

VAT: Why the private sector complain so much, and what we may be able to do about it.

The basics

1. Complaining about Tax is popular. It is guaranteed to get unanimous agreement in the bar or club. There are few other topics where groups will agree ...
2. But looking deeper why is VAT so unpopular? After all, it is a near universal form of consumption taxation (operating in around 150 countries) and it is far better and fairer than the selective Sales Taxes it replaced.
3. If you look at the range of VATs in operation worldwide, you cannot fail to conclude that the tax is incredibly flexible, and note that it can, and does, operate successfully with a wide range of rate structures and relief provisions. Obviously all countries are different (economically, socially and politically) and this is perhaps why not just VAT but excise taxes and taxes on income and profits vary considerably. As regards VAT perhaps the wide divergences are because:-
 - Taxes are inherently political, and have to satisfy political needs as well as economic ones. And politics tends to complicate where theory would argue for simplicity. Can we change this – no - it is the nature of politics and electoral considerations (in democracies) favour the status quo (or the award of further concessions) rather than a return to absolute tax simplicity.
 - Special interest groups exaggerate arguments for special treatment in order to get it. However little analytical work is routinely done by governments (and is certainly seldom published) to investigate the rights or wrongs of concessions granted. People don't like to be proved wrong 'post hoc'. As a result, once concessions are given they are hard to withdraw, even when the underlying circumstances change.
4. VAT in concept is:-
 - a simple tax with a broad base covering all goods and servicesbut most countries have departed from the theoretically perfect VAT design – a single low rate applied across the board. In short, politicians complicated it...introduced many exemptions...eroded the tax base....increased the tax rate....leading to increased evasion....and tougher and more oppressive enforcement The target must remain to get back to as close possible to one low rate covering everything except exports.
 - a tax on consumption by final consumers. It should not be a cost on businesses. But VAT designs often maximise exemptions and restrictions on deducting input tax so that businesses become the de facto final consumer.
5. It is argued that VAT is cost neutral between businesses. That is true up to a point. Retailers/cash service businesses definitely gain a cash flow advantage (they have

the use of the tax collected on sales until it is due to be paid – say an average of 3 or 4 weeks). Manufacturers on monthly returns have an average of 3-4 weeks to get their sales paid for by their customers before having to pay the tax across to the Revenue Authority. Is 3-4 weeks a realistic timeframe to secure payment? For example, what if a main purchaser is Government who, as we all know, do not pay fast? Are monthly tax periods too short? The UK has 3 months for most businesses and monthly returns are used only for repayment traders and those who are non compliant. Is this a fairer model?

Compliance costs of VAT

6. Income Tax is a tax on profits and clearly a cost on businesses, as accountants are paid to calculate the liability and complete the tax returns. PAYE/Income tax is levied by the employer on the payroll and, like VAT, collected by them as ‘an unpaid tax collector’ - this is rarely complained of, presumably because, they regard it as a service they provide for employees. However, the operation of VAT is a cost to businesses – they are our unpaid tax collectors. Do we recognise this? Should we recognise this?

7. There are many papers and studies on the costs that Value Added Tax place on business. Cedric Sandford (Sandford C, M R Godwin, and P J W Hardwick, 1989, *Administrative and Compliance Costs of Taxation*, Bath, United Kingdom, Fiscal Publications), found that across a sample of UK industry, VAT compliance costs in broad terms were some 4% of revenues raised. Later studies have found that small businesses and those involved in cross border trade bear disproportionately higher compliance costs compared to other businesses. Sandford laid out three separate elements to the costs of compliance:-
 - (1) the fiscal costs associated to establishing and registering a company, the employee costs of running day to day VAT accounting, the cost of expertise to understand and keep up with changes in policies and rates, the cost of submitting VAT returns, and the cost of external accountants for operational and advisory services;
 - (2) the costs of the time of senior management in overseeing the function – in theory these can be turned into money, but in reality this is a very scarce resource in a company;
 - (3) the psychological costs caused by the onus being on the business to conduct their VAT affairs properly, with financial and civil/criminal sanctions for failing to do so.

8. Studies suggest that it is the very small companies just above the VAT threshold who bear the heaviest burden - in the UK a National Audit Office study in 1994 found that, in the smallest companies, the cost of VAT compliance was some 20 per cent of the tax paid. A more recent European Commission survey (European

Tax Survey, Working paper n°3 October 2004 ISSN 1725-7557) found that the absolute compliance costs (for VAT and corporate taxes combined) corresponded to 1.9% (of sales) for Large Businesses but 30.9% for Small and Medium-sized Enterprises (SMEs).

