (AETR). The AETR, defined as the income from capital divided by the tax paid, while providing useful information about the burden of taxes on the business in the present, measures the average over taxes on income from all past investment and tax credits on the current investment. The METR on the other hand is a forward looking measure that looks at the burden faced on a new investment into the business. As investment in capital is a key driver of productivity, the METR provides a useful methodology to measure this burden faced by capital in its various forms.

**Calculation of the METR**

The various Inputs into the calculation of the METR\(^9\) are as follows:-

- The statutory Income Tax rate
- The rates of Depreciation for different capital assets
- Additional depreciation allowances if any
- The Inflation rate
- The domestic tax rate on Interest and Dividend
- The Capital Gains tax rate
- Tax benefits given to certain sectors
- Implicit Vat Tax on capital
- The international Interest Rate
- Sector-wise Debt-Equity ratio
- Sector-wise composition of capital assets

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\(^9\) The model being used has been developed by Kenneth McKenzie, Professor, Department of Economics, University of Calgary, Canada. A Detailed description of the model can be found in the paper by Kenneth J. McKenzie, Mario Mansour and Ariane Brûlé (1997). “The Calculation of Marginal Effective Tax Rates,” Working Paper, Technical Committee on Business Taxation, Department of Finance, Canada
Box 2: METR vs. AETR

The METR must be differentiated from the AETR, the Average Effective Tax Rate. The AETR, defined as the tax paid divided by the income from capital is commonly seen in income analysis. This measure is less useful because it measures the average burden of taxes on income from all past investment and tax credits on the current investment.

The METR is a more useful than the AETR because marginal factors determine investment decisions and not average factors. The METR is a forward looking measure that looks at the burden faced on a new investment into the business. As investment in capital is a key driver of productivity, the METR provides a useful methodology to measure this burden faced by capital in its various forms.

The METR is calculated using the economic concept that taxpayers maximize profits and as a result invest up to the point where the marginal benefit of the incremental investment equals its marginal cost. When undertaking this calculation, it incorporates all the tax provisions that impact the return from the investment. The AETR on the other hand calculates the tax impact of specific investments undertaken and only incorporates the tax provisions that are impacted by the investments that are already undertaken. As a result the METR is the most appropriate measure to assess the impact of the tax system on investment.

METR and non-tax parameters

It must be noted that the METR is highly sensitive to non-tax parameters such as the interest rates. The METR is most useful when used as a tool to compare the burden imposed by the tax system across different capital assets or across different sectors of the economy. It is not particularly useful to see it in terms of levels\textsuperscript{10}. When comparing across countries, several simplifying assumptions are made in order that a comparison of only the tax systems are being made. As a result non-tax parameters are kept constant as far as possible. For example, the interest rates might vary across countries due to various reasons, but only the tax aspects that cause this difference are incorporated into the METR.

When a comparison of the METRs is made, the interest rate in the local country is taken to be inflation plus international real interest rate, when the country operates as a small open economy. This is a valid assumption because any interest rate that is different from this can be arbitragged away in the financial market through the open economy. When the country is considered a closed economy, the interest rate in the local country less the tax imposed on it, when reduced by inflation is assumed equal to the international interest rate. As a result in the closed economy model, the tax system imposes a wedge between the international interest rate

\textsuperscript{10} For example a zero METR does not necessarily imply that the tax collected is zero, as in the case of a 100\% investment allowance.
and, the local interest rate less inflation. As this translates to a higher interest rate in the local country, the METRs calculated using the closed economy model takes into consideration the differential interest rates across countries that are explained by the taxation of interest income. All other non-tax factors that impose a wedge between the after-tax interest rate and inflation plus international real interest rate are not a part of the calculation. As a result local credit constraints, country risk premium, etc. that might result in high cost of doing business in a country are not included in the analysis.

**Capital Asset Ratios and Debt-Equity ratios**

The two input parameters into the model, the debt equity ratio and the sector-wise composition of assets are very important in determining the METRs. For the purpose of the calculation these ratios as taken as exogenous. In reality, these parameters are also a function of the tax and economic parameters. Hence there is need to fix this at an arbitrary but reasonable value. The debt-equity ratio, for example, is a function of the extent of risk that an investor faces and his expected returns from the investment, both of which depends on the tax system. The same applies to the sector-wise composition of capital assets. While the capital asset composition depends on the nature of the business, the differential effective tax rates on asset types distorts the investment in different assets. (This only affects the total METR which is a weighted average of the separate asset-wise METRs). When the sector-wise ratio of debt to equity and the capital asset ratios for the country being studied are available, it is not unreasonable to use this ratio as an input into the model when one is analyzing the METR across sectors within an economy. But, when comparing across countries these ratios are kept fixed and the tax system is analyzed from that stand point.

The ratios used were tested against the parameters drawn from a small sample of tax returns in Lesotho. It was found that overall; the debt equity ratio was 48:52, while the standard debt-equity ratio used in the METR calculation was close to this at 40:60. The actual capital asset ratios for the manufacturing sector had a larger share of inventory and a correspondingly lower share of equipment. The capital asset ratios for Finance had a greater weight of equipment and correspondingly lower weight of building in the capital asset basket. In the tourism sector, the share of buildings was lower with a higher share for equipment.

**Limitations of the METR analysis**

The METR analysis while being a very useful parameter to measure the burden on investment across capital assets and sectors has its limitations. First, it only measures the burden on capital investment. It does not measure the burden of
other taxes such as payroll taxes, custom duties, etc. that do not affect the calculation of the METR on capital.

Second, it is an analysis of the tax code as it exists in the statute books and does not incorporate the actual implementation of the tax code which might vary widely due to compliance reasons and the way the tax administration operates.

Third, the METR analysis does not incorporate revenue considerations of the government. While a lower METR is good for encouraging investment, this is only a one sided view, as lower taxes also implies lost revenue for the government. The economics literature suggests that the optimal tax on capital is zero; but this is only true when economic efficiency is the only consideration. When equity is also a consideration a zero METR need not be the optimal choice. Also, the METR analysis does not incorporate issues of incidence. It is assumed that the burden on capital is borne by capital, though in reality, part of this could be passed on to labor. Like-wise taxes other than those imposed on capital such as payroll taxes can also be passed on to capital. For the purpose of this study incidence issues are not taken into consideration.

Fourth, it must be noted that, in order that the METR analysis can be used to provide broad information of the tax burden faced by different sectors of the economy, it limits the input parameters to those mentioned above. Hence highly nuanced tax benefits faced by a small number of taxpayers are generally not incorporated into the METR analysis, though it can be done in these individual cases.

Despite these limitations, the Marginal Effective Tax Rate analysis is one of the very few tools that allow us to quantitatively summarize the impact of the complicated tax system on investment. As a result it is used on a regular basis to analyze tax systems all over the world and very useful in comparing tax systems. The approach used in this report uses the analysis developed by Hall & Jorgenson (1967), King & Fullerton (1984) and Mintz (1995)11.

A few technical assumptions for the METR calculations used in this paper are also worth noting. First, with the assumption of capital mobility in a global economy, we use an international real interest rate, which is determined in the international financial market, rather than in any individual “small open economy” such as Lesotho. For the same reason, we chose to use the G-7 average,

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rather than country-specific, tax rates on financial investment incomes to estimate the financing cost of capital.

Second, due to the lack of country-specific data, we use Canadian capital weights within any given business sector to estimate METR. This may sound problematic since Lesotho is not Canada. But there are good reasons why Canadian weights are used: it allows cross-country comparisons; capital and technology are increasingly mobile; absolute capital weights may vary across country but relative weights vary far less (e.g. manufacturing uses more machinery and less land compared to agriculture); lastly, capital weights are not available in most African countries, including Lesotho.

Third, since the METR takes into account tax impact at the margin, any tax levied as a fixed amount that is not in proportion to the size of capital or income will not affect METR calculations. Therefore, any tax levied as a fixed amount will be excluded from our calculations. Such taxes include mainly local levies on immovable property including buildings, mining concessions, and farmland.

**METRs for Lesotho - Overview**

Tax rates used are as of 1st of April, 2006. This series of studies calculates the METR for four broad classes of capital - Equipment, Building, Land and Inventory. Using this, the METR is calculated for the Manufacturing, Agriculture, Finance, Tourism, and Mining sectors.

Over all the METRs for Lesotho ranges from a low of 11% for the Manufacturing sector to a high of 51% for the Financial sector in the case of large corporations. For small business the ratios rise to 36% for Manufacturing and 54% for tourism. In the case of assets, the METR range from a low of 7% on inventory to a high of 47% on land.

As this is the fifth in the series of country studies, it is possible to compare Lesotho’s METRs to those in Zambia, South Africa, Rwanda and Tanzania. When comparing across six Southern African countries (Annex C), Lesotho has a low METR for manufacturing, a median METR for agriculture, but high METRs for financial services and tourism (despite the lower headline rate of income tax).

METRs have been calculated for small as well as large business. Calculations assume that the small business are incorporated and pay tax at the flat rate of 25% or 10% whichever applicable. In the case of large business, it is assumed that the marginal investor is foreign, while in the case of small business, it is assumed that investors only have access to local financing. METRs for Lesotho have been computed both for the open and closed economy case.
In the case of a large investor with access to international capital markets, the interest rate for borrowing to finance business is lower than one without this access. The applicable rate of interest in this case is taken to be the international interest rate (4%) plus inflation (5%) which is 9%. As this implies a lower required rate of return on any new investments, the METRs are much smaller for large firms. We have used a small open economy model to analyze these investors, though the large economy version is also provided for compassion purposes.

In the case of small businesses that only has access to local finances, the interest costs are higher. The required rate of return on new investments in this case has to be much higher than the large investors in order to make up for the higher borrowing costs. In order to analyze small business, the interest rate entailed by the closed economy is more appropriate. This implies an interest rate of \((4\%+5\%)/(100-35)\% = 13.9\%\)\(^{12}\), assuming that the interest income to domestic taxpayer is taxed at a marginal rate of 35%.

**METR analysis for a South African Investor in Lesotho**

The economies of Lesotho and that of South Africa are closely integrated. As a result, quite a number of investors are likely to be operating out of South Africa through a subsidiary in Lesotho. The case when the subsidiary is funded entirely out of equity from the multinational company has been analyzed. In this case, three additional parameters come to play that determine the METR for the multinational company.

- The Standard Corporate Tax Rate in South Africa
- The Withholding Tax rate on Interest in Lesotho
- The Withholding Tax rate on Dividend in Lesotho
- The inflation rate in South Africa

The METRs are affected because:

- Interest payments on borrowed capital by the subsidiary to the MNC now attract withholding tax.
- Dividend payments to the MNC attract withholding tax
- Interest expenses of the MNC are deducted in the resident country (South Africa) at the rate of tax applicable there.
- The real rate of return is affected by any differential inflation rates between South Africa and Lesotho.

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\(^{12}\) The identity used here is \(R_c(1-t)=\pi + R_i\), where \(R_c\) is the interest rate in the country, \(R_i\) the international interest rate, \(\pi\) is the rate of inflation in the country and \(t\) is the Personal Income Tax rate.
For the purpose of these calculations the inflation rate in South Africa is taken to be 4% and the Corporate Tax Rate is taken as 29%. It is also assumed that the host country (South Africa) spares any tax paid by the MNC in Lesotho and as a result does not tax it again. The METRs are compared in Annex D. It can be seen that the METRs are slightly larger for such an investor as compared to a local investor. The main driver of this difference is the fact that the debt financing for the subsidiary is deductible in the hands of the multinational and this lowers the required rate of return for the subsidiary. On the other hand, withholding taxes raises the required rate of return. If the Withholding taxes are removed the METRs drop significantly with the METRs being negative in some cases (further discussion and analysis in Annex D).

Conclusion

The fact that Lesotho’s headline low corporate income tax rates (between 0% and 25%) do not translate into very low METRs (besides manufacturing) – highlights value of the METR methodology. Many factors interact to determine the tax on a marginal investment in capital, and the headline rate of tax is just one of those factors. The sector analyses discuss in more detail the role of tax as a determinant of investment incentive and how and why the METR varies from (a) other sectors and (b) other countries.

Sector Analysis

Agriculture

Agriculture prospects in Lesotho are not encouraging. Only 10% of land is arable, soil quality is low, there is a lack of access to modern farming equipment, yields have been declining and there is a high prevalence of HIV/AIDS among the economically active population. Furthermore, population density, at 65 people per square kilometer, is high for a predominantly subsistence economy.

According to the 1999 Labor Force Survey, about 80% of the economically active rural population listed “subsistence agriculture” as the household’s main occupation (World Bank DTIS 2003). The poor derive more than twice as much income from subsistence farming than do the non-poors. As a result, negative shocks such as droughts have a particularly adverse impact on the poor.

Summary of the tax/incentive system

The agricultural sector, as is common in most tax regimes, receives favorable tax treatment.
Box 3. Should the Agricultural sector be exempt from VAT and/or other taxes?

It is a common feature that agricultural enterprises are taxed relatively lightly. The sector receives ‘special’ treatment because:

- In many developing countries agriculture is outside the formal sector
- Farmers are remotely located making education and compliance difficult
- Agriculture has seasonal revenues
- The rural / agricultural sector is relatively poor, and providing special tax benefits to this sector is perceived a social benefit
- Exempting, or zero-rating, VAT in agriculture is seen as a way to pursue wider social objectives such as lowering the price of food, and supporting poor communities (predominantly rural).

Many of these features are not unique to agriculture and there is no a priori evidence that agriculture deserves special treatment. The reality however, is that special provisions are usually provided. With VAT specifically, the ‘cleanest’ system is to zero-rate agricultural inputs, (as happens in Lesotho), although this creates its own problems in terms of defining what is destined for agricultural use or not. Another option is to exempt inputs from VAT although this can lead to ‘exemption creep’. Once in place such schemes are very hard to undo and there are few examples of any country, developed or developing, which effectively moves toward graduating agriculture to a standard tax system. Complications are compounded when thresholds are introduced in an attempt to capture tax on value added from larger farmers (not a particular problem in Lesotho given then very small scale of the commercial agricultural sector).

Box 4. How to tax Agriculture?

It is common for agriculture to be taxed separately from the ‘normal’ business tax regime. Various options include:

Direct Taxes:
1. Income tax
   - on actual income (scheduler)
   - on presumed income (from land)
     - based on land income
     - on rental income (annual rental value or capital value)
     - value of gross or net income
2. Personal (or poll) tax
   - on individual or household
   - on livestock
3. Wealth and property tax
   - based on area with adjustments
   - based on capital (market) value
   - based on land improvements

Indirect Taxes:
1. Tax on domestic trade (GST/VAT and turnover tax)
2. Tax on foreign trade (import duty and export tax)
3. Excise on specific marketed products
4. Cess on specific marketed products
5. Stamp duty

A major argument in favor of indirect taxes has been that they can generate significant government revenues and are relatively easy and inexpensive to administer. However, they can adversely affect efficiency and raise equity concerns. Land taxes can, arguably, raise efficiency and improve equity. But they often face strong vocal opposition, are hard to assess, and quite expensive to enforce and administer.


Corporate Income Tax

Farmers are exempt from income tax for ‘primary production’ – which we understand to be broadly interpreted as subsistence production. Those few enterprises which are registered for tax benefit from a 10% CIT rate. Small-holders only pay taxes through the trading license, although compliance with this ‘tax’ is limited.

Agricultural exporting firms do not benefit from a 0% CIT rate, as do manufacturing exporting firms.
**Value Added Tax**

Farmers also benefit from relief on indirect taxation. The following agricultural inputs and outputs are zero-rated: Maize meal, maize (grain), bread, milk, beans, peas, lentils, agricultural input fertilizers, seeds and pesticides, livestock feed, malted sorghum, sorghum meal, poultry feed, fertilizer, seeds, and pesticides.

Wool and mohair provides one of Lesotho’s only exported agricultural product. These farmers are mostly outside the tax net, but they do pay VAT on certain inputs, such as imported drugs, packaging and fuel.

**Other taxes / relief**

There are a few non-tax levies, not administered by the LRA, which potentially impact on the sector. Sheep (mohair) farmers must pay a M2 fee per head per annum to the Ministry of Agriculture as a ‘dipping fee’. Yet the service provided is sporadic in return, and the efficacy of the practice is questionable. Taxes and levies such as this may appear minor but do place a burden on the estimated 25,000 wool and mohair farmers.

There exists a ‘livestock importation levy’ (Legal Notice No. 196 of 1991) which is a duty collected by the Ministry of Agriculture when import permits are issued. For private persons the rate is M 30 and M 15 for each head of large and small stock, respectively. For licensed butchers it is M 10 for meat in bulk quantities, M 7.50 and M 3.75 for each head of large and small stock, respectively.

There is in the statute (‘Ground rents Land Act No. 17 of 1979; Land Regulations, Legal Notice No. 15 of 1980; and Legal Notice No. 131 of 1991.’) a fee for use/right to occupy land collected by the Ministry of Local Government. This is charged according to ‘area of land and location’. Owner-occupiers are exempted. The rate is M 0.25-0.30 a year per square meter for commercial land. There is also a levy of 5 % for late payment. However, we could not find any evidence of these ground rents being paid by commercial farmers renting land.
Box 5. Lessons on Rural Land Taxation from Elsewhere in Africa

While taxing rural land is fraught with difficulties, there are some experiences from recent history which offer some insights.

In the case of rural land taxation, decentralization of valuation and enforcement activities promotes efficiency. Recent successes with active and effective local Valuation Offices in Zambia have demonstrated this.

Some form of taxation (flat-rate or site-value) is useful to encourage active land use, as opposed to speculation. Land owners have greater incentive to maximize the productivity of their land when owning it imposes real costs. Local authorities in Kenya in particular have attributed the rapid development of Nairobi and other cities in the 1970s to improved application of land taxation.

Site-value taxation is preferable to flat-rate taxation, because it is more accurate in terms of determining ability to pay taxes, identifying property owners as beneficiaries of public expenditure on social and economic infrastructure, and is more neutral than income taxes with respect to resource allocation. Arguments have been made that taxing development tends to discourage investment, but in the case of agricultural land, site-value taxation can be made dependent on soil quality (representing productive potential) rather than physical improvements.

Research and data management systems for comprehensive and accurate valuation are critical to the success of such systems. Establishing land value need not be a complicated process; in Zimbabwe a simple equation based on land attribute classifications has proven effective. In Tanzania, reforms aimed at strengthening cadastral records and tax administration since 1991 have resulted in visible improvements in collection efficiency.


The Tax and Incentive Regime in Practice

Tax is not a major issue constraining investment in this sector. Other factors are more important in driving growth and investment, issues such as land tenure reform, skills gaps, access to credit, soil erosion and poor rural infrastructure. However, businesses that supply and buy from farmers, are assessed by the LRA and face a similar set of issues as urban enterprises.

Corporate Income Tax

In practice, very few farmers pay corporate income tax. Non-compliance is due to a combination of a lack of understanding of tax obligations and geographical remoteness. Such a situation is common in countries with a large number of smallholder farmers.
It is only larger (incorporated) farmers who are benefit from the reduced rate of 10% on CIT. The LRA commissioned Customer Satisfaction Survey notes there are three corporations in this sector in Lesotho.

**VAT**

The VAT treatment benefits all commercial farmers who purchase inputs and sell their outputs. Unlike the preferential 10% income tax rate, the zero-rating of many agricultural inputs and outputs benefits smallholders as much as larger agricultural enterprises.

However, the ‘zero rated’ list is not exhaustive. For example, there is still VAT on fuel, on veterinary drugs, on farm services (transport, etc.) and packaging used in agricultural processing. The VAT on packaging used by sheep (mohair) farmers is an issue which has been discussed within government.

**Other Issues including compliance (administration) costs**

Manufacturing exporting companies enjoy 0% CIT following the 2006 budget. While Lesotho exports very little in the way of agricultural products, it appears inconsistent to penalize agricultural exporting firms.\(^{13}\)

The M2 ‘dipping fee’ per sheep per annum, payable to the Ministry of Agriculture, is very unpopular. This is because the service provided in return is sporadic and the efficacy of the practice is questionable.

Farmers are often at even more of a disadvantage than other small businesses when it comes to the compliance (administration) costs of taxation, because farmers are more remote and often less well educated than urban businesses (see Small Business section). In Lesotho this debate is rather moot, given that the vast majority of farmers operate outside the tax net.

However, agricultural traders interviewed, who do fall within the tax net, complained of the following issues:

- LRA staff has little knowledge of farming which results in inaccurate assessments.
- LRA staff does not provide agri-business traders with written details of how the assessment was arrived at, so that the businesses are unable to challenge the assessment with any authority.

\(^{13}\) While currently exported agricultural products are few, there exists real potential for horticultural exports, to complement SA farmers’ output (see Market Analysis of Selected Strategic Sectors in Lesotho by Global Development Solutions, June 2004).
Agricultural business (like all businesses) wants to minimize their tax payments. If they kept even basic accounts they would be in a better position complete self-assessment instead of being assessed by the LRA.

However, the self-assessment form (14 pages for individuals and 16 for companies) is viewed as complicated and time consuming.\textsuperscript{14} It would make a priori sense that there is a link between the length and complexity of the self-assessment form and the fact that only 32\% of taxpayers submitted them. While data was not available, anecdotal evidence (but supported by the LRA Customer Satisfaction Survey), indicates that the level of self-assessment compliance within rural areas is far lower than the average of 32\%.

