CENTRAL BANK OF LESOTHO

INTRODUCTION OF VAT IN LESOTHO

Prepared by: L. M. Lephoto
Research Department

1. INTRODUCTION

As part of Lesotho's medium term economic objectives and given the importance of fiscal prudence in light of the country's monetary policy limitations, the government aims to limit the budget deficit to levels that will serve to contain aggregate demand and that can be financed by external grants and concessional loans. In order to attain this, there is need to streamline expenditure and mobilise revenue. Hence Government's decision to strengthen tax administration through the establishment of a Lesotho Revenue Authority (LRA) and to introduce Value Added Tax (VAT) in an effort to increase tax efficiency and equity as well as to widen the tax base. The LRA became operational in January 2003 while the implementation date for VAT was July 1st, 2003.

The introduction of VAT arises against the background that government revenue relies heavily on SACU receipts. Given the uncertainty surrounding future SACU revenue due to the removal/reduction of customs duties in line with WTO obligations as well as the outcome of the SACU Agreement negotiations, there is need for strengthening as well as diversification of domestic tax revenues.

The choice of VAT to improve tax revenue is in line with the general view, in tax reforms, that broad-based commodity taxation is the most effective form of taxation. The basic criteria for judging effectiveness of a tax system includes its:

- Capacity for raising government revenue
- Impact on efficiency of resource allocation
- Impact on distributional equity
- Administrative cost

Effects on revenue, efficiency and equity may be viewed as basic objectives, while administrative costs provide a constraint.

The purpose of this paper is to review the reasons why VAT has been chosen, its possible impacts and how it works in Lesotho.

2. WHAT IS VAT

VAT is a broad-based commodity tax that is levied at multiple stages of production. It is usually intended to be a tax on consumption, hence the provision of a mechanism enabling producers to offset the tax they have paid on their inputs against that charged on their sales of goods and services. Under VAT revenue is collected throughout the production process without distorting any production decisions.

3. WHY VAT IS PREFERRED OVER SALES TAX

While theoretically the amount of revenue collected through VAT is equivalent to sales tax collections at a similar rate, in practice VAT is likely to generate more revenue for government than sales tax since it is administered on various stages on the production – distribution chain. With sales tax, if final sales are not covered by the tax system e.g. due to difficulty of covering all the retailers, particular commodities may not yield any tax. However, with VAT some revenue would have been collected through taxation of earlier transactions, even if final retailers evade the tax net.

There is also in-built pressure for compliance and auditing under VAT since it will be in the interest of all who pay taxes to ensure that their eligibility for tax credits can be demonstrated. VAT is also a fairer tax than sales tax as it minimises or eliminates the problem of tax cascading, which often occurs with sales tax. These are facilitated by the fact that VAT operates through a credit system so that tax is only applied on value added at each stage in the production – distribution chain. At each intermediate stage credit will be given for taxes paid on purchases to set against taxes due on sales. Only at consumption stage where there are no further transactions will there be no tax credits. Lack of input credit facility in sales tax often results in tax on inputs becoming a cost to businesses which are often passed on to consumers. Sales tax is often applied again to the sales tax element of the cost, thus there is a problem of tax on tax. This is not the case with VAT, which makes it a neutral tax as it provides the least disturbance to patterns of production and the generation and use of income.

In addition, the audit trail that exists under the VAT system makes it a more effective tax in administration terms than sales tax as it helps with the verification of VAT amounts declared as due. This is made possible by the fact that one person's output is another's input. As with sales tax imports are treated the same way as local goods while exports are zero-rated to avoid anti-export bias.

Notwithstanding the advantages mentioned above, it is worth noting that VAT is a considerably complex tax to administer compared with sales tax. It may be difficult to apply to small companies due to difficulties of record keeping and its coverage in agriculture and the services sector may be limited. To cover the high administration costs, VAT rates of 10-20 per cent are generally recommended. The equity impact of the relatively high rates have been a cause for concern as it is possible that the poor spend relatively high proportions of their incomes on goods subject to VAT. Thus the concept of zero VAT rate on some items has been introduced.

4. OTHER CONSIDERATIONS

It is imperative that policy makers in considering adoption of VAT should be interested in the economy wide impact of this tax. Special emphasis is often placed on its effect on equity, prices and economic growth. This is particularly important because of the potential effects on consumption of certain commodities that have a direct or indirect effect on labour productivity.

VAT effect on inflation

In considering the introduction of VAT, countries are often concerned that it would cause an inflationary spiral. However there is no evidence to suggest that this is true. A survey of OECD countries that introduced VAT indicated that VAT had little or no effect on prices. In cases where there was an effect it was a one time effect that simply shifted the trend line of the consumer price index (CPI). To guard against any unforeseen price effects the authorities may consider a tighter monetary policy stance at the introduction of VAT.

