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ZiCA 2025

The Case of Value Added Tax

Comments on the Domestic Resource Mobilisation

February 2025

Agenda

1. Overview of the VAT System
2. VAT Policy and Administration
3. Ideal vs Real VAT Policy and Administration in Zambia
4. Conclusion and Recommendations



01

Overview of the VAT System



General Overview¹



Introduction to VAT

Modern fiscal innovation, introduced less than 50 years ago.

Contributes approximately 25% of total tax revenue in many countries.

Definition and Purpose

Tax on consumption, levied at multiple stages of production.

Ensures tax burden is borne by the final consumer.

VAT generates significant revenue, with some countries raising over 10% of their GDP from this tax.

Historical Development

Concept traced back to the 1920s.

Many countries have increased their VAT rates over time.

Global Spread

Adopted widely from the late 1960s.

As of 2001, implemented in about 123 countries.

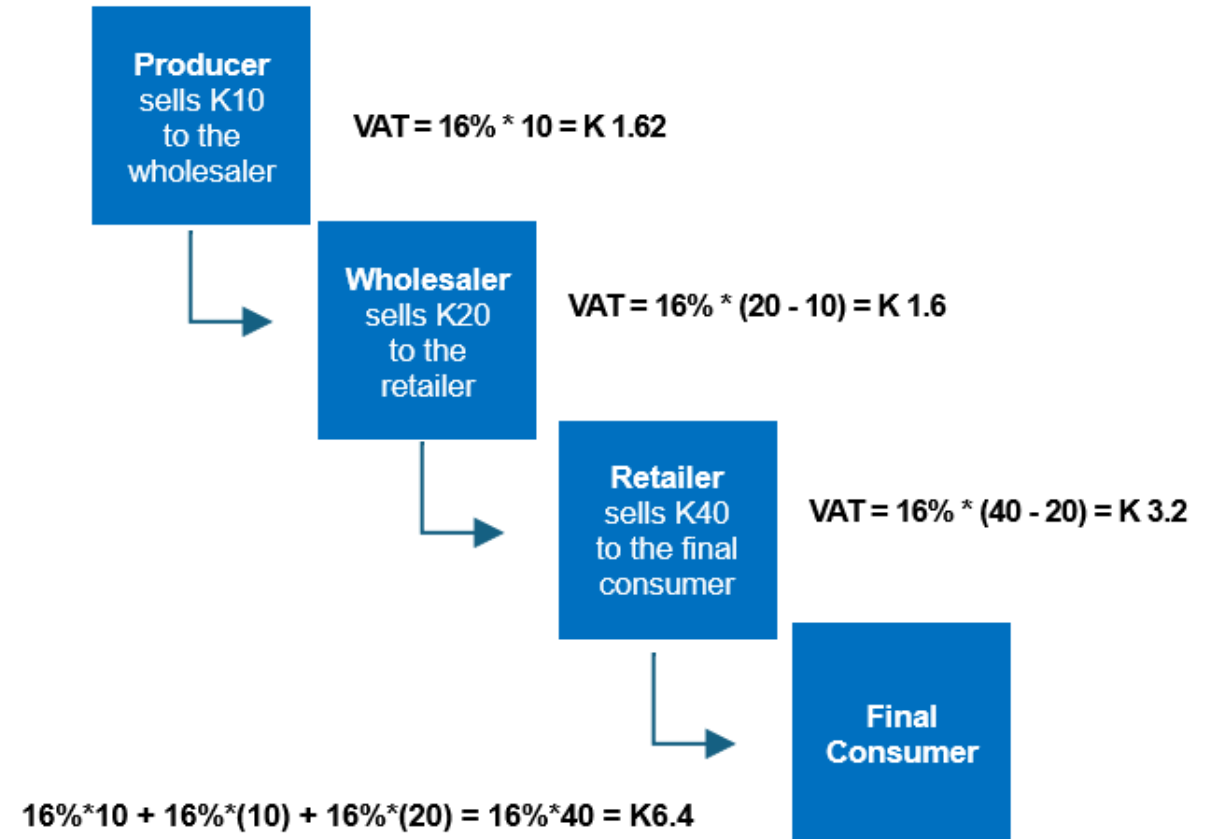
VAT systems have become more complex, with multiple rates in some countries.

