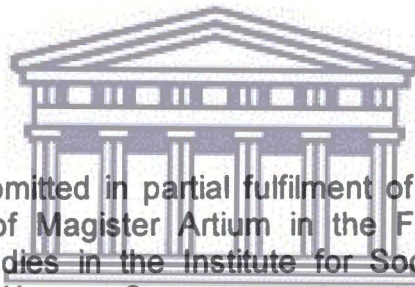


# THE VALUE ADDED TAX SYSTEM: A CASE STUDY OF RWANDA.

**AGNES NTIBANYURWA**

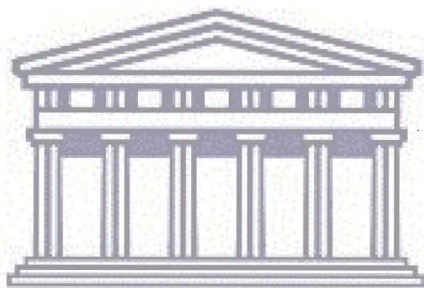


A mini-thesis submitted in partial fulfilment of the requirements for the degree of Magister Artium in the Faculty of Arts, in Development studies in the Institute for Social Development, University of the Western Cape.

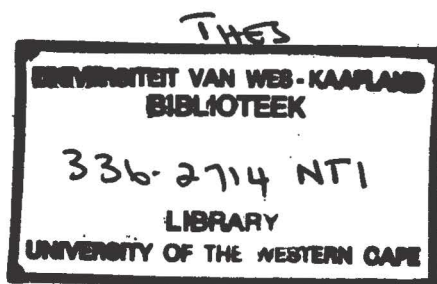
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**Supervisor: Professor Pieter Le Roux**

November 2001



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## Key words

Appropriate tax

Development

Impôt sur le Chiffre d'Affaires

Policymakers

Revenue officials

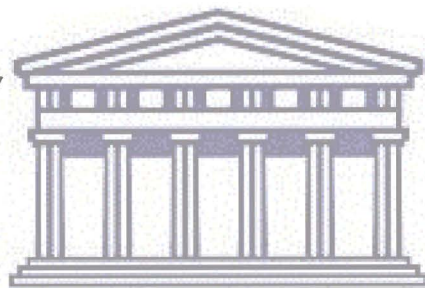
Rwanda

Rwanda Revenue Authority

Taxpayers

Tax revenue

Value Added Tax



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## ABSTRACT

### THE VALUE ADDED TAX SYSTEM: A CASE STUDY OF RWANDA

AGNES NTIBANYURWA

M.A mini-thesis, Department of Development Studies in the Institute for Social Development, in the Faculty of Art, University of the Western Cape.

Internationally, the Value Added Tax system is recognised as an appropriate tax system for countries like Rwanda, who needs to increase the revenue potential of the tax system. Although VAT is considered to be a good tax system, its most common feature is that it is regressive with respect to income and therefore unfair. Despite this shortcoming, VAT is considered to be a much more efficient taxation system than other consumption taxes.

Historically, the Rwandan taxation system was characterised by many shortcomings that undermined the country's social and economic development. Over the last decades, the Rwandan government reformed its tax system in search of a more appropriate system. In January 2001, Rwanda introduced the Value Added Tax system at a rate of 15% to replace the turnover tax (ICHA, Impôt sur le chiffre d'affaires). The Rwandan government argued that VAT would increase state revenue substantially. This, in turn, means less reliance on foreign debt and therefore greater financial independence. In the 2001 fiscal year, for instance, total tax income in Rwanda could only cover 45% of government expenditure, which indicates the strong reliance on foreign debt financing.

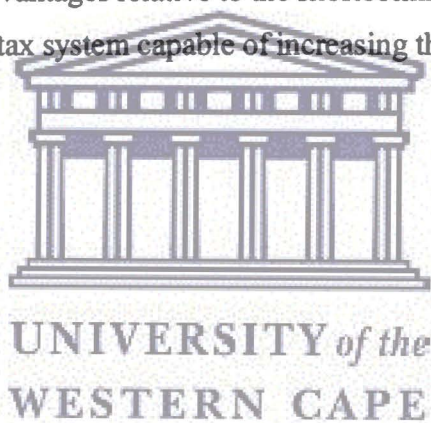
In Rwanda, there were arguments in favour for and against the implementation of the VAT system. The goal of this study was therefore to learn from other countries such as Korea, Argentina, Côte d'Ivoire and South Africa about the successes and pitfalls of the VAT system.

Just as in Rwanda, the Value Added Tax implemented in Korea, South Africa and Côte d'Ivoire is of a consumption type and this steadily contributes to increasing tax income. In order to implement VAT successfully, these countries engaged in educating their citizens about the new taxation system, and also provided training to revenue officials to ensure the proper management of tax revenue.

However, the Argentinean VAT system was of the income type and was not as successful in generating government revenue as the systems implemented in the other countries. This was largely due to fact that some sectors were exempted from the system, and VAT could not contribute as much to the tax income of the country as was expected.

With regards to its many advantages relative to the shortcomings, it can be concluded that a VAT system is a reliable tax system capable of increasing the government revenue.

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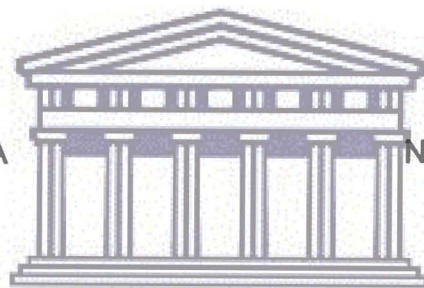


## DECLARATION

I declare that THE VALUE ADDED TAX SYSTEM: A CASE STUDY OF RWANDA is my own work, that it has not been submitted before for any degree or examination in any other University, and that all the sources I have used or quoted have been indicated and acknowledged by complete references.

AGNES NTIBANYURWA

NOVEMBER 2001



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SIGNED:

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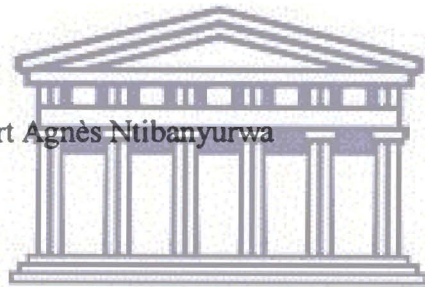
## DEDICATION

This thesis is dedicated:

To sweetheart and loving husband, Bernard Narcisse Kayitankore, thank you for your love, understanding, patience and everlasting encouragements;

To my beloved daughter, Perle Divine Isimbi, my heartfelt appreciation for your kindness and for allowing me to leave you only at six months old for my studies;

From the bottom of my heart Agnès Ntibanyurwa



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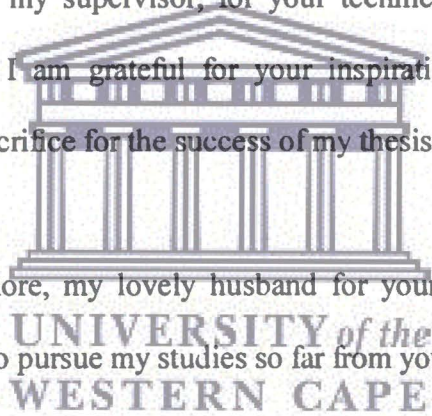
## ACKNOWLEDGEMENTS

From the bottom of my heart, I would like to express my sincere gratitude and appreciation to the following individuals and institutions for their valued contribution to this mini-thesis:

Almighty God Heavenly Father for the strength and protection you granted me during my life and especially during my study period.

Professor Pieter Le Roux, my supervisor, for your technical guidance and pertinent comments on this thesis. I am grateful for your inspiration, excellent supervision, encouragement and your sacrifice for the success of my thesis.

Bernard Narcisse Kayitankore, my lovely husband for your undying support and for being so kind to allow me to pursue my studies so far from you.



Athanase Ntibanyurwa and Béatrice Bazizane, respectively my father and mother for your support and your prayers and all you have been for me, especially for taking care of my daughter during my stay in South Africa.

I wish to thank all my brother, sisters and nieces; Barthélémy Bizimana, Charlotte Irakiza, Yvonne Bukuru Ndeze, Yvette Butoyi Ndeze, Chouchou Cyiza, Sylvie Bazizane, Alice Kamanzi and Gisèle Kamanzi, for your encouragements.

My family-in-law, for your support and encouragements, Silas Munyampundu's family for your love and support, and Violette Ruzibiza for looking after my little daughter.

Charline Mulindahabi for your sacrifice, encouragement and kindness you showed me.

Forum of the Rwandan students in the Western Cape region I thank for your support, advice and encouragement during our time together in South Africa.

Dr Emile Rwamasirabo and Dr Jean Bosco Butera, respectively rector and academic vice rector of the National University of Rwanda for the sponsorship granted to me to improve my knowledge and sustain my life in South Africa.