Distribution effects of VAT

Value added tax is widely criticised as being regressive with respect to income, that is its burden falls heavily on the poor than on the rich. This emanates from the fact that consumption as a share of income falls as income rises. Hence a uniform VAT rate falls heavily on the poor than the rich. This criticism is valid when VAT payments are expressed as a proportion of current income. However if, following the premise that welfare is demonstrated by the level of consumption rather than income, consumption is used as the denominator the impact of VAT would be proportional. A proportional burden would also be demonstrated if lifetime income rather than current income is used. A lifetime income concept considers the fact that many income recipients are only temporarily at lower income brackets as their earnings increase.

In order to address the regressivity of VAT the following measures can be taken:

- The VAT itself can be used to differentiate taxation of consumer items that are consumed primarily by the poor such that they pay less or at zero rate or to tax luxury goods at a higher than standard rate.

- VAT exemptions may also be granted on goods and services that are consumed mostly by the poor.

- Equity concerns may also be addressed through other ways, outside the VAT system, such as other tax and spending instruments of government. This could be in the form of lower basic income tax rates on the poor or some pro-poor expenditures of government.

The use of multiple rates of VAT has however been widely discouraged for various reasons. These include:

- The fact that sometimes it is almost impossible to differentiate between higher quality expensive products – e.g. food, consumed by the rich and ordinary products consumed by the poor. Thus any concessions extended may tend to benefit the rich much more than the poor.

- Increased costs of VAT administration as a differentiated rate structure brings with it problems of delineating products and interpreting the rules on which rate to use.

- Significantly increased costs of tax compliance for small firms, which are usually unable to keep separate records/accounts for sales of differently taxed items. This results in the use of presumptive methods of determining the tax liability, which leads to more difficulties in monitoring the compliance. The higher compliance cost resultant from differentiation of VAT rates may also be regressive with respect to income since smaller firms with lower income tend to bear proportionately more of the burden than do larger firms.

Exemptions refer to situations where output is not taxed but taxes paid on inputs are not recoverable. The rationale behind exemptions is to reduce negative distributional effects of tax through the effect on incomes. The effects of exemption may be as follows:

- Falling of revenues – exemptions break the VAT chain. If exemptions are granted at prior to the final sale, it results in a loss of revenue since value added at the final stage escapes tax.

- Unrecovered taxation of some intermediate goods may lead to producers substituting away from such inputs thus distorting the input choices of the said producers.

- Exemptions may create incentives to "self supply" i.e. tax avoidance by vertical integration.

- Exemptions tend to feed on each other giving rise to a phenomenon called "exemption creep". This arises from the fact that each exemption gives rise to pressures on further exemption. For example creating an exemption to reduce the tax burden on a particular commodity or goods may lead to increased pressure for exemption or zero rating of inputs used for the production of such a commodity.

Based on the above, it is important that care is taken when introducing exemptions in order to avoid distortions in the production process as well as to minimise revenue loss resulting from such distortions.

Given the fact that the primary purpose of VAT is to raise government revenue in an efficient manner and with as little distortions of economic activity as possible, distribution effects are perhaps better addressed by other forms of tax and government expenditure policies which can often be better targeted at these aims.

VAT effect on economic growth

Economic growth can be facilitated through investment by both government and the private sector. Savings by both parties are required in order to finance investment in a non-inflationary manner. Compared to other broadly based taxes such as income tax VAT is neutral with respect to choices on whether to consume now or save for future consumption. Although VAT reduces the absolute return on saving it does not reduce the net rate of return on saving. Income tax reduces the net rate of return as both the amount saved as well as the return on that saving are subject to tax. In this regard VAT may be said to be a superior tax in promoting economic growth than income tax. Since VAT does not influence investment decisions on firms, by increasing their costs, its effects on investment can be said to be neutral.

5. KEY FEATURES OF VAT IN LESOTHO

The nature of the tax

Value added tax (VAT) was introduced in Lesotho on 1 July 2003, replacing the general sales tax (GST). The primary law governing the implementation of VAT is the Value Added Tax Act No 9 of 2001 and its amendment Act No 6 of 2003. VAT is chargeable upon disposal by sale or transfer of goods and supply of most services in Lesotho. It also applies on some goods and services imported from outside Lesotho. Before a transaction can be subjected to tax, it must be supplied by someone who is or should be registered for VAT. Sales by private individuals and some small traders will not normally be subject to VAT. It is therefore required that all businesses with turnover above M500, 000 threshold register to be VAT taxpayers. Below this threshold registration is voluntary. Taxable turnover in this case refers to the total value of business supplies in Lesotho. The said businesses should charge VAT through its inclusion in the price of goods and services. That is by increasing the price of goods and services by the amount of VAT. The tax charged on the supplies of a business would be its output tax while tax paid by the same business would be its input tax.