**Analysis of the Tax Regime**

The **METR for the Agriculture sector is 18\%** which is higher than that for the manufacturing sector. The primary reason for the higher METR as compared to manufacturing is the composition of the asset basket and the differential depreciation allowance for building.

In the case of **small agriculture business, the METR is 41\%** slightly higher than the case of small manufacturing business. This result occurs because of higher financing costs. As the agricultural inputs are zero-rated for the purpose of VAT, this does not affect the METRs for the small business of this sector.

**Recommendations**

Taxation is not a major impediment to the success of the agricultural sector, as such there is little in the way tax reforms which could help the sector expand and grow. Nevertheless:

- **Monitor carefully the impact of the recently introduced 10\% CIT rate.** It will be instructive to see if the rate successfully drives additional agricultural investment.

- **Investigate the expansion of the list of zero-rated farm inputs**, for example to include the packaging used by sheep (mohair) farmers, and veterinary drugs.

- **As part of a general review of the self-assessment form, consider a specific self assessment form for farmers, which would be tailored to**

\textsuperscript{14} While accepting that longer forms may contain more information and so be easier to follow and complete. See ‘Institutional and Organizational Issues’ section.
their specific needs and requirements. This would only be applicable to those farmers with a commercial level of income, but would provide them with an opportunity and incentive to keep (very basic) accounts and appropriately challenge LRA assessments they deem inaccurate.

- While it is accepted that the ‘dipping fee’ for sheep and goat farmers is administered by the Ministry of Agriculture, it is perceived as a tax by farmer. Abolishment of this mandatory fee, would be a positive benefit to livestock farmers.

**Mining**

**Summary of the tax and incentive regime**

Historically mining has not been a significant contributor to the economy. The contribution of the mining and quarrying sector to GDP increased from 0.2 % in 2003 to 2.3 % in 2004.

Diamond mining is the main source of large scale mining in the country while small scale and artisan operations are focused on the production of agate, clay, crushed and dimension stone, sand and gravel mainly for local consumption.

Higher diamond prices have contributed to the revival of diamond mining sector, sparked by the reopening of the Letseng Diamond Mine in November 2004 (closed since 1982). Two additional mines have also entered the sector: the Liquobong Diamond mine which recently entered the exploration phase and Kao Diamond Mining which is in the advanced stages of acquiring a mining license.

The potential of the mining industry is largely unknown due to the lack of documented mineral resources. Any future economic contributions are thus likely to come from the diamond sector which, based on current and future planned activity, could become a significant future contributor to the economy.

**Corporate income tax**

The recently reduced standard corporate tax of 25% applies in the sector. The sector like all other sector benefits from an indefinite carry over of losses incurred.

Interest on loan expense deductions are limited by a ratio of allowable debt to equity of 3:1, any interest expenses above this amount may be disallowed.
Standard depreciation rates apply to the mining sector, namely: 25% on light vehicles and light general purpose trucks, 20% on office furniture, equipment, buses and heavy general purpose trucks, 10% for all other equipment and 5% for industrial buildings.

The cost of expenditures relating to exploration, drilling, development or the acquisition of rights, is depreciated over 10 years.

**Negotiated Agreements**

Individually negotiated agreements are in effect in the diamond mining industry in Lesotho. All aspects of diamond mining leases (financial, technical and commercial) are negotiated with the Mining Board which is a body made up of representatives of the Ministry of Minerals and Energy (Permanent Secretary, The Commissioner of Mines, Legal officer), Ministry of Finance and three other appointments made by the Minister one of which has to be from the Chamber of Commerce. There are currently two agreements in effect and an additional in the negotiation phase.

Most agreements have most or all of the following elements, which are not applicable in the general tax code:

- 100% write off (100% capital allowance) of all capital equipment in the year the cost is incurred;
- Royalty rate of between 7-8%;
- Zero import duty on imports from South Africa;
- Government equity ranging from between 20% - 25%;
- Withholding tax of 10% on technical services.

In addition to the above diamond mines also have the option to negotiate a reduction on withholding taxes on interest of foreign loans. Based on our discussions with mining companies current reductions in effect range from 0% - 10%.

**Value Added Tax**

The standard VAT rate of 14% is applicable to limited services in the mining industry. Most mined minerals are exported from Lesotho and are therefore zero-rated and not subject to VAT.

**Royalties**

Royalties are charged at the rate of 10% for precious stones and at 3% for other mineral products. All other mining operations without an agreement or mining
lease are subjected to a royalty rate of 15%. Royalty payments are based on gross turnover.

**Surface Rentals**

A surface rental is payable by mines to the government at a rate of R 5 per/km² per year.

**Withholding Tax**

A withholding tax of 25% is levied on royalties, interest on foreign loans, management fees, natural resource payments and dividends paid to non residents or non-resident companies, trusts or partnerships.

A lower rate of withholding tax applies in countries which have double taxation agreements with Lesotho. Lower rates of withholding tax on dividends are applied to the United Kingdom and Mauritius (10%) and South Africa (15%).

A lower withholding tax of 10% applies to service contracts earned within Lesotho.

**Duties and Excises**

Due to Lesotho being part of the Southern African Customs Union, no duties are applied between imports from South Africa, Botswana, Namibia, Swaziland and Lesotho.

**Tax and incentive system in practice**

**General**

*The design of a mineral taxation regime is crucial to ensure that government receives short term-revenues without jeopardizing the investment potential of long-term projects.* The justifications for a specific mix of instruments and a separate tax regime for the mining industry are related to economic rent associated with the extraction of a scarce and finite resource such as minerals (Box 6).
Box 6: Economic Rent

Economic rent can be thought of as the difference between the market price of a commodity and the opportunity cost of engaging in supplying the commodity. Pure rent represents a surplus, financial return not required to motivate economic behavior and therefore in theory could be taxed without influencing production decisions (i.e. without distorting the resource allocation). Even with all pure rent taxed away, resource owners would earn an acceptable return on their investment, so the resource allocation would be unchanged and the investment would go ahead. This is the theoretical argument underpinning the policy advice that the government can aim at taxing a large share of economic rent from mineral extraction. The opportunity cost of supplying a commodity is given by the supply price of investment, which is the return that is required to an investor to justify a decision to invest. This should be sufficient to cover the cost of exploration, development and production, the cost of capital and a risk premium. While all investment outcomes are unknown, ex ante, mineral extraction projects face an especially high degree, especially related to geological, commercial and political risk. For a more risky project to go ahead an investor will therefore require a higher risk premium, which increases the supply side of the investment. The share of total return the government can tax without discouraging the investment from taking place (economic rent) will therefore be smaller the riskier the investor perceives the project to be.

The investor’s risk premium will reflect both sovereign (political) and project (commercial) risks. The government can reduce commercial risk, for example, by making freely available exploration data or perhaps by financing exploration activities. Political risk can be reduced by strengthening macroeconomic and fiscal stability. This illustrates that there are actions the government can take to minimize uncertainty, which will reduce the supply price of investment thereby increasing the economic rent that can be taxed without discouraging the investment taking place.

Source: IMF, Primer on Mineral Taxation, 2001

Governments are faced with the decision on how best to extract their share of economic rent. The choice of tax instruments are crucial to a successful regime, a mix of instruments which may generate the same amount of economic rent paid may have two different effects on the profitability and risk of projects. There is currently no definitive or ideal tax regime which can be broadly applied to the mining sector, making the choice of tax instruments all the more difficult.

Commonly, specific regimes applied to the mining sector include the adjustment of the standard regime in the form of either a separate mining code or through standardized or negotiated mining contracts as in the case in Lesotho. These adjustments usually center around the treatment of exploration expenses, investment incentives such as accelerated depreciation and initial capital allowances, withholding tax on technical services and interest on foreign loans, ring fencing of mining projects, import duties and the payment of VAT. In addition there are also a number of specific and unique taxes applied in the mining sector such as: royalties, resource rent tax, surface rentals, progressive corporate taxes. Examples and commonality of different types of mining taxes and incentives are provided in Box 7.
Box 7. Taxes and incentives used by governments in the mining industry

**Tax type:**
- income or profits based tax (common)
- import duty (rare: exemptions often available)
- export duty (rare: exemptions often available)
- royalty tax (common: unit type, ad valorem type, profit type)
- application/issuing/registration fees (common: usually minor)
- surface rentals (common: usually minor)
- withholding tax (common: loan interest, dividends, services)
- VAT (common: exemptions or credits usually available)
- stamp duty (common: usually minor)
- sales tax (rare: exemptions usually available)
- local government taxes (common: usually a property tax based on book or assessed value
- mandatory "payroll" based taxes paid by company: (common)
- government equity (very rare: except in West Africa region)

**Incentive type:**
- accelerated depreciation (common)
- depletion allowance (rare)
- ring-fencing (common)
- tax stabilization (used in some large producer developing countries)
- exploration expense carry-forward (common)
- deductible environmental, reclamation, closure costs (common)
- tax holidays
- loss carry forward (common)
- loss carry back (rare)

Source: Mining Taxation in Developing Countries, J. Otto, 2000

**Corporate income tax**

*Mining operations pay the national corporate tax rate, 25%, which is lowest in the region (regional rates vary between 30% - 45%).* In countries with large resource bases and where there are significant known resources, higher corporate tax rates tend to apply. In these countries tax rates usually differ by type of mineral. Some countries also adopt stepped or progressive based income tax regimes where corporate tax rates increase as profits increase. Progressive tax rates are usually linked to higher product prices, production volume, profit to sales or profit to capital ratios. These progressive profit taxes protect companies in the early stages of projects and also allow government to benefit from the upside when higher taxes are collected during years of extreme profitability. However, if corporate tax rates are considered too high this increases the risk of tax avoidance and deters investment.
For diamond mines in particular, the standard corporate tax of 25% is lower than other SACU states such as Botswana and Namibia, where taxation on diamond mines range from 25% - 55%. The disadvantage of a flat rate is that in cases where projects exceed expectations governments miss an opportunity to increase taxes and extract a greater amount of economic rent. Due to the lack of documented resources in Lesotho, the potential risk of this occurring is greater than in countries with known deposits. Higher corporate tax rates or progressive corporate taxes are however, not necessarily the solution as corporate tax carries an administrative burden, is not guaranteed and is sometimes avoided by conglomerates through transfer pricing. Alternative means of increasing tax on economic rent can also be sought, such as through progressive royalties, resource rent tax or additional profit tax.

Table 10: Corporate Tax Rates for Mining Companies

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax rate</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lesotho</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Botswana</td>
<td>25% - 55%</td>
<td>Standard 25%, formula for diamond mines based on profitability ratio ranging from 25% - 55%.</td>
</tr>
<tr>
<td>Brazil</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Ghana</td>
<td>35 – 45%</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Kenya</td>
<td>30%</td>
<td>(Resident companies 30%, non-resident 37.5%)</td>
</tr>
<tr>
<td>Malawi</td>
<td>30%</td>
<td>(Resident companies 30%, non-resident 35%)</td>
</tr>
<tr>
<td>Mexico</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Mozambique</td>
<td>40%</td>
<td>(Mining tax 40% with a fifty % reduction to 20%, for a period of 10 years after the start of production, national rate 32%)</td>
</tr>
<tr>
<td>Namibia</td>
<td>37.5%</td>
<td>Diamond 25% - 55%, other mines 37.5%, national rate 35%</td>
</tr>
<tr>
<td>Peru</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>PNG</td>
<td>35%</td>
<td>(for large mines and 25% for most other mines)</td>
</tr>
<tr>
<td>Tanzania</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>Uganda</td>
<td>25 – 45%</td>
<td>(Mining companies 25-45%, national rate 30%)</td>
</tr>
<tr>
<td>Zambia</td>
<td>25%</td>
<td>(Copper and cobalt 25%, national rate 35%)</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>35%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Global Taxation and Mining Taxation in Developing Countries, Otto (2000) and Comparative Mining Tax Regimes, Price Waterhouse Coopers (1998).

Corporate tax currently has little to no impact on the mining sector in Lesotho. Diamond mines, specifically, are not paying any corporate tax due to the lack of production volumes of mines (there is currently only one mine in the production phase) and due to the capital intensive nature of their investments. In addition due
to investment incentives such as initial capital allowances and indefinite carry over of assessed losses the payment of corporate tax is further prolonged.

The debt/equity ratio limit of 3:1 does have an impact on the mining sector which tends to have highly geared finance of up to 80% debt. Although this impacts negatively on investments which are more highly geared it does encourage increased equity and does reduce the incentive to ‘lever up’ on projects. The debt/equity ratio limit is considered reasonable and is comparable with other countries. Only one company is over the debt/equity limit and as a result cannot claim the balance of the interest as an expense for income tax purposes, this has resulted in them seeking ways to increase their equity in order not to be disadvantaged, indicating the effect this law is having on the incentive to increase equity.

Investment Incentives

Only large scale diamond mines benefit from a 100% initial capital allowance, which can significantly improve project profitability especially in the early years of a project. Other mines have to apply standard rates of depreciation. Internationally many governments have recognized the capital intensive nature of mines and thus allow taxpayers in the mining industry to claim large depreciation deductions in the early years of a project.\(^{15}\)

<table>
<thead>
<tr>
<th>Country</th>
<th>Depreciation rate</th>
<th>Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lesotho</td>
<td>20%</td>
<td>Declining Balance</td>
</tr>
<tr>
<td>Argentina</td>
<td>60%</td>
<td>Initial 60%, then 20% straight line thereafter</td>
</tr>
<tr>
<td>Botswana</td>
<td>100%</td>
<td>Initial 100%</td>
</tr>
<tr>
<td>Brazil</td>
<td>20%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Chile</td>
<td>33.33%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Ghana</td>
<td>75%</td>
<td>Initial 75%, then 50% declining balance thereafter</td>
</tr>
<tr>
<td>Indonesia</td>
<td>10%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Mexico</td>
<td>10%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Namibia</td>
<td>33.33%</td>
<td>Depreciated over 3 years</td>
</tr>
<tr>
<td>Peru</td>
<td>20%</td>
<td>Straight line</td>
</tr>
<tr>
<td>PNG</td>
<td>150%</td>
<td>Declining balance over 7 years</td>
</tr>
<tr>
<td>Rwanda</td>
<td>50%</td>
<td>Initial 50%, then 25% thereafter</td>
</tr>
<tr>
<td>South Africa</td>
<td>100%</td>
<td>Initial 100%</td>
</tr>
<tr>
<td>Suriname</td>
<td>25%</td>
<td>Straight line</td>
</tr>
<tr>
<td>Tanzania</td>
<td>100%</td>
<td>Initial 100%</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>100%</td>
<td>Initial 100%</td>
</tr>
</tbody>
</table>

Source: Global Taxation and Mining Taxation in Developing Countries, Prof. James Otto (2000) and Comparative Mining Tax Regimes, Price Waterhouse Coopers, 1998.

\(^{15}\) Mining Taxation in Developing Countries, 2000 (J.Otto), pg 13
All mining companies in Lesotho currently benefit from the indefinite carry-forward of losses resulting in a reduction in the corporate tax burden, which is relatively common in the industry. Countries where this provision applies in the mining sector include: Bolivia, Botswana, Chile, Ghana, South Africa, Sweden, Western Australia and Zimbabwe. Other countries (Argentina, Bukino Faso, China, Ivory Coast, Philippines and Poland) limit the carry over to 5 years.

Pre-production expenses

In Lesotho pre-production expenses can be written off over 10 years on a straight line basis, which offers little benefit in relation to other competitive countries. Treatment of pre-production expenses differs by country and range from a complete write-off to the depreciation thereof over a number of years. Due to the extensive amounts incurred prior to production on non-revenue generating activities like exploration and prospecting most mining countries make provision for the write-off of these expenses during the production phase. This also encourages companies to undertake exploration which in many countries pose considerable risk, especially where little information is available on the potential of resource deposits.

Table 12: Treatment of pre-production expenses in the Mining Sector: Comparisons

<table>
<thead>
<tr>
<th>Country</th>
<th>Depreciation rate</th>
<th>Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lesotho</td>
<td>10%</td>
<td>Amortized on a straight line over 10 years</td>
</tr>
<tr>
<td>Argentina</td>
<td>200%</td>
<td>100% expensed and 100% depleted</td>
</tr>
<tr>
<td>Chile</td>
<td>100%</td>
<td>Expensed in 1st year of production</td>
</tr>
<tr>
<td>Ghana</td>
<td>75%</td>
<td>In first year of production and declining balance thereafter</td>
</tr>
<tr>
<td>Indonesia</td>
<td>10%</td>
<td>Amortized on a straight line over 10 years</td>
</tr>
<tr>
<td>Mexico</td>
<td>100%</td>
<td>Expensed in the year incurred or could elect to depreciate over 10 years on a straight line basis</td>
</tr>
<tr>
<td>Peru</td>
<td>100%</td>
<td>Expensed in the year incurred</td>
</tr>
<tr>
<td>PNG</td>
<td></td>
<td>Amortized over the life of the mine</td>
</tr>
<tr>
<td>Rwanda</td>
<td>100%</td>
<td>Expensed in 1st year of production</td>
</tr>
<tr>
<td>South Africa</td>
<td>100%</td>
<td>Expensed in 1st year of production</td>
</tr>
<tr>
<td>Tanzania</td>
<td>100%</td>
<td>Expensed in 1st year of production</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>100%</td>
<td>Expensed in 1st year of production</td>
</tr>
<tr>
<td>Zambia</td>
<td>100%</td>
<td>Expensed in 1st year of production</td>
</tr>
</tbody>
</table>

Withholding Tax

Lesotho currently applies a relatively low withholding tax on foreign services of 10% compared to the average rate in comparative developing countries which is around 20% (the rate applied in Chile, Indonesia, Ivory Coast, Kazakhstan, Uzbekistan and Zimbabwe). The effect of withholding taxes is sometimes negated in Lesotho where mining service providers which are presented with withholding
tax tend to inflate the service fees by 10% in order to compensate for the withholding tax.

Lesotho also levies withholding tax on interest on foreign loans, dividends and management agreements which is applied at a relatively high rate of 25% to all mining operations with the exception of diamond mines. Some diamond mines seem to have negotiated lower withholding tax on interest on foreign loans with the Ministry of Finance of between 0% and 10%. The low corporate tax rate in the sector is balanced by the relatively high withholding taxes on foreign dividends. Similarly in countries where corporate tax rates are high withholding taxes on foreign dividends are usually exempted. Many other countries also levy a withholding tax on the interest on foreign source loans in the mining sector. Only South Africa, Tanzania, China, Greenland and Sweden do not. In countries which do levy withholding tax in this area, the rate ranges from 10% to 30%, with an average of 12% to 15%, indicating that the standard regime in Lesotho is high at 25% while the rates negotiated by diamond mines of 0% - 10% are on the low side.

Negotiated Agreements

Diamond licenses and contracts are negotiated with the Mining board in Lesotho on a project by project basis which increases: subjectivity, the risk of inconsistency in their application and increases administration costs and the possibilities of corruption.

In addition to negotiation with the Mining Board investors are also able to negotiate directly with the Ministry of Finance on issues such as withholding taxes. Although the Mining Board is well structured and its tasks well defined in law, the negotiation with the Board and similarly with the Ministry of Finance is non-transparent process and is potentially open to manipulation and abuse. On the positive side, if contracts are well negotiated government may be able to extract more economic rent out of projects on an individual basis than through a published regime.

However, the success of the contracts from a government perspective is dependent on the government representative’s negotiating skills and knowledge of: the company, international best practice and the mining industry in general. Based on the nature of the process in place and based on the differences in the size and nature of the current and planned investments in the diamond sector three different contracts are likely be in effect in Lesotho. This not only ensures that the code is not evenly applied but also increases the costs of the LRA with respect to the tax administration and monitoring process by having to manage multiple agreements. This could become more problematic in future if additional contracts are granted. The use of contracts or development agreements in mining tax
regimes is relatively common practice. There are however different ways in which contracts are developed and implemented from individually negotiated agreements to the freezing of the current tax regime.

In general, for the above reasons, individually negotiated agreements should be avoided. If a separate regime is required for the mining sector or for a particular type of resource, such as diamonds, then it is preferable to write these differences into the mining and/or tax code in order to ensure transparency and even application. In addition, if flexibility is built into tax regimes through progressive profit taxes, progressive royalties and resource rent tax, this reduces the need for contracts as these formulas can take the size of the investment, profitability and the return on the investment into consideration when taxing economic rents.

**Value Added Tax**

The mining sector is traditionally highly capital intensive and heavily reliant on the importation of specialized equipment and thus usually benefits from some sort of exemption or deferment scheme on import VAT. The payment of sizeable VAT refunds can place significant additional administration and budgetary burdens on authorities and can lead to delays in payments. In addition they can place considerable pressure on projects by impacting negatively on cash flows.