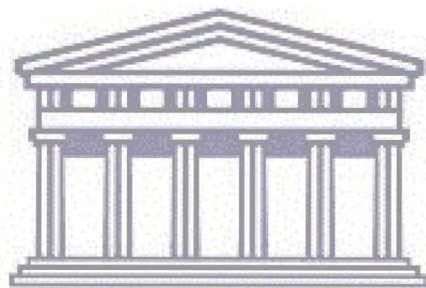
Rwanda Revenue Authority, Ministry of Finance and Economic Planning workers for the useful materials and information provided for this study. Jean de Dieu Mbarushimana, Martin Nkurunziza and Philemon Munyaneza for your availability to present during the seminar on this study,

My friends and colleagues who contributed to make my life enjoyable, all the staff of the Institute for Social Development, especially Ms Priscilla Kippie for your friendship.

Geraldine Dyason for the proofreading of my thesis.

All the respondents who participated in the interviews and the study seminar, I thank you for your time you allocated to this study.

All those who contributed directly or indirectly to this study, I thank you.



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# ACRONYMS

The following acronyms were used in this study:

COMESA : Common Market of Eastern and Southern Africa

CFA : Communauté Financière Africaine

COSATU : Congress of South African Trade Unions

CBI : Cross-Boarder Initiative

ESAF : Enhanced Structural Adjustment Fund

GDP : Gross Domestic Product

GST : General Sales Tax

HIPCI : Heavily Indebted Poor Countries Initiative

H.E : His Excellence

ICHA : Impôt sur le Chiffre d'Affaires

ID : Identity book

IDA : Institute for Defense Analyses

IMF : International Monetary Fund

L.B : Labour Bulletin

MAGERWA : Magasins Généraux du Rwanda

NNSDP : National Nutrition and Social Development Programme

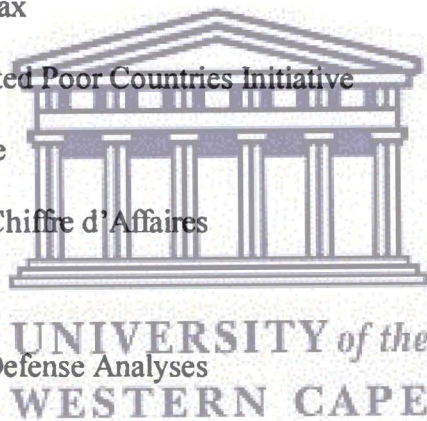
RRA : Rwanda Revenue Authority

RPF : Rwandan Patriotic Front

SARS : South Africa Revenue Service

SSA : Sub Saharan Africa

TVA-TPS : Taxes sur la Valeur Ajoutée – Taxes sur les Prestations de Service

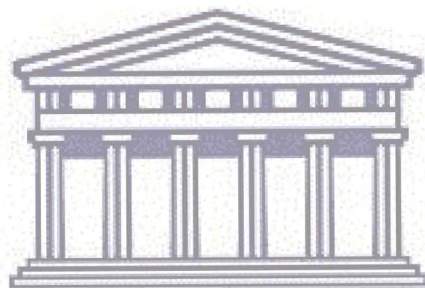


UCT : University of Cape Town

US : United States

VAT : Value Added Tax

WIP : Work In Progress



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# CHAPTER ONE:

## PURPOSE AND OVERVIEW OF THE STUDY

### 1.1 Orientation

Rwanda is a developing country located in Central Africa. It is a small land area of 26 338 square kilometres and its population is around 8 000 000. The country has experienced a slow economic growth due to many factors. Some of the factors were, the political instability and the crisis that culminated by the genocide of 1994, when more than one million people were killed. The taxation system was operating even before the colonialism in 1916. The taxation system was of a traditional type where livestock and harvest were given to comply with the civil obligations. However, because of the introduction of a money economy and a currency in the economy during the colonial era, the taxation changed and is now levied in the form of monetary obligations. Moreover, because the country wanted to increase its revenue from the domestic source, it undertook a tax reform, which brought about the introduction of VAT to replace the old system of a turnover type of indirect taxation, known as ICHA (Impôt sur le chiffre d'affaires).

Taxes are compulsory contribution from individuals to the government. There are many types of taxes (income tax, consumption tax, etc.), but the one considered in



this study is the Value Added Tax (VAT). Deloitte and Touche (2000:9) defined VAT as follows:

*“Essentially VAT is a tax collected by registered business (Vendors) on the value added by them in conducting their activities. It is the tax on the value added by each particular vendor, which has to be determined and paid over to the receiver.”*

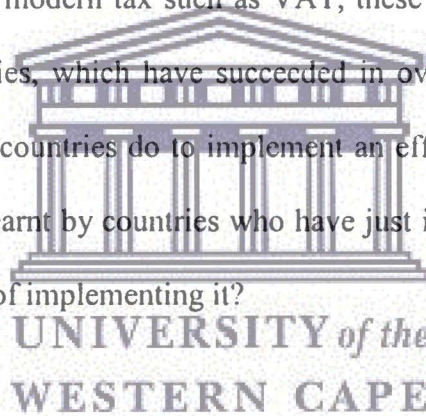
Evidence has shown that VAT is a tax with a broad base (levied on many goods and services/transactions) and is self-policing in the sense that the credit mechanism and tax invoice leave little room for manoeuvre to dishonest traders.

In developing countries, the question that arises is to know which appropriate tax is reliable for them. Given the need for more revenue in those countries, the question is to know whether VAT is really an appropriate tax and also if it has been effectively introduced. In the following chapters, the discussion focuses on the problems developing countries face with regard to the taxation system, especially when it comes to taxpayers who must comply with their obligations and to tax administration.

All taxes impose a burden and most taxes affect the behaviour of taxpayers. It is necessary to have a tax system that is beneficial to both taxpayers and policymakers. The country cannot sustain its economy without the contribution from all its citizens. That's why taxes are of a great importance. Therefore, taxpayers should understand the reasons for taxes and consequently be ready to pay without many complaints.

The Value Added Tax system, because of its many successes in many countries, interested the Rwandan State. The VAT is known to be appropriate for a country that wishes to expand its revenue and at a same time, to involve many taxpayers into the system. This was not the case under the turnover tax, which was limited to only certain categories of taxpayers.

The administrative capacity is a major problem in all developing countries and Rwanda is no exception. Additionally, the attitude of taxpayers with regard to paying tax is also a major constraint to the administrative efficiency of the tax system. Even with a modern tax such as VAT, these challenges are still present. But there are countries, which have succeeded in overcoming these difficulties. What did successful countries do to implement an efficient system of VAT? Are there lessons to be learnt by countries who have just implemented a VAT system or are in the process of implementing it?



## **1.2 Problem statement**

In January 2001, the Rwanda Revenue authority has introduced VAT at a rate of 15%. The VAT in Rwanda has replaced the previous tax 'ICHA' (Impôt sur le chiffre d'affaires which is general sales tax known as GST). It was argued that VAT has advantages over GST, (for example it is supposed to avoid cascading effects, the base will be broadened, etc.). The key issue is whether it has indeed been sensible to change to a VAT system of taxation in Rwanda.

The main focus of the study is therefore on Value Added Tax (VAT) and its suitability for Rwanda. The research also looks at the implementation of the new system and has analysed whether the VAT system has been effectively implemented in Rwanda.

The study examines the experiences of some developing countries that have introduced the tax system during the past few decades. This is in order to investigate what Rwanda can learn from their experiences. The countries that were studied included: South Africa which introduced VAT in 1991, Argentina which introduced VAT in 1974, the Republic of Korea introduced the system in 1977 and finally the Côte d'Ivoire which implemented the TVA-TPS in 1960.

With regards to the introduction of VAT the following questions were taken into consideration:

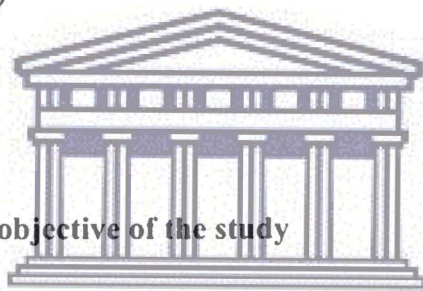
1. Given the low level of income of the majority of Rwandan citizens, is the VAT rate not too high?

2. Should this rate be the same on all goods or is there a need for differential rating? For example: a high VAT rate on luxury goods that are consumed mainly by the high-income group and a low VAT rate for more essential goods, and of course, with exemptions for basic foodstuffs. This would be consistent with the tax norm of ability to pay.

3. What has been done to ensure that taxpayers consider the tax not only as a burden but also as beneficial, because the tax income can be used by government to improve their quality of life?

4. Which lessons should Rwanda learn from the experience of other countries with the introduction of VAT?

5. How can Rwandan citizens ensure that the tax revenue collected is efficiently used?



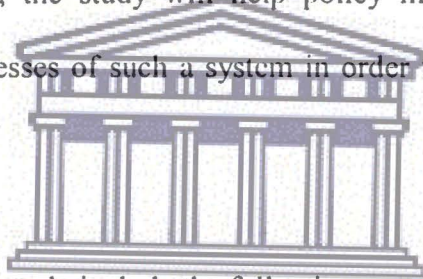
### **I.3 Significance and objective of the study**

This study of the taxation system in a developing country such as Rwanda is relevant in that it has been noticed that over 90% of Rwandan domestic revenue is collected from taxes (Official gazette of the republic of Rwanda, 2000). If the taxation system is not well applied, such the case of Argentina in chapter two, it can negatively affect the economy of the country. However, a good tax system can contribute to the development of a country (example in Korea, Côte d'Ivoire and South Africa).



