

Chapter 2

Using a Risk Management Framework in the Zambia Revenue Authority

Robert Ng'uni, Senior Internal Auditor, Zambia Revenue Authority, Government of Zambia

Introduction

This chapter considers how tax policy and administration reforms have helped to improve public expenditure management in Zambia. In particular it focuses on revenue administration as an important aspect of public expenditure management and shows how a risk management framework can be applied to improve revenue collection and by implication public expenditure management. First there is a brief overview of the public expenditure management framework in Zambia; then the expenditure system is linked to the revenue system with an explanation of how Zambia Revenue Authority (ZRA) has successfully used a risk management framework to ensure it meets its monthly and yearly tax revenue collection targets.

General overview

This is a case of how one government agency applied emerging risk management principles in the pursuit of an important public policy. Over the past two decades effective risk management, integrated at both the planning and operational levels, has become more important around the world. There has been an increase in public expectations that governments will systematically identify risks and then act upon them to mitigate their effects. In addition, the art and science of integrated risk management has matured. It has moved out of the financial and scientific worlds into all aspects of government activity. That being said, the desire for effective risk management far exceeds its realisation, especially in the public sector. It is therefore important to find examples like these that show the practical elements of risk management.

Zambia as a country has a liberal political and economic system with trade and investment regimes fully liberalised since 1991. In a bid to maintain macro-economic stability and stimulate investment and trade, the government has consistently implemented tight monetary and fiscal policies, which have been accompanied by other structural, institutional and legal reforms. Tax policy and administration and public expenditure reforms have also been implemented quite successfully in the last two decades. One such tax policy change was effected through the enactment of the Public Finance Act 2004 which introduced under section 7(3)(a) the requirement for controlling officers of public finances to maintain an effective, efficient and transparent system of financial and risk management and internal

controls. Public organisations such as ZRA are therefore required through legislation to maintain a system of risk management which should be effective, efficient and transparent, to support public expenditure management.

The advantage of implementing the risk management framework at ZRA was to increase revenue collection and make it more predictable by promoting efficiency in revenue allocation (budgeting) and hence reducing resource wastages that do not help maximise and sustain tax revenue collection.

In general, risk management recognises the significance of mitigating negative impact on organisational goals before it happens and taking advantage of opportunities that may arise because of the organisation properly managing the risk. Therefore, risk management is becoming an important tool for efficient and effective public expenditure management in both raising resources and allocation of such resources to public expenditure programmes. There is a growing and deliberate approach by governments to require risk management as a way of conducting government operations, especially in the management of tax revenues to enable the government to achieve delivery of its programmes.

Risk management as a systematic methodology of identifying, analysing and treating risk is a relatively emerging concept and as such may not be widely applied in Commonwealth countries especially for the purpose of public expenditure framework. Therefore, its application at ZRA may be of significance as a learning point for other Commonwealth countries.

Zambia's tax collection is centrally managed through ZRA, which employs around 1,300 people. It collected 8,193.1 billion kwacha (about US\$2.1 billion) in the year 2007 and 9,350.9 billion kwacha (about US\$2 billion) in 2008 through income tax, value added tax and customs duties. ZRA has been continually improving its tax collection mechanisms to respond to the changing business environment. Risk management at ZRA has since evolved to become the main tool for planning, and more recently cascaded to the operations within the organisation.

The ZRA governing board brought risk management to the fore in 2004, soon after the enactment of the Public Finance Act which made a requirement for public organisations to have an effective, efficient and transparent system of financial and risk management and internal controls under section 7(3)(a). The initial risk management framework was drafted through a team of risk champions appointed by senior management. The team comprised management staff and experts from operating divisions who were tasked with drafting the risk management framework, setting the risk register templates and including initial identified risks in the registers. The process was subject to approval by the ZRA governing board.

The risk champions were trained through an intensive hands-on training programme with the objective of developing an understanding of corporate risk management and drafting a risk management framework in line with the working practices within ZRA. The training was conducted by external and internal experts in risk management. Then followed a series of training meetings and workshops to explain the risk management framework to the entire ZRA management. Zambia Revenue Authority Internal Audit Division became the

driving force conducting the strategic planning workshops at which the risk management process was explained to ZRA management of operating divisions. Hence the internal audit became the centre of expertise for advice on the risk management process.

Public expenditure occurs within the premise of a well-defined government revenue collection mechanism, which must be both predictable and sustainable to minimise disruption to public expenditure. Zambia Revenue Authority supports the public expenditure framework of the government through collection of tax on behalf of the Government of Zambia, ensuring sustained availability of revenue to support public expenditure.

Public expenditure management in Zambia

Zambia has a quite elaborate public expenditure management system. The Ministry of Finance and National Planning is the hub of disbursement of public funds collected from both tax and non-tax sources through the secretary to the treasury who, in accordance with the Zambia Public Finance Act 2004 section 7(1), designates officers in charge of controlling public funds disbursed to respective line ministries subject to approval by the Zambian parliament. Approval is detailed in a document called a yellow book which shows expenditure plans of all government departments. There are permanent secretaries at ministry level who are the controlling officers for all public expenditure. However, this expenditure framework can succeed only if revenues are predictable to facilitate effective budget execution. Therefore, at the beginning of each fiscal year, which commences around the month of April, parliament sets tax and non-tax revenue collection targets and directs these towards ZRA.

