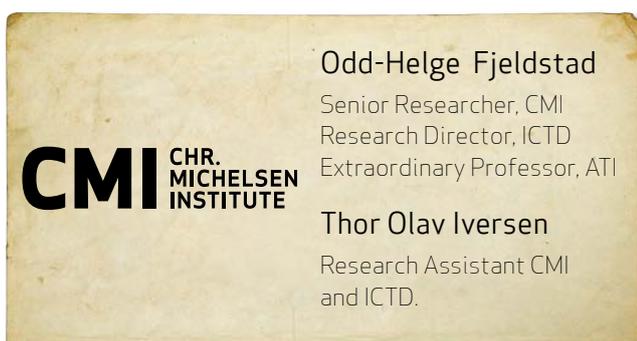


The Added Value of Value Added Tax: People are more willing to pay tax



Raising domestic tax revenues is a priority for most sub-Saharan African countries. But the tax bases in most African countries are undermined by widespread tax avoidance and evasion. A new study from CMI supports the claim that improved knowledge about the tax system makes a difference in people's willingness to pay tax. The study shows that exposure to Value-Added-Tax (VAT) makes people take a greater interest in tax issues and makes them more willing to pay tax. This brief argues that making the VAT more visible, can be an efficient and important tool in building a tax-paying culture.



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Tax administrations across Africa apply various approaches to taxpayer education. They cooperate with media, religious authorities and artists. They have information meetings in markets and shopping centres and distribute pamphlets and brochures with tax information. The Mozambique Revenue Authority engages in radio and TV broadcasts. The Tanzania Revenue Authority (TRA) broadcasts radio programmes and has started tax clubs in secondary schools. Once a year, students participate in a popular contest on tax knowledge on behalf of their school. There seems to be a general agreement that targeting young citizens is key. A tax officer in the Zambia Revenue Authority (ZRA) put it this way: "We need to focus on educating the future generations of taxpayers. The current generation is lost." (Fjeldstad/Heggstad, 2012)

Tax compliance and taxpayer education

Revenue administrations have always seen taxpayer education as an important part of building taxpaying cultures. The main objective of the Kenya Revenue Authority's taxpayer education programme is:

"to educate taxpayers on their rights and obligations, to create tax awareness so as to enhance voluntary compliance with the tax laws as well as to broaden the tax base and widen the tax net by recruitment of taxpayers through education."

The heterogeneity in tax knowledge is particularly large in developing country contexts where a small number of people and companies carry a large proportion of the tax burden. Different segments of the taxpayer population need tax education programmes tailored to their needs and potential. Poorer countries also have large informal sectors out of reach of traditional direct taxation.

The Value-Added-Tax

VAT has emerged as the major indirect tax in most Sub-Saharan Africa. Currently, around 80 percent of the countries in the region levy a VAT, contributing about one-quarter of total tax revenue. The popularity of the VAT has been tightly linked to a rationale of compliance-enhancement compared to more narrow-based taxes such as personal and corporate income taxes. Proponents of the VAT argue that it encourages greater compliance. While sellers are required to charge the tax on all their sales, they can also claim a credit for taxes that they have been charged on their inputs. This mechanism induces a degree of self-policing, as a firm's efforts to realize tax credit will create a trail of transactions recognisable for tax purposes. The advantages of this is that revenue is secured by being collected throughout the process of production, but without distorting production decisions. Even if a business cheats, all intermediary transactions up until that point will have been taxed.

VAT is a consumption tax. It has replaced more narrow-based sales and turnover taxes in many countries. An advantage of the VAT over the sales tax is that sellers have an incentive to collect the tax and pay it to the government in order to realize tax credits. For the buyer of a product it is a tax added on the purchase price. The seller gains tax credits to offset any taxes they had previously paid on inputs. If sellers are able to realize tax credits, only the end consumer is taxed. VAT has been widely introduced in both developed and developing countries.

The effectiveness of VAT, however, depends on thorough book-keeping and reliable self-assessment. It has therefore proved to be an efficient means of extracting tax revenue in countries with good written or electronic records of economic transactions. In most African countries where these conditions are not in place, VAT is harder to collect and VAT is exposed to fraud and corruption. Concerns about fraud have often led to very detailed checks by the tax administration before VAT refunds are made. This can lead to serious delays in repayment of tax credits with negative cash flow impacts on businesses. In addition, the VAT base is often undermined by exemptions and zero-rating, granted to a wide range of goods and services. VAT has also been criticised for being a regressive tax that falls heavily on the poor. Studies have shown that this is not true. Rather, VAT is found to be distributionally neutral. One reason is that most countries that levy a VAT, give reductions or exemptions for basic consumption items, especially food, which poorer segments of the population depend on. The challenges facing the administration of VAT in poor countries does not imply that it should be removed, but rather improved to better fit the specific country context.