The Rwandan government was dealing with tax reform that culminated in the implementation of an appropriate tax system, VAT, which is beneficial to both taxpayers and policy makers.

Given the poor living conditions of many Rwandese, it is important to carefully consider the impact of a VAT system on their livelihoods and to make sure if the system is well understood. It is also important for Rwanda to incorporate in its VAT system the benefits of the systems of the other countries as discussed in the chapter two and to avoid their pitfalls. With different views on the implementation of VAT in Rwanda, the study will help policy makers to consider both the strengths and weaknesses of such a system in order to make it more efficient as well as equitable.



The objectives of the study include the following:

The overall objective was to examine whether VAT is an appropriate tax for a developing country such as Rwanda. In addition to this, the study has:

- a) Discussed the experiences of other developing countries with regards to VAT so that Rwanda could learn from their successes and avoid their mistakes,
- b) The study also puts forward arguments considering the usefulness of a tax system and the need for tax revenue.

#### **I.4 Research methodology**

Firstly, the literature available on taxation has been consulted in order to provide a theoretical framework on taxation.

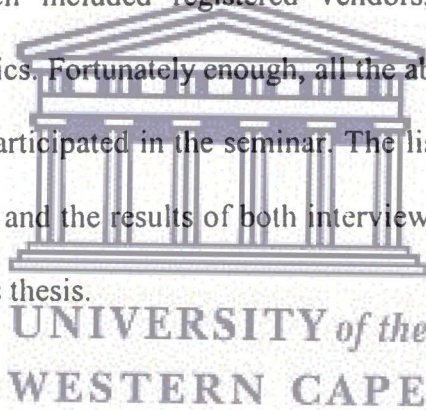
Secondly, direct observation amongst taxpayers and tax collectors helped me to develop an understanding of the system of taxation in a Rwandan context.

Thirdly, policy makers, revenue officials and taxpayers (businessmen and non businessmen) in Rwanda were interviewed, about the taxation system. The total number of people interviewed was 80 of which 10 policy makers, 20 revenue officials and 50 taxpayers. The interviews were made during two periods: from January to March 2001 and from May to June 2001 (see appendix 2). The methodology used to interview people was twofold. On one hand a questionnaire was used to guide policy makers, revenue officials and few taxpayers willing to respond to the questions. On the other side, many taxpayers were interviewed using an informal conversation method in order to encourage them to be more open and not to feel as if I was sent by Rwanda Revenue Authority to investigate them. Because the interview was made in Kinyarwanda (my mother tongue) in order to accommodate the interviewees, the results were recorded and translated in English every evening after the interview(s).

Fourthly, a seminar was organised and was held at the University Club in Butare City (in Butare Province) second town of the country after Kigali town to which

participants from the different sectors were invited. At this seminar the preliminary findings of this study were put to a broad audience in order to get their response to the views developed.

The seminar took place on Saturday 16<sup>th</sup> of June 2001. It started at 9h00 and ended at 17h00. The purpose of the seminar was to bring all the different participants to discuss deeply the issue of VAT in Rwanda. I invited 100 people of different categories but only 50 attended the seminar due to other commitments. The different categories that were invited were: Policy makers, revenue officials, and taxpayers, which included registered vendors, final consumers but not vendors, and academics. Fortunately enough, all the above categories were present among the 50 who participated in the seminar. The list of the participants will be found in appendix 3, and the results of both interviews and seminar are presented in chapter four of this thesis.



### **1.5 The structure of the study**

The study is structured as follows:

The first chapter, as is obvious from the preceding paragraphs, is concerned with the purpose and overview of the study. In this chapter, the reader is introduced to the research, its significance and its objectives.

The second chapter provides a general overview of value added tax system in a

number of countries, viz. Argentina, Korea, Côte d'Ivoire and South Africa. The main purpose of this comparative study is to show how VAT was implemented in other countries, what its benefits were and what its main constraints were.

Chapter three presents the fiscal system of Rwanda. Here, a general overview of the Rwandan taxation system, including a historical background and a discussion of the evolution of the tax system is presented. It also examines the revenues and expenditures of the Rwandan Government for the fiscal year 2001, to show the relevance of taxes in the economy. The fiscal reform goals are also presented.

In chapter four, the research examines VAT in Rwanda and the question of whether it provides a problem or solution to the development challenge. It first presents an account of how the interviews were conducted, secondly it shows how VAT works, thirdly, it looks at the reasons for the introduction of VAT in Rwanda, fourthly, it discusses the differences and similarities between VAT and ICHA. Finally, the research considers the different opinions regarding the relationship between VAT and economic development.

Lastly, chapter Five summarises the research, draws conclusions and provides some recommendations for the future.



# CHAPTER TWO:

## GENERAL OVERVIEW OF VALUE ADDED TAX SYSTEM IN SOME COUNTRIES.

### 2.1 Introduction

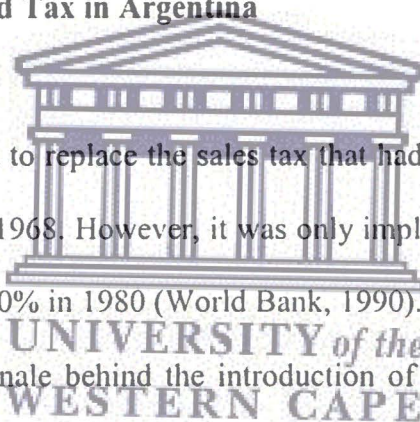
The efficient administration of taxation is a major problem because many people try to escape paying taxes and to become 'free riders'. That is why taxes are compulsory everywhere. In most countries, the larger part of government resources comes from its citizens through taxation. It means that before any kind of government expenditure to be made, it must take resources from the people and taxes are the most important method for acquiring these resources. The value added tax system is found to be a very effective tax system in many countries as it brings more tax revenue into the state finances, without the distortions of some of the other types of taxes.

Usually the value added tax is a tax on the consumption of goods and services, paid by the consumer to the vendor. The latter has to pay back the tax revenue collected to the revenue service. Finally, it is the end user who bears the burden of VAT since a registered vendor can claim the input tax paid on his purchases. In some rare cases, VAT is levied on income. This chapter considers the implementation in a number of developing countries of both types of VAT. What

did countries that succeed to implement VAT do; and why did some fail to implement VAT successfully?

As mentioned above, the following countries were included in this study: Argentina, Republic of Korea, Côte d'Ivoire and South Africa. These are all countries that have introduced a VAT system during the past few decades. In the case of all, but one of them VAT was successfully implemented.

## 2.2 The Value Added Tax in Argentina



In Argentina the idea to replace the sales tax that had been operating since 1930s by VAT emerged in 1968. However, it was only implemented in 1974 at a rate of 16%, which rose to 20% in 1980 (World Bank, 1990). According to Osvaldo *et al.* (1990:116), the rationale behind the introduction of VAT in Argentina was the expectation of collecting more revenue:

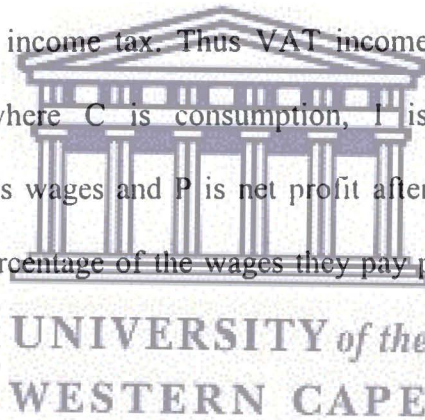
*“One reason for the stronger revenue performance of the VAT, compared with the tax it replaced, was the inclusion of a significantly larger number of firms in the indirect tax base under VAT. By 1977, the third year of the VAT, there were twice as many registered taxpayers as there had been under the sales tax. The sharpest increase in the number of taxpayers occurred in 1980, when the VAT base was broadened to include the following sectors: mining, electricity, gas, potable water, communications, transport and storage.”* (Osvaldo *et al.* 1990:116)

As in many other countries where VAT is levied, Argentina taxes imports and

exempts exports. However, Argentina's VAT had serious imperfections:

*"The imperfections of the VAT in Argentina are not related to the external sector. They are instead caused by the type of VAT adopted, the use of exemptions to promote regional or sectoral objectives, and the exclusion of certain sectors from the system"* (Osvaldo et al, 1990: 117).

Unlike other countries, Argentina's VAT is of an income type with one qualification: true economic depreciation is not allowed. The income type of VAT reflects value added in the conventional sense of total economic activity in the country during the tax period. The aggregate base is the same as that for a comprehensive income tax. Thus VAT income equals to a percentage of  $(C+I-D=W+P)$  where C is consumption, I is gross investment, D is depreciation, W is wages and P is net profit after depreciation. The vendors pay VAT as a percentage of the wages they pay plus a percentage of the net profit they get.



As observed in the World Bank Symposium (1990:117), a legal rate of depreciation of 20% was established in 1974 (and changed to 33% in 1983). The income VAT, in contrast to expenditure VAT, has been found to discriminate against capital accumulation and favour present consumption.