_Although Lesotho offers a type of VAT deferment scheme on imports through the Import VAT Credit Facility none of the mines are currently using this facility effectively._ As a result some mining companies have issues relating to the late payment or delays in payment of refunds which in some instances are sizeable amounts. The inclusion of mining projects in this scheme will help both government and mining operators. Although the Import VAT Credit Facility (IVCF) will help to alleviate the need for refunds, refunds will still need to be paid on input credits from local purchases. Therefore, the refund system needs to be reviewed and improved upon. Various solutions could be adopted to reduce the number of refunds and to speed up the refund process, as detailed in Box 8.
Box 8. Vat Refunds – Suggested model of best practice

Successful tax administrations have found that the most efficient and effective VAT refund processing systems are those that (1) distinguish between refund claimants with a history of compliance and those claimants with poor or unknown compliance histories (this entails maintaining historical profiles for each refund claimant); (2) use pre-refund audits for high-risk refund claims and post-refund audits for claims of lesser perceived risk; and (3) apply criteria to determine the likely extent of revenue risk associated with each refund claim.

Against this background, some desirable features of an effective VAT refund system – that are particularly suitable for developing and transitional countries – are outlined below.

- The number of VAT payers should be kept at a level that can be realistically managed by the tax administration.
- VAT registration applications should be subject to proof of identity and other basic checks designed to prevent fictitious traders from entering the VAT system and stealing from the government through the refund system.
- Suitable forecasting and monitoring systems should be established to anticipate refund levels and make sufficient funds available to meet all legitimate refund claims when they occur.
- Refunds should be processed (i.e., paid, offset, or denied) within a reasonable statutory period (e.g., 30 days of the date on which a refund claim is made).
- Interest should be paid on late refunds to compensate taxpayers with legitimate refund claims for being deprived of their working capital.
- Excess VAT credits should be offset against VAT and other tax arrears, except where an outstanding amount is subject to a genuine dispute.
- Immediate refunds of excess VAT credits should always be paid promptly to exporters or to enterprises that export a large share of their products (e.g., where at least 50% of the turnover is attributed to export sales).
- Verification of VAT refund claims should be a component of a wider audit program aimed at achieving broad coverage of taxpayers and compliance issues.
- Preferential treatment should be given to regular exporters with sound compliance histories. Some tax administrations assign an approved refund level within their computer systems for taxpayers with sound compliance records and accounting practices. Others categorize refund claimants according to their compliance history and perceived level of risk. Low risk claimants receive automatic refunds, often within a few days of filing their claims. Selected higher risk taxpayers are required to substantiate their claims.
- Appropriate sanctions should be consistently applied to taxpayers who falsely claim refunds, or do not comply with record-keeping requirements.
- Taxpayers should be entitled to appeal, on reasonable grounds, a decision by the tax administration to withhold a refund. Such appeals should be considered by an independent tribunal and dealt with promptly.
- The tax administration should provide clear information to taxpayers explaining their rights and obligations, and the procedures for making a refund claim. VAT returns and refund claim forms should be simple, have clear instructions, and be filed through means convenient to taxpayers.

Source: Extracts from IMF, VAT Refunds a review of country experience, 2005
Mining operations have experienced issues in the past and seek future clarity relating to the refunding of VAT on the costs of the construction, operating and provision of staff accommodation and related social facilities. The input VAT on the construction costs of staff accommodation is currently in dispute in respect of one mine. An amendment to the VAT Act in 2003 appears to exempt the supply of accommodation by an employer to an employee, meaning that any VAT on inputs relating to that supply, such as construction costs, are not refundable. The private sector argues that VAT should be reclaimable on all activities directly related to mining, including the provision of accommodation and other facilities to staff. Mines contend that they have no choice but to provide these facilities as there are no alternative facilities in the vicinity of the mines.

Duties and Excise

Duties have very little impact on the mining sector as all imports from South Africa are not subjected to duty due to the fact that Lesotho is part of the Southern African Customs Union, which provides for free trade between countries. Most countries globally have chosen to either eliminate customs duties altogether on mining equipment or have applied specific exemptions relating to specific mining projects by pre-approving a list of approved imports over a particular period of the project.

Royalties

The attractiveness of royalties to government is that they are a guaranteed source of income as soon as production starts and have a high compliance rate and a low cost of collection. In addition, the payment of corporate tax is not guaranteed due to the nature of the industry and the possibility of large international conglomerates using transfer pricing to avoid payment thereof.

Over the past number of years globally there has been a general trend moving away from royalties as a main source of mining taxation. There are however a number of countries which still apply royalties. Countries where royalties are not applied include: Canada\textsuperscript{16}, Chile, Greenland, Mexico, Peru, South Africa, Sweden and Zimbabwe. South Africa however, is currently considering introducing royalties on minerals.

Royalties can be applied in different forms. While some are based on production volume, most are based on the value of production. Values can be on a gross basis or net of costs. When setting gross turnover type royalties it is important to ensure that the rate is not too high, as this will have a significant impact on the viability

\textsuperscript{16} Some Canadian provinces do impose profit sensitive mining taxes over and above the corporate income tax.
of a project and could deter investment. Due to gross royalties being levied early on in projects, they affect the net present value of projects before any profit is made. In addition royalties also increase the marginal cost of projects which can result in otherwise marginal investments not being undertaken leading to viable resources left un-exploited.

Lesotho applies gross royalties based on a percentage of revenue, adjusted to an open market price at the time of sale, with no deduction for operating or capital costs and therefore does not take the profitability or internal rate of return of projects into consideration. As Box 9 explains, economic rents are revenues net of these costs. One better approach of tying taxation to economic rents is to impose a ‘resource rent tax’. Another, economically equivalent, approach is to apply progressive royalties which postpone the payment of royalties until all costs (plus a prescribed rate of return) have been recovered, then impose the rent tax on net income.
Box 9. Resource rent tax

Recognizing the potential for mineral extraction to generate large economic rents, in the late 1970’s attempts were made to design a tax system that would tie the tax burden more directly to economic rent, through special resource rent taxes. These can be divided into so-called R-factor based systems and rate of return based systems. The first type links taxation to the investment payback ratio (the R-factor), defined as the ratio of the contractor’s cumulative receipts over the cumulative costs (including the upfront investment). The tax kicks in when the R-factor exceeds one. This approach has been applied in some production sharing contracts with the government’s share increasing with the payback ratio. Under the R-factor based system, the accumulated cash flows are not discounted, which distinguishes it from a rate of return based tax.

This other type of resource rent tax is a cash flow based tax linked to the real rate of return. It applies after a target real rate of return on the investment has been realized. In principle, the target real rate of return should equal the supply price of capital; in other words, represent the return on investment just sufficient to induce the investor to go ahead with the project. In practice, the target rate of return is often set as some mark-up on the return from a safe alternative investment, with the mark-up representing a country-specific risk premium. The tax is calculated by increasing the annual cash flow (typically without deductions for interest cost and depreciation allowances), which is initially negative because of the investment outlay, by the target rate of return, and continuously carry this forward until it turns positive. When the carried-forward cash flow turns positive, the target real rate of return has been realized and the resource rent tax applies on profits above this threshold. Some fiscal regimes have incorporated a stepped resource rent tax schedule with incremental brackets to smoothen the shift to the higher tax regime.

Though a resource rent tax has some very positive features, there are practical problems associated with it. The main attraction is that the tax, in theory at least, both secures the target rate of return for the investor and provides an appropriate share of economic rent to the government. By relying solely on a resource rent tax, however, the government’s revenue stream becomes back-loaded, and for less profitable projects that do not achieve the targeted rate of return, the government will not receive any revenue at all. This can be addressed by combining the resource rent tax with either royalties or a standard profit tax that will provide some revenue early on, and only for very profitable projects will the resource rent tax then become effective. To assure an effective tax, it is also important to derive the appropriate thresholds for the target rate of return and the tax rate. If these are set too high, chances are that the resource rent tax will never apply (incentives for tax avoidance are certainly high); if the threshold is too low, the tax may become a major deterrent to investment. Perhaps the biggest question mark regarding the resource tax is the very low level of revenue raised from this tax in the few countries that actually apply one.

While it is often implied that a fiscal regime relying solely on a resource rent tax will remove all disincentives to investment from taxation, this is not strictly speaking true. Since the resource rent tax reduces the after-tax profit at high rates of return, but the government does not share the losses from non-profitable projects, the tax will necessarily reduce the expected after-tax profitability of the investment. In that sense, the tax regime will be less neutral than would a pure cash flow tax, such as a Brown tax. Of course, this raises questions whether it would be appropriate for the government to take on project risk. Moreover, it is still correct to say that a resource rent tax will result in less disincentives to investment than other tax regimes, including standard profit-based taxes, relying on more up-front payments to the government. The neutrality of the tax is also dependent on how close the presumed target rate of return is to the investor’s actual discount rate (the opportunity cost).

Source: IMF Primer on Mineral Taxation, 2001
When compared to other countries the current royalties in effect in Lesotho cannot be considered as high especially not when comparing the negotiated diamond mining royalties of 7% - 8%. Royalties however, must not be compared in isolation and should be considered in the context of the overall comparative mix of tax instruments.

Table 13: Royalties: an international comparison

<table>
<thead>
<tr>
<th>Country</th>
<th>Gold</th>
<th>Diamonds</th>
<th>Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>3%</td>
<td>3%</td>
<td>Net smelter return</td>
</tr>
<tr>
<td>Botswana</td>
<td>5%</td>
<td>10%</td>
<td>On gross sales, less realization expenses</td>
</tr>
<tr>
<td>Bukino Faso</td>
<td>3%</td>
<td>7%</td>
<td>FOB value</td>
</tr>
<tr>
<td>Brazil</td>
<td>3%</td>
<td>n/a</td>
<td>Gross Sales</td>
</tr>
<tr>
<td>China</td>
<td>4%</td>
<td>2%</td>
<td>Sales Revenue</td>
</tr>
<tr>
<td>Ghana</td>
<td>3% - 12%</td>
<td>3% - 12%</td>
<td>Gross value, depends on profit margin</td>
</tr>
<tr>
<td>Indonesia</td>
<td>US$ 225/kg</td>
<td>10%</td>
<td>Gold: prod. &lt; 2 000kg, Diamond: Sales rev. Prod. &gt; 2 000kg</td>
</tr>
<tr>
<td>Ivory Coast</td>
<td>3%</td>
<td>3%</td>
<td>Revenues less the cost of transportation and processing</td>
</tr>
<tr>
<td>Namibia</td>
<td></td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>PNG</td>
<td>2%</td>
<td>n/a</td>
<td>Realised FOB value</td>
</tr>
<tr>
<td>Philippines</td>
<td>2%</td>
<td>n/a</td>
<td>Market value of gross output</td>
</tr>
<tr>
<td>Tanzania</td>
<td>3%</td>
<td>5%</td>
<td>Netback value, Market value FOB</td>
</tr>
</tbody>
</table>

Source: Global Taxation and Mining Taxation in Developing Countries, Otto (2000) and Comparative Mining Tax Regimes, Price Waterhouse Coopers, 1998.

Analysis of the tax/incentive regime

Equipment forms more than 59% of the capital asset bundle in the case of mining with building contributing 25%. Industrial buildings are entitled to an annual depreciation of 5%.

These factors together make the marginal investment in the mining sector face an METR of 26%. Without the 100% investment allowance, the METR almost doubles to 49%. As a result this tax benefit significantly reduces the burden on new investment in the mining sector. For the purposes of computation of the METR, the royalty is deductible for the purpose of computing the taxable income.

The small business METRs have not been analyzed for this sector as this case is unlikely.

Recommendations

The tax system is not currently evenly applied in the mining sector, which is not uncommon, internationally. The taxation of mines other than diamond mines is largely consistent with the standard regime.
The effective tax system on the diamond mining sector is conducive to growth in the sector and is generally comparable with regimes in other competitive and comparative countries. Government however can make adjustments to the regime to help extract more economic rent from projects and to bring it more in line with best practice.

- **Move away from individually negotiated agreements by standardizing all aspects relating specifically to diamond mines in the tax and mining code.**

  Remove the areas of subjectivity from the process by developing a diamond mining tax code that can be broadly applied to all diamond mines equally. Concerns relating to the differences in the size, nature and impact of investments can be overcome through the use of progressive types of corporate, royalty and resource rent taxes.

- **Consider implementing a resource rent tax, such as a progressive formula based tax regime.**

  Adopt a similar corporate or resource based tax structure as in other SACU countries (such as the 25% - 55% corporate tax in Namibia and Botswana), where diamond mining is a significant contributor to the economy. Keeping the ‘base rate’ within the resource tax structure the same as the current basic corporate tax rate, will ensure that during periods of moderate profitability the net effect of the new tax will be zero. Whilst during periods of high profitability, government’s share of economic rent received will increase as profitability increases.

- **Clear up the issues in the sector regarding the IVCF and the interpretation of VAT and make improvements to the VAT rebate system.**

- **Allow prospecting and exploration expenses to be expensed in the first year of production.**

**Manufacturing**

*Lesotho’s economy depends heavily on export-oriented FDI in the apparel industry in terms of export revenue and employment.* The textiles and garments sector accounts for about 20% of GDP, and over 70% of exports. Under the

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17 The manufacturing sector consists primarily of textiles and garments exporters, but also includes footwear, television, bricks and garden umbrella exporters, food-processing and a brewery.
African Growth and Opportunity Act (AGOA), garment exports to the U.S. increased at an average annual growth rate of over 50% over 1998-2004 (to US$450 million in 2004), and employment grew to 50,000 by early 2004 making it the largest employer in Lesotho.

However, the textile and garment sector has recently experienced a slowdown due to the appreciation of the exchange rate since 2002, elimination of textile quotas under MFA in 2005 and the resultant competition from low-cost producers in Asia, and uncertainty about privileges under AGOA II. This has resulted in factory closures and a loss of about 20% of the employment in the sector in 2004/05. To retain existing investors and attract investment in the textile and garment industry, the government announced special measures in the 2006/07 Budget as per the recommendations of the Tax Task Team (October 2005).

Summary of tax and incentives in the manufacturing sector

The apparel export sector in Lesotho has benefited from a generous tax incentive package to promote investments in the sector (see Box 10). Following the 2006/07 Budget, the preferential corporate tax rate of 15% was reduced to 0% for manufacturing firms exporting outside SACU, and to 10% for firms exporting outside SACU. The revenue impact of these changes was estimated to be minimal since most textiles firms were already reporting losses.

Box 10. Tax and Incentives for Manufacturing Firms

- Preferential CIT rate of 0% for textiles and garments extra-SACU exporters; 10% on profits earned by other manufacturing firms
- 5% depreciation allowance for industrial buildings.
- 125% training expense deduction.
- No withholding tax on dividends distributed by manufacturing firms to local or foreign shareholders.
- Free repatriation of profits derived from manufacturing firms.
- VAT deferment facility for imports for manufacturing exporters.
- Upfront VAT refund scheme for local purchases by textile and garment exporters.
- Duty free imports of raw materials and capital goods for manufacturing exporters.

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18 Between end 2001 and end 2004, the Loti appreciated relative to the dollar by 51% in nominal terms and 57% in real terms. This was due to both the strength of the Rand to which the Loti is pegged, and the depreciation of the US dollar.
19 The expiry of the provision allowing use of third-country fabrics was extended from 2004 to 2007.
20 The revenue loss was considered to be outweighed by the ‘marketing benefit’ of a zero-tax policy.
**The Tax and Incentive Regime in Practice**

The manufacturing sector, dominated by apparel exports, has contributed negligibly to revenue from income tax, payroll contributions or VAT. Textiles and garment exporters have been declaring losses in Lesotho, possibly due to difficult external market conditions or transfer of profits to the parent company by engaging in transfer pricing to take advantage of lower tax jurisdictions. For example, through the sale of export proceeds at below-market prices to an affiliated company located in a lower tax jurisdiction. Conversely, the new zero-corporate tax rate in Lesotho may encourage international parent companies to declare profits in Lesotho through transfer pricing to avoid paying tax in other higher taxed countries. It will therefore be interesting to monitor whether the recent changes in corporate tax rates have an impact on corporate income tax declarations (see Box 11 for a discussion of how India tackled poor compliance with textile firms).

As a result, extra-SACU exporters contributed less than 4% of total CIT revenue and intra-SACU (including Lesotho) contributed less than 8% of the total. Almost 86% of corporate revenue is generated from the non-manufacturing sector. In addition, since average wages in the sector are only slightly above the minimum wage and below the threshold for PAYE, there is little PAYE collected from the sector (the minimum wage textile for a general worker is M643 per month). Since exports are zero-rated for VAT, all VAT on inputs is refundable.
Box 11. Tax Compliance among Textile exporters in India

A recent study of Textile exporters in Southern India has revealed a rough estimate of the extent of compliance among this group of exporters. The study was helped by a ‘natural experiment’ in the year 2000 when an amendment to the tax law removed tax benefits for one group of exporters and retained it for another group. A simple comparison of Net Profit (before tax) as a percentage of Sales before and after the year 2000 shows the basic response to the tax. This measure dropped from 14.4% of sales before 2000 (average for years 1998-2000) to 7.6% of sales after 2000 (average for years 2001-2004). This in itself could be the result of confounding factor that could have reduced the profitability of the textile sector during this period. The second group of textile exporters could help in this regard as they allow us to estimate the trend in profitability during this period. This group did not lose its tax benefits and hence its profitability was not expected to respond to the removal of tax benefits for the first group. The second group of exporters on the other hand had a net profit of 4.7% before the year 2000 and this increased to 6% after the year 2000. Hence just the removal of tax benefits resulted in profits before tax to drop by 6.8% of sales, even when the non-taxed group slightly increased their profitability.

The response was analyzed to break-up the components of that response. It was seen that there was no differential response of sales between the groups. Both groups continued to maintain the same level of depreciation deductions before and after the year 2000. Even the export sales to local sales did not change between the two groups. The only thing that changed was the net profits due to a large unknown expense to the tune of 7% of sales. In fact, most of this response was in the very first year after the change in taxes. As the tax exemption was withdrawn in phases, the massive response in terms of lower profits in the 1st year was the result of just a 5% increase in effective tax rate. This response has been isolated to be the evasion response to the tax change. The estimate was that more than 50% of the true income was hidden from the tax authorities.

Source: James (2005)

Export Incentives

In effect, manufacturing firms that export, benefit from the advantages of manufacturing “in bond” (no import or export duties) and ‘EPZ-type’ privileges. There are no export processing zones (EPZs) in Lesotho and international best practice suggests that tax incentives when offered as part of EPZs risk undermining the tax system without generating sustainable growth and investment. The Tax Task Team report acknowledges that selective incentive packages create distortions and are ‘second-best’ solutions to encouraging investment.

However, tax incentives that are linked to export performance are WTO incompatible (see Box 12). Most countries have moved away from such incentives, and the grace period for least developing countries to comply with

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these WTO regulations will eventually expire. Article 27.2(a) of the Agreement on Subsidies and Countervailing Measures (ASCM) stipulates that Member States that are designated as LDCs by the UN are not bound by the prohibition of export subsidies. When a state is no longer an LDC (GNI above $900 p.c., amongst other factors) however, the prohibition becomes binding. The LDC country list is reviewed at three-year intervals by UNCTAD (current since March 2006). At each review, countries may remain, be added, or be graduated out. As Lesotho prepared for graduation in the future, it will need to ensure WTO compatibility. As such, the preferential corporate tax rate for exporters in Lesotho is not a sustainable policy and may have to be phased out ultimately in line with international and regional trade agreements (SACU, COMESA). Until such time, it would be interesting to evaluate whether the incentives yield benefits in terms of investment inflows, output and employment.

**Box 12. Complying with WTO Regulations on Export Subsidies**

Under Articles 1-8 and Annex I of the WTO's Agreement on Subsidies and Countervailing Measures, subsidies “contingent… in fact” upon exports are “prohibited” (Art. 3.1(a)). Foregone government revenues through government tax concessions and fiscal incentives are considered subsidies in the meaning of Article 1.1(ii) of the Code. Thus, tax incentives are prohibited if tied to actual or anticipated exports (whether or not there is a legal requirement for export). As such, a low corporate income tax rate should be the same, regardless of whether the income is generated through exports or internal activities, for example, within a zone or customs territory.

Special Economic Areas do not present any WTO issues since these are considered a special customs territory within the national economy rather than an export platform. EPZs or SEZs are made WTO compatible through:

- **Removal of the conditionality of the subsidies on export performance including:**
  - removal of all explicit export requirements connected to subsidies;
  - removal of all disincentives for zone products that are imported to the domestic economy (duties on imported goods is possible to levy but not tax on zone value-added for example);
  - removal of all discriminatory practices in the admittance procedure of zone investor candidates, such as the systematic and biased licensing in favor of firms that are known as exporters.

- **Generalizing of the incentives so that these could be given regardless of location and status.**

- **Removal of all illegitimate subsidies combined with the introduction of allowed subsidies such as**
  - subsidies in form of relief of indirect taxes on products incorporated in the goods manufactured within the zone;
  - subsidies of services as long as these are not prohibited export subsidies;
  - subsidies in the agricultural sector.
Selective incentives create pressures for granting similar concessions to other sectors. One, there is pressure to extend the preferential 0% CIT to exports within SACU since the South African market represents a sustainable opportunity for export growth. While this raises the risk of round-tripping, options could be explored to mitigate this (e.g. marking of alcoholic beverages to differentiate exports from domestic sales).