The VAT can have additional advantages in developing countries. Developing countries frequently host large informal economies outside reach of most direct tax instruments. The larger the informal economy, the more a government has to rely on indirect taxes. Indirectly, the VAT taxes the informal sector when informal businesses buy supplies from a registered company. VAT is thus a way of taxing individuals who are outside the reach of direct taxation, because they pay tax via the goods and services they purchase.

VAT as an instrument for taxpayer education

Can the introduction of VAT contribute to build broader taxpayer knowledge on how the tax system works and improve compliance? New empirical evidence from the African context suggests that the answer is yes. In a recent study, using data from the Afrobarometer survey, CMI researchers Merima Ali, Odd-Helge Fjeldstad and Ingrid Hoem Sjurson find that VAT-related tax knowledge has large, positive effects on general tax compliance attitude among citizens in Kenya, Tanzania, Uganda and South Africa.

The Afrobarometer-survey asks a specific question about VAT knowledge; "Regardless of whether you are able to pay, are you required to pay value added tax on the foods and the goods that you buy from shops or traders?" Answering yes to this question indicates greater taxpayer knowledge. In all the countries included in the analysis, the variable for VAT knowledge significantly increases the likelihood of having a tax compliant attitude compared to the respondents who say they do not pay VAT. The perceived requirement to pay value added tax has a large positive predictive effect on compliance. The survey also contains a general tax knowledge question for the respondents to rank the difficulty to know which taxes to pay. Tax knowledge is found to be significantly correlated with a tax compliant attitude.

AFROBAROMETER

Afrobarometer is an independent research project that gathers data on the social, political and economic situation in Africa. The Afrobarometer survey is currently conducted in 35 African countries and repeated in regular cycles. Trends are thus traceable over time. Because the survey asks a standard set of questions, data from different countries can be compared systematically. For further information, see: www.afrobarometer.org

These results suggest that VAT can be an instrument in taxpayer education in the African context. The strength of the VAT as a gateway to enhance knowledge about the tax system, including their rights and obligations, lies in its wide outreach. Ideally, taxpayer education strategies should be tailored to different segments of taxpayers who are exposed to different taxes, which require different procedures and interactions with the tax authorities. However, the majority of citizens in African countries remain outside the reach of direct taxation and do not relate directly with tax legislation and administration to the extent that citizens in developed countries do. Educating

by making VAT a visible part of the price of a product or service by displaying the amount of VAT paid on the items purchased in the vendor prices or on the items themselves.

It is important to emphasize that taxpayer education is only one part of a broader strategy to enhance taxpayers' compliance. Education is unlikely to be the best response to deliberate tax evasion. Tax administrations should therefore aim for a mixture of responses such as improved legislation, simplified procedures for tax payment and audits, in addition to taxpayer education.



Taxpayer education is an important part of addressing tax compliance, and is a central component of revenue administrations' effort to build taxpaying culture in developing countries.

the general public on the purpose and procedures of direct taxes is therefore not particularly relevant. VAT, however, could be a useful starting point to enhance tax knowledge because it is a tax to which both formal and informal businesses, urban and rural populations, are exposed.

VAT could therefore be an instrument to enhance the public's awareness and knowledge about the tax system. More knowledge of personal contribution to government finances - through the VAT and other taxes - might also contribute to increase citizens' demand for accountability and transparency in public finance management, which in turn could foster constructive state-citizen relations.

Conclusions and policy recommendations

Taxpayer education is an important part of addressing tax compliance, and is a central component of revenue administrations' effort to build taxpaying culture in developing countries. Focusing on the VAT when tailoring tax education strategies for groups who have a high likelihood of not being exposed to other taxes may be an effective starting point for improving awareness of personal obligations and contributions. Improved tax knowledge could in turn foster greater citizen engagement around matters of taxation, public spending and governance, also among businesses and people in the informal economy.

Such an outcome requires that people are aware of their contribution. In addition to targeted educational programmes, making the VAT more visible could thus be one way to increase tax awareness. This can be achieved

Lessons learnt:

- Include taxpayer education as part of a broader tax compliance programme.
- Adapt education to the needs of the different groups of taxpayers. Emphasis increased understanding of the VAT when dealing with education of taxpayer segments that are not exposed to direct taxes.
- Use the VAT as an entry point to discussions of public spending and governance with groups who do not pay other taxes and who are likely to have a limited understanding of their contribution to government revenue.
- Make VAT payments more visible in order to increase interest in taxation and awareness of peoples' contribution to government revenue.
- Avoid excessive exemptions and zero-ratings that severely reduce the VAT tax base, as this might hollow out the educational potential of the VAT, in addition to undermining the revenue base and distortive taxpayer incentives.

CMI is an independent development research institute in Bergen, Norway. CMI generates and communicates research-based knowledge relevant for fighting poverty, advancing human rights, and promoting sustainable social development. CMI's research focuses on local and global challenges and opportunities facing low and middle income countries and their citizens. Our geographic orientation is towards Africa, Asia, the Middle East and Latin America.

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Recommended reading

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