9. Drawing on this Tax Survey one might conclude that the factors that are likely to cause a high cost of VAT compliance are likely to include:-

- the turnover threshold for VAT registration;
- collection costs surrounding higher rates of VAT;
- exemptions that result in VAT registered businesses being unable to reclaim all their input tax;
- differing treatments of the liability to VAT of goods and services exist between countries (think of the difficulties our VATs must bring for e.g. Shoprite or PEP Stores who operate in many countries in the region);
- the nature of exemptions from VAT in a number of countries, which impose the burdens of documentation requirements and time limits to prove that the exemption thresholds and criteria for each country are being met (particularly applicable to large multi nationals and investors particularly in the Tourism and Mining sectors);
- transfer of own goods to another country may require registration in the other country for the acquisition and also the subsequent sale of the goods;
- supplies of services where the VAT treatment can depend on the type of service or the identity of the customer (e.g. a public sector/diplomatic/aid organisation).

10. Any VAT borderline (whether caused by multiple rates or by a relief provision) must be likely to have an impact upon the compliance costs of VAT registered businesses. For example, retail businesses need to either identify sales at different VAT rates at the point of sale (on their cash registers) or compute the apportionment based on the proportions of purchases made at the respective rates. Where businesses supply exempt goods or services, further complications (and administrative costs) arise as businesses have to separate out the purchases that relate to exempt supplies and ensure that no input tax is deducted in respect of them (as well as foregoing a proportion of the input tax incurred on business overheads). These 'Partial Exemption' calculations vary between countries - some countries permit the use of simplified partial exemption methods to reduce the administrative burden, but most countries require:-

- partly exempt taxpayers to directly allocate input tax VAT to taxable and exempt supplies made; and
- where direct attribution is not possible, to only deduct only a pro rata amount of the unattributable input tax (based on the proportion of the value of taxable supplies to the value of total supplies made).

The face of tax administration

11. Most African VATs have been introduced in the last 15 or so years and replaced Sales Taxes of one sort or another. In so doing, the tax net was widened to include the retail level and a wide range of service trades. Hitherto the Sales Taxes were collected mainly from larger businesses (mainly in manufacturing) or at import. However, under VAT, a large number of small and medium sized businesses (SMEs) had their first face to face contacts with the newly formed (and more aggressive) Revenue Authorities – Income Tax on profits being an annual calculation done by their accountants keeping the taxman at arm's length. VAT changed that and brought the taxman to their premises; imposed stricter record keeping requirements; wanted returns usually monthly; and imposed stiff penalties for non compliance. Is it any wonder, therefore, that VAT is pretty unpopular as a form of taxation?

Possible solutions

12. So far I have described the problem – it is now time to start looking at possible solutions or things that can be done to ameliorate the downsides of VAT tax design and administration. The list is not exhaustive but will, I hope, encourage VAT administrations to review how they do things and formulate the steps they can take to improve the image of the tax.

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VAT – The problems and their possible solutions

Problem	Solution
<p>1. Help, advice, publicity</p>	
<p>VAT law is seldom available, in a up to date consolidated form; leaflets are often out of date, out of print, not available on line and provide limited coverage. Average number of VAT leaflets in the region, I guess is about 10. UK has 130 VAT leaflets and a further 60 or so VAT Information sheets. Using professional advisers – accountants, tax consultants is expensive (and they may or may not understand the details of the tax). Web sites rarely contain up to date leaflets and a complete set of forms that can be downloaded.</p>	<p>Businesses need to have access to information in a readily digestible form and the ability to speak to or visit knowledgeable VAT advisers at times convenient to them. ie look at the quality of the VAT advice staff, accessibility – location and hours of opening, call centre times, websites and increase the quantity and quality of reference material available (all leaflets should always be readily available). In short Revenue Authorities need to invest more in securing <u>voluntary tax compliance</u>.</p>
<p>2. Registration</p>	
<p>Forms and information not readily available. One of many registrations a business is required to make (egg for a TIN, other Taxes and Customs). Each require different information but require the same accompanying documents – certificates of incorporation, business plans, etc etc. Registrations require many visits and can take many months. Again using professional advisers – accountants, tax consultants is expensive. Back dated registrations create business costs (cannot usually charge output tax to past customers).</p>	<p>Information and forms should be readily available at ‘one stop shops’, open at times convenient to business. One Revenue Authority TIN registration to collect most of the required information and all the required accompanying documentation. Registrations should not generally be retrospective (except in cases of fraud).</p>
<p>3. Returns</p>	
<p>The forms are claimed to be too complicated (too many boxes) and monthly is too much of a burden</p>	<p>The complexity of VAT returns varies considerably between countries. The VAT return in France has 40 boxes. In essence the VAT return data that is essential can be distilled down to only 5 boxes –</p> <ul style="list-style-type: none"> Box 1 - VAT due on Sales Box 2 - VAT on Purchases Box 3 - VAT payable or repayable (i.e. Box 1 – Box 2 or Box 2 – Box 1) Box 4 - Total Sales Box 5 - Total Purchases <p>The VAT return frequencies can also be varied – for smaller compliant</p>