Second, domestic manufacturing firms that primarily supply exporting firms are subject to the standard regime and seeking to benefit from tax incentives. In countries where EPZs exist, firms which mainly supply direct exporters can also receive EPZ status. The removal of differential tax rates to promote both intra-SACU trade and upstream manufacturing may be important considerations to develop a diversified economy. Since upstream manufacturing is likely to be more capital intensive than garment assembly, non-distortionary incentives could be considered such as immediate depreciation allowance of up to 100% for new investment for new or existing investors.

Duty Credit Certificate Scheme

Firms in the apparel sector have benefited from the Duty Credit Certificate Scheme (DCCS) for raw materials sourced from SACU, under which exporters of textiles and clothing products can earn duty credits based on the percentage of their exports. The objective of the DCCS is to influence and encourage textile and clothing manufacturers to compete internationally. Participation in the DCCS is linked to a Performance Assessment and Training and Development Requirement. Duty Credit Certificates can be transferred only between manufacturing firms, and are being actively traded (at a premium according to some firms). As such, even though apparel exporters are entitled to duty free imports, in practice some firms pay import duties in order to obtain duty credit certificates.

While a full assessment of the DCCS in Lesotho has not been undertaken, in South Africa, the DCCS scheme has not been considered to be a success (see Box 13). In South Africa more than half of exporters instead opted for duty free importation (Kaplan, 2003). In addition, clothing exporters in South Africa could only use the DCCS for importation for sale or production only for the domestic market. Therefore, most DCCS were sold (e.g. to large retailers) at a discount of typically 30-40%.

As a result, the DCCS scheme is expected to be terminated by the South African Government in March 2007. In its absence, Lesotho could continue administering a well-functioning duty drawback and VAT deferment scheme for all exporters.

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22 A more developed supply chain and domestic source of fabric will help Lesotho to maintain duty free access to the US after 2007.
(pro-rated). Alternatively, it could consider options for devising its own scheme that is WTO compatible i.e. if the amount of credit is an accurate proxy for the amount of duty actually incurred (versus a scheme where the credit is inflated and provides an incentive). India, for example, administers a Duty Entitlement Passbook Scheme for exporters. The risk with any such scheme is that it is prone to abuse especially by over invoicing of exports. Whereas in the case of a duty drawback scheme there is a physical exporter that could be investigated, in the case of a duty credit scheme, an exporter that indulges in fraud can disappear if the credit is sold to another firm.
Box 13. The DCCS experience in South Africa

An explicit export incentive, known as the Duty Credit Certificate Scheme (DCCS), was introduced to coincide with the phase down of the LDC provision under AGOA until the end of 2007. The DCCS allow firms to claim a remission of duty for proven exports. The level of support depends on the product exported – with highest support for clothing followed by fabric and then yarn. Also, there is greater support for firms exporting more than 15% of their turnover. The DCCS has not been less successful in South Africa and has failed to stem the decline of the industry, principally due to the ending of the Multi-Fiber Agreement, hailing a new era of intensive international competition.

According to a study on the DCCS scheme in South Africa, while the DCCS does provide a significant incentive to exporting on the part of firms, its efficacy is constrained by a number of factors. Most critical is the limited usage to which the DCCS can be applied. DCCS can only be used for imported inputs in respect of the domestic market and then only for a same stage product or one stage back. This limited usage for the DCCS results in exporters selling a large part of their DCCS to importers at a very considerable discount. The DCCS would be a more effective export incentive if its usage could be widened. DCCS could be used against imports not only for production for the domestic market, but also for the export market. Furthermore, DCCS could be used not only for the import of the same product plus one stage back, but also for all imported inputs.

Widening the usage to which DCCS could be put would not result in an exporter earning more DCCS, but it would allow the exporter more possibility of using DCCS “in-house” rather than selling DCCS at a discount. Less DCCS would be supplied to the market and the price of DCCS would rise, reducing the discount and the value captured by the importer as opposed to the exporter.

The DCCS is necessary to compensate clothing exporters who face higher imported input costs. In the longer term, policy should aim at allowing clothing exporters access to inputs at international prices. If tariffs on textiles are reduced, pari passu this will allow the level of the DCCS benefit to be accordingly reduced, without a reduction in the incentive to export. Thus, the level of benefit enjoyed by clothing exporters through DCCS can be adjusted and synchronized in line with tariff reductions on textile inputs.


Processing of VAT refunds

Exports are zero-rated for VAT, and manufacturers are thereby eligible for refunds on most VAT paid on inputs. While the law mandates a three-month time limit for the repayment of refund claims, in practice firms have experienced considerable delays. Delays in processing VAT refunds affect the cash-flow of firms, and can undermine the competitiveness of the export sector. Delays in refunds from revenue authorities can occur when tax collection targets are not met, and revenue authorities do not set aside sufficient funds to meet claims. Lesotho does not have suitable forecasting and monitoring systems to anticipate
refund levels and make sufficient funds available to meet refund claims. For non-exporters, there exists mandatory carry forward for excess VAT credits.

*To reduce refund claims, the LRA had provided an Import VAT Credit Facility for large exporters.* Firms qualify for this VAT deferment facility if the claims are more than M1 million (US$145,000) per annum. Small manufacturing firms, however, are required to pay VAT at the border and can offset the credit after 3 months. In practice, firms consider that this deferment scheme is working, but in some cases carries high administrative costs in terms of time spent reconciling statements. To minimize delays in refunds, the LRA has committed to monthly refunds for exporters with sound compliance histories based on a risk-profiling system (based on criteria under the Value Added Tax processing system). A good risk-profiling system depends on developing profiles for each claimant, and requires basic computer applications developed to provide information on compliance history for VAT, income tax and customs.

*VAT refund claims above a specified level trigger verification audits.* VAT pre-refund audits in Lesotho are based on the amount of refund rather than risk level of the taxpayer. In countries that implement a risk-profiling based system, fully compliant claimants who make claims (of around the size expected) have their claims approved for payment (without pre-refund audit) within a few days. Claimed are audited post refund periodically, perhaps annually, and where possible as part of the planned audit cycle. See Box 14 for lessons from VAT refund checking systems.

**Box 14. VAT Refund Checking regimes**

The UK is an atypical case where computerized checks screen claims and over 90+% of claims are paid immediately i.e. without manual intervention/checking. The balance is given a desk check and/or a visit (and visits can be before or after repayments have been made).

Practices in Africa vary widely:

- In Uganda all claims have to be subjected to a pre repayment audit and copies have to be taken of ALL input tax invoices and submitted to management (different levels depending on the amount of the claim) with the audit report to substantiate that the claim is genuine.

- In Zambia claims are filtered by a system of computerized checks and also by checking selected invoices. The back of their VAT return also requires claimants to put details of the 4 largest purchase invoices (and the amounts/VAT numbers etc are checked automatically to make sure that the amount shown as output tax by the suppliers in question is sufficient to cover the invoice amount). This invoice information is also stored and available to visiting officers subsequently. About half of claims are stopped by the computer checks (the monetary levels/% levels in each check are changed weekly to make the checks unpredictable so as to deter internal fraud) and go to a desk screening. Telephone calls/previously provided or collected information enable some to be cleared; but about a third of all claims are visited before repayments are made (authorization of claims being made by managers at appropriate levels using audit report recommendations).
South Africa – some desk screening but a high proportion of claims are subjected to audit verification before repayment. Consequence is that a large part of the audit resources is tied up on verification of repayments with a noticeable lack of attention being paid to those vendors who pay VAT (but evade etc their true liabilities).

Lessons:

- Some type of screening of claims is vital so that a reasonable percentage can be repaid without a pre-repayment audit visit. In the early days of VAT repayments this will be a small percentage but it should increase as knowledge of genuine and accurate claimants increases. A computerized checking regime is desirable but a manual screening of claims is not impossible, using a simplified table of checks.

- There must be a realistic split of audit resources between those who should pay and those who claim – errors on the payment side affect the State revenues as much as errors on claims;

- Internal controls within the Revenue Service must ensure that managers approve claims; a second independent check by a Finance or Internal Audit team is also beneficial.

### Table 14. Ideas for Checks on claims

<table>
<thead>
<tr>
<th>All taxpayers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Check 1</strong></td>
</tr>
<tr>
<td><strong>Check 2</strong></td>
</tr>
<tr>
<td><strong>Check 3</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Payment traders only</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Check 4</strong></td>
</tr>
<tr>
<td><strong>Check 5</strong></td>
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</table>

<table>
<thead>
<tr>
<th>Repayment traders only</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Check 6</strong></td>
</tr>
<tr>
<td><strong>Check 7</strong></td>
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</table>

<table>
<thead>
<tr>
<th>New businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Check 8</strong></td>
</tr>
</tbody>
</table>
In addition, the LRA has introduced an Upfront VAT Refund Scheme for textile and garments exporters whose average monthly claims exceed M100,000 (US$15,000) and are compliant. The advance refund is based on an average of past quarterly claims. VAT refunds for exporters arise from VAT payments on local purchases of input. This is very innovative scheme, not observed elsewhere in the region. This helps to level the playing field between purchasing imported and local inputs. However, this scheme causes cash-flow problems for the Government, and has been granted selectively to firms.

In the past, delays in refund payments discouraged the purchase of domestic inputs which were charged VAT, and thereby affected the development of local suppliers. The above schemes have improved the refund process, and large manufacturing exporters are being paid on a monthly basis. The upfront scheme is working less effectively. Contrary to some other countries, Lesotho does not allow excess VAT refunds to be offset against other tax liabilities such as income tax (but this requires an adequate taxpayer accounting system and debt management infrastructure).

Other countries have zero-rated supplies to exports (Ireland, France) but this creates breaks in the VAT credit chain and shifts the problem to larger group of suppliers (see Box 15).
Box 15: Zero-Rating Supplies to Exporters

When France adopted the first VAT-type tax with an invoice-based credit mechanism in 1948, a specific scheme (Le système des achats en franchises) was implemented to allow regular exporters to purchase their business inputs free of tax. The aim of the scheme, which in effect applied a zero-rate to supplies made to exporters, was to eliminate the need for exporters to claim refunds of excess credits. The scheme was further developed in 1954 and 1968, when the structure of the tax was improved to become a modern VAT (including broadening the base and extending the VAT credit mechanism).23

When the VAT was introduced in other European member states in the 1970s, some of them (e.g., Ireland, Italy, and the Netherlands) adopted the zero-rating scheme for their exporters, although the Netherlands later abandoned it in the 1990s. While the Sixth Directive provides EU member states with the option of adopting this system, only a limited number have done so. In the 1980s, the scheme was introduced in several former French colonies (including Algeria, Côte d’Ivoire, Morocco, Tunisia, and Senegal), and in the 1990s in a few transition and emerging market countries (e.g., Korea, Albania, and Azerbaijan).25

Although the scheme may have facilitated introduction of the VAT in France in the early 1950s, it has since been shown to add complexity and revenue risks to VAT administration, largely because the scheme breaks the VAT credit chain. Zero-rating supplies to exporters effectively shifts the problem of controlling refund claims away from a small number of well-known exporters to an often larger and lesser-known group of suppliers. The certificate mechanism, such as that operating in Azerbaijan, is open to abuse, and adds to administrative workloads in monitoring the activities of downstream suppliers.


23 The current scheme is limited to direct exporters and operates under self-assessment principles. Exporters who qualify for the scheme advise their suppliers in writing not to charge VAT, except for capital goods. Zero-rated supplies to exporters are subject to an annual ceiling, equal to the total value of exports made by the exporter in the previous year. At year-end, each exporter subject to the scheme must provide the tax authorities with details of purchases and exports made during the year. New exporters must seek approval from the authorities to enter the scheme, and delinquent taxpayers can be removed from the scheme.

24 In Ireland, traders who export more than 75% of their output can obtain an authorization that allows their suppliers not to charge VAT.

25 In Azerbaijan, zero-rate authorization certificates are issued by the tax authorities to exporters in the hydrocarbon sector, as well as to their direct suppliers. The direct suppliers in turn provide copies of certificates to their suppliers, thus giving suppliers further down the chain authority not to charge VAT.
Training Levy

A tax deduction of 125% can be claimed for training expenses incurred in government courses. Nevertheless, labor productivity in Lesotho’s manufacturing sector is more than 50% lower than in Kenya, India and China (ICA, World Bank, 2005). To increase labor productivity, training in the manufacturing sector needs to be further encouraged. One option would be to increase the amount of additional deduction, and/or allow the deduction for non-government (but approved) private sector courses. A refundable training levy is another option, whereby training expenses are refunded for firms that undertake approved forms of internal or external training. Such schemes often prove bureaucratic and end up being perceived as simply another tax on hiring. In most countries, skills levy rates range between 0.5-2% of payroll, and smaller firms are excluded from the scheme (see Box 16).
Box 16. Levy-Disbursement Schemes

Under levy-disbursement schemes, the payroll tax is linked to a disbursement scheme, with firms receiving grants in proportion to the level of training that their employees undergo. The advantage of this scheme is that the payroll tax proceeds are used to encourage firms to either set up programs of in-service training or upgrade skills of their workers by purchasing training for them at a recognized training center, and then qualifying for a rebate of up to a specified percent of the tax paid. Interventions where the tax is linked to a disbursement scheme takes various forms involving payroll tax exemption, levy-grants or training cost reimbursements.

- **Payroll tax exemption**: firms can reduce or eliminate their levy obligations by the amount of training they provide or purchase. It is assumed that as firms know what their training needs are, they will spend their money on appropriate training programs. Examples of countries which implement these schemes include Cote d’Ivoire and France.

- **Training cost reimbursement**: firms are paid grants based on the cost incurred for certain designated forms of training. These schemes usually encourage ad-hoc approaches to training provision, rather than pressing firms to develop systematic training programs. Examples of countries which implement these schemes include Kenya, Malaysia and Singapore.

- **Levy-grant schemes**: grants are paid to firms conditional on criteria met once a systematic training approach is adopted. In thinking about its eligibility to qualify for a rebate of the levy, levy-grant schemes encourage firms to act systematically in relation to their training programs. Examples of countries which implement these schemes include South Africa and Hungary.

If governments are mainly concerned with upgrading the skills of the workforce, a levy-grant scheme can be implemented that is revenue neutral overall. All money collected by the government through a levy would be transferred back to firms – possibly after the government takes a small administration fee.

In Singapore, under the Skills Development Fund, the number of firms benefiting from the fund more than doubled since 1991, and the number of workers trained tripled since inception (mostly on-the-job training).


**Tax Administration**

While the private sector acknowledges the considerable improvement in tax administration by the LRA, delays in resolving any tax issues negatively affect businesses as they cannot renew their manufacturing license without a Tax Clearance Certificate (certifying no tax obligation), obtained on a quarterly basis. In particular, firms complain about the lack of clear criteria used by LRA for assessing income tax, as well as no (statutory) time limit for resolving issues. Anecdotal evidence includes tax assessments being consistently revised upwards,
estimates differing depending on the tax auditor, expenses being disallowed without substantiation, and lack of clarity about expenses qualifying for Fringe Benefit Tax.

**Analysis**

Equipment forms the largest share of manufacturing capital assets (52%) and building forms the second largest share (28.5%). As the tax code allows equipment to depreciate at an annual rate (20%) higher than economic depreciation, this lowers the METR to a large extent. Further, as the manufacturing sector typically employs industrial buildings which are allowed to depreciate at 5% (unlike ordinary buildings), the burden on capital is lower than in the case of other sectors where building cannot be classified as such.

*As a result of these depreciation benefits and the very low corporate tax rate, the METR for manufacturing sector in the case of large foreign investors, is the lowest for any sector at 11%.* Lesotho, unlike other countries does not provide any special depreciation ‘allowances’ or tax ‘credits’ for capital investment in the manufacturing sector. It is the low corporate tax that results in a low METR. For manufacturing firms exporting outside SACU (benefiting from the 0% CIT), the METR on capital is 1%. The METR would be 0% was it not for these firms paying some amount of property tax.

In the case of a small business with access only to the domestic market for credit, which is VAT registered, the METR is 38%. The higher finance costs pushes up the METR quite significantly. In cases where these businesses are not VAT registered the METR goes up even further to 52%.

**Recommendations**

- Preferential corporate tax rates for exporters may well need to be phased out in the medium term to ensure WTO compatibility.

In line with WTO commitments, tax incentives should not be linked to export performance. Further, GOL should investigate harmonizing CIT rates between the export and domestic manufacturing sector to support local private sector in developing higher value added products and to develop local/regional input sourcing. In the short term, Lesotho may wish to evaluate whether the incentives for exporters yield benefits in terms of investment inflows, output and employment (see Box 17 for Ireland’s experience).
Box 17. Attracting FDI through low tax regimes: the case of Ireland

Ireland had a 15-year (zero) tax holiday on profits from new export profits from the 1950s, which changed into a 10 per cent corporate tax to all new firms (compared to around a standard 50 per cent corporate tax rate by that time) from 1982 to be consistent with EU rules. Under further international pressure Ireland is committed to a 12.5 per cent corporation income tax for all firms from 2003, with some concession until 2010. It is generally thought that fiscal incentives are the single most important reason for the surge in FDI. However, it is not clear whether Ireland must maintain an absolute tax level that is as low, or whether a relative tax incentive is more important. Firms that began to pay 10 per cent taxes in 1990 as opposed to 0 per cent generated a lot of fiscal resources, while there is no evidence that firms have left because of the tax increase.


- Increase transparency and disseminate criteria used for income tax assessments.

- Remove the need to provide Tax Clearance Certificate to renew sector licenses.

Under the upcoming licensing reform, Lesotho should seriously consider removing the link between licensing renewal and clearance of tax obligations. While the current regime currently provides leverage for the LRA to collect taxes owed, the system also unfairly discourages genuine appeals from businesses. Although not a tax issue as such, the need for quarterly trading licenses is excessive – and moving to licenses valid for at least a year would have a significant impact on business activity.

- Provide VAT refunds to fully compliant claimants without pre-refund audits, and carry out post-refund audits during planned audit cycle.
Based on the risk-profiling based system, fully compliant claimants who make claims (of around the size expected) should have their claims approved for payment (without pre-refund audit) with the shortest delay possible. Post-refund, claims could be audited periodically, where possible as part of the planned audit cycle (see Box 18 for system adopted in Pakistan).

**Box 18. Audit Requirements under the Risk Profiling System in Pakistan**

Pakistan implemented a risk-management system in the late 1990s to improve the processing of VAT refunds, especially for exporters in the textile sector. Under this scheme, refund claimants are categorized in three main groups: (1) “gold” for claimants exhibiting minimal revenue risk; (2) “silver” for moderate risk claimants; and (3) “others,” representing those of high or unknown risk. Gold refund claimants normally have their claims approved for payment, without a pre-refund audit, within 3-5 days. Silver claimants are assigned an upper refund limit, where claims not exceeding the limit are subject to a brief desk review and approval is given within 15 days. Post-refund audits are conducted at least once a year on two or three claims submitted in the past 12 months by gold and silver claimants. If the post-refund audits detect persistent inaccurate claims, the gold or silver status of a claimant is withdrawn.

Refund claims from taxpayers without gold or silver status are processed (paid or denied) within the statutory deadline. Claims are selected for pre-refund verification in the following circumstances:

- The claim is a first-time refund claim.
- The claim exceeds a value prescribed by the tax administration.
- The claim deviates from the regular refund pattern of the claimant.
- Previous claims have been rejected or reduced as a result of verification checks.
- The claimant has a record of poor compliance in relation to VAT and other taxes (e.g., non-filing, and late payment).

**Tourism**

In 2005 Lesotho tourism industry is estimated to have contributed 2.6% of GDP and generated 9,177 jobs, while the broader direct and indirect travel and tourism economy contributed an estimated 7.5% of GDP and 26,750 jobs. Travel and tourism demand is estimated to have achieved 3.2% real growth in 2005 and expected to achieve 4.4% real growth per annum between 2006 and 2015.

The tourism industry in Lesotho is extremely small and is largely regionally based. True international overseas tourists make up a very small percentage of

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26 World Travel and Tourism Council, Lesotho Country Report 2005

27 Estimated tourist arrivals for 2005 project a total of 303,578 arrivals, of which 289,332 are expected from Africa and 280 399 from South Africa. The largest proportion of visits are undertaken to visit friends and relatives (176 590), holiday and business tourism only accounting for 66,709 and 60,279 visits respectively.
tourists. Most visitors undertake short trips, (1-3 days) and tend to travel to the
country by road on a self-drive basis, indicating the regional based nature of
tourism to the country and the fact that Lesotho is considered an add-on
destination to international tourist trips, mainly to South Africa. Tour packages,
which are almost entirely operated by South African operators, currently make up
a very small proportion of visitors.

**Summary of the tax and incentive regime**

*Corporate tax*

Corporate tax in the tourism industry is applied at the recently reduced standard
rate of 25%.

Most vehicles in the tourism sector in Lesotho are likely to fall under the category
of light vehicles or general purpose trucks and are therefore subjected to 25%
depreciation. Furniture and equipment in hotels, bed and breakfasts and guest
houses are depreciated at 20% - any other equipment is depreciated at 10%. Hotel
and other tourism buildings are not deemed to be industrial buildings and
therefore are non-depreciable.