Additionally, VAT is usually seen as a regressive tax:

*"Because consumption expenditures represent a higher proportion of income for poor families than for rich families, the consumption VAT is thought to be regressive"* (Osvaldo et al (1990: 117).



Osvaldo uses the example below to illustrate the situation: Consider the effects of a consumption VAT of 20% on Mr. Rich, who has an income of \$1,000, and Mr. Poor who has an income of \$100. After satisfying his most essential needs at a cost (net of taxes) of \$80 and incurring \$20 in VAT, Mr. Poor has no savings. In contrast, Mr. Rich spends \$400, pays \$100 in VAT, and saves \$500. Because the tax takes up 20% of Mr. Poor's income but only 10% of Mr. Rich's, it is said to be regressive.

Osvaldo argues that the problem with this argument is that it ignores what happens in the future. Assume that these individuals live for one more period and earn their same respective incomes in the second period. (For simplicity, also assume a zero interest rate.) In the second period Mr. Rich exhausts both his savings and his second-period income when he consumes \$1,200 and pays \$300 in tax. This tax burden represents 30% of his second-period income, whereas Mr. Poor will again end up paying 20% of his income in taxes. Over their lifetimes both men spend 20% of their respective incomes on taxes; hence the consumption tax is not regressive but proportional when considered from the proper perspective of lifetime.

There are two types of problems with Osvaldo's arguments. Firstly, Mr Rich may well continue to save something each year, which means that the actual tax rate on his total income will be less than Mr. Poor pays. Furthermore, the principle of equity and fairness must be applied. In many countries especially developing countries, it has been observed that the rich people receive more from the Government than the poor. Thus, my suggestion is that with regards



to VAT, one should consider multiple rates: Zero rate for the basic foodstuffs, a low rate for the goods that are most used by low-income group and a high rate for luxury products or goods that are most consumed by rich people.

### ***2.2.1 Regional and Sectoral Promotion***

With regard to the regional and sectoral promotion, two types of VAT exemption were found in Argentina's VAT system (Osvaldo et al. 1990). The first exemption is sometimes called a false exemption, because it does not in the end constitute a real exemption, and the second one is called a true exemption, because it does. The false exemptions are granted when the "exempted" value added will be taxed in a subsequent stage of production where collection will be easier and cheaper. Not only does this procedure not exempt anything, it generates additional tax liability because the "exempted" taxpayers cannot claim a fiscal credit for the VAT embodied in the prices of their inputs.

The second type may be called true exemptions, and occurs when certain products are zero-rated. True exemptions are usually granted to exports and certain other goods and activities.

As the Osvaldo *et al.* (1990:117) explains:

*"The exemptions are "true" because both those who engage in such activities and their customers get a fiscal credit for the VAT they pay on their inputs. And because the exempted taxpayers include the VAT*

*in their invoices (to enable their customers to claim a fiscal credit) but do not pay it to the treasury, the promoted activity, rather than the government, collects the tax.”*

### **2.2.2 Excluded sectors**

In Argentina's VAT system; there was an exclusion of certain sectors, which generates an implicit tax, over and above the VAT itself, on their purchases from other firms in the system. Argentina's VAT system illustrates the rule of the implicit tax. Until May 1983, the agricultural sector was excluded from the system (Oswaldo *et al* 1990:118). The agricultural sales to other sectors concerned with the VAT system were exempt and its purchases of taxed inputs did not generate a fiscal credit\*. This meant that the use of agricultural products as inputs by other sectors could not generate a fiscal credit for those sectors. That is, inputs of agricultural origin would be treated, for VAT purposes, as value added of the sectors that use those inputs. Thus the exemption of the agricultural sector implied that the value of its sales to the industrial sector (and certainly the value added in those sales) was taxed exactly as industrial value added. The agricultural sector's sales to final consumers, however, are subject to the VAT. A common way to compensate for this distortion as suggested Oswaldo *et al* (1990:118) is:

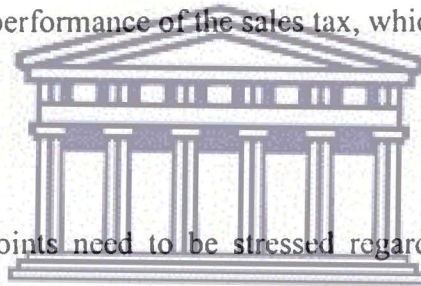
*To grant the users of agricultural products an arbitrary rule-of-thumb deduction, a so-called presumptive fiscal credit on the value of their purchases of agricultural goods. The rate is usually equal to*

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\* Fiscal credit is the tax included in the price of the inputs in the production of goods and services.

*a fraction of the VAT rate. In Argentina the users of agricultural products were allowed to deduct from their VAT liability 4% of the total value of those purchases. Nevertheless, the presumptive fiscal credit is merely a subsidy on agricultural product sold to industry. It cannot neutralise the implicit tax on industrial inputs bought by agriculture, and therefore the effect on resource allocation persists.*

In sum, VAT in Argentina has not been a successful source of revenue. Except for 1980-82 as observed in the World Bank Symposium (1990: 120), VAT revenue did not rise above 3% of gross domestic product (GDP) and remained substantially below that level most of the time. This is only modestly better than the revenue performance of the sales tax, which raised revenue of 1.5% to 2.0% of GDP.



Two important points need to be stressed regarding the implementation of VAT in Argentina. Firstly, the Argentina's VAT was found to be of an income type and as a result, the choice between consumption and saving is likely to be distorted (World Bank 1990:120). Secondly, the fact that some sectors are excluded from the VAT system undermined the neutrality of the tax with regard to resource allocation. However a guide to a solution is proposed below as follows (World Bank Symposium 1990: 120):

*A change toward a consumption-type VAT with broad coverage would promote efficiency from the viewpoint of both capital accumulation and the composition of current consumption.*

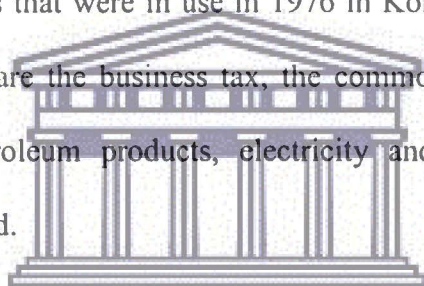
The experience of Argentina clearly shows that an income type of VAT, which in theory exempts some sectors such as agriculture, actually does not



function more effectively than a sales tax. Countries, which have gone the consumption VAT route and have avoided sectorial exemptions, have, as we will see in the following sections, done much better.

### **2.3 The Value Added Tax in the Republic of Korea**

Due to the fact that the Korean indirect tax system was complicated (Han 1990), the Republic of Korea decided to introduce VAT in July 1, 1977. Of the eleven types of indirect taxes that were in use in 1976 in Korea, eight were replaced by VAT in 1977; these are the business tax, the commodity tax, and the taxes on textile products, petroleum products, electricity and gas, travel, admissions, entertainment and food.



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The adoption of VAT in Korea was not as simple as one could have expected it to be. There were several arguments both against and in favour of adopting VAT. As Han (1990:129) summarised below, the arguments in favour of VAT were:

1. VAT would simplify the system of indirect taxes. By replacing eight of eleven indirect taxes, the VAT would reduce not only the number of indirect taxes but also the number of rate brackets.
2. VAT would promote tax neutrality in international trade. Under the old system of indirect taxes, it was difficult to calculate the amount of tax to be refunded on exports and the amount of compensatory tax to

be collected on imports. As a result the tax hidden in the process of production and distribution was either overcompensated or under compensated. Statistical evidence suggests that it was more a case of under compensation than over compensation. Under the destination principle of taxation, such under compensation would erode the competitive edge of exports and give imports an advantage over domestic industries.

3. VAT would help to allocate resources more efficiently. Because the VAT stimulates investments and savings, taxpayers may decide to spend little money on consumption and save more. This is due to the fact that VAT is levied on consumption and if the taxpayer opt for savings, this will increase his earnings which can be investment-oriented since investment is excluded from the tax base. However, this is more effective in the case of the high-income group, since low-income taxpayers spend all their earnings on consumption.

4. VAT would promote domestic investment. With a consumption-type VAT, this is self-evident, because expenditure on investment is excluded from the tax base. Full credit is given for VAT paid on purchases of capital goods. This implies that, as compared with the case in which there is no investment, the total VAT burden can be greatly reduced.

5. VAT would discourage tax evasion. The VAT system requires that tax invoices be issued in transactions, and taxpayers must hold on to the invoices in order to benefit from tax deductions. The authority would thus be able to crosscheck the invoices documenting transactions between taxpayers, which would make tax evasion more difficult.

6. The VAT system would provide the government with a steady source of revenue because the VAT base is broad and also because of limited room for evasion.

These arguments are of course also valid in the case of any other country that considers the implementation VAT, including Rwanda. However, there were counter arguments against the adoption of VAT in Korea, arguments, which generally also are applicable to other countries. These are:

1. The current bookkeeping practices were not sophisticated enough for the VAT system to work. Businesses and traders would need more time to develop this capacity.
2. The strongest argument against adopting VAT was that it would increase prices.
3. The VAT is a regressive tax. Although a single rate VAT would improve the allocation of resources, it was also argued, it would work

against the equitable distribution of income. The special excise tax on certain types of luxury products that was introduced at the same time as the VAT was meant to offset the regressive nature of VAT.