	taxpayers – three monthly returns should be the aim. [This will also reduce processing costs for the Revenue Authority and have minimal impact on revenue cash flows]
4. Cash flow costs	
The shorter the tax return period the greater the potential impact on business cash flows. For non cash based businesses they find that they have to pay the VAT on their sales before their Customers have paid them. Also if VAT has to be paid outright at importation this means that stock is not being carried tax free.	The aim of the mechanics of VAT must be to get as close as possible to the aim of all stock being carried ‘tax free’. Differential tax period lengths to reflect the cash flow realities of life (ie longer for manufacturers and shorter for retailers) can ameliorate this. Some relaxation of the requirement for established (ie trustworthy) businesses to pay VAT upfront at importation can also help. The availability of cash accounting for SMEs can also be of considerable assistance.
5. Refunds	
Delays in refunding VAT repayments and procedures that place administrative costs on business are a frequent complaint. A tax structure that makes many taxpayers receive regular VAT refunds is a problem. It is inevitable for exporters but should be avoided, wherever possible, for home supplies. If the tax base zero-rates basic foodstuffs or other essential goods then regular refunds from these sectors can be anticipated.	Businesses that regularly claim refunds, because they convert standard rated purchases/imports to zero rated sales, should be easy to identify and predict. A VAT import deferred or postponed accounting system can reduce cash flow costs. The Lesotho ‘up front’ VAT repayment scheme is an excellent model (under which regular VAT refund claimants – exporters – receive an automatic monthly refund in advance of their return being submitted). Other methods are possible (auditor certificates etc) but all impose costs on businesses. The worst VAT refund operations require copies of all tax invoices to be submitted and/or have a 100% audit requirement. Such methods increase the costs greatly for both business and the RAs and create an adversarial climate.
6. Penalties/interest	
Penalties or interest are levied at non commercial (ie punitive) rates and, where genuine errors have been made, cannot be passed onto customers.	<p>For ‘genuine errors’ penalties or interest should be charged at rates that are not unduly punitive. Where genuine errors have been made the tax levied should only carry interest akin to commercial restitution (ie at rates similar to the rates commercial banks charge).</p> <p>In cases of fraud or negligence charging a penalty that is punitive is reasonable and such actions can act as a vehicle for enhancing voluntary compliance.</p> <p>Delays to furnishing VAT returns should be marked with a penalty but not at levels that will preclude the survival of the business.</p>