On a monthly basis businesses are required to fill VAT returns. Here they are required to deduct their input tax from their output tax and at the same time pay the balance to the Commissioner of VAT, or get a refund. Occasionally private individuals may have to pay VAT directly to the department of VAT. This arises, for example when goods are imported or are registerable goods such as motor vehicles. VAT may also be due on gifts from people in other countries.

Four rates of VAT are applicable and these were published in the government gazette. VAT at an appropriate rate is charged on the consideration given or received for goods or services. When there is not sufficient consideration, a "fair market value" rule applies. This allows the Commissioner to determine the monetary value that the transaction would fetch if carried out in Lesotho on the same day. The four rates of VAT are as follows:

- 15 per cent on all alcoholic beverages
- 5 percent on electricity and telephone services
- 0 per cent on all zero rated goods as well as exports of goods and services
- 14 per cent on other supplies of goods and services

The following goods and services are exempted from VAT:

- Education
- Financial services
- Passenger transport services
- Public postal services
- Supply of unimproved land
- leasing or letting of immovable property (for manufacturing purposes)
- Water supply
- Supplies to diplomats and diplomatic missions upon identification
- Sales or transfer of second hand motor vehicles already registered in Lesotho
- Services of doctors and dentists
- Sporting activities (non professional)

- Cultural activities
- Supply of Charity arrangements
- Sale /lease of residential property

Supply of goods and services to government is taxable so it should be charged VAT.

Failure to comply with regulations concerning VAT registration and its operations is an offence and may be subject to penalties as stipulated by the law. This is aimed at strengthening tax compliance and timeliness of tax payments.

Administrative arrangements

Implementation of VAT was accompanied by a number of administrative arrangements that facilitated the efficiency of collecting this tax. These included:

- *Tax payer education*

  The Lesotho revenue Authority undertook education campaigns in all districts and in the media prior to and after implementation of VAT to teach stakeholders about the VAT system and its requirements. These were aimed at raising awareness of the various stakeholders on what VAT is, what their obligations were and how they should fulfil them. This facilitated effective implementation of VAT as it increased the rate of tax compliance.

- *Computerisation of VAT systems*

  VAT processes were automated in order to enhance the administration of VAT. This was done through the commissioning of the VAT Information Processing System (VIPS). The computerisation of VAT return processing enabled the LRA to track vendors and identify businesses that default from their tax obligations with relative ease, thus facilitating timely follow-up and enforcement.

- *New border procedures*

  New border procedures were introduced to facilitate compliance and collection of import VAT. These procedures allow importers from RSA to submit tax invoices to the LRA, instead of having to first claim VAT paid in RSA from the South African Revenue Service (SARS) and then pay the LRA. The LRA then claims the VAT from SARS. This has been made possible by the bilateral arrangements between LRA and SARS.

5. IMPACT OF VAT ON THE LESOTHO ECONOMY

Fiscal impact

The introduction of VAT resulted in a significant increase in tax collection during 2003/04 fiscal year. During the first quarter of implementation (second quarter of fiscal year) the level of VAT collected was 79.9 per cent higher than that of GST collected in the previous quarter. This performance was sustained throughout the remainder of the fiscal. Total VAT collected at the end of 2003/04 was 50 percent higher than the level of GST collected in the previous year.

Table 1: Performance of VAT during 2003/2004
(million maloti)

	Quarter1	Quarter2	Quarter3	Quarter4	Total
Sales tax/VAT	75.00	134.95	157.99	151.53	519.47
Total tax revenue	591.0	767.9	743.4	812.8	2915.1

The introduction of VAT has also reduced the dependence on SACU revenues somewhat. Historically, SACU revenue has been the main source of government revenue, averaging more than 50 per cent of total revenue while sales tax contributed around 10 per cent to total revenue. During 2003/04the contribution of VAT to total revenue (excluding grants) VAT had increased to 14.92 per cent indicating improved capacity to raise government revenue domestically. The contribution of SACU revenue to total receipts, excluding grants, during the same year fell to 40.8 percent.

Table 2: Performance of VAT vs GST
(Million maloti)