### *2.3.1 Preparations for implementation of the VAT*

Although the VAT system was introduced in Korea to replace eight existing taxes, taxpayers considered VAT to be a complex tax system and an additional tax burden. Nevertheless, because the government was concerned, it attempted to educate the taxpaying public in order to counter their fears and do away with some of the uncertainty surrounding the adoption of VAT.

Apart from the education given to taxpayers, the government also had to train the tax officials to understand the new tax system, and it had to reorganise the tax administration. With the help of Korean Chamber of Commerce and Industry and other economic associations, newspapers, television, and radio, the government launched a public relations campaign for the VAT (Han, 1990: 131). These included a series of articles, questions and answer sessions, feature stories, and lectures on the need for the VAT. A movie was produced about the VAT and shown in all the movie theatres in Korea. Seminars, conferences, and meetings were held on the VAT. About thirty different pamphlets about VAT were printed, including “The VAT: What Kind of Tax Is It?” and “Explaining the VAT law, tax invoice and how to report it”, and 16 million copies were distributed.

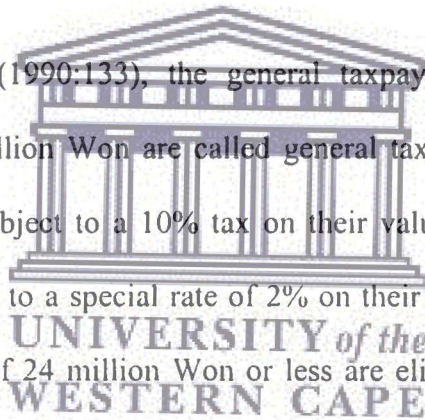


### **2.3.2 Taxpayers**

In the Korean VAT system, any unit separately engaged in the supply of goods or services in the course of business, whether the business is motivated by profit or not, is legally responsible for the VAT. The taxpayers include individuals, corporations (including state and local authorities) and foundations, which are not incorporated.

In Korea, a distinction is made between groups of taxpayers with regard to VAT: general taxpayers and special taxpayers.

According to Han (1990:133), the general taxpayers (those with an annual turnover over 24 million Won are called general taxpayers and are subject to a 10% tax rate) are subject to a 10% tax on their value added, whilst the special taxpayers are subject to a special rate of 2% on their gross sales. Taxpayers with an annual turnover of 24 million Won or less are eligible for the special rate of 2%. They are called special taxpayers.

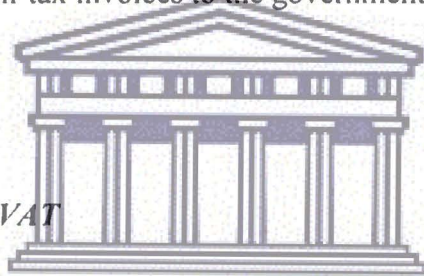


### **2.3.3 Relief for small businesses**

Unlike large businesses, small businesses are incapable of meeting all the VAT requirements (such as keeping their books and rendering tax returns in the format required). This is due to the fact that large businesses are more able to absorb the costs of complying with the VAT's standard accounting and procedural



requirements. However, small businesses are found to be an important part of the total business (and taxpaying) community. As a result, there is both a political and an economic need to alleviate the burden of a complicated VAT system on businesses with a small turnover. According to Han (1990:134), individual traders who supply goods and services for which the VAT-inclusive annual turnover is less than 24 million Won are subject to a special VAT rate of 2% levied on their turnover rather than on the value added. In addition, a relief measure for small businesses is incorporated into the VAT regime in Korea. Special taxpayers could deduct from their VAT liability up to 5% of the taxes they paid on purchases, provided they submit their tax invoices to the government.



#### *2.3.4 Administration of VAT*

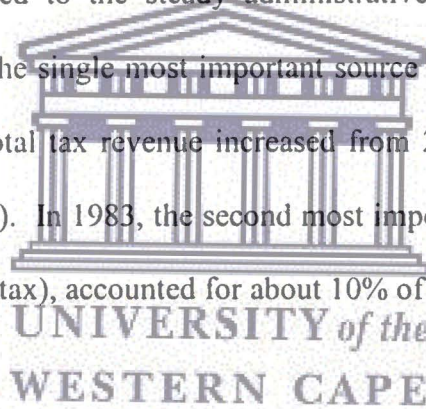
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The administration of VAT in Korea was not too problematic because one of the eight indirect taxes that were replaced by VAT in 1977 (that is the business tax) had similar administrative requirements to the VAT (World Bank, 1990). Because the business tax was a tax on turnover, the traders were already practicing some form of book keeping. The government resolved to use the business tax as a stepping-stone to VAT and transformed it accordingly in 1974. The number of tax rates was reduced from six to five, but the rates were raised. The tax base, which had been restricted to the manufacturing sector and certain parts of the wholesale sector, was expanded to include all manufacturing, mining, and wholesale businesses. Traders were asked to issue a standard invoice (similar to the tax

invoice under the VAT system), and penalties were applied to those who did not comply with the rule. A registration system using taxpayer identification numbers was introduced, which greatly eased the process of computerisation. (Han 1990:135)

#### **2.3.4 Evaluation**

When it comes to the evaluation of the VAT system in Korea, studies have found that it has contributed to the steady administrative efficiency of indirect tax revenue and is now the single most important source of government tax revenue. The VAT share in total tax revenue increased from 20.5% in 1978 to 22.3% in 1983 (Han, 1990:138). In 1983, the second most important source of tax revenue (the personal income tax), accounted for about 10% of the total tax revenue.



One of the arguments against VAT in Korea was the regressivity of that tax system, meaning that it is inequitable. Although several scholars pointed out that Korea was one of the few developing countries, which had experienced rapid economic growth without profound changes in income distribution, there were signs that income inequality was widening in the mid-1970s. The introduction of a regressive tax was seen to aggravate the already existed income inequality in Korea. The results of a study as Han ((1982b,pp414-16) quoted by Han (1990:139)) observed seem to support this argument.

*"In 1978 the effective VAT burden on the lowest income decile of nonfarm households was 9.4%, and the tax burden decreased as the*

*level of household income increased. The burden on the highest income decile of nonfarm households was 3.8%. The regressive nature of VAT was also apparent in the case of farm households. The VAT burden on the lowest income decile of farm households was 8.4%, and the effective burden decreased as the income level increased; the burden was 2.9% for the highest income decile."*

Even if the general burden of VAT was lower for farm households, the tax burden distribution showed a similar pattern for both farm and nonfarm households.

An interesting fact came out when the effective indirect tax burden was compared between 1976 and 1978. In 1976, when the eight indirect taxes that were replaced by the VAT were still in function, the effective indirect tax burden of nonfarm households was observed to be lower in the case of low-income groups and higher in the case high-income groups as compared with the burden distribution in 1978. The indirect tax burden of the middle-income groups, particularly those in the fifth to seventh income deciles, appeared to have been less affected by the change of the indirect tax system. In contrast, the indirect tax burden of the farm household was generally higher in all income brackets in 1978 than in 1976 (Han 1990:139). This finding clearly supports the argument put forward earlier in this chapter regarding the regressivity of VAT. Except for the problem of its impact on equity the switch to VAT clearly benefited the Korean economy.



## 2.4 The Value Added Tax in Côte d'Ivoire

Also in Côte D'Ivoire there was pressure to broaden the base for the tax system. As was the case in the other countries considered; this led to pressure to introduce the value added tax. In the Ivorian case, they modified their production tax and adopted what they called TVA-TPS (taxes sur la valeur ajoutée (TVA), which is VAT, and taxes sur les prestations de service (TPS), which is a turnover tax on services). As Betty et al. (1990:145) suggested, the scope of the TVA and TPS was limited to concerns with annual sales over CFAF 30 million (US \$ 120,000 at the 1960 exchange rate). Smaller firms whose activities were otherwise subject to the TVA or TPS were instead subjected to a fixed tax rate (8% for TVA and 7.57% for special import duty). Such firms represented 60-66% of total industrial employment in 1965 and 1970 (Betty *et al* 1990:145). Those firms generated 61%, 45%, and 32% of manufacturing GDP in 1960, 1965, and 1969, respectively (Den Tuinder, 1978:322). Agriculture and commercial activities were excluded from the TVA-TPS base because of perceived difficulties in tax administration in sectors dominated by small producers. For example, an estimated 280,000 small coffee plantations produce the country's major export crop (Europa Publications 1984:441). Furthermore, 90% of commercial activity occurs in traditional retail outlets (Tixier & de la Biche 1973:15). In 1970, 49,000 of the 50,000 commercial outlets in the Côte d'Ivoire were small African-owned shops, market stalls, or street vendors (République de Côte d'Ivoire 1978:209).

The choice of TVA-TPS structure was influenced by the economic and political



circumstances surrounding the Côte d'Ivoire at independence, especially the close economic and cultural ties it had with France (Betty C.H. (1990). This is illustrated by the fact that about 50% of Ivorian exports were destined to France while 65% of its imports came from France.