History, Overview and Mechanism of VAT in Zambia²



According to the ZRA VAT guide, VAT is an indirect tax introduced in Zambia on July 1, 1995, to replace the Sales Tax system. The primary objective of this transition was to create a more efficient and transparent tax system that could better support the country's economic needs.

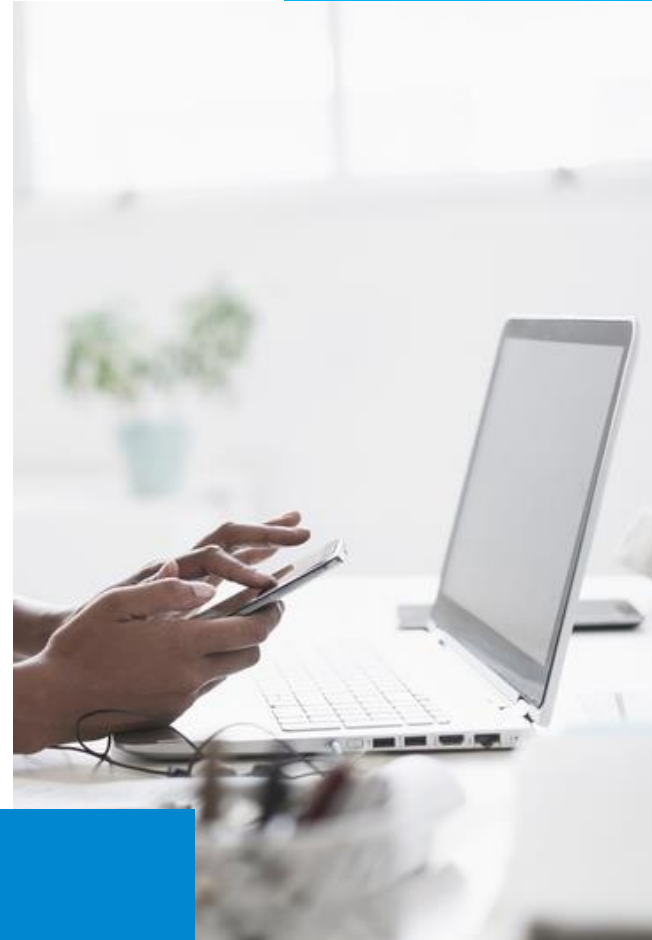
- VAT in Zambia operates on an invoice-based system.
- Applies to all businesses in the production chain (manufacture to retail). Also levied on imports.
- VAT collected at each stage when value is added to goods/services.
- Applies even if goods/services are sold for less than purchase amount, with exceptions like Open Market Value.



The ZRA administers VAT through its Indirect Taxes and Excise Division, under the Value Added Tax Act, Chapter 331, supplemented by regulations and rules issued by the Minister and Commissioner General.

02

VAT Policy and Administration





Ideal VAT Policy and Administration³

The "good VAT" is characterized by several well-defined norms that ensure its efficiency and effectiveness as a revenue tool:

1. Broad Consumption Base

VAT should cover a wide range of goods and services with minimal exclusions. This broad base maximizes revenue, minimizes distortions in consumption patterns, and ensures that the tax system is equitable, with all sectors contributing fairly to the revenue.

2. Single Rate

A single, uniform rate applied to all taxable goods and services simplifies administration and compliance. It reduces opportunities for tax evasion and disputes over classification, minimizes administrative complexity, and makes the tax system more transparent.

3. Minimal Exclusions

Exemptions should be limited to avoid complicating the tax system and creating loopholes. Common exclusions might include basic necessities, but these should be kept to a minimum. Limiting exemptions helps maintain the integrity of the tax base and ensures that the VAT system is not undermined by special interests.