*Value Added Tax*

The standard rate of 14% is applicable to most services in the tourism industry, with
the exception of:

- Alcoholic beverages which is charged at a rate of 15% VAT;
- Telecommunications which is charged at 10%;
- The transportation of fare paying passengers by road, by definition
  tourists, is exempt from VAT.
- The international transportation of passengers originating in Lesotho to
  a destination out of Lesotho is zero rated. Although international air
  services are zero rated, the services provided by a tour operator or travel
  agent in arranging and booking that service, are not defined as zero
  rated or exempt and therefore subject to VAT at the standard rate.
- The export of a service, which is defined as the supply of services for
  use or consumption outside of Lesotho, is zero rated for VAT;
- In 2003 the VAT act was amended to exempt the supply of
  accommodation by an employer to an employee from VAT.

*Incentives*

The tourism industry does not benefit from any investment incentives in Lesotho.
Duties and Excises

Standard rates of duty apply to the tourism sector. However, due to Lesotho forming part of the Southern African Customs Union, no duty is applied to items imported from union states.

Visas

Holders of the following passports do not require visas for Lesotho: South Africa, Zimbabwe, Denmark, Sweden, Norway, Finland, Ireland, United Kingdom, Germany, France, Italy, Switzerland, Holland, Canada, Israel and Japan. Others such as Australia, New Zealand, U.S.A., Belgium and Austria do need visas. Visas cost M40, around $6.70.

Tourism Levy

No tourism levy is currently in effect, however government is currently considering the introduction of one.

Airport Taxes

A variety of taxes are levied in relation to air travel, airport departure taxes are levied at M20 (US$3.30) for international travel.

Tax and incentive regime in practice

Corporate Income Tax

The headline corporate tax in the tourism sector in Lesotho is the lowest in the region, with only Botswana at an equal rate. Corporate taxation is not a major issue, especially after the reduction of the national tax rate, which has been welcomed by the tourism sector.

Currently the corporate tax burden on the sector is very low where only a limited number of operators pay corporate income tax. The recent reduction of the corporate income tax rate from 35% to 25% is unlikely to stimulate significant new foreign direct investment, but will mainly provide corporate tax relief to existing operators.

The low capital depreciation rates of capital in the tourism sector do not encourage the re-investment and on-going replacement or refurbishment of capital. Lesotho’s current depreciation structure follows best practice in that it is simple and consists of 3-4 rates. However, it is questionable whether the
depreciation rates exceed the real life of assets, effectively resulting in relatively low depreciation rates on buildings, fixtures, fittings and equipment.

Box 19: Depreciation rates in developing countries

Allowable depreciation of physical assets for tax purposes is one of the most important structural elements in a CIT in determining the cost of capital, and thus the profitability of investment. Designing an appropriate depreciation system is, therefore, crucial for fostering a favorable investment climate. Yet, notwithstanding the great importance they frequently attach to promoting investment, developing countries far too often have depreciation systems that are complex, incoherent, restrictive, and in general not investment friendly.

The most common shortcomings found in the depreciation systems in developing countries include: (1) an excessive number of asset categories and depreciation rates; (2) excessively low depreciation rates; and (3) a structure of depreciation rates that is not in accordance with the relative obsolescence rates of different asset categories. Rectifying these shortcomings should receive a high priority in tax policy deliberations in countries.

In restructuring their depreciation systems, developing countries could well benefit from the following guidelines: (1) under most circumstances, classifying assets into, say three or four categories should be more than sufficient, e.g., grouping long-lived assets such as buildings at one end and fast-depreciating assets such as commercial vehicles and computers at the other end, with one or two categories of machinery and equipment in between; (2) only one depreciation rate should be attached to each asset category; (3) depreciation rates should generally be set higher than the actual physical lives of the underlying assets to compensate for the lack of a comprehensive inflation-compensating mechanism in most tax systems; and (4) on administrative grounds, the declining-balance method – still not commonly used in developing countries – should be preferred to the straight-line method. As is well known, the declining-balance method allows the pooling of all assets in the same category and automatically accounts for capital gains and losses from asset disposals, thus substantially simplifying bookkeeping requirements.

Source: IMF, Tax Policy for Emerging Markets: Developing Countries, 2000

Value Added Tax

Most tour operators and travel agents in the country are under the VAT threshold and don’t pay VAT.

The standard VAT rate of 14% applicable to certain services in the tourism industry in Lesotho is lower than most countries in Africa and increases the price competitiveness of the product in relation to competitor destinations. Tables 7 and 8 illustrate the VAT rates in competitor countries.

The charging of a slightly higher rate of 15% VAT on the sale of alcohol and a lower rate of 10% on telecommunications in Lesotho is problematic. Managing multiple rates increases operator’s compliance costs and increases the administration costs for the LRA. Compliance costs in Lesotho incurred by
smaller lodges and bed and breakfasts are far greater than that incurred by larger hotels. Larger hotels generally have sophisticated electronic point of sale systems which are able to separate the VAT component on each individual item automatically. Smaller operators however, have to rely on manual based systems. In order to reduce the time and cost of compliance some operators have chosen to apply the different VAT rates by whole departments and not by each individual item, which is erroneous and effectively increases the cost of some items. For example, some small operators have chosen to charge the 15% VAT on all items sold in their bar (including standard rated items such as: soft drinks, fruit juice and other items).

Lesotho, like some other countries, has chosen not to exclude the transportation of tourists from the more general VAT transport exemption. This adds complexity to the collection and compliance process. Other countries choose to clarify the exemption as only be applicable to public transportation and do not include the transportation of tourists. Tanzania and Kenya have adopted an entirely different approach and have explicitly included the transportation of tourists in the definition of exempt transport services. The use of exemptions should be avoided where possible as they not only provide little benefit and relief, as they do not allow the deduction of input VAT, but also add to the complexity to the compliance, monitoring and administration processes. This is further exacerbated in the tourism industry where packages may consist of VAT able and non VAT able items, which facilitates the possible manipulation of revenues and costs associated with each revenue source.

Export services are zero rated in Lesotho, which is currently not being applied by the private sector to the tour operator services associated with the packaging and brokering of tours to Lesotho.

In Lesotho, charging VAT on commissions and services associated with the issuing and booking of international travel increases the price of the ticket and creates a competitive imbalance in the market. Travel agents in Lesotho are required to charge and pay VAT on the service of issuing and arranging of international travel. Airlines however, are currently not required to charge or pay VAT on any part of the sale or distribution of international air tickets even though they, like travel agents sell and distribute tickets directly to consumers.

Considering that all travel agents in Lesotho are currently under the VAT threshold and are not registered for VAT this does not currently pose a significant problem in the industry. It however, does discourage travel agents to voluntarily become part of the VAT net.
Duties and Excise

The tourism sector in Lesotho has a considerable competitive advantage compared to other tourist destinations (where importation duties usually apply). The vast majority of purchases in the tourism sector is either imported from South Africa or is available locally and is therefore not subjected to import duties.

Departure Tax

Departure tax in Lesotho is very low when compared to other destinations in the region, which helps to reduce ticket prices and encourages demand.

Table 15. Departure Taxes: Lesotho in comparison with the region

<table>
<thead>
<tr>
<th>Country</th>
<th>Lesotho</th>
<th>Botswana</th>
<th>Mozambique</th>
<th>South Africa</th>
<th>Rwanda</th>
<th>Tanzania</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>M20 (+- $3)</td>
<td>$20</td>
<td>$20</td>
<td>R116 (+- $19)</td>
<td>$20</td>
<td>$20</td>
<td>$20</td>
<td></td>
</tr>
</tbody>
</table>

Tax Administration Issues

Although a large proportion of the private sector indicated a definite improvement in their dealings with the LRA over the past two years, some administration issues still occur. The following were raised by the private sector as the main administrative issues:

- “Fictitious” revenues are being raised in an attempt to force operators to pay greater amounts of tax;
- Although most tour operators are under the VAT threshold, pressure is being placed on them by the authorities to register for VAT, by refusing to accept that revenue is below the threshold;
- A lack of understanding of the operating margins and value chain in the tourism industry by LRA audit staff results in differences in declared and assessed amounts.

Analysis of the tax/incentive regime

The Tourism sector bears the second highest METR in Lesotho of 43%. The main reason for this is that this sector has a high share of non-depreciable buildings among its capital assets. Building forms the biggest share of its capital assets as compared to the other sectors.
Small business tourism bears a much higher METR of 54% if registered for VAT and rises to 58% if they are not. The Small Business section discusses in more detail why this is so.

**Recommendations**

*While there are a number of factors constraining the growth of tourism in Lesotho, tax policy and tax administration is not a major factor.* The tourism sector in Lesotho is in the early stages of development, lacking in the areas of tourism regulation and legislation. The private sector is highly fragmented, unorganized and undeveloped. The quality, variety and standard of products is also limited, so most visitors use South Africa as a base and restrict their visits to Lesotho to day trips. Due to the small size of the country and the fact that it is surrounded by South Africa, most tour packages in Lesotho are sold and operated as add-ons by South African tour operators. This, combined with the fact that local tour operators lack experience, have no set standards or formal training programs, generally operate lower standard vehicles and fail to provide accident and public liability insurance for passengers, results in South African tour operators not collaborating with or sub-contracting to local operators. The tour operator sector is therefore undeveloped and currently operates on an informal basis due to lack of demand. Some of the general non-industry specific constraining factors in Lesotho according to the private sector are the relatively high wage costs and the bureaucratic administration.

*The tax system applicable is largely consistent with the overall tax system and offers no additional benefits and concessions to the tourism industry. This standard tax regime however, is generally conducive to growth* and does provide benefits to tourism operators when compared to other regimes, such as no duties on imports from within SACU, a relatively low VAT rate and low corporate taxes.

- **Simplify the VAT system by applying VAT to all tourism and transport services.**

Although no African countries that we are aware of, apply VAT to transport services, both Namibia and Uganda explicitly exclude the transportation of tourists from the more general VAT on transport exemption. Rwanda’s exclusion is more implicit by stipulating that the exemption only applies to vehicles with a capacity of 14 passengers or more. South Africa has recently included a clause in the VAT code which excludes game drives from this exemption. We also do not advocate the application of the tour brokerage service as an export service and hence its zero rating. In some countries, such as South Africa, this is being applied. However, large discrepancies in the interpretation and application of this law are common which make it very difficult to monitor and easy to manipulate. This complexity is magnified when this application is considered in the context of a
tour package which can be made up of multiple products and services which may have different applicable VAT rates. This creates the need to separate relevant revenues and applicable input costs by products and service, which is extremely difficult and can be open interpretation and manipulation through transfer pricing. A better alternative would be to simplify the application of taxes by standard rating all products and broadly applying VAT, to the sector.

- **Zero rate travel agent commission from VAT.**

In order to restore a competitive marketplace, the options are either to zero rate or standard rate this service and make it applicable both to travel agents and airlines. Applying VAT only to a portion of the airline ticket will create potential transfer pricing issues and will be difficult to implement and administer. It would therefore be more practical to also zero rate the service comprising of the issuing or arranging of an international ticket. This is the case in South Africa, where the law states that the services comprising of the issuing or arranging of the international transport of goods or passengers is zero rated.\(^2^8\) Recently in South Africa this has also been extended to the service fees payable by the traveler to the travel agent.\(^2^9\) This is in response to the changes occurring in the world-wide travel industry and in South Africa, where airlines have reduced commissions (from 7% to the current 1% in South Africa), thus forcing travel agents to charge fees for their services direct onto the customer as they can no longer rely on commissions from airlines as a source of income.

- **Considering increasing rates of depreciation, especially the depreciation of hotel buildings which are currently non depreciable.**

Consider greater rates of depreciation especially on buildings, perhaps to 5% to bring it into line with industrial buildings. Initial capital allowances on buildings and equipment could also be considered and slightly higher rates of depreciation on furniture and equipment, to bring Lesotho into line with comparative countries (Table 16).

\(^2^8\) Section 11(2)d of the South African VAT Act

\(^2^9\) South African Revenue Service ruling “Value-Added Tax: Travel Agents” reference 28/3/20, 3 May 2005
Table 16. Depreciation Rates in the Tourism Sector: Comparisons

<table>
<thead>
<tr>
<th>Country</th>
<th>Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lesotho</td>
<td><strong>Declining Balance</strong></td>
</tr>
<tr>
<td>Botswana</td>
<td>Initial capital allowance on buildings of 25% and depreciated at a rate of 2.5% thereafter, plant and machinery is depreciated at: 10% for long life, 15% medium life and 25% for short life (straight line method)</td>
</tr>
<tr>
<td>Kenya</td>
<td>Investment allowance of 100% on hotel buildings, hotel buildings are depreciated at a rate of 4% - (straight line method), plant and machinery of 12.5% to 37.5% (declining balance)</td>
</tr>
<tr>
<td>Mozambique</td>
<td>Accelerated depreciation on new immovable and other tangible fixed equipment assets (straight line method);</td>
</tr>
<tr>
<td>Namibia</td>
<td>Initial capital allowance of 20% on commercial buildings, thereafter depreciated at a rate of 4% for 20 years, machinery, vehicles and other movable assets are depreciated over 3 years (straight line method);</td>
</tr>
<tr>
<td>Rwanda</td>
<td>Registered investors benefit from an initial capital allowance of 50% on new or used business assets including tourism vehicles, for all investors hotel buildings are depreciated at 5% and machinery and equipment at 25% (straight line method)</td>
</tr>
<tr>
<td>South Africa</td>
<td>Hotel buildings depreciated at 5%, capital expenditure on internal renovations of hotels at 20% (straight line)</td>
</tr>
<tr>
<td>Swaziland</td>
<td>Initial investment allowance of 50% on hotels;</td>
</tr>
<tr>
<td>Tanzania</td>
<td>Initial capital allowances of 50% on plant and machinery, standard rates of 37.5% on vehicles, 12.5% on furniture fixtures and equipment (declining balance) and 5% on buildings (straight line)</td>
</tr>
<tr>
<td>Uganda</td>
<td>Initial investment allowance on hotel buildings of 20% and 5% thereafter (straight line), 35% on light vehicles, 30% heavy vehicles, 20% on all other assets (declining balance)</td>
</tr>
<tr>
<td>Zambia</td>
<td>Initial investment allowance of 10% and 5% wear and tear allowance on the cost of the building and 50% depreciation on machinery in tourism enterprises (straight line method)</td>
</tr>
</tbody>
</table>

- Eliminate multiple rates of VAT by converting VAT on alcohol and telecommunications to the standard rate.

Managing multiple rates increases the compliance costs from an operator’s perspective and increases the administration costs from the LRA’s perspective and should be avoided.

**Financial Services**

**Lesotho has a very small financial sector.** While access it credit is widely cited as an impediment to private sector development, improving access to credit is primarily an issue of regulation, legislation and institutional capacity rather than taxation.
There are four commercial banks in Lesotho: NED Bank, Standard Bank, and FNB. The fourth, Lesotho Bank (1999), is jointly owned by the Standard Bank and government of Lesotho. The ratio of banking sector assets to GDP is low at slightly above one-third (IMF 2005).

There is ample opportunity for businesses to borrow from the more developed South African banking sector. At the same time, instead of looking for investment opportunities in Lesotho, the banks can always invest their excess liquidity in South African securities.

Many Basotho resort to informal money lenders, credit societies (such as burial societies). Most money-lenders and credit societies are not regulated by central bank.

There are four private pension companies in Lesotho and a several insurance firms offering life, medical, business and other insurance products.

**Summary of the tax/incentive system**

**Corporate Income Tax**

All financial service firms (banks, insurance companies, pension houses) pay 25% corporate income tax following the 2006 Budget.

**Value Added Tax**

Financial service firms, as in South Africa, and many other economies, are exempt from VAT. This means that financial services firms pay VAT on their inputs but are unable to charge VAT on their outputs. As a result VAT acts a turnover tax for this sector.

**Other taxes / relief**

A withholding tax is levied on interest (10%). This tax is not ‘final’ for companies in that it can be credited against corporate taxation. There are no withholding taxes on dividends but there are on superannuation funds (25%).

Non residents are subject to a withholding tax of 25% on interest, dividends, royalty or natural resource payment, and payments on a contract.

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30 There is an individual allowance for interest income of M 500.

31 However the rate is 15% to South Africa, 10% to the UK and Mauritius and 20% elsewhere.
Box 20: The Taxation of Pensions

Under standard international practice for private pensions, the return on the savings directed into the pension plans is in effect exempt from taxation, consistent with basing the taxation system for these earnings on consumption rather than income taxation. Arguments in favor of this tax-preferential treatment are that it ensures that pensioners have an adequate standard of living in retirement and need to rely less on public pension plans, and that it encourages saving. This outcome could theoretically be achieved by either exempting the contributions that fund the plan and the current investment return on the saved assets, then imposing tax on the entire value of the fund when it is withdrawn (the “E/E/T” structure); or by taxing the contribution at the time it is made, but then exempting the return and the payout from the fund on maturity (the “T/E/E” structure). Under limiting assumptions, the two approaches will yield the same final benefit in present value terms.

If taxing the principal amount but in effect exempting the return (as in best international practice) is ultimately to be adopted for retirement savings, this leaves the decision whether to exempt the contribution on the way in or the benefit on the way out. Practical considerations other than the timing of government revenues point toward using the E/E/T model. While equivalent in present value terms (if tax rates do not change) to T/E/E, the incentive to obtain a current income tax deduction is likely in practice stronger than the promise of a deduction or exemption in 20 or 30 years.

Source: International Monetary Fund: Fiscal Affairs Division

The Tax / Incentive Regime in Practice

The primary impediments to growth and development in this sector are weak institutions and poor / outdated / lack-of appropriate legislation.

However, it is also true that all financial service firms are now at an income tax disadvantage vis-à-vis manufacturing, agricultural or manufacturing exporting firms. This inequity of treatment is not lost on the private sector, or indeed on the GOL as the issue was acknowledged in the 2005 Tax Task Team Final Report.

It is unsurprising that financial service firms will now start to lobby and advocate for similar treatment at 10%.

Banks

Banks are aware that this VAT position disadvantages them against other sectors, but also recognize that such a practice is common in most tax regimes (though in South Africa some financial services are VAT-able). There is some debate over whether banks have been inadvertently not paying VAT on imported (non-financial) services. We are aware that LRA is cognizant of this and is investigating ways to ensure full compliance going forward.
Insurance / Pension

Currently pension (‘retirement annuity fund’) contributions are deductible against income tax (up to 20% of gross income), for the employer and the employee. Pension fund income is exempt from income tax, but the annuity payments are taxed at the marginal rate. This system (the ‘Exempt/Exempt/Tax’ system) provides a positive incentive for individuals to save and for firms to contribute to employee pension schemes (see Box 21).

The Tax Task Team examined the issue of providing equivalent treatment for tax exempt contributions for employees who receive a large proportion of their income at the end of a multi-year contract. These employees are effectively penalized as they ‘lose’ their tax exempt allowance in the early years when they are unable to afford pension contributions. The solution proposed by the Tax Task team would alleviate this situation, as would simply allowing a roll-over of tax exempt allowances not taken.

Box 21: Self Assessment and Pension Contributions

The IMF made the following assessment and recommendation in 2003 regarding a simplification of the self assessment system. “Refunds due to voluntary pension contributions: In order to take advantage of the deduction under section 96, an individual must file a return. This creates needless paperwork for the tax administration. Income tax officials thought that many employers deduct these contributions for their employees and send them to superannuation funds. If so, this would provide an easy solution. The deduction could be allowed in computing the amount of tax to be withheld, in cases where the employer deducts the contributions and sends them to the superannuation fund itself. Funds could be required to submit to the LRA a report of contributions made through each employer, in order to allow LRA to exercise oversight. (For this purpose, an amendment to section 130 to require information returns from approved funds would be appropriate.) Only in cases where employees make contributions on their own would they have to file returns to take advantage of the deduction.”

The FIAS mission is not aware of any action taken to respond to this recommendation, which is a logical solution to administrative burden for both the taxpayer and the LRA.


Other Issues

Banks argue that the 10% withholding tax on interest payments contributes to savings being moved to South Africa. (There is however, also an interest rate
spread between Lesotho and South Africa which is probably more of a driver than the withholding tax, given that the Lesotho withholding tax is creditable, and in South Africa interest income is treated as income and taxed accordingly.)

The ‘Tax Task Team Final Report’ of 2005 includes an in depth discussion of the 10% interest withholding tax – which is far below the standard corporate or personal income tax rates. The Report (following a discussion of alternatives) argues for the ‘withholding tax rate on interest to be raised to 25% and should continue to be final for individuals and not final for companies.’ This recommendation has not been implemented thus far.

There is currently no leasing market in Lesotho (operating or capital) however, we are aware that legislation has been drafted. Leasing provides a very effective method for businesses lacking the credit history required for a formal loan, to access assets, and the commercial banks are (in theory) interested in this market following appropriate legislation.

Box 22 outlines some of the lessons learned from the development of the leasing market in emerging economies. A key issue is how to tax leases, in terms of import duties on the capital, depreciation allowances and the application of VAT.