A French consulting firm in the late 1950s proposed a VAT covering goods and services through the wholesale stage. As Betty et al. (1990:145) observed:

*“The Finance Ministry felt its accounting demands on taxpayer and tax administrators were excessive, that its revenue effects were uncertain, and that inadequate administrative resources would lead to loss of revenues and widespread evasion. The proposal was rejected and the Finance Ministry proposed the less extensive tax sur le chiffre d'affaires structure, which, with modifications, is in place today.”*

In Côte d'Ivoire, the TVA was more attractive than the previous production tax for a number of reasons. These are summarised below (Betty 1990: 145):

- Compliance costs were generally reduced,
- Acceptable deductions were broadened to include TVA paid on most inputs and investment goods,
- Elimination of the head tax and exclusion of most products consumed by the rural population from the TVA,
- Tax rates were carefully chosen to have only a minor effect on the effective tax rates on domestic production and imports, and
- Exports were zero-rated to eliminate bias against exporting.

### 2.4.1 Tax Neutrality and Incentive Effects

The Ivorian TVA-TPS was more neutral than the earlier, production tax. The TVA-TPS avoided the cascading effects by alleviating the bias towards vertical integration (Betty *et al.* 1990). The tax system also eliminated the biases against capital by reducing the double taxation in the previous tax. However, the TVA-TPS probably initiated a bias towards the investment code, favouring the capital-intensive production methods. For example, the investment code exempted “priority” firms of TVA, for ten years on imported capital goods and inputs (excluding those that can be produced in the Côte d’Ivoire).

According to the World Bank (1985:45) study, the Ivorian TVA-TPS created some non-neutrality in product and factor markets independent of its relationship with the investment code. These were:

**1. Different rates.** Resource allocation was affected by the rate structure through prices and consumer demand.

**2. Small versus large firms.** A potential bias against large firms in wholesale and retail trade was avoided by exempting these activities altogether. Similarly, many specific agricultural products and activities were exempted for all firms. Within manufacturing, the exclusion of small producers could give rise to a bias against small producers who cannot use the credit for TVA paid on inputs or invoice TVA to customers. The small firms if they wished to, could avoid this

bias by opting for TVA. Small construction firms may have imported inputs subject to the TVA invoiced directly to the customer.

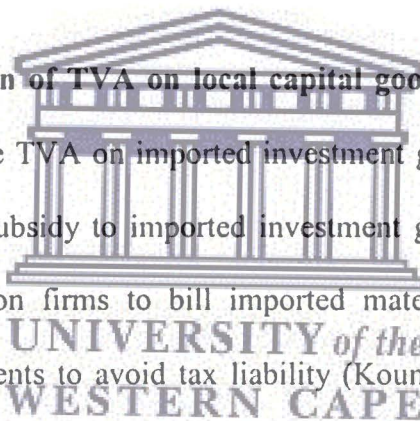
**3. Different rates on imports and domestic production.** There was only one case of different rates on specific imports and domestic production. Nonetheless, differences occurred between the imports on domestic rates for the same activity, when imports were described incorrectly as related products subject to lower tax. This also happened when differences existed between the tariff and the tax code nomenclature (Koumoue Koffi 1981:190) cited by Betty *et al.* (1990:145).

**4. Rounding of the import rate.** The rounding of the tax-exclusive import rate to the nearest integer caused a small difference between the import and domestic rates for the same activity.

**5. Deductibility of the TVA on investments.** This could cause a small bias favouring vertical or horizontal integration of existing firms, because they could immediately credit the TVA against the tax liability from their other operations.

**6. Reimbursement of the TVA.** The TVA paid on inputs used in exports is credited against TVA liability and could lead to reimbursement. However, an internal World Bank Report stated in

1974 that “in practice it has been difficult for exporters to obtain the refund” (Koumoue Koffi 1981:202, author’s translation). Difficulties with the reimbursement process could work against firms with insufficient domestic TVA liability. A related problem associated with the investment code arises with the exemption of TVA on imported inputs, but not on local inputs. When reimbursement is difficult, priority firms had an incentive to substitute imported for local inputs in export production. This bias was eradicated to the extent that firms supplying inputs for export production are allowed to omit the TVA.

**7. Non-exclusion of TVA on local capital goods.** Priority firms are exempt from the TVA on imported investment goods. This imparts a slight indirect subsidy to imported investment goods and may cause local construction firms to bill imported material directly to their priority firm clients to avoid tax liability (Koumoue Koffi 1981:70). The tourism investment code allowed exoneration of the TVA on both imported and local investment goods.

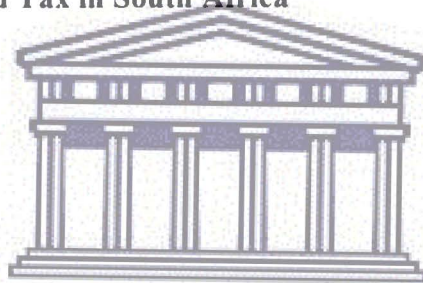
In conclusion, the TVA-TPS was introduced without many problems (Betty et al. 1990). The new tax system offered improvements in neutrality, equity and eased the tax administration. It did not involve significant rate increases over its production tax predecessor. From being primarily a tax on imports, it became an important tax on domestic activity. Even if the Ivorian TVA-TPS retained some non-neutrality, it was a noticeable enhancement over its predecessor. It involved



some partialities favouring capital (particularly imported capital goods) and more fully integrated production. These biases were insignificant compared with those found in other aspects of the Côte d'Ivoire tax policy (especially the investment code).

As for the case of Korea and unlike Argentina, the VAT in Côte d'Ivoire was likely to bring about economic growth. This is also valid for the case of South Africa as discussed below.

## **2.5 The Value Added Tax in South Africa**



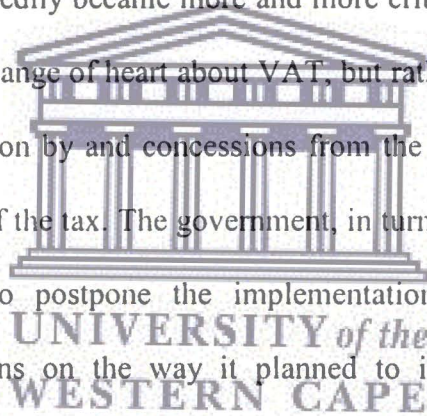
### **2.5.1 Introduction**

It has been observed that the VAT that replaced GST in South Africa would definitely be a regressive tax as it was the case in the above-analysed countries. VAT could lead to a massive redistribution of wealth from poor to rich.

The introduction of VAT in South African tax system has not been an easy task. There was strong opposition to its implementation. According to WIP (1991), most opposition to VAT came from pro-capitalist forces, which, although they were basically in agreement with the change to VAT, disagreed with VAT as it affected their particular interests. The construction and private health sectors, for

example, argued against the imposition of VAT in their sectors, but not against the tax as a whole.

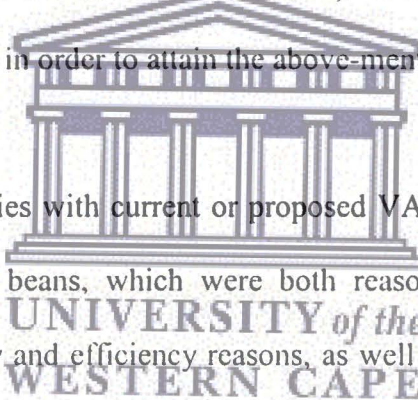
Since July 1991, however, there was growing resistance from progressive forces, led by the Congress of South African Trade Unions (COSATU). COSATU called for the delay of the implementation of VAT and for discussions between progressive structures and the government, with a view to reaching an accord on how the new tax could be implemented. COSATU threatened extensive protest action if the government did not respond positively. Big business and the commercial press speedily became more and more critical of the government, not because they had a change of heart about VAT, but rather because they feared that the lack of consultation by and concessions from the government could threaten the implementation of the tax. The government, in turn, dug in its heels. It refused to maintain GST, to postpone the implementation date of VAT or make significant concessions on the way it planned to implement VAT (Work in Progress 1991, Finance week 1991:3). As a result, VAT was implemented as planned.



## **2.5.2 The South Africa's VAT system**

### **2.5.2.1 Reason for the introduction of VAT**

The introduction of VAT in South Africa in 1991 was intended to achieve many goals amongst which the reduction of the impact of the new tax burden on the poor and to provide a safety net program. The National Nutrition and Social Development Programme (NNSDP), was also introduced in 1991, designed to distribute R400 million annually in community-based food projects (McLachlan & Marshall, 1995 cited in Alderman *et al.* 1999). There were also exemptions for some basic foodstuffs in order to attain the above-mentioned goals.



The list of commodities with current or proposed VAT exemptions included, for example, maize and beans, which were both reasonable candidates for VAT exemptions for equity and efficiency reasons, as well as for their impact on food nutrient consumption (Alderman *et al.* 1999). The list also contained commodities such as bread, which did little to address equity concerns but could have favourable consumption effects, as well as fresh milk and meat, which neither enhanced equity and nor had a clear impact on nutrition.