Ideal VAT Policy and Administration

The "good VAT" is characterized by several well-defined norms that ensure its efficiency and effectiveness as a revenue tool:

4. Invoice-Credit Method

The calculation of tax liability should use the invoice-credit method, where businesses can deduct the VAT paid on their inputs from the VAT collected on their outputs. This method ensures that VAT is only paid on the value added at each stage of production and distribution, promoting transparency and accountability in the tax system.

5. Destination Principle

VAT should be levied on a destination basis, meaning that goods and services are taxed in the country where they are consumed. This principle ensures that exports are zero-rated and imports are taxed, maintaining neutrality in international trade. The destination principle helps prevent tax competition and ensures that VAT does not distort trade patterns.

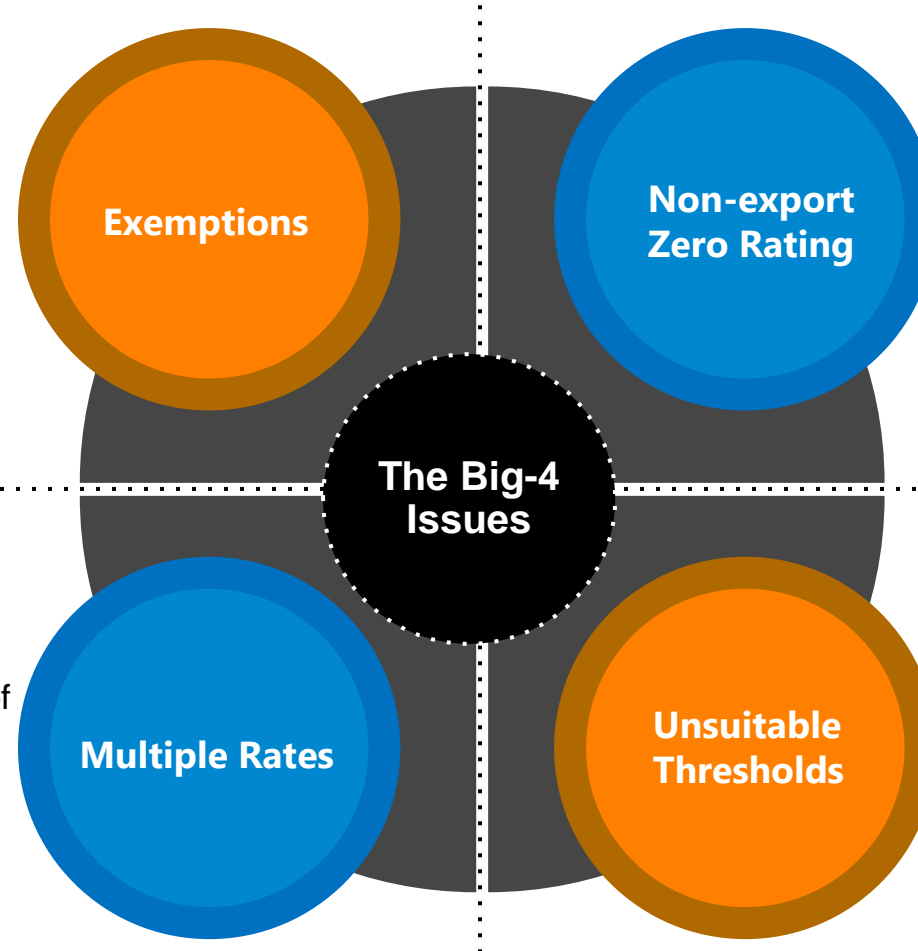


Challenges in Developing Countries

1. The Big-4 Issues

The implementation of VAT in developing countries faces significant challenges, known as the "Big-4 Issues," which prevent achieving the ideal "good VAT" status.

- Widespread exemptions complicate administration and reduce revenue.
 - Exemptions can expand over time ("exemption creep"), eroding the tax base.
 - Exempting government purchases increases compliance costs and risks VAT-free personal consumption.
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- Complex rate structures complicate administration and invite classification disputes.
 - Can lead to "rate creep," expanding the range of goods/services with reduced rates.
 - Sectors like tourism may benefit from reduced rates, leading to increased refunds and further demands for reduced rates.