Between 1980 and 1990, the public budget execution was so inefficient and ad hoc that it lost credibility and significantly stifled public expenditure programmes. This is largely because the treasury functions of the Ministry of Finance could not adhere to funding profiles, due to insufficient and erratic flow of tax and non-tax revenues into the treasury. This generated a secondary behavioural aspect in civil servants charged with the responsibility of budget execution. They had lost confidence in the process because when government departments requested funds as per budget these funds were not readily available, due to the unpredictable manner in which they were being collected by the ZRA. As a result public officers would request funding from the treasury well in advance, before they were ready to spend the money. This created further inefficiencies in the public expenditure system when funds were held that were not immediately required for public expenditure in some government departments and in other departments there was a lack of funds which were sometimes critical to the overall achievement of government programmes.

To help address this problem, government requested that revenues be predictable and increased, leading to the tax policy and administration reforms that were undertaken. One of those reforms was in the funding of ZRA, which like every other government department or agency was based on the medium-term expenditure framework (MTEF). This framework publishes estimates of revenue by source and then how the revenues are proposed to be allocated across different expenditure lines on a three-year cycle. It also shows the projected deficit, often capped at a reasonable percentage to GDP to support macro-

economic stability. In essence, the MTEF has two important blocks: the revenue block which estimates government revenue by source (taxation, non-tax revenue, grants and loans), and the expenditure block, which details estimated annual expenditure based on activity-based budgeting. Money not spent in a particular year is recalled to form part of the next budget.

Despite the funding being fixed in advance, the tax revenue collection targets were increasing disproportionate to the funding pattern. In adapting to these changes in the revenue administration, ZRA had to employ innovative mechanisms in its tax administration to manage risks and maximise revenue collection relative to expenditure, in line with the requirements of the Public Finance Act 2004. Management at ZRA therefore drafted a risk management policy document detailing the methodology, which was essentially a hybrid of adaptations of risk methodologies such as the COSO model.¹³ The working definitions for the different stages of the process include risk identification, analysis and treatment.

The risk management document sets out the risk policy statements. The general policy statement indicates that the risk management process at ZRA is aimed at achieving nine critical objectives, namely:

- Developing financial, operational and management systems that support management of risks to corporate objectives;
- Maintaining active, structured and commonly shared knowledge of risks that need to be managed;
- Developing staff objectives that reflect ZRA's strategic and operational risk priorities;
- Assigning management of risks to staff who have appropriate authority to manage them;
- Assigning resources to management of risks in a way that optimises value for money;
- Communicating management priorities in respect of risk down the organisation;
- Ensuring that the management view is informed by upward reporting of risks;
- Ensuring that systems of control support the preparation of the Statement of Internal Control; and
- Embedding the risk management system into the corporate business and planning process.

Hence management set the tone to the effect that risk management had to be translated into the corporate culture of ZRA from the planning stage to execution stage. Several risk management aspects such as the risk appetite are set in the risk management framework document. Apart than documenting the risk management framework, ZRA has appointed risk champions at divisional level to co-ordinate the implementation of the risk management framework at operational level. A risk committee has been set up at corporate level to oversee the appropriate cohesion of the implementation of the risk management framework. Risk management at corporate level is under a risk manager who reports to the

directorate of research and planning. There are risk registers in place at both the divisional level and corporate level capturing the current and emerging risks. Divisional risk champions and the risk manager maintain these respectively.

Revenue administration in Zambia

Zambia Revenue Authority has developed the criteria and decided on the structure of the risk management process the organisation has undertaken. The corporate plan for ZRA runs for a period of three years. Each ZRA division then derives its divisional action plan from the corporate plan for the year, while also reflecting its division mandates and vision. The divisional action plan is further cascaded down into work plans, and individual (staff) performance management contracts are derived from the action points in the action plan.

As a result of the risk management process ZRA has helped bring confidence in the public expenditure framework of the Government of Zambia by ensuring predictable and sustainable revenue inflows to support public expenditure.

Risk management for revenue administration

Zambia Revenue Authority conducts strategic planning at corporate level and at operational level. The strategic planning at corporate level involves defining corporate objectives following the corporate risk management framework, which includes defining the relationship between ZRA and its environment, and identifying the organisation's strengths, weaknesses, opportunities and threats (SWOT).

Priority areas ranked according to the risk management framework form a basis for budget setting, which is tied to revenue collection as set out by parliament in Zambia in the annual budget where revenue collection target are set. Tying revenue collection to the risk management framework ensures that areas of priority are attended to, enabling ZRA to achieve the set revenue targets.

Role of internal audit

The role of internal audit is to provide an independent assurance and consulting service on the risk management framework. Therefore, internal audit at ZRA quality assures the controls meant to mitigate risks in revenue administration both in customs duties administration and income tax administration. Further, internal audit quality assures the risk management process on an annual basis and by so doing ascertains whether management allocates funds according to priorities arrived at using the risk management framework. It makes recommendations on the efficient, economic and effective way of resource allocation and use. At ZRA, the role of internal audit in the risk management process is to assure the governing body about how the risk management of a system has functioned in the previous year and to make recommendations on how it could be improved. Thus the internal audit role at ZRA has been and continues to be providing a monitoring mechanism that assures the effective and efficient revenue administration.