One may ask itself why could South Africa Revenue Service (SARS) oblige people to pay VAT instead of general sales tax for their different consumptions. Why was it necessary to impose such a tax? When looking at the perspective of taxpayers, VAT, as is the case with other forms of tax, was considered to be more

of a burden than a benefit. This is why some temptations of VAT evasion and avoidance were found in the system. According to the Financial Mail (October 4, 1991: 27-28):

*“ VAT undermines decision-making; confuses consumers; obscures the fundamental merits of the system; and sets the scene for continual controversy over peripheral issues. People ask: Why a good tax cost consumers more and gives the taxman less? A calculation by Sanlam economist Pieter Calitz shows that the broader VAT base amounts to 70%-75% of the consumer basket, compared with the 52% of the basket to which GST was applied.”*

However, when looking at the perspective of the government, it is clear that the tax revenue collected helped to achieve many of the Government's goals, including social services to the community. Although the trade unions strongly opposed the VAT system, the Government was very concerned to increase its revenues. After introducing VAT, the Finance Minister Chris Liebenberg's Budget for the year 1995-1996 was found the most important since South Africa became a unitary State in 1910 (Financial mail 1995:20-21). It was also argued that:

*“ South Africa requires an appropriate tax system, which provides for an adequate return. Not only that, but we must get our fiscal and monetary houses in order, ahead of the abolition of the Finrand and the establishment of a unified currency system in the not too distant future” (Financial mail 1995:21)*

According to the interview, many taxpayers did not understand the usefulness of tax revenue since it was difficult to them to see the outcome of the tax that they paid. This was due to the fact that the benefits they received and are still receiving



from the government were and are only indirectly linked with the tax paid. More importantly, it is necessary to emphasize the advantages of VAT system, so that taxpayers may be aware of that utility. The study also highlights the difficulties faced by tax collectors in the process of tax - collection. It shows how do tax collectors resolve some of the problems that they face in collecting tax

### **2.5.2.2 The base and the rate of VAT**

According to Deloitte & Touche (2000: 5-6), in the early 1990's, the South African Government had the intention of introducing VAT at a standard rate of 12% on as a broad range of goods and services as possible. The idea behind the new tax system was to get more money from taxpayers, by keeping to a minimum the number of zero ratings and exemptions. However, the opposition forced the government to reduce the VAT rate to 10% and to increase 'temporarily' the range of zero - rated basic foodstuffs. Maize, bread, meat and fluid milk were included amongst the zero-rated basic foodstuffs.

The study done by Alderman *et al.* (1999) confirmed the logic of VAT exemption for maize. As he observed:

*"Based on tax efficiency and equity, this commodity dominates all alternatives. Also, tax exemptions for fluid milk or bread have similar implications as maize for the total revenue foregone, but have less favourable impacts on equity. Similarly, while the tax exemption for maize helps improve nutrition in both urban and rural areas, the tax exemptions on fluid milk has virtually no impact on energy or even*

*protein intake. In contrast to milk, however, the impact on nutrient consumption of a tax exemption for bread is fairly similar to that of maize; the two commodities differ, however, in that a VAT exemption for maize has strong estimated equity impacts while it does not for bread."*

They continued arguing that the equity and efficiency of commodity taxation could be achieved if exemptions on kerosene and sugar were substituted for those on fluid milk.

According to Alderman *et al.* (1999) VAT exemption for meat was not justified either in terms of equity or nutrition: It would favour non-poor urban households and have a negative impact on the calorie consumption of rural households. However, the exemption on maize was well targeted and had a measurable positive impact on calorie consumption by deficit households.



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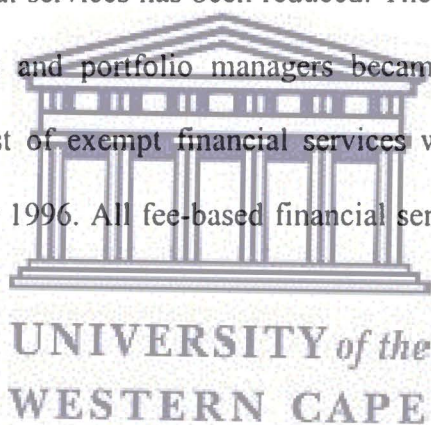
The following interview of COSATU's Sam Shilowa (assistant general-secretary) in Labour Bulletin illustrates the case of the consultation with the Government with regard to VAT. (SA Labour bulletin Vol.16 n03):

*"LB: To be more concrete, to what extent have you succeeded in making an impact on the VAT taxation itself?*

*Shilowa: Firstly, the moment we started our campaign, VAT was reduced to 10%. Secondly, we managed to get a number of food- stuffs zero-rated. Thirdly, a number of SA organisations, both to the left and to the right of COSATU, and other trade union organisations have been able for the first time to come together, and the issue of tax-action is not only left to workers to raise. The stay away has raised the issue at a broad public level. "*

Taxpayers felt that the Value added tax affected their day-to-day lives of people and the money in their pockets (Work in Progress, December 1991, Finance week October 1991:10). Work in Progress argued, “the government could have learnt that labour was serious when it said ‘don’t restructure the economy without consulting us’.” COSATU reported 80-90 percent stay away countrywide in the strike it called, and denied allegations of ‘intimidation’.

From 1993, the standard rate increased from 10% to 14%. From April 1995 the list of exempt financial services has been reduced. The activities of life insurance brokers, stockbrokers and portfolio managers became subject to VAT at the standard rate. The list of exempt financial services was further narrowed with effect from 1 October 1996. All fee-based financial services attracted VAT at the standard rate.



### *2.5.3 Usefulness of VAT in South African context.*

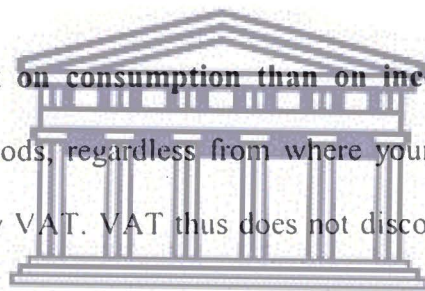
In South Africa, as in many other countries where VAT was implemented, experience showed that the VAT system has many advantages over GST system for both the taxpayers and the policy makers. These include: (VAT Manual 1991, SARS interview):

- **VAT is a multiple collection system while GST was a single collection system.** The advantage to policy makers comes into play especially when there is a manoeuvre to evade tax. The amount of

revenue collected will be lost under GST because of the evasion, while some money can be gained under VAT because of the multiple collection.

- **Broad base:** Many activities are now liable to tax because of VAT, which was not the case under GST. The advantage again is that the Government will earn more under VAT than GST. For example: the building of houses was not included under GST but now is taxable under VAT system.

- **VAT is a tax on consumption than on income.** When you buy consumption goods, regardless from where your income comes, you are liable to pay VAT. VAT thus does not discourage income-raising activities.



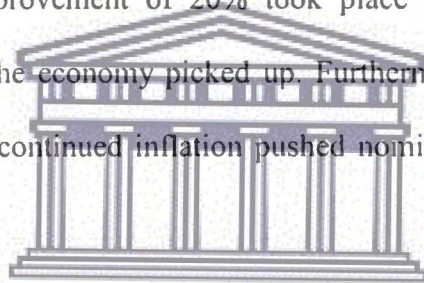
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- **With the system of record keeping under VAT,** the vendors have a full control of their financial situation or transactions because they have to report their financial situation to the Receiver.
- **There is no cascading effect under VAT.** No double taxation like under the GST system.
- **The financial burden is lower under VAT than under GST.** The reason is that the burden is shared between all taxpayers in chain.



- **Audit trail:** using one's tax- invoice, it is relatively easy for the Receiver to control other vendors in the chain to make sure that what they have declared is true and correct.
- **VAT is internationally accepted.**

The figure for the revenue collections as noted in Financial Mail (March 1995:20-21) for the period from April 1 to December 31, 1994, showed that income rose to R41,2 billion from R34,3 billion in the same period of 1993. There is no doubt that part of this improvement of 20% took place because of an increase in corporate profits as the economy picked up. Furthermore more personal income tax was collected as continued inflation pushed nominal incomes up into higher tax brackets.



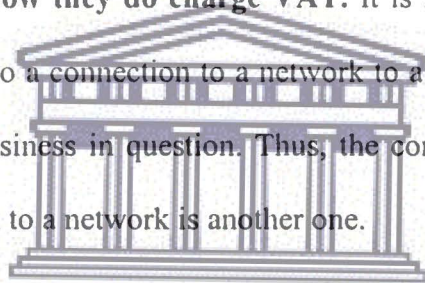
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However, despite the advantages of the VAT system, tax collectors faced many constraints when collecting tax revenue.

#### ***2.5.4 Difficulties encountered by tax collectors in VAT system***

From the interview with the South African revenue officers (November 2000), it is clear that they face several problems in the collection of tax. Those problems are summarised below:

- **Insufficient infrastructure** (such as means of transport, computer systems) to control vendors,
- **Vendors must have computers in their business systems in order to record each activity.** This is a problem since many vendors do not have enough money to purchase and maintain computers in their business practices.
- **There is a need for a network system to connect vendors and control them to see how they do charge VAT.** It is not only a computer that is needed but also a connection to a network to allow the revenue officers to control the business in question. Thus, the computer is one problem and the connection to a network is another one.
- **Registration problem.** If there were no limit to registration, it would be a burden for the revenue to support the administration cost, which most likely was higher than the VAT collected. When VAT was implemented in South Africa, SARS allowed vendors with a turnover of R 50 000 per annum to register for VAT purpose. The result was that the number of registered vendors was large and the administration fee very high compared to the VAT return from those vendors. To resolve this issue, the Minister of Finance increased the level of turnover at which a vendor may register to R 300 000 per annum to avoid the high administration fees. Nevertheless the minimum turnover for voluntary registration was R25000



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per annum while compulsory registration required a minimum turnover of R 300 000 per annum. A proof of turnover has to be provided for voluntary registration while a business plan has to be issued for compulsory registration.