- Zero rating of domestic supplies, like foodstuffs, leads to revenue loss and administrative challenges.
 - Often benefits higher-income households more than low-income households.
 - Can cause disputes over classification, increase fraud opportunities, and disrupt the VAT chain.
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- Low registration thresholds burden tax administrations and contribute little to revenue.
 - A small number of large businesses account for most VAT collections, while many small businesses contribute little.
 - Setting thresholds too low can lead to inefficiencies and focus on low-revenue-generating small businesses.



Challenges in Developing Countries

2. Policy and Administration Clash

In developing countries, VAT implementation faces challenges due to the clash between tax policy (design and theory) and tax administration (practical implementation and enforcement). This separation leads to inconsistencies and inefficiencies.

1. Registration and Segmentation

- Effective VAT administration requires understanding the registrant population and segmenting them by turnover.
- Segmentation helps target administrative efforts, as compliance by large businesses presents different challenges than compliance by small businesses.
- Large taxpayer units (LTUs) are used to manage segmentation, focusing on data collection and maintenance for large registrants.

3. Refunds

- Refunds are a significant challenge, especially when arising from non-export zero rating and VAT withholding.
- Various administrative strategies, such as zero-rating supplies to exporters and certification of refund claims by CPAs, have been developed to mitigate refund problems.
- Refunds can be delayed, subject to restrictions, and lead to cash flow problems for compliant businesses, affecting their operations and trust in the tax system.

2. VAT Withholding

- Intended to improve compliance by assigning the responsibility of withholding VAT to purchasers, typically large businesses.
- However, this practice can lead to excess credit positions for suppliers, complicate audits, and create opportunities for fraud.
- Withholding can break the relationship between output VAT and input VAT, making audits more challenging.

4. Failure to Apply Statutory Provisions

- Many statutory provisions of VAT laws are not applied in practice, leading to inconsistencies and inefficiencies.
- This issue is often due to excessive discretion on the part of revenue authorities and a lack of enforcement.
- Interest and penalty provisions, for example, are rarely applied, undermining the effectiveness of the VAT system and reducing compliance.