It is international best practice to treat capital leases equivalently to a similar transactions structured as a loan to purchase an asset (when the interest payments would not be subject to VAT).\footnote{While it is true that VAT-registered businesses would be able to credit these VAT payments; (a) not all businesses are VAT registered, (c) some firms are engaged in Vat exempt activities (such as transport), and (b) it creates a cash flow problem, especially for small businesses.} Equal treatment would help stimulate the capital leasing market in Lesotho.
Box 22: International Best Practice on Taxation of Leasing

In April 2005 the International Finance Corporation published a document on best practice regarding how to expand the leasing market. The highlights are:

Incentives for the leasing sector, if any, should be moderate as the over endowment of preferential tax treatments on leasing may cause distortions in domestic markets, and ultimately a negative effect on the general financial sector. The main reason to provide preferential treatment should be to increase domestic investment, and not stimulate the leasing sector.

The report provides the pros and cons of removing VAT on the import and/or sale of equipment intended for leasing. The tendency is to either make all steps VAT-able or VAT-exempt, rather than a mix, in order not to break the VAT-chain.

With capital lease payments the IFC recommend that “There should be a level playing field in terms of the tax effects of domestic credit offerings and leasing should not be disadvantaged against other forms of credit.” Therefore, the interest portion of capital lease payments should be VAT exempt, as are interest payments for normal bank loans (see Figure 3).

In terms of deductible expenses against revenue, again, IFC recommend a level playing field vis-à-vis a traditional loan (used to purchase an asset). i.e. that both the depreciation and interest component of lease payments are deductible for income tax purposes. In terms of depreciation, IAS-17 is clear on under what circumstances the lessee or the lessor can claim ownership for a capital or operating lease (and the definition of these two terms). It is possible (but not advisable) to offer more favorable, accelerated, depreciation rate for leased vs. traditional procured assets.

An amendment in 2003 to the Income Tax provides the Lesotho Unit Trust with a general exemption from the act’s provisions. This is (as the Lesotho ‘Tax Task Team Final Report’ points out) clearly inappropriate.

The most salient and relevant features of Lesotho’s regime are that (1) an effort has been made to minimize the need for individuals to file income tax returns, thereby arguing in favor of a surrogate-type approach to taxing investment funds, and (2) the corporate tax system is integrated, again arguing in favor of a surrogate approach, since there is no double taxation of dividends. By contrast,
the approach now in force for the Lesotho Unit Trust makes life complicated for the LRA by imposing tax at the individual level.

Finally, the financial services sector is one that relies more than most on skilled employees. The personal income tax differential between South Africa and Lesotho encourages the ‘brain drain’ of some of the most talented Basotho in this sector.

**Analysis of the Tax Regime**

**The METR for companies in this sector is the highest for any sector at 51%.** The biggest contribution to this high METR is the exemption for the purpose of VAT as is common in many countries. This implies that all capital inputs bear an implicit sales tax. The higher composition of non-depreciable building is the other contributor.

The Finance sector has close to half of its capital assets (48%) as building and about 40% as equipment. Buildings in this sector cannot claim any depreciation.

The small business METRs have not been analyzed for this sector as this scenario is considered unlikely.

**Recommendations**

- Amend the VAT act to specifically address the application to the leasing sector, when the leasing legislation comes into force. Treat capital leases equivalently to secured loans for the purposes of VAT and depreciation allowances.

- Following its current period of exemption, tax the Lesotho Unit Trust in the same way as any corporation. On balance, assuming that individuals can make direct investments in the Trust, the approach that seems to make the most sense is to tax the Trust in the same way as any corporation. Upon distribution of dividends, the Trust would pay advance corporate tax. No advance corporate tax would be due on dividends distributed out of dividend income. Favored treatment may be provided for investors in the Trust by exempting unit-holders from capital gains tax upon disposition of their shares. This approach is also the simplest for tax administration.33

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33 See IMF (2003), note by Victor Thuronyi, Senior Counsel (Taxation), International Monetary Fund. During my visit I met among
Small Business Sector

Lesotho does not have a special tax regime for small businesses, in contrast to most tax regimes in Africa. Simplified tax regimes can help make taxes understandable for smaller businesses as well as reduce the costs small businesses incur in complying with the tax requirements. Tax policies are, of course, not the only factors that affect the growth of numbers of small businesses. The availability of micro finance, the ease of registering and licensing a business, property rentals and availability of suitable premises are all key factors.

While the LRA does not categorize taxpayers according to size, the Ministry of Trade defines micro businesses as those with a turnover of less than M250,000 (US$36,23) and small/medium businesses with turnover between M250,000-500,000 (US$36,230 – US$72,463).

The Tax Regime in Practice

Income Tax

Small businesses which are incorporated are subject to CIT, rather than given the choice to opt for a simplified tax regime. Most small businesses are sole proprietors, and are in effect taxable under the personal income tax regime. The rates of tax since April 1, 2006 are different for companies and sole proprietors. The personal income tax is 25% on annual income up to M33,075 (US$4,793) and 35% above. There is also a tax credit of M2,772 (US$401). As a result, sole proprietors incur a higher tax burden than companies of a similar size. These higher rates (top marginal rate of personal income tax should be close to the corporate tax) could be an incentive for incorporation.

However, small businesses may perceive that the administrative costs of incorporation outweigh the tax break. For example, to incorporate a business, an attorney must be hired to file the registration papers to the Registry (fees of US$268). The total cost to incorporate amounts to over 30% of GNI (compared to over 9% in RSA)34. Therefore, the cost of incorporation will need to be reduced so as not to penalize sole proprietors in terms of tax burden, in relation to established companies.

Small businesses consider the high compliance cost imposed by the tax systems as onerous.\textsuperscript{35} Small firms find it difficult to prepare self-assessments for income tax since they are unable to keep proper books. As a result, they are often forced to use accountant services which add significant expense.

Under the Income Tax Act the threshold for the requirement to use accrual rather than cash accounting (i.e. tax based on invoices rather than payments) for calculating tax payable is only M150,000 (US$21,740). This threshold has not been adjusted since 1993, and therefore excludes a large number of small businesses that would benefit from cash accounting. Accrual accounting particularly affects the cash flow of small growing enterprises that carry significant inventories (e.g. manufacturing).

Companies with a turnover of below M150,000 per year are required to submit audited accounts for the purpose of the Companies Act (and incur the costs of engaging auditors). If this turnover level were raised substantially it would ease the entry of small businesses into the formal sector. In most other countries, such as members of the European Union, small businesses (i.e. those with a turnover of below €10m or less than 50 employees) do not have to submit audited financial statements (for either company legislation or for tax purposes).

In practice, the LRA raises assessments on an estimated basis when taxpayers fail to keep adequate records. Anecdotal evidence suggests that the closure of some retail businesses was precipitated by excessively high tax pre-assessments, which businesses were unable to pay and which led to the non-renewal of business licenses. The 2004 LRA Customer Satisfaction Survey of the LRA found that as many as 44\% of those interviewed believed the LRA was responsible for causing the closure of businesses (of all sizes).

\textit{VAT registration for Small Businesses}

The VAT registration threshold is M500,000 (US$90,000). Small businesses which fall below the VAT registration threshold may opt for voluntary registration if they can keep proper accounts and records. In practice, voluntary

\textsuperscript{35} Under a hypothetical simplified small business regime based on turnover, assuming a ratio of taxable income to turnover of 10\%, a 25\% CIT would equate to a turnover tax of 2.5\% (or on average about 2\% given the tax credit), and a 25\% PAYE (first band) would translate into a 2.5\% turnover tax. Hence, while these rates are in line with other countries where taxes based on (presumptive) turnover are in the 1-3\% range, in Lesotho the administrative burden of complying with the standard regime is where small businesses are most affected.
registrants are mainly in the construction industry. The objective of the threshold is to not impose a burden on small businesses that are unable to keep proper accounts. However, businesses that are not registered cannot claim back VAT on inputs, resulting in breaks in the VAT chain. For example, for small manufacturers, the METR for non-registrants is 52% compared to 38% for registered firms, indicating the high burden from staying out of the VAT net. However, those businesses that are registered must submit VAT returns on a monthly basis, significantly adding to their administrative burden.

In Lesotho the VAT registration threshold is quite high and, although voluntary registrations are permitted below the threshold, this threshold effectively excludes small business from the VAT requirements. Table 17 provides comparative data for ten countries in the sub region:

**Table 17. VAT Registration Thresholds in Africa**

<table>
<thead>
<tr>
<th>Country</th>
<th>Registration threshold</th>
<th>US$ equivalent (approx)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lesotho</td>
<td>M 500,000</td>
<td>82,000</td>
</tr>
<tr>
<td>Botswana</td>
<td>P 250,000</td>
<td>46,000</td>
</tr>
<tr>
<td>Kenya</td>
<td>K Sh 3,000,000</td>
<td>42,000</td>
</tr>
<tr>
<td>Malawi</td>
<td>MK 2,000,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Namibia</td>
<td>$ 200,000</td>
<td>33,000</td>
</tr>
<tr>
<td>Rwanda</td>
<td>RwF 15,000,000</td>
<td>26,000</td>
</tr>
<tr>
<td>Tanzania</td>
<td>Tz Sh 40,000,000</td>
<td>33,000</td>
</tr>
<tr>
<td>South Africa</td>
<td>ZAR 300,000</td>
<td>49,000</td>
</tr>
<tr>
<td>Uganda</td>
<td>Ug Sh 50,000,000</td>
<td>27,000</td>
</tr>
<tr>
<td>Zambia</td>
<td>K 200,000</td>
<td>60,000</td>
</tr>
</tbody>
</table>

Many countries, when introducing VAT, adopt a high threshold but, once VAT administration capacity has been established in both the tax administration and the business community, the threshold is reduced. With only about 10% of the live income tax business registrations also being VAT registered, there is considerable scope for expanding the VAT taxpayer base. However, if this is to be done it will be important to link this with the availability of simplified schemes for smaller businesses otherwise the end result is likely to be non compliance and additional pressure on the LRA. The ideal level for the VAT registration threshold is described by the IMF as being where the threshold is at the point where the collection costs saved balance the revenues lost.

Unlike Income Tax, businesses below the VAT registration threshold do also pay tax (as they incur irrecoverable VAT on their purchases). Thus small businesses are de facto within the VAT net but the irrecoverable VAT on their purchases for resale and on their business expenses can be higher than that due on their “Value Added”. This is evident in the METR calculations for Lesotho. For Income Tax,
however, the entry threshold is low and small businesses are expected to operate the same self assessment income tax regime as the largest. The absence of a small business tax regime is an exception to the practice in the region and there are many options that could be explored that would positively encourage voluntary compliance from this vital sector.

Small Business Regimes

International experience suggests that tax regimes for small businesses should be as simple as possible. Simplifying tax regimes should go hand in hand with developing the capabilities of small businesses. The objective of a simplified system is not revenue collection but to encourage businesses to register with tax authorities and formalize. This objective needs to be carefully balanced with maintaining justifiable administrative costs of collection and compliance undertaken by revenue authorities.

A tax regime for small businesses should be designed such that the effective tax burden is low enough so as not to discourage participation but not so low that it allows for tax evasion by larger firms. International best practice suggests that a special tax regime for small enterprises should offer reduced compliance costs and a reduction in the actual tax burden. This reduction in the actual tax burden is intended both to compensate for the difficulties that this sector faces in accessing capital and to act as an inducement to enter the “formal sector”.  

Small businesses are usually provided with special facilities that ease the burden of dealing with tax. This may just be cash accounting (under which tax is not payable until they have received payment from their customers) or a relaxation in the frequency that VAT or other tax returns are due (e.g. 3 monthly rather than monthly tax periods). But some countries go further and have in place optional simplified regimes for the calculation of the tax liability. Flat rate VAT schemes and presumptive Income taxes both rely on payments of a percentage of turnover. To ease the task of maintaining a record of turnover, officially provided record books can be supplied. Using these schemes obviates the business from having to maintain other business records.

The flat rate percentages can be devised in many ways (but should be preceded by consultations with business). Rates can be structured by turnover bands; by the nature of the business (import/export, wholesale, retail, services); by the goods or services supplied (with differential rates reflecting the different profit margins in each trade); and can also be tailored to favor new businesses and/or businesses in

36 For small businesses, participating in a tax regime brings a firm into the formal sector, and allows the firm to access formal credit markets, government procurement, and access to markets.
rural areas. However the rates are devised they must not be too complicated and must be viewed by businesses as being a fair proxy for the tax otherwise due on the taxable profit (or for VAT, the difference between the output and input tax amounts). By way of example, the Indian ‘Model VAT’ (1998) provided that small businesses with turnovers between Rs 500,000 to Rs 2.5 million would pay VAT at the rate 1% of their gross turnover (this was broadly equivalent to collecting VAT on an assumed gross profit margin of 10%). Such a flat rate scheme avoids undue costs to both taxpayers and the tax authorities and permits a lower VAT registration threshold to be adopted than would otherwise be practicable, and for VAT compliance costs borne by business to be reduced.

**Outreach**

*Small businesses complain about the lack of information on tax compliance and onerous reporting requirements.* Education programs and seminars organized by LRA have not specifically targeted this sector. The lack of proper tax education was evident in the Customer Satisfaction Survey of the LRA (2004), in particular in rural areas. There are indications that many businesses choose to operate informally as a result. To tackle widespread tax evasion, one of the schemes introduced in 2002 was a tax amnesty which lasted about eight months. It followed an intensive information campaign on part of LRA in the form of workshops. Overall, the amnesty scheme was not successful in increasing tax compliance.

Some industry groups, such as the Chamber of Businesses, which has offices in districts, could have a role in educating small businesses in the areas of taxation.

In many countries, tax administrations assist taxpayers to understand their tax obligations and entitlements. In particular, support is given to new businesses and potential taxpayers that are in the informal and who may not be fully aware of the tax registration requirements. Some countries provide a “small businessman’s kit” to small businesses that register with the revenue authority for the first time for this purpose. Such efforts lowers tax administration costs in the long run and also contribute to portraying a positive image of the tax authorities.
Box 23. Outreach to Small Taxpayers

Revenue administrations have undertaken activities to make potential taxpayers aware of the general concept of taxation and why they should pay tax. For example, efforts to make compliance easier for taxpayers have included publishing pamphlets and creating web pages giving out information on tax laws, rules and procedures and changes thereto; organizing seminars and workshops for taxpayers, providing assistance to taxpayers in filling up tax returns, looking up their accounts to see how much they owe and clarifying doubts on legal and procedural matters; setting up telephone hot lines to answer questions; appointing floor walkers to assist taxpayers waiting in queues; and keeping tax offices open for longer on days when there are declaration filing deadlines.

Jamaica, for example, has also constructed one-stop Revenue Centers that provide services relating to all taxes, customs and issue of driver’s licenses at one place. Efforts have also been made to reduce compliance costs through simplification of forms, reducing the number of steps required to obtain tax clearance certificates, re-engineering of business processes and introduction of electronic filing of tax returns and electronic payment of taxes.

The lack of an adequate number of private sector firms specializing in tax advisory work is a major drawback in most countries, especially in transition economies. Although large taxpayers usually have access to local branches of international accounting firms and some local firms, the small and medium taxpayers as well as individuals, generally, do not have this facility. This puts pressure on the revenue administration to double up as a tax adviser. For instance, the Volgograd tax administration in Russia has created an advisory service run by current and retired employees, who help taxpayers prepare returns and face audit queries, for a small fee. Ostensibly a Chinese wall exists between the advisory and administrative branches of the tax administration, but the potential for conflict of interest in this arrangement is obvious. Efforts are also being made in Russia to create and strengthen Taxpayer Associations and to catalyze the establishment of a tax advisory services profession.


Analysis

The METR calculation assumes that the small business are incorporated and pay tax at the flat rate of 25% or 10% whichever applicable.

Small businesses are assumed to only have access to local finances, and so the interest costs they face are higher. The required rate of return on new investments in this case has to be much higher than the large investors in order to make up for the higher borrowing costs. In order to analyze small business, the interest rate entailed by the closed economy is more appropriate. This implies an interest rate
of \((4\%+5\%)/(100-35)\% = 13.9\%\), assuming that the interest income to domestic taxpayer is taxed at a marginal rate of 35%.

**The METR is 38\% for small manufacturing businesses** with access only to the domestic market for credit and that are VAT registered. In case these businesses are not VAT registered, the METR goes up even further to 52\%.

**In the case of small agriculture business, the METR is 41\%**, slightly higher than the case of small manufacturing business. Small business tourism bears a much higher METR of 54\% if registered for VAT and increases to 58\% in case they are not registered for VAT.

The calculations assume that small businesses are incorporated and pay tax at the flat rate of 25\% or 10\%, whichever applicable. The METRs for small businesses are significantly higher than large businesses due to (i) higher finance costs under the assumption that small businesses only have access to the domestic market for credit, and (ii) inability to reclaim VAT on inputs due to non-registration (due to administrative cost, lack of education etc).

**Recommendations**

- **Examine options for the introduction of a small business tax regime.**

  A simplified tax system for small businesses could be considered to encourage businesses to formalize and thereby widen the tax net. Such a system could be based on a low rate based on turnover, include a graduated system of taxation, and imbibe a culture of compliance through education on basic business operations, accounting, and monitoring.

- **Raise the ceiling for the requirement to use accrual accounting to M500,000.**

  Small businesses should be allowed to use a simplified cash accounting method, and the threshold should conform to the VAT registration threshold.

- **Raise threshold for requirement to submit audited accounts.**

  The requirement for small companies (with a turnover above M150,000) to submit audited accounts could be revisited with a view to this threshold being raised considerably.

37 The identity used here is \(R_e(1-t)=\pi + R_i\), where \(R_e\) is the interest rate in the country, \(R_i\) the international interest rate, \(\pi\) is the rate of inflation in the country and \(t\) is the Personal Income Tax rate.
• **Shift to quarterly or bi-annual filing of returns for VAT for small taxpayers.**

Small businesses (if tax compliant) should be allowed longer VAT return tax periods to reduce compliance costs. For example, in the UK, small businesses can choose to file VAT returns quarterly rather than monthly. In addition, small businesses in the UK can avail of shortened tax returns, and essential business services are available online.

In South Africa, various VAT return periods exist depending on the turnover category of the business:
- Monthly (annual taxable turnover in excess of R 30 million)
- Bimonthly (annual taxable turnover of less than R 30 million)
- Six-Monthly and Annually (in special cases)

However, in South Africa, Small Business Corporation with turnover less than R20,000 cannot register for the VAT (registration is optional for corporations with turnover in excess of R20,000 but less than R300,000, and compulsory for companies with turnover in excess of R300,000). This is not in line with international best practice which suggests that an opt-in be allowed for small businesses.

• **Devise simplified regimes for VAT for small businesses.**

Small businesses below the current VAT registration threshold could benefit from a simplified VAT regime, with a view to the threshold being reduced to levels more in line with those in the region. Schemes adopted in the UK provide some possible approaches (see Box 24)

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**Box 24. VAT Simplification Schemes in the UK**

To reduce the administrative burden of VAT, small businesses can mix the three following schemes, thereby tailoring a solution for their particular business needs.

- The Flat Rate Scheme is open to any small business with an annual turnover of up to £150,000*. The scheme allows businesses to calculate the VAT they owe by applying a single percentage – determined by their trade sector – to their turnover. There is a lower percentage for businesses during their first year of trading. The Flat Rate Scheme can save time, make VAT returns simpler to complete, and allow businesses to see how much VAT they owe at any point.

- The Cash Accounting Scheme is open to small businesses with an annual turnover up to £600,000*. Cash Accounting Scheme businesses only have to pay VAT when they themselves have been paid by their customers – but similarly they can only reclaim VAT when they have paid their suppliers. This scheme helps businesses’ cash-flow and gives automatic relief on the VAT element of bad debts.
The Annual Accounting Scheme is also open to small businesses with an annual turnover up to £660,000*. Annual Accounting Scheme businesses complete just one VAT return each year instead of the normal four. The VAT itself is paid ‘little and often’ – in installments over the year with a final balancing payment. This scheme cuts VAT administration for businesses and the smaller regular payments can ease the cash-flow impact of VAT.

* 2004-05 turnover figures.

- **Enhance and increase the outreach function of the LRA to encourage voluntary compliance.**

Small taxpayer education could be increased through representative business organizations and regional tax offices. For example, the Rwanda Revenue Authority has effective programs of community information dissemination (e.g. through media) and joint public-private Business Development Service centers have been recently launched. The centers will serve SMMEs, cooperatives, and entrepreneurs by offering information, training, access to financing facilitation, networking and consulting services. Such centers are a good venue for training on financial accounting practices, as well as facilitating the process of formalization by providing information and training on tax registration.
3. ORGANIZATIONAL AND INSTITUTIONAL ISSUES

This section explores the political and institutional dimensions to tax policy and its administration with the aim of providing governments with an international, national and sector perspective. The project aims also to understand how the private sector (of all types: large/SMMEs/informal/foreign & domestic etc.) and its representative bodies engage in the taxation process, with what objectives, degree of coordination and potential influence over both process and sustainable outcomes.