The environment in which taxes are administered is dynamic, and emerging risks are identified and evaluated by internal audit through its assurance work involvement on critical ZRA system projects at which an array of consultancy activities are offered by internal audit. Recommendations are made on the reallocation of resources to ensure ZRA meet its revenue collection targets. This has helped in ensuring predictability in revenue collections and in ZRA meeting monthly and annual revenue targets.

Key challenges in implementation

The objective of implementing the risk management framework at ZRA was to increase revenue collection and make it more predictable by promoting efficiency in revenue allocation (budgeting) and hence reduce resource wastages that do not help maximise and sustain tax revenue collection. Zambia Revenue Authority has over the years formed a reputation of exceeding its tax revenue collection targets and has succeeded in collecting tax revenue at minimum cost due to its risk management mechanisms, which minimise resource wastage and focus resources to critical tax revenue collection functions.

Zambia Revenue Authority has, nevertheless, faced challenges in the funding for operational purposes, which has limited its capacity to implement mitigating controls to tackle all the critical risks that permit tax revenue leakages or minimise predictability of revenue collection. The funding for operational purposes is not related to the revenue targets set by parliament.

For example, not all the action plans arising from the risk management workshops are funded for implementation. In the area of customs, border smuggling has been identified as a risk to maximising tax revenue collection. However, responses such as procuring border-mounted or mobile scanners and deploying human resources to act as deterrent to the scourge have not been fully funded. Smuggling therefore continues to be a big challenge in areas where natural barriers are non-existent, providing porous points for illegal entries and revenue leakages. This challenge is envisaged to be addressed by way of relating cost of collecting tax as a percentage of targeted revenues to be collected in any particular year. A presentation has been made to the parliament of Zambia that ZRA intends to seek government support in ensuring funding allocated for tax administration is directly proportional to the revenue target set by parliament. This is intended to ensure areas of revenue leakage receive attention. This challenge of funding is yet to be resolved.

Furthermore, ZRA has not fully achieved operationalising the risk management framework across all the divisions. Although the risk management framework has been operationalised in the administration of customs duties collection through the ASYCUDA system, the other critical revenue collection functions such as the inland taxes have not fully operationalised risk management in the collection mechanisms. This has been attributed to the failure of a system implementation of an integrated tax administration system, which, though fully funded, did not take off as expected. This in turn has caused the administration of inland taxes to lag behind in operationalising risk management. Zambia Revenue Authority is in the process of modernising the tax administration and implementing integrated tax administration systems to address not only tax collection bottlenecks but also

the issues of taxpayer services such as electronic real time payment systems for tax so that the risk management framework operationalised across all the divisions.

The main factor in successfully implementing the risk management framework at ZRA has been management support: direct involvement of both senior management and the governing board. This has seen risk management being funded and supported, with training of key staff such as risk champions and middle management through participation at planning workshops that are organised at a cost to ZRA. Support from government and from the governing board has encouraged staff at key levels of the organisation to embrace risk management. This has helped entrench the concept into a corporate culture because the support is from all stakeholders.

Key lessons learned

At ZRA the implementation of the risk management framework has established that organisation goals can be achieved in a systematic way. The other lessons learned in the implementation of the risk management framework include the following:

- Risk management implementation requires the involvement of management in setting the policy and driving the process;
- Implementation of a risk management process requires resources – either human capital or financial resources and time commitment;
- The risk management process takes time to be adopted as a way of conducting business by all the stakeholders, so it requires consistent management drive and planning for stakeholder buy-in to be achieved; and
- An enterprise risk management mechanism can sometimes be slowed by some functional disparities involving integrated computer systems where these are main drivers of operations and the main source of management information system.

Conclusion

The objective of a risk management framework in public expenditure management is to provide predictability and efficiency in both the revenue collection and public expenditure. When applied effectively, risk management can help enhance revenue collection through efficient allocation of resources targeted at maximising operations and minimising costs in revenue-collecting institutions. For ZRA the risk management framework has enabled the meeting of revenue targets and this has helped support public expenditure. For example, whereas prior to the introduction of the risk management framework tax revenue collection was unpredictable and sometimes falling below the targeted collection, the introduction of the risk management framework has largely reversed this trend and has helped improve planning and the budgeting process. The revenue collections faced a challenge in the first and second quarter of 2009 due to the global economic recession which saw Zambia's foreign exchange earnings tumble and the consequent reduction in custom duty collection. However, the resilience of the risk management model has helped mitigate the impact on the overall tax collections and ensured predictability and sustenance of tax revenue.

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Note

- 13 The COSO model of risk management is an integrated risk management conceptual framework created by the Committee of Sponsoring Organizations of the Treadway Commission. For more information see: www.coso.org [accessed August 2011]. This model suggests the need to tie risk management to corporate strategy as well as internal culture to achieve a fully integrated approach.