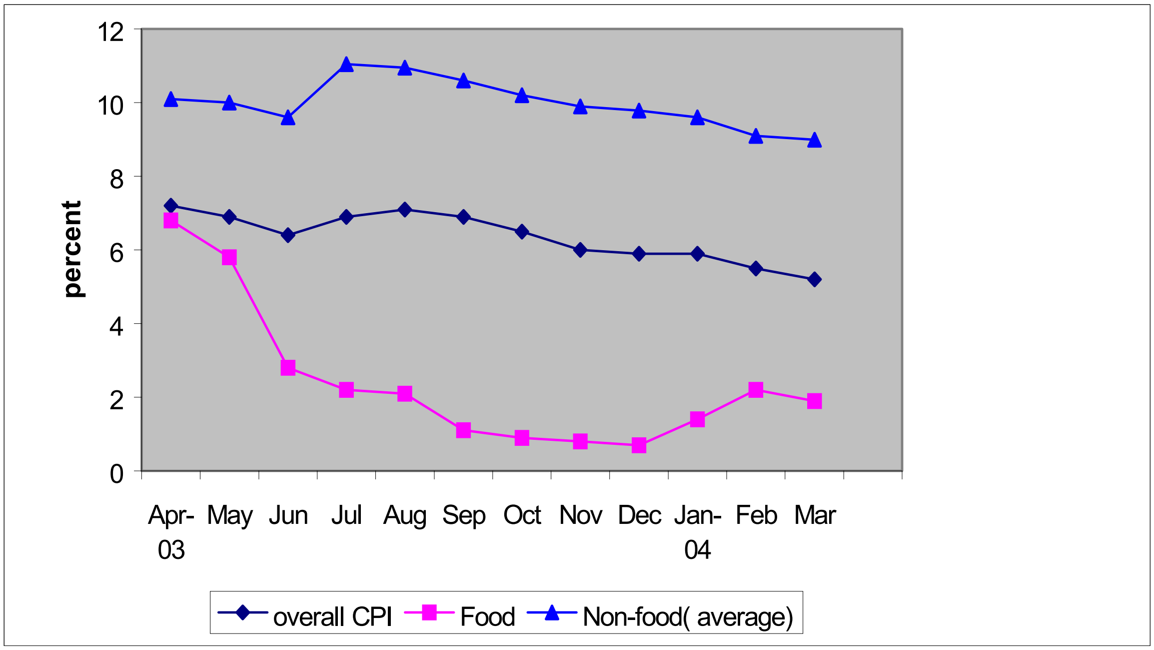
	1999/2000	2000/2001	2001/2002	2002/2003	2003/2004
Sales tax/VAT	238.0	279.8	302.0	348.0	519.5
Total revenue (excl. grants	2312.6	2626.6	2788.1	3049.2	3481.4
GST/VAT as % of revenue	10.29	10.65	10.83	11.41	14.92

Impact on inflation

Price data for the month of July gave the first indication of the possible effect of VAT introduction on inflation. On annual basis, overall inflation rate (as calculated from the Consumer Price Index, CPI) rose to 6.9 per cent in July from 6.4 per cent the preceding month. The food category, which holds the largest weight of 39.8 per cent in the CPI basket, slowed down to an annual rate of 2.2 per cent, during the month of July compared with 2.8 per cent in June. The same trend continued during the month of August with the CPI growing at the rate of 7.1 per cent and the food category slowing down further to 2.1 per cent. As figure 1 shows, food prices have been rising at a falling rate since the beginning of the 2003. This trend was influenced by increased food supply following shortages caused by drought. Since regional prices of cereals are linked to international prices, which are quoted in foreign currency, the appreciation of the rand against these currencies also brought the domestic cereal prices down. During the remainder of the year and the first quarter of 2004 the inflation rate continued the downward trend. In March 2004, the overall CPI rose by 5.2 percent while inflation rate for the food items was recorded at 1.9 per cent.

The trend of non-food (including alcoholic beverages and tobacco) category was generally flat except for a jump between March and April and another for June and July. The March/April increase in non-food inflation rate from 7.2 per cent to 10.2 per cent was driven by an increase in fuel prices and telephone charges. The jump between June and July reflects the effect of VAT introduction. It was expected that prices of most non-food items and services would increase by four percentage points, which is the difference between the former 10 per cent sales tax and the new VAT rate of 14 per cent. In the same manner, the food inflation rate fell further in July due to zero-rating of major food items. It declined to 2.2 and 2.1 per cent in July and August respectively, from 2.8 per cent in June. The slowdown in food inflation partially offset the rise in the non-food category, resulting in a marginal rise in overall inflation rate (see figure 1). This shows that the introduction of VAT had a minimal inflationary effect on the economy.

Figure 1: Inflation Rate (annual percentage changes)



6. CONCLUSION

The introduction of VAT in Lesotho considerably improved government revenue in the short run. Thus confirming that VAT is a more effective tax that GST. VAT revenue is expected to continue to improve in the short to medium term until it stabilises when the highest possible level of efficiency has been reached. The effect of introducing VAT on inflation was a one off event that occurred at the very beginning. It was probably brought about by the initial lack of understanding of some businesses of how VAT was supposed to be computed. Thus charging VAT over their old prices, which already included GST. However, that was quickly corrected through tax education. Equity considerations of VAT have been addressed through the use of exemptions as well as zero rating. It is therefore expected that the regressivity of VAT has been mitigated somewhat.