Private Sector Strengthening of the ‘Fiscal Contract’

This section of the study analyzes the state’s ‘fiscal contract’ with the private sector, to consider how entrepreneurs and business organizations respond or mobilize in response to taxation. It seeks to understand how business concerns might be helping to deepen the ‘fiscal contract’ between government and the citizen, over how tax rules are made, revenue targets and other public priorities are set; on connecting revenue collection to productive expenditure, such as more reliably infrastructure, peace and security, and better courts; and on improving administrative processes such as transparent and fair application of laws, user-friendly rules and efficient systems to calculate and pay tax, and potentially lower rates of tax. The section examines the political economy impact of the tax mix – e.g. VAT, whilst an administratively convenient tax, raises political problems as potentially regressive and, perhaps more importantly in the long-term, from the political challenge of indirect rather than direct taxation.

LRA’s Political legitimacy

The Lesotho Revenue Authority is an operationally autonomous body that was established by an Act of Parliament in 2001 to be the “main body responsible for the assessment and collection, on behalf of the Government, of specified revenue; for the administration and enforcement of laws relating to such revenue and for related matters.” The LRA came into being on 27 January 2003 and has a Governing Board which consists of 7 members and the Commissioner General (as an ex officio member). One member is appointed by the Minister of Finance, the other six are appointed from:

- The Ministry of Finance and Development Planning;
- The Ministry of Trade and Industry;
- The Central Bank;
- The Association of Lesotho Employers and Business;
The Lesotho Institute of Accountants; and
• The Chamber of Commerce and Industry.

The Board maintains strategic oversight across the LRA. Businesses believe that the LRA is operating in a transparent manner – some believe that the transparency reveals the sole focus on securing revenue. The LRA does not have discretionary powers beyond those relating to administrative processes.

Politics of business taxation in Lesotho

It is important for any Revenue Authority to have the confidence of both the public and the business community. The creation of the LRA is a positive step towards improving the transparency of revenue collection in Lesotho.

Accountability: The LRA Annual Report, once it is approved by the Board, is laid before Parliament by the Minister of Finance. The Parliamentary Public Accounts Committee can call the Minister of Finance, with support from the LRA, to discuss the report (although this has not yet happened). Additional accountability is available as cases of maladministration can be examined by the Ombudsman. The overall accountability processes will be enhanced significantly when the Revenue Appeals Tribunal becomes operational.

FIAS discussions with businesses and their representatives indicated that they did not think that they were involved enough in the formulation of tax policies. There is a perception that some tax changes are proposed by other Ministries and that these do not seem to go through an examination process (by the Ministry of Finance and Development Planning and the Lesotho Revenue Authority) that is as rigorous as was conducted by the Task Force. It was also reported that small lobby groups (e.g. textile manufacturers) are regularly seeking exemptions and favorable treatment from Ministers and that when concessionary treatment was given it gave rise to other groups seeking similar treatment. When concessionary treatment is decided upon, it is preferable, for reasons of legal clarity, for both taxpayers and tax administrators, that all changes to tax laws are undertaken through amendments to the primary tax legislation (e.g. the Income Tax Act) and where agreements are entered into (e.g. the Mining Agreements) that these are given a clear (and transparent) status within the Income Tax Act. If this is not done there is a danger that contradictory and/or confusing legal provisions will be created.

In devising tax policies the views of both business and the tax administration must be considered. Businesses in general in Lesotho are not, however, well organized; small businesses especially do not have a particularly strong political ‘voice’. This makes it difficult to harness the views of business when tax changes are being designed. As a result, and when e.g. for reasons of confidentiality consultation is
not possible a Revenue Authority can represent them. Tax policy makers need to understand the impact on business and a Revenue Authority can also advise if the proposed change is practical and workable; estimate the impact on compliance; and also assess their costs of administering the change. Self evidently, a Revenue Authority can only represent the views of business; assess business costs, and the likely impact on voluntary compliance, if they have a good understanding of the business area and this in turn requires close contact with business. As a result we recommend that increased efforts are made to involve all stakeholders, especially business representatives, when changes in tax laws are being considered.

**LRA and the business community and the public**

The LRA commissioned a Customer Perceptions Survey in late 2004 – the findings are reproduced in Box 26. The team conducting the survey recommended that, in the light of the findings, the following issues needed to be addressed:

1. The existing Corporate Plan of the Organization needed to be reviewed and updated.
2. A comprehensive Communications Strategy needed to be formulated whereby clear guidelines are provided on communications, client handling and all public relations activities.
3. A performance program was required to improve the LRA service delivery and enable LRA to become a true customer orientated organization. An integrated and holistic one approach was required and the LRA leadership should address the outcome of the survey in a tri-fold approach, i.e.

   - Change management program – to change the behavior and mindset of both management and staff and to define the appropriate organizational culture.
   - Training, awareness and education – Increased focus on practical and hands-on training is required to improve the staff compliance to processes and procedures and follow this up with a continuous assessment program.
   - Internal Processes – Review and evaluate all internal systems and procedures relating to customer services, policy implementation and operational procedures, and at the same time ensuring staff buy into the process to ensure compliance and future sustainability.

The business community was appreciative of the caliber of the LRA staff and how approachable they are. They were, however, critical that their manner and approach frequently appeared driven by pressures to meet revenue targets. The feedback the FIAS received was consistent with the LRA’s own Customer Satisfaction Survey. If the new Corporate Plan can strike a balance between revenue and service targets we would expect that there will be an impact on staff
attitudes. In addition however, the performance management system will need to be modified to incorporate service measures (i.e. marry together quantitative revenue targets with qualitative measures, particularly customer service) and the planned organizational review, later this year, will also need to harness the change of emphasis.

By way of comparison and best practice the UK Government sets, every two years, a series of performance targets for its Revenue Authority (H.M. Revenue and Customs). The latest such Public Service Agreements, which does not contain overall revenue targets, is reproduced in Box 25.

**Box 25. HM Revenue and Customs: 2004 Spending Review PSAs**

AIM: Administer the tax and customs control systems fairly and efficiently and make it as easy as possible for individuals and businesses to understand and comply with their obligations and receive their tax credit and other entitlements.

OBJECTIVES AND PERFORMANCE TARGETS:

Objective I: Improve the extent to which individuals and businesses pay the amount of tax due and receive the credits and payments to which they are entitled.

1. By 2007-08, reduce the scale of VAT losses to no more than 11% of the theoretical liability.
2. By 2007-08:
   - reduce the illicit market share for cigarettes to no more than 13%;
   - reduce the illicit market share for spirits by at least a half; and
   - hold the illicit market share for oils in England, Scotland and Wales at no more than 2%.
3. By 2007-08, reduce underpayment of direct tax and national insurance contributions due by at least £3 billion a year.
4. By 2007-08, increase the percentage of individuals who file their Self-Assessment returns on time to at least 93%.

Objective II: Improve customer experience, support business and reduce the compliance burden.

Objective III: Strengthen frontier protection against threats to the security, social and economic integrity and environment of the United Kingdom in a way that balances the need to maintain the UK as a competitive location in which to do business.


**Box 26: LRA Perceptions survey**

The main issues identified in this report were:-

**Communication** - The lack of communication is a serious issue raised by both the customers and the staff. The main issues raised were:

- **External Communication**
  The lack of proper tax education is evident from the survey as is the public’s understanding of the role of the LRA. It is clear that much more effort is required to educate and inform the public on tax and related issues in general. Another important issue is the lack of understanding by taxpayers of LRA procedures. Sharing of information with the rural community seems to be a particular problem and requires special attention especially with businesses in the district.

- **Internal Communication**
The lack of internal communication is evident as most of the staff cited this as the most important reason for the poor co-operation between and within Divisions. It is further highlighted by the perceived poor relations between management and staff. Although adequate policies are available, the staff raised the issue of their not understanding the policies and therefore not being able to adapt to them effectively. It will be of vital importance to create permanent communication structures and mechanisms to disseminate vital information within LRA. All managers must make more time available to communicate with their staff.

**Procedures** - The application of procedures is lacking, both in the eyes of the customers and staff. Education of the public and training of the staff will address this issue to an extent but more effort is required to firmly entrench operational and customer procedures. Policies must be fully explained to all staff members and measures taken to get staff buy-in to ensure that they implement these policies. The lack of understanding and application of procedures by the staff is possibly one of the most important factors that created a negative perception of the organization in the eyes of the customers.

**Staff Morale** - More than half of the staff indicated that they do not enjoy working at the LRA and it is evident from a number of contributing factors, i.e.

- The poor relationship between staff and management
- The lack of co-operation between Divisions
- The fact that most of the staff is dependant on the input of other staff to complete their work.
- The perceived lack of proper communication
- Not having sufficient opportunity to provide their input and/or voice their concern
- Perceived lack of access to management
- The feeling that their working environment is not safe
- Their potential exposure to bribery and corruption

To improve morale, staff will require a dedicated and constant focus by management on the issues that contribute to the poor morale, all of which need to be addressed in an integrated and holistic manner rather than by ad-hoc interventions.

**Staff Behavior** - The customers indicated that the staff has not been treating them with respect and indicated a lack of professionalism. The lack of professionalism stems from incidents where the staff are arguing with the clients rather than resolving issues, being loud, eating in front of the public and similar unprofessional behavior. Problem solving and decision making seems to be a major problem, in particular with the frontline staff, middle management, and at a supervisory level. This behavior possibly stems from the fact that many of the staff lack sufficient work experience.

**Accessibility** - Accessibility to services appears to be a problem, in particular in the rural districts and at border posts. This influences the perception of the customers who consequently think they are not receiving good services and so needs to be addressed, especially for those customers who have to travel long distances to Maseru to receive attention. The main issues that contributed to these perceptions were:

- **Infrastructure:**
  In some instances, insufficient infrastructure was available. A lack of basic items such tables, chairs and other amenities creates a poor impression for any visitor. This is mainly applicable to the district offices and border posts.
- **Availability of staff:**
In some district offices and some border posts there are no staff available and some customers pointed out where border posts open late and close early. The lack of staff in certain instances also leads to long queues and creates frustration with the customers.

**Growth and taxation in Lesotho**

The LRA has succeeded in improving revenue collection during the short time of its operations. The authority has been innovative and introduced measures that made tax payment easier; provided public tax education and established a tax advice centre. A large degree of harmonization of the VAT with South Africa (at 14%) and capacity building at border posts has helped remove long queues.

By introducing the cross border VAT refund/payment scheme operated in conjunction with SARS and their VAT refund administrator (where by VAT repayments due from SARS on export from South Africa are paid directly to LRA, in payment of the importers VAT liability and importation) importers had one less thing to bother about. At two of the main border points over two years (2004 and 2005), revenue collections increased by 167% and 320% respectively. At all posts, year on year growth in revenue collection was 204%. Further reforms at the border minimized risks from smuggling and tax evasion. Since the refunds on imports were made directly to the LRA, the incentive to cheat was been removed. As duplication of effort by the respective Customs services was reduced, waiting times at the borders also reduced. This cross border VAT refund/payment scheme is probably unique and undoubtedly has encouraged more buyers to declare their transactions. It is an example of good practice that other countries in the sub region should consider. The Authority also intensified efforts to enforce tax compliance by seizing goods of those who try to evade tax. Tax audits were also undertaken to ensure that profits and sources of their incomes are declared fully.

A key revenue administration reform in recent years was the introduction of VAT in July 2003. VAT was introduced at 14% (for most goods) to replace General Sales Tax (GST), which was charged at 10%. The higher tax rate was adopted to compensate for higher administration costs and the lower coverage that could arise under VAT as a result of the complex nature of the VAT system.

**LRA Administration**

The LRA has put into place the required corporate support mechanisms but is now seeking to make progress with operational systems (computerizing the

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current manual processes of both Income Tax and Customs) which should help respond to the LRA ‘perception survey’.

The work undertaken to date on computerization is encouraging covering both the imminent revision of VAT Information Processing System (VIPS) and the planned extension of computerized systems to Income Tax. There are currently some 20,000 Income Tax registrations, although around 5,000 are considered dormant. However the current filing rate for Income Tax is only 32% which shows that computerization (combined with other efforts to enhance voluntary compliance) can bring significant improvements.

The VAT administration was built around the Crown Agent’s VIPS computerized system which, at the time of the mission, was being upgraded to VIPS+. The filing rate for VAT ranges between 80 and 90%. There are several features in VIPS that are not currently being used – e.g. collection of data post audit visits on the size, complexity and compliance of businesses for future risk assessment and visit selection purposes.

Customs processes are entirely manual and although the best clearance times inwards are not unreasonable (24 hours), automated processing should be able to reduce delays (and business costs) considerably. This is particularly important for exports but, once automated processes are operational, resources should be able to be freed up e.g. to respond quicker to export examination requests. We understand that there are embryonic plans to link with SARS to secure access to their automated Customs systems (CAPE and CCA1). Whilst this is welcome it remains to be seen if this is the fastest way to get automated Customs document processing operational.

Together, the Customs and Tax computerization initiatives can provide the key to improvements in customer service (as well as releasing resources to undertake other tasks – e.g. taxpayer education or enhancing the investigation efforts against deliberately non compliant businesses).

The Authority are implementing a Performance Management and Development System and are exploring opportunities for improving skills and training (e.g. with the Southern African Taxation Institute or with the administrations in neighboring States). It is vital that attention is focused on staff management and development as well as on the operational systems and processes.

**Securing voluntary taxpayer compliance**

During meetings with businesses and their representatives ‘harassment’ by LRA staff was reported. The examples quoted included inflated estimated assessments and auditors identifying ‘underpayments’ that were subsequently withdrawn on
appeal. But conversely, from discussions within LRA, it was evident that the full range of debt recovery legal powers is invoked only infrequently – wherever possible a ‘light touch’ approach is used to secure the outstanding tax. However, the availability of such discretion in the tax codes is potentially problematic and can result in unequal treatment. Furthermore the LRA have demonstrated a willingness to put into place innovative procedures designed to help businesses comply with their legal obligations e.g. the Import VAT Credit Facility.

There is clearly a need to strike a balance between revenue and customer service targets to influence the behavior of LRA staff. However, if a tax compliance strategy were in place, this would also influence the behavior of taxpayers. There are many examples of such compliance strategies – Box 27 describes that adopted by the Australian Tax Office. A taxpayer charter, such as that of the LRA, can be used in a complementary manner, to reassure taxpayers as regards their rights and legitimate entitlements, including fair and equitable treatment, as well as informing them of their obligations.

Revenue Services worldwide are faced with limited resources that make it impossible to enforce compliance across all businesses. Risk based systems help to determine priorities but a key part of any compliance strategy is to obtain improved voluntary compliance by taxpayers. This requires getting closer to the customer and increasing taxpayer education and help, especially for new businesses and investors (e.g. via a one stop shop). Discussions with businesses and their representatives in Maseru indicated that they recognize the good initial steps that the LRA have taken, through creating the excellent advice centre at the LRA HQ, the LRA website and their other taxpayer education efforts. Undertaking continued taxpayer education; making fully up to date laws easily available; and providing accessible and clear guidance will all contribute to securing improvements in voluntary tax compliance. We also noted that most audits include an education element.

The task for the future is to build on this sound base and intensify the taxpayer education effort so that new businesses and those who want to comply are helped. Compliant businesses should see the benefit through less intrusive controls being exercised by the LRA and reduced compliance costs. The LRA has in place a number of excellent initiatives, including the up front VAT refund scheme, that demonstrate willingness to try new ideas and other ideas were being considered at the time of the visit. For example, longer VAT periods could be introduced for compliant businesses – such a step would reward compliant businesses with improved cash flow and reduced administrative costs. Conversely non compliant businesses should receive disproportionately greater LRA attention and experience the link between non compliance and increased business costs. Botswana are one of a number of countries that give small and medium sized businesses longer VAT periods – in their case businesses with a turnover below
Pula 12m (approx US$ 2.2m) can file returns every two months, larger business have to file monthly.

**Recommendations**

- Put in place new performance measures for the LRA that balance revenue targets with customer service measures.

- The LRA needs to devise a tax compliance strategy as a key institutional tool to impact on the implementation of tax policies.

Such a strategy will help the tax policy makers and administrators understand better why taxpayers are not complying and guide the development of appropriate and proportionate policies and responses.

**Box 27. Tax Compliance Strategy**

Tax compliance behavior is influenced by many factors – business, industry, sociological, economic and psychological – all of which influence whether a person chooses to meet their obligations. The model shows a continuum of taxpayer attitudes towards compliance. At the base of the continuum, taxpayers have the desired attitude of being ‘willing to do the right thing’. At the other extreme, taxpayers have decided not to comply – choosing to evade or opt out of the system.

The model also summarizes the different sorts of support and intervention that we may need to provide to collect the required revenue. The model suggests that we have the ability to influence taxpayer behavior through our response and interaction.
Annex A: An Overview of the METR Methodology

A  General Discussion

The concept of a marginal effective tax rate was created to analyze in a single measure how investment decisions are affected by the large number of provisions of the business and individual income tax systems, as well as by features of any property and wealth taxes, sales taxes including VATs, customs duties, and special incentive regimes such as tax holidays, that affect the incentives to invest. METR analysis is based on the standard neoclassical model of investment in which the level of investment is a function of the “cost of capital” faced by a firm – the minimum or “hurdle” rate of return that an investment must earn to be profitable. Although earlier research was mixed on the issue, the most recent empirical evidence confirms the basic assumption of this model – which investment does in fact react inversely to changes in the cost of capital (Gordon and Hines, 2002). METR analysts, such as King and Fullerton (1984), Broadway, Bruce and Mintz (1984) and many others, have taken the basic neoclassical model and modified it to take into account the net effect of all the provisions of a tax system on the cost of capital to the firm.39 The primary goal of an METR analysis is thus to describe this net effect of a tax system on investment incentives in a straightforward and intuitively appealing form.

The METR terminology naturally provides some insight into the nature of this tool. A METR is marginal because it is based on analysis of a prospective incremental investment – one that just breaks even, with its after-tax cost equal to its after-tax returns.40 It calculates the effective tax burden in that it captures the net effects of all the provisions of the tax system, rather than focusing on a single characteristic such as the maximum statutory corporate tax rate. And it is a tax rate in that it is defined as the difference between the gross of tax and net of tax returns to an investment – the “tax wedge” between gross and net returns created by the tax system – expressed as a percentage of the gross return.

The calculation of a METR requires careful specification of the characteristics of an investment in a specific asset in a specific sector, including the time path of its returns, the rate of economic depreciation of the asset, how the asset is financed, the economic environment in which it occurs, including the inflation rate, interest


40METR analysis is thus not well suited to analyzing tax effects on investments that generate above-normal returns.
rates, and returns to equity, and all of the features of the current or proposed tax system that affect both the after-tax returns and the after-tax costs attributable to the investment, including all tax depreciation allowances, investment credits, interest deductions, special exemptions, etc., allowed under the income tax as well as any other taxes that impinge on investment decisions. Given this information, the analysis calculates the effective tax rate on a marginal or breakeven investment under the assumptions of profit maximization by the firm, competitive markets, and perfect certainty (e.g., with respect to future returns and inflation rates).

Several additional assumptions underlying the METR approach should be noted. For example, METRs assume that firms are profitable, so that if the effective tax rate on an investment is negative (it is subsidized at the margin), the resulting losses can be used currently to offset other income. METR calculations are typically static; that is, they usually assume that the tax system in place at the time of investment remains unchanged for the life of the investment, and that inflation, when included in the analysis, also remain constant. Since the analysis typically assumes that assets depreciate at a constant rate but last forever, strictly speaking this implies that the analysis assumes the tax system and inflation rate remain fixed forever. In addition, the calculation of METRs is partial equilibrium in nature. Thus, some rate of return in the economy must be taken as fixed; in the context of a small open economy such as that of Lesotho, it is natural to take as fixed an interest rate that is determined in international capital markets. The return to equity, inclusive of an equity premium, can also be treated as determined in international markets.

Another implication of the partial equilibrium nature of METR analysis is that it cannot be used to analyze the shifting of business taxes to consumers or workers (that might occur with market adjustments in the context of a general equilibrium model of the economy). Instead, METRs typically implicitly reflect rather simplistic assumptions regarding tax incidence – which capital taxes on specific assets are borne by the owners of those assets, that taxes on labor are borne by labor, and that general consumption taxes are borne by consumers. Accordingly, to the extent that these incidence assumptions are incorrect, reported METRs levels and differentials may be somewhat misleading. METRs also typically do not take into account issues of tax administration, compliance and evasion, as they describe the tax system as it would operate if it were effectively administered and enforced. Again, to the extent that certain types of taxes (e.g., taxes on capital assets rather than capital income) are more easily enforced than others or are plagued with less tax evasion, the reported METRs may be misleading with
respect to the effects of the tax system as it actually affects investment decisions and tax revenues.\textsuperscript{41}

Finally, as noted above, a METR is defined as the tax wedge between the gross of tax and net of tax returns earned by a marginal investment, expressed as a percentage of the gross return. (The "gross" and "net" terminology refers to returns before and after taxes; both types of returns are defined net of actual economic depreciation.) The net return can be measured at the company or "entity" level, in which case only entity level taxes (including withholding taxes) are considered. Such calculations are sometimes referred to as "open economy" METRs, since the taxation of saving at the level of the saver is ignored. Alternatively, the net return can be measured at the level of the "saver" or provider of funds; in this case, the calculation includes taxation at the individual level. Such calculations are sometimes referred to as "closed economy" METRs since the source of investment funds is assumed to be domestic savers. Since the focus of this report is on tax effects on investment, including foreign direct investment, and Lesotho closely approximates a small open economy, the METRs presented are calculated solely at the business level (including, in some cases, withholding taxes on repatriations of funds from Lesotho subsidiaries to their foreign parents).