<p>7. Non deductible input tax</p> <p>Restrictions on non deductible input tax are viewed as a tax on business – cf the basic tenet of VAT as a tax on consumer expenditure</p>	<p>There are many input tax deduction restrictions beyond the obvious one of non business purchases. To get around apportionment difficulties between business/non business expenditure on cars, fuel, phone costs, business entertainment/staff meals etc many VATs make the whole category non deductible. Businesses perceive this as unfair (especially if the deduction rules for VAT are different to those pertaining to Income tax).</p> <p>Partial exemption calculations are also perceived as unfair (as well as difficult to operate).</p> <p>Disallowing input tax on defective tax invoices is also seen as unfair – the RA should penalise the supplier not the recipient of the supply.</p>
<p>8. Audits</p> <p>Complaints are many and varied and include:-</p> <ul style="list-style-type: none"> - There is a disproportionate focus on large businesses – which is expensive on their management time - Auditors have an underpayment mentality .. no invoice no input tax. - Businesses incur costs in contesting erroneous (speculative) assessments. Integrity is also a concern with the suspicion that many ‘technicalities’ are picked up just to create the climate for inducements to be sought/paid. - VAT auditors frequently do not make appointments and expect immediate attention – causing disruption to the business - Auditors ask for information that may already have been provided (e.g. Financial accounts submitted for Income Tax) etc - Little co-ordination across tax types and even within VAT and many visits - Tax underpaid frequently cannot be passed onto the customer 	<p>Revenue Authorities should have a risk based audit programme (ideally covering all tax types). Audits should be carried out by appointment and co-ordinated across tax types. All visiting by RA staff should be consolidated into an audit function, and all visit requirements (except for debt collection or fraud investigation) channelled to that function.</p> <p>Auditors must be encouraged to move away from the underpayment mentality and have their performance judged by the quality of the audit rather than revenue found. Additional revenue paid (rather than that assessed) is, in any event, a more accurate measure of auditor effectiveness! Ideally the compliance impact of an audit should be assessed but that has not proved possible even in the Western countries.</p>

9. Investigation	
Investigations are ineffective so honest businesses do not have a level playing field and VAT fraud is rampant (with VAT staff taking bribes etc from the fraudsters).	Non compliance must carry a price and an effective investigation arm (and Court processes) is a vital part of achieving voluntary tax compliance. If the skills etc are not available then capacity must be built to produce a realistic investigation service. RAs rarely link across taxes – smugglers do not pay VAT or Income tax on the sales of smuggled goods; sales suppressed for VAT after Income Tax on profits. Greater co-ordination across taxes is called for.
10. Records/requirements	
Record keeping is seen as a cost – a cost brought on by VAT. And where ‘tax tills’ are required that is an added expense	Record keeping is necessary for the running of the business, as well as for Income Tax. Many businesses fail to connect the size of the accountant’s fees with their lack of records! Revenue Authorities could make it easier for businesses by providing (free) record books (or spreadsheet models) and by offering training in basic business record keeping.
11. Debt collection	
Debt collection under VAT is viewed as heavy handed – using oppressive legal powers.	If VAT has been collected from customers and not paid across to the Revenue Authority – the recovery powers should, of course, be exercised. But where a business has not been paid by their customers more sympathetic stances are required – Time to pay agreements (that reflect a realistic cash flow projection) should be offered. Extending cash accounting can avoid many such difficulties.
12. Appeals	
Appeals against VAT assessments can be expensive, slow and require payment up front.	An accessible appeals mechanism is a vital part of good tax administration. The RA should welcome appeals either on points of law or on matters of fact and only press for up front payments/deposits when the case is viewed as a delaying tactic or otherwise not a genuine appeal. Before cases go to an appeal Tribunal the RA should conduct an independent review in house and decide objectively if the assessment or ruling should stand.

13. Simplified schemes	
<p>'One size does not fit all' - there are no special provisions to help smaller businesses or those in particular business groups.</p>	<p>A good VAT will have a range of special methods (e.g. for Partial Exemption or for Retailers) to enable affected businesses to operate the tax easier.</p> <p>Cash accounting is vital for many businesses and should not be restricted to only small businesses – many who deal with donors or Government are also deserving cases.</p> <p>Import VAT deferment is another easement that can be offered to compliant businesses to avoid cash flow costs.</p> <p>Longer VAT return periods for smaller, compliant, business reduce administration costs for both the business and the RA.</p> <p>Flat rate schemes that take a percentage of turnover as the 'Value Added' in lieu of requiring the keeping of listings of purchases and sales can also assist small businesses (with little VAT revenue impact). The French 'forfait' system carries this further and requires the RA and the taxpayer to agree a legally binding amount of VAT due for 2 or 3 years ahead – and gives small businesses some certainty (and an additional incentive to grow).</p>
14. Large taxpayers	
Expect preferential treatment	Special efforts should be made to encourage large taxpayers to comply voluntarily. Building up a good working relationship, via a dedicated VAT contact person in the RA, is a good first step.
15. Investors	
How standard is the VAT? The less standard it is the greater the costs of employing advisers.	The less standard the VAT is (compared to VATR's internationally as well as in Africa) the more it will cost a business to understand and/or operate. A standard VAT will reduce their compliance costs and be more likely to encourage investment. Constantly changing VAT provisions, non standard features, non availability of the law or guidance will all put investors off.