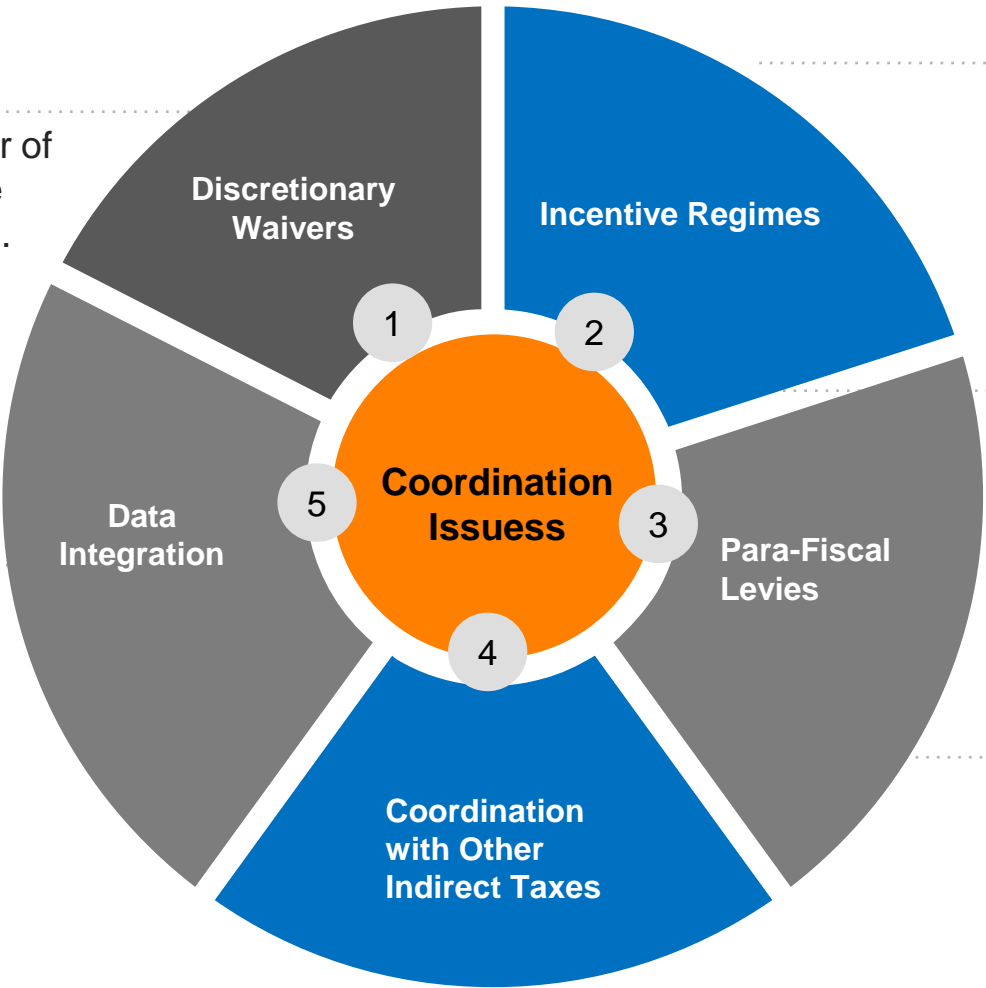
Challenges in Developing Countries

3. Coordination Issues

Effective VAT implementation requires seamless coordination between government agencies and departments, but in developing countries, coordination issues often lead to inefficiencies and revenue losses.

Conditional exemptions by the Minister of Finance create inequities and revenue leakage, undermining the VAT system.

Integrating data between customs and domestic tax administrations prevents fraud and ensures compliance, though it is challenging due to advanced customs systems.



Including VAT in tax incentives leads to destructive competition and removes potential VAT collectors, increasing pressure on other businesses.

Collection by agencies other than the Ministry of Finance causes accountability issues and revenue leakage, complicating monitoring.

Proper coordination between VAT, import duties, and excises is essential for effective revenue collection and optimized revenue generation.

03

Ideal vs Real VAT Policy and Administration in Zambia



Ideal VAT policy and administration in Zambia



An ideal VAT policy and administration are characterized by several well-defined norms as highlighted above that ensure its efficiency and effectiveness as a revenue tool.

Broad Consumption Base

The VAT system in Zambia is complicated by numerous exemptions and zero-rated items, which reduce the tax base and complicate administration. These exemptions often include goods and services provided by governments, real property, and financial services, leading to "exemption creep" where the range of exempt items expands over time, further eroding the tax base.

Single Rate

While Zambia's standard VAT rate is 16%, exemptions and zero-rated items complicate the system. This complexity undermines the simplicity and uniformity of a single rate, making administration and compliance more challenging.

Minimal Exclusions

Zambia's VAT system has numerous exemptions and zero-rated items, which complicate VAT administration and increase the risk of abuse. These exemptions can lead to higher compliance costs and the risk of VAT-free personal consumption, undermining the integrity of the tax base.

Invoice-Credit Method

The invoice-based system is in place, but issues like false claims of input credits and over-invoicing persist, complicating audits.

Destination Principle

Zambia's VAT system follows both the destination and origin principles, creating challenges in administration and compliance. This dual approach can lead to inconsistencies, increased complexity, and potential double taxation, making it difficult to maintain a clear and efficient VAT system.

Real VAT policy and administration in Zambia (1/2)



The VAT system in Zambia encounters numerous challenges that hinder its ability to achieve the ideal "good/ideal VAT" status, impacting its efficiency, effectiveness, and overall integrity.

Refund Delays

Significant delays in VAT refunds affect business cash flows and erode trust in the tax system. Exporters and businesses entitled to VAT refunds experience delays, some dating back to 2013, impacting their cash flows and trust in the system.

Large Informal Sector

A substantial portion of Zambia's economy operates outside the formal tax system, reducing the overall tax base. Efforts to bring these businesses into the VAT system face resistance due to perceived high compliance costs and bureaucratic hurdles..