The basic concept of a METR can be illustrated with the following simple example. Suppose a business makes a marginal investment in a capital asset that just breaks even taking into account all taxes in the system, and earns a return of 10% net of depreciation but before any taxes. Suppose further that, after accounting for all taxes, the net real return received by the firm and paid to its investors is 7%. In this case, the METR on the investment is 30%: $0.3 = (0.10 - 0.07)/0.10$.

B Issues Illuminated by METR Analysis

The primary applications of METR analysis are twofold. First, the results of an METR analysis show the net effect of all components of the tax system on the level of the taxation of capital income generated by the marginal investment analyzed. Thus, a METR provides a measure of the actual tax burden on a prospective investment attributable to the existing (or proposed) tax system. Moreover, an appropriately weighted average of the METRs on specific types of investments can be constructed to provide a measure of the overall level of

\textsuperscript{41}Note also that since METRs are calculated for marginal investments they are not a particularly good indicator of the tax revenues that are raised from taxing capital income, which depend heavily on the taxation of inframarginal and other investments that earn above-normal returns.
taxation of capital income in the economy, showing how the tax system distorts investment decisions (and, if individual level taxes are considered, saving decisions as well) and thus introduces inefficiencies or “excess burdens” into the economy.\footnote{Note that "distortions" of investment decisions must be measured relative to some benchmark. In general, a tax system would not distort investment decisions only if the METR were zero on all types of investment; this would occur, for example, under an ideal consumption-based tax (Zodrow and McLure, 1991). In this case, METR differentials – and the associated distortions of investment decisions – would be measured relative to a benchmark tax rate of zero. However, under an income-based tax, the benchmark level of taxation of capital income is typically the statutory income tax rate. In this case, the distortion of saving/investment decisions implied by the taxation of capital income at the statutory rate is in a sense taken as given, and the distortions attributable to tax differentials are measured relative to the statutory income tax rate. In addition, note that this discussion assumes that efficiency requires a tax system that is neutral across assets. This need not be true. For example, tax differentials may be desirable to correct for negative production externalities (e.g., pollution) or to offset other inefficiencies in the economy (e.g., inefficiencies in the taxation of labor income). These complications are ignored in the analysis, as they are best addressed with specific tax policies as needed (e.g., taxes on effluents or reform of the system of labor income taxation) rather than through the ordinary income tax system applied to capital income; for further discussion, see Gugl and Zodrow (2004).}

Second, by considering a wide variety of investments that differ by asset, method of finance, investor or economic circumstances, METR analysis provides an indicator of the tax differentials that arise across different types of investments, that is, it shows how taxes affect the composition of investment. In particular, a METR analysis shows how the tax system results in a variety of distortions of investment decisions, thus creating additional efficiency losses, beyond those associated with simply taxing capital income at a uniform effective tax rate. The most commonly cited distortion is across types of assets, as differential taxation of different types of assets induces businesses to invest too heavily in tax-advantaged assets and too little in tax-disadvantaged assets. This of course translates into distortions across business sectors, as the tax system favors sectors with production processes that use tax-favored assets intensively and penalizes businesses that use relatively heavily taxed assets intensively. The following subsections discuss these distortions and a wide variety of others, all of which can be analyzed with an appropriately designed METR analysis.

**Distortions of the Level of Investment and Saving**

METRs provide an indication of the overall level of taxation of various forms of capital income and thus indicate how the tax system affects investment and saving decisions. Because they consider many aspects of the tax system, METR analyses often give very different results regarding the effects of the tax system on investment decisions than would a simple examination of statutory tax rates (or
special preferences) in isolation. Effective tax rates that are far above or below the statutory rate indicate potential areas for reform, as relatively high positive rates act as a deterrent to investment, while negative METRs suggest that the tax system stimulates investments that are socially undesirable because they earn a return lower than the opportunity cost of funds.

**Distortions of the Allocation of Investment**

METRs are also very useful in identifying the extent to which the tax system distorts investment allocation decisions by asset and by business sector (given the benchmark level of taxation of capital income in the tax system). Apart from the arguments for differential taxation noted above, most public finance economists would argue that competitive markets are generally efficient in allocating resources. The implication of this view is that tax differentials are generally undesirable because the associated distortions of investment allocation decisions result in reduced productivity of investment; that is, a disproportionate amount of capital is allocated to those sectors and assets in which tax treatment is relatively favorable rather than to those sectors and assets where investment would be most productive in the sense of generating output valued by consumers. In other words, the tax system should generally be characterized by "economic neutrality" with respect to investment allocation decisions, or METRs that do not vary according to the type of asset or business sector.

In addition, METR analysis demonstrates the extent to which certain types of preferential treatment confer an advantage to the tax-favored activity. Indeed, METR analysis can be used to determine whether the effects of "preferential" treatment of certain forms of investment are in fact consistent with the intent underlying such treatment. For example, in some cases such as certain types of tax holidays, supposedly preferential treatment results in METRs that are actually higher than those under the ordinary income tax system. Similarly, a preferentially low tax rate in a sector can have the effect of increasing METRs if depreciation deductions and other investment allowances under the regular tax system are sufficiently generous.

**Method of Finance**

MTR analysis is useful in determining whether the tax system favors one form of finance over another. Under a market-based approach to tax reform, such distortions are also undesirable as they imply a tax-induced alteration of the allocation of risk-bearing in the economy. For example, a tax bias toward debt finance may increase the overall indebtedness of firms and thus increase the likelihood that costly bankruptcies – or perhaps even more costly government bailouts – will be incurred during an economic downturn.
In addition, tax differentials across methods of finance may discriminate against certain types of firms. For example, a tax system that results in an unusually high METR on new share issues will discourage investments by firms that tend to use new issue finance to a disproportionate extent, including new enterprises that have little retained earnings and limited access to debt finance. Again, most public finance economists would argue that neutrality with respect to firm financing decisions is a desirable property of tax system.

**Choice of Organizational Form**

METR analysis identifies the extent to which the tax system distorts decisions regarding the choice of organizational form. Typically, firms may be organized as corporations subject to the corporate income tax or non-corporate entities that are taxed on a “pass through” basis, with business income attributed to the individual owners and taxed under the personal income tax. Economic neutrality with respect to decisions regarding organizational form is also generally desirable, so that firms may select the form of business organization that best meets their needs without worrying about differential tax consequences.43

**C Effects of Inflation**

An important benefit of METR calculations is that they can be used to demonstrate how tax rate differentials, as well as the level of capital income taxation, vary with the rate of inflation. Unless a tax system is completely indexed for inflation, the pattern of METRs will be different for each expected steady state rate of inflation. The fluctuations of METRs with inflation can be considerable, especially for large differences in the expected inflation rate. Note that such variation in METR levels and differentials with inflation adds an element of complexity to investment decisions, as it makes it more difficult to interpret the effects of the tax system on alternative investments. Such uncertainty is likely to reduce the overall level of investment at any given inflation rate.

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43As in the case of resource allocation, there may be externalities associated with the choice of organizational form; for example, tax enforcement may be less costly for firms that are publicly held corporations.
Annex B: Description of the tax structure in Lesotho used in the METR calculations

By “tax structure,” we mean tax provisions stipulated in the tax laws rather than the tax administration that affects how the tax structure is implemented. For example, when a business sector is taxable under the value-added tax (VAT), the law implies that firms in this sector are entitled to a full refund for the VAT paid on their capital inputs, or input tax credit. In terms of tax structure, therefore, this sector as a whole bears no VAT cost on its capital inputs. However, it is quite possible that, owing to administrative delays or even intentional denial, many firms in this sector might not be able to receive the input tax credit on time, if at all. When they do not receive the input tax credit on time, they have to bear the cost of cash flow that is held up by the revenue authority; and when they do not receive the input tax credit at all, they have to bear an indirect tax cost on their capital investment. Both problems in this case are the result of poor VAT administration rather than the tax structure itself. As such, METR analysis should not be expected to quantify the investment impact of tax administrative efficiency since it only deals with the investment impact of the tax structure.

Generally speaking, the principal taxes affecting capital investment and business activities may be divided into two types: direct taxes on income generated from capital investment and transaction taxes on capital inputs. The direct taxes normally include company income tax, taxes on financial investment income, and some other taxes either based on capital or based on gross receipts; and the indirect taxes on capital inputs include sales tax (including VAT) and import duty on capital inputs that are not refundable to investors.

In Lesotho, the principal direct taxes affecting capital investment are stipulated in the newly approved Law of 2005 on **Tax on Direct Income** (henceforth the New Law), but also include certain taxes levied locally (e.g., property tax). Indirect taxes on capital inputs are virtually non-existent except for the non-refundable value-added tax (VAT) on capital goods in certain segments of the financial services sector (see below). Our review of these taxes starts with a description of the general tax provisions, followed by a review of special tax incentives and taxation of small business.

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44As illustrated by the effective tax rate analysis, taxes on any financial investment income could affect the cost of capital investment through the financing cost of capital.
Annex C: Cross-country analysis

For purposes of comparison, Tables C1-C4 provide the METRs on capital income in Lesotho, South Africa, Rwanda, Tanzania and Zambia (all assuming large firms, in an open economy).

The METRs are calculated for the general tax system in each of these countries and reflect only provisions available either to all firms or to all firms within one of the sectors analyzed in the report; that is, the report does not consider incentives granted to specific firms within a sector or to other categories of firms such as exporters or firms in tax-favored regions. Since the treatment of mining is relatively idiosyncratic, the comparison examines the tax treatment in the other four sectors – manufacturing, tourism, agriculture and financial services. Full details of the tax data used to compile these tables can be found in the relevant FIAS report at <www.fias.net>

### Table C1: Comparison of METR Calculations in Agriculture

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Tanzania (with cess)</th>
<th>Zambia</th>
<th>Lesotho</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>29%</td>
<td>8%</td>
<td>30.3%</td>
<td>11.9%</td>
<td>10%</td>
</tr>
<tr>
<td>Buildings</td>
<td>12%</td>
<td>5%</td>
<td>16.3%</td>
<td>0.9%</td>
<td>23%</td>
</tr>
<tr>
<td>Land</td>
<td>-13%</td>
<td>5.3%</td>
<td>8.7%</td>
<td>4.5%</td>
<td>39%</td>
</tr>
<tr>
<td>Inventories</td>
<td>-13%</td>
<td>5.3%</td>
<td>27.5%</td>
<td>24.1%</td>
<td>7%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>7%</td>
<td>5.7%</td>
<td>23.1%</td>
<td>n/a</td>
<td>18%</td>
</tr>
</tbody>
</table>

### Table C2: Comparison of METR Calculations in Manufacturing

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Tanzania</th>
<th>Zambia</th>
<th>Lesotho</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>22%</td>
<td>14%</td>
<td>3.8%</td>
<td>-11.1%</td>
<td>10%</td>
</tr>
<tr>
<td>Buildings</td>
<td>22%</td>
<td>25.6%</td>
<td>27.7%</td>
<td>-1.3%</td>
<td>12%</td>
</tr>
<tr>
<td>Land</td>
<td>-13%</td>
<td>5.3%</td>
<td>1.6%</td>
<td>7.5%</td>
<td>47%</td>
</tr>
<tr>
<td>Inventories</td>
<td>-13%</td>
<td>32.4%</td>
<td>21.9%</td>
<td>49.2%</td>
<td>7%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>7%</td>
<td>21.3%</td>
<td>15.3%</td>
<td>n/a</td>
<td>11%</td>
</tr>
</tbody>
</table>

### Table C3: Comparison of METR Calculations in Tourism

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Tanzania</th>
<th>Zambia</th>
<th>Lesotho</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>23%</td>
<td>17.4%</td>
<td>-3.8%</td>
<td>-11.1%</td>
<td>26%</td>
</tr>
<tr>
<td>Buildings</td>
<td>13%</td>
<td>13.5%</td>
<td>20.5%</td>
<td>-1.3%</td>
<td>47%</td>
</tr>
<tr>
<td>Land</td>
<td>-13%</td>
<td>5.3%</td>
<td>1.6%</td>
<td>7.5%</td>
<td>38%</td>
</tr>
<tr>
<td>Inventories</td>
<td>-13%</td>
<td>32.4%</td>
<td>21.9%</td>
<td>51.6%</td>
<td>18%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>13%</td>
<td>13.9%</td>
<td>14.9%</td>
<td>n/a</td>
<td>43%</td>
</tr>
</tbody>
</table>
Table C4. Comparison of METR Calculations in the Financial Sector

<table>
<thead>
<tr>
<th></th>
<th>Rwanda</th>
<th>South Africa</th>
<th>Tanzania</th>
<th>Zambia</th>
<th>Lesotho</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery</td>
<td>46%</td>
<td>43.3%</td>
<td>42.5%</td>
<td>37.7%</td>
<td>59%</td>
</tr>
<tr>
<td>Buildings</td>
<td>11%</td>
<td>17.1%</td>
<td>17.4%</td>
<td>-0.9%</td>
<td>47%</td>
</tr>
<tr>
<td>Land</td>
<td>-13%</td>
<td>5.3%</td>
<td>1.3%</td>
<td>9.7%</td>
<td>38%</td>
</tr>
<tr>
<td>Inventories</td>
<td>-13%</td>
<td>32.4%</td>
<td>21.7%</td>
<td>59.5%</td>
<td>18%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>28%</td>
<td>29.8%</td>
<td>28.9%</td>
<td>n/a</td>
<td>51%</td>
</tr>
</tbody>
</table>

These results suggest that METRs in Lesotho are generally higher than those in South Africa, Zambia, Tanzania and Rwanda, except in Manufacturing where Lesotho is very competitive.

In Tourism and Financial Services, Lesotho’s METRs are the higher than economies studied so far by FIAS in Africa. These seemingly anomalous results (given Lesotho’s low headline corporate tax rates) highlight the importance of looking at how the tax structure as a whole impacts on the marginal tax on capital (i.e. taking into account depreciation allowances, etc.)

However, care needs to be taken before generalizing that “despite Lesotho’s new low corporate income tax rates it remains a high tax location for investment outside manufacturing”. Such a conclusion would be erroneous because it is very difficult to determine one standard tax regime across countries, against which to benchmark METRs. Further, this result needs to be put into context (i.e. is tax a driving force behind the investment decision or not – see the Tourism chapter for more details).

Finally, it is worth noting that METRs in developed (OCED) countries are not necessarily lower than developing countries. The average METR on manufacturing in Canada for example is 35.5%, in Australia 29.4%, New Zealand 30.1% and India 23.2%. All of these are higher than the METR in manufacturing in Tanzania (15.3%).

Commentators typically believe that developed countries can sustain higher effective tax rates on capital than less developed countries, simply because developed economies have other characteristics that are attractive to capital investment. Less developed economies, on the other hand, need to impose low taxes on capital in order to overcome the lack of these other factors and attract capital.
Annex D: Marginal Effective Tax Rates on Capital in Lesotho

Marginal Effective Tax Rates for Asset Categories and Sectors

Table D1: Open Economy Case

<table>
<thead>
<tr>
<th>METR Category</th>
<th>Manufacturing</th>
<th>Tourism</th>
<th>Agriculture</th>
<th>Mining</th>
<th>Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large Firms</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>METR Equipment</td>
<td>10%</td>
<td>26%</td>
<td>10%</td>
<td>31%</td>
<td>59%</td>
</tr>
<tr>
<td>METR Building</td>
<td>12%</td>
<td>47%</td>
<td>23%</td>
<td>8%</td>
<td>47%</td>
</tr>
<tr>
<td>METR Land</td>
<td>47%</td>
<td>38%</td>
<td>39%</td>
<td>42%</td>
<td>38%</td>
</tr>
<tr>
<td>METR Inventory</td>
<td>7%</td>
<td>18%</td>
<td>7%</td>
<td>26%</td>
<td>18%</td>
</tr>
<tr>
<td>METR Total</td>
<td>11%</td>
<td>43%</td>
<td>18%</td>
<td>26%</td>
<td>51%</td>
</tr>
<tr>
<td>Small Firms</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i.e. Open Economy and non-VAT Registered)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>METR Equipment</td>
<td>54%</td>
<td>59%</td>
<td>54%</td>
<td>61%</td>
<td>59%</td>
</tr>
<tr>
<td>METR Building</td>
<td>12%</td>
<td>47%</td>
<td>23%</td>
<td>8%</td>
<td>47%</td>
</tr>
<tr>
<td>METR Land</td>
<td>47%</td>
<td>38%</td>
<td>39%</td>
<td>42%</td>
<td>38%</td>
</tr>
<tr>
<td>METR Inventory</td>
<td>7%</td>
<td>18%</td>
<td>7%</td>
<td>26%</td>
<td>18%</td>
</tr>
<tr>
<td>METR Total</td>
<td>40%</td>
<td>49%</td>
<td>30%</td>
<td>50%</td>
<td>51%</td>
</tr>
</tbody>
</table>
### Marginal Effective Tax Rates for Asset Categories and Sectors

**Table D2: Closed Economy Case**

<table>
<thead>
<tr>
<th>Small Firms (registered for VAT)</th>
<th>Manufacturing</th>
<th>Tourism</th>
<th>Agriculture</th>
</tr>
</thead>
<tbody>
<tr>
<td>METR Equipment</td>
<td>37%</td>
<td>45%</td>
<td>37%</td>
</tr>
<tr>
<td>METR Building</td>
<td>38%</td>
<td>56%</td>
<td>43%</td>
</tr>
<tr>
<td>METR Land</td>
<td>55%</td>
<td>56%</td>
<td>55%</td>
</tr>
<tr>
<td>METR Inventory</td>
<td>36%</td>
<td>42%</td>
<td>36%</td>
</tr>
<tr>
<td>METR Total</td>
<td>38%</td>
<td>54%</td>
<td>41%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Small Firms (not registered for VAT)</th>
<th>Manufacturing</th>
<th>Tourism</th>
<th>Agriculture</th>
</tr>
</thead>
<tbody>
<tr>
<td>METR Equipment</td>
<td>61%</td>
<td>64%</td>
<td>61%</td>
</tr>
<tr>
<td>METR Building</td>
<td>38%</td>
<td>56%</td>
<td>43%</td>
</tr>
<tr>
<td>METR Land</td>
<td>55%</td>
<td>56%</td>
<td>55%</td>
</tr>
<tr>
<td>METR Inventory</td>
<td>36%</td>
<td>42%</td>
<td>36%</td>
</tr>
<tr>
<td>METR Total</td>
<td>52%</td>
<td>58%</td>
<td>47%</td>
</tr>
</tbody>
</table>

---

45 It is assumed that the Small Firms are incorporate (i.e. not sole traders).
### Table D3: METRs for an investor tax resident in South Africa v. Lesotho

#### Large Firms

<table>
<thead>
<tr>
<th>METR</th>
<th>Manufacturing</th>
<th>Tourism</th>
<th>Agriculture</th>
<th>Mining</th>
<th>Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lesotho</td>
<td>S.Africa</td>
<td>Lesotho</td>
<td>S.Africa</td>
<td>Lesotho</td>
</tr>
<tr>
<td>METR Equipment</td>
<td>10%</td>
<td>14%</td>
<td>26%</td>
<td>38%</td>
<td>10%</td>
</tr>
<tr>
<td>METR Building</td>
<td>12%</td>
<td>16%</td>
<td>47%</td>
<td>55%</td>
<td>23%</td>
</tr>
<tr>
<td>METR Land</td>
<td>47%</td>
<td>49%</td>
<td>38%</td>
<td>48%</td>
<td>39%</td>
</tr>
<tr>
<td>METR Inventory</td>
<td>7%</td>
<td>11%</td>
<td>18%</td>
<td>34%</td>
<td>7%</td>
</tr>
<tr>
<td>METR Total</td>
<td>11%</td>
<td>15%</td>
<td>43%</td>
<td>51%</td>
<td>18%</td>
</tr>
</tbody>
</table>

#### Large Firms (No Withholding Tax on Interest and Dividend)

<table>
<thead>
<tr>
<th>METR</th>
<th>Manufacturing</th>
<th>Tourism</th>
<th>Agriculture</th>
<th>Mining</th>
<th>Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>METR Equipment</td>
<td>-10%</td>
<td>25%</td>
<td>-10%</td>
<td>30%</td>
<td>59%</td>
</tr>
<tr>
<td>METR Building</td>
<td>-8%</td>
<td>46%</td>
<td>7%</td>
<td>5%</td>
<td>46%</td>
</tr>
<tr>
<td>METR Land</td>
<td>40%</td>
<td>37%</td>
<td>30%</td>
<td>40%</td>
<td>37%</td>
</tr>
<tr>
<td>METR Inventory</td>
<td>-18%</td>
<td>15%</td>
<td>-18%</td>
<td>23%</td>
<td>15%</td>
</tr>
<tr>
<td>METR Total</td>
<td>-10%</td>
<td>42%</td>
<td>-1%</td>
<td>24%</td>
<td>51%</td>
</tr>
</tbody>
</table>
REFERENCES


IMF (2005) “Kingdom of Lesotho: 2005 Article IV Consultation—Staff Report; Staff Statement: Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Lesotho”, IMF Country Report No. 05/437, Washington D.C.