Tax Evasion and Fraud

Issues such as false claims of input credits, over-invoicing, and under-reporting sales are common. These fraudulent activities complicate VAT administration and reduce revenue potential..

Limited Capacity and Resources

The ZRA struggles with shortages of skilled personnel and financial resources, leading to delayed audits and inadequate compliance monitoring, limiting the effectiveness of VAT administration and enforcement.

Real VAT policy and administration in Zambia (2/2)



The VAT system in Zambia encounters numerous challenges that hinder its ability to achieve the ideal "good/ideal VAT" status, impacting its efficiency, effectiveness, and overall integrity.

Complex Tax Exemptions and Zero Rating

Numerous exemptions and zero-rated items complicate VAT administration and increase the risk of abuse. This complexity can lead to disputes over classification of goods and increased opportunities for fraud.

Resistance to Compliance

Small and medium-sized enterprises (SMEs) often resist VAT registration and compliance due to perceived high costs and bureaucratic hurdles, reducing the overall tax base and complicating VAT administration.

Effectiveness of VAT Administration Measures

The use of Electronic Fiscal Devices (EFDs) and Smart Invoicing aims to improve compliance and revenue collection. These measures have led to improved compliance and increased revenue collection but face challenges such as inadequate preparation, limited stakeholder engagement, and affordability issues for small businesses.

04

Conclusion and Recommendations



Conclusion



1. Significant Potential and Challenges

Zambia's VAT system has significant potential but faces substantial challenges, including refund delays, tax evasion, a large informal sector, and limited administrative capacity.

2. Major Revenue Source

VAT is designed to be a major revenue source for the government, but its effectiveness is currently undermined by systemic issues.

3. Systemic Issues

The effectiveness of the VAT system is compromised by several systemic issues, such as refund delays, tax evasion, a large informal sector, and limited administrative capacity.

4. Complex Exemptions

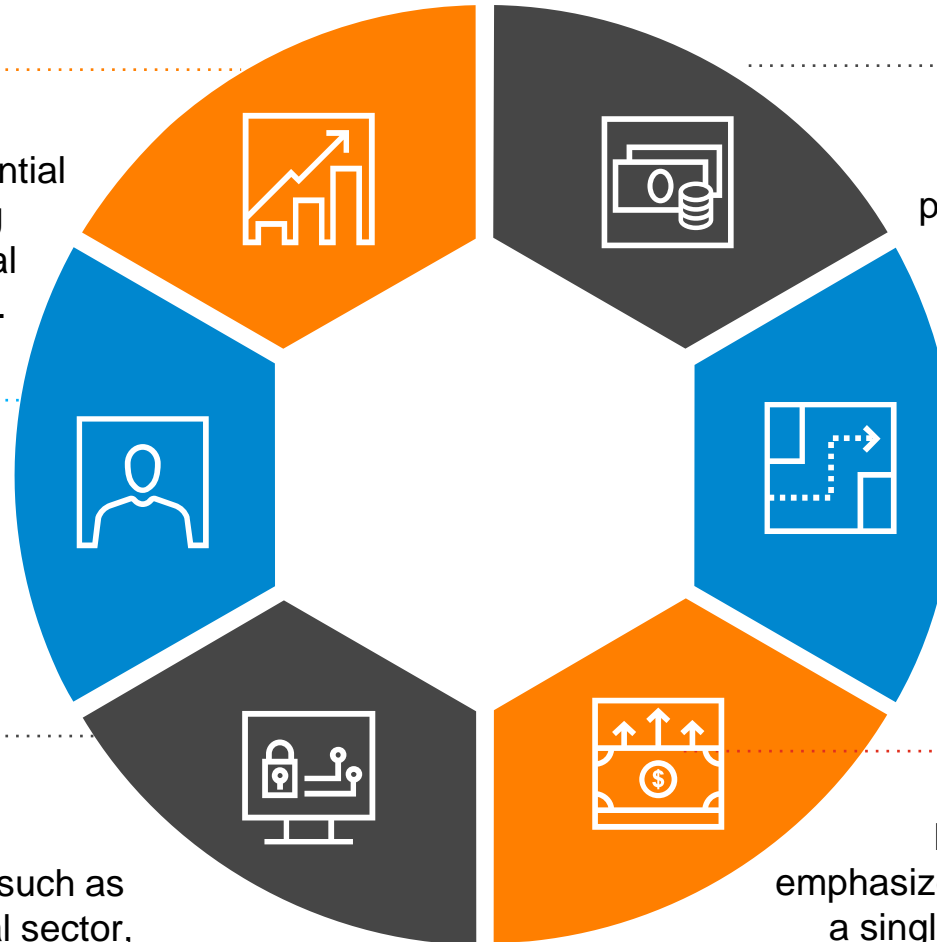
Intricate tax exemptions and zero-rating practices add complexity to the system, making it difficult to administer and comply with.

5. Need for Reforms

Comprehensive reforms are necessary to align the VAT system with "good VAT" standards, addressing issues like the clash between tax policy and administration, coordination problems, and resistance to compliance by SMEs.

6. Expert Insights

Reports from the World Bank, IMF, and TADAT emphasize the importance of a broad consumption base, a single VAT rate, minimal exclusions, and robust risk management practices to ensure the efficiency and effectiveness of the VAT system.





Recommendations

1. Policy Recommendations

1. Policy and Legal Reforms

- **Review and Update VAT Legislation:** Regularly review and update the VAT Act and related regulations to address emerging challenges and align with international best practices.
- **Enforce Statutory Provisions:** Ensure consistent application of statutory provisions, including interest and penalty clauses, to enhance the credibility and effectiveness of the VAT system.

2. Simplify Legal and Administrative Requirements

- **Review VAT Laws:** Ensure VAT refund requirements, procedures, and documentation are simple and avoid unreasonable administrative demands on taxpayers.
- **Clear Legal Framework:** Establish a clear and simple legal framework for VAT refunds with minimal requirements for effective payment

3. Budget for VAT Refunds Based on Reliable Projections:

- **Net VAT Budgeting:** Budget only net amounts of VAT (gross collection less refunds due) on the revenue side for funding government expenditure.
- **Cash Flow Forecasts:** Include VAT refund amounts in the treasury's cash flow projections and update them regularly.

4. Record VAT Refunds as Government Liabilities:

- **Government Debt:** Record unpaid VAT refund claims as government liabilities and include them in public debt reports.
- **Accrual Accounting:** Use accrual accounting to trace VAT refunds back to the event that generated the overassessment or overpayment.



Recommendations

2. Administrative Recommendations

1. VAT Refunds⁶

Implement best practices from the IMF, such as:

- **Using the Tax Return for Refund Claims:** Use the tax return as the sole document for claiming refunds to reduce compliance burdens.
- **Real-Time Cross-Matching:** Implement real-time cross-matching techniques using data from e-invoices, customs declarations, and other third-party sources.
- **Risk-Based Verification:** Use a risk-based approach for post-refund verification, focusing on lower-risk cases and conducting random audits.
- **Timely Refunds:** Set and monitor refund processing deadlines, applying interest on delayed refunds to ensure timely disbursements.
- **Avoiding Mandatory Carry-Forward Requirements:** Implement short carry-forward periods and apply interest on unpaid balances after the legal due date.
- **Tradable Tax Certificates:** If tax certificates are used, ensure they are tradable in the domestic financial market and allow offsetting against other tax liabilities.

2. Simplify the VAT System

- **Reduce Exemptions and Zero-Rated Items:** Streamline the VAT code to broaden the tax base and simplify administration.
- **Implement a Single VAT Rate:** Adopt a uniform VAT rate to reduce complexity and improve compliance.

3. Enhance VAT Administration

- **Strengthen Administrative Capacity:** Invest in training and resources for the Zambia Revenue Authority (ZRA) to improve audit capabilities and compliance monitoring.
- **Improve Refund Processes:** Streamline verification processes and ensure timely disbursements to maintain business cash flows and trust in the tax system.



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Thank You!



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