- **Sometimes vendors issue false information to the revenue service, which negatively affect their returns.** To prevent this, some requirements must be met:

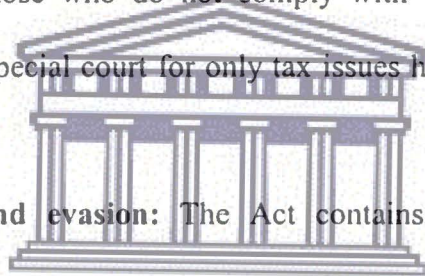
- Companies, have to prove that they are registered.
- If it is an individual registration, then a copy of the ID (identity book) must be issued and a bookkeeping system insured. The individual must also provide bank particulars.
- The Auditor must make sure that the registered vendor is a valid and legal person and really a businessman.
- Regular refunds must be checked properly because sometimes especially during the implementation phase of VAT, some individuals pretended to be businessmen, settled their so-called business purposely to claim Input tax during that period and abscond after receiving the money.

- **Late payment of the tax.** For late payment, a penalty of 10% is applicable from the end of tax period to 5 days after the tax period. If the vendor does not pay, then the interest will be added to the penalty. But the problem faced by tax collectors is that because the interest rate charged is less than the bank interest (14% compared to 21% (Interview in SARS)), the vendor prefers to

continue with his business and not to pay the money, thus keeping the overdraft lower. In the end of the day he will pay the penalty and interest, this being less than the money he saved by not having a higher overdraft. This is because the interest he has to be paid for his savings in bank is higher than the interest charged by the revenue service.

However, some methods are used to overcome the above-difficulties. In the interview with the Revenue Officer the following was mentioned.

- **Special recoveries for outstanding tax cases:** in order to resolve the problem of those who do not comply with the revenue rules, internal attorney and special court for only tax issues have been introduced by the SARS.
- **Avoidance and evasion:** The Act contains a general anti-avoidance provision.



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Tax evasion amounts to fraud and usually involves the making of false returns, and the entering into of sham transaction of records. According to Ernst & Young (2000:112):

*“ When the offences set out below are committed, a fine of up to R10 000 and or twenty-four months imprisonment (or both) may be imposed, quite apart from the collection of tax and penalties. There is a presumption that false documents, statements or entries have been made with the intent to evade tax by the person on whose behalf they are made.”*

Among these offences are: The making of false statements or entries or answers to requests for information; the preparation of false books of account or any fraud, art or contrivance whatsoever; collusion in the acceptance of



supplies of goods or services on which tax should be charged but is not; and the issuing of incorrect or fraudulent tax invoices, credit notes or debit notes. (Ernst & Young 2000:112).

The name, address and enterprise of a person convicted under these provisions could be publicised by the Commissioner, together with such particulars as the Commissioner thinks fit, including the amount evaded and additional tax imposed (if any). But no such publication has taken place to date.

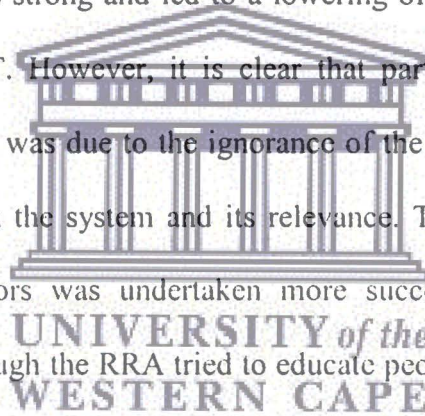
The penalty for evasion or attempted evasion, including claims for excessive tax credit or refunds, is an amount up to double the tax amount concerned. In other words, a total amount payable, including the tax itself, may be three times the original liability (Ernst & Young 2000:112). A fine (without limit) or twenty four months' imprisonment (or both) may be imposed for variety of offences, including the impersonation of a VAT inspector; the failure to keep books of account; the failure to render returns of any kind or the obstruction of Revenue officials; the claim that tax is chargeable when it is not or a lesser rate is due; the failure to supply a tax invoice, credit note or debit note when due; the issuing of more than one tax invoice; the failure to keep records or otherwise to comply with the VAT obligations of an agent.

**- For those who pretend to be businessmen in order to steal the money from revenue service, the SARS requires from external or foreign businessmen to submit the name of a South African referee who will be responsible for all that may happen. In addition, the businessman must have a**

bank account in South Africa to allow the Receiver to exercise control over him.

- **A Help line to report fraud has been installed.** However, no rewards are paid because of the dishonesty of revenue workers

In conclusion, although there were many challenges in introducing VAT in South Africa, as it was the case in Rwanda, Korea, Côte d'Ivoire and Argentina, the system operates relatively efficiently. The opposition to the introduction of the VAT system was strong and led to a lowering of the rate at the time of the introduction of VAT. However, it is clear that part of the opposition to the introduction of VAT was due to the ignorance of the public and the inability of the SARS to explain the system and its relevance. The education of taxpayers and tax administrators was undertaken more successfully in Korea. In the Rwandan case, although the RRA tried to educate people on VAT system, much still needs to be done to bring all the partners in VAT on board. Nowadays, the system in South Africa has been accepted and taxpayers consider it as part of their life. Paying tax is a civic obligation for most citizens. Nevertheless, some taxpayers still have temptation to evade and avoid tax. In a mean time, SARS officers are very concerned to overcome and abolish all fraudulent manoeuvres.



## 2.6 Conclusion

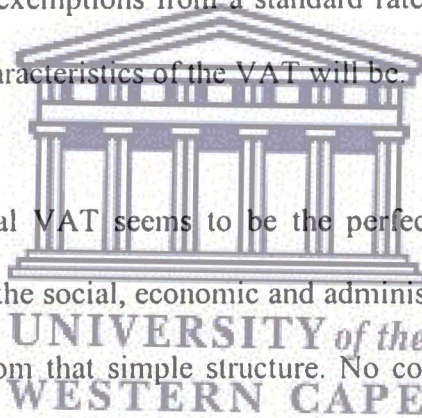
Developing countries that want to reform their tax systems by introducing the VAT system or those who have already adopted it but want to improve it can learn from the experiences of the countries considered in this chapter. There are several reasons behind the VAT successes. Some of them have to do with the kind of VAT adopted, some with the type of exemptions under the system and, probably most important of all, some have to do with the administrative system established to collect revenue.

The VAT adopted in Korea, Côte d'Ivoire and South Africa, was of a consumption type and did contribute to increase the income revenue of the above countries. However, the VAT adopted in Argentina was of an income type. Together with the exemption of some sectors from the system, VAT in Argentina did not succeed to function efficiently. When considering the applicability of the lessons learned from the experiences of these countries, for a country such as Rwanda, there are a number of questions that can be asked. The first is why should one implement VAT rather than another tax? Another question is, what kind of VAT is likely to be adopted (assuming that VAT is a desirable system), given the different starting points of most countries?

Because of its many advantages, the value added tax has been adopted in many countries and is still on agenda in many others. The turnover tax was found to have a cascading effect, which is taxing the full sales value at manufacturing stage



and again at the wholesale level without any refund. The VAT, in contrast, taxes the value added at each stage only once, at the stage where it is added. Another advantage of the VAT over the turnover tax as Gillis *et al.* (1990:230) argued, is the VAT's neutrality insofar as production efficiency is concerned: it taxes productive inputs equally and does not cause distortion of production choices. Moreover, the consumption type tax of VAT does not distort the choice between consuming now and consuming later, in favour of the former, as does the income tax. Accordingly, VAT does not penalise, as does the income tax, capital accumulation and economic growth. The larger the base for the VAT is, and the fewer the number of exemptions from a standard rate of tax, the more important will these superior characteristics of the VAT will be.



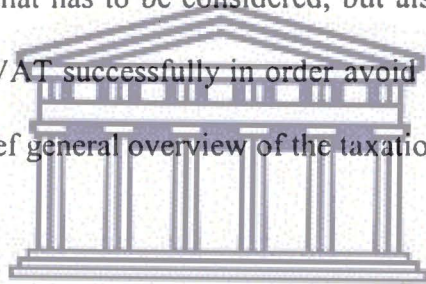
The broad and neutral VAT seems to be the perfect choice for a tax system. However, because of the social, economic and administrative objectives, there is a need for deviation from that simple structure. No country has achieved, or will attempt to adopt, such a perfectly broad and neutral VAT. The need to reduce regressivity in the structure of the tax for reasons of equity in income distribution leads to pressures to include zero-rating for some essentials and for goods designed for some special groups and to have higher than the standard tax rates for other goods that are considered non-essentials or luxuries. The commitment to certain social and economic policies will determine the use of multiple rate of VAT in developing countries. However, the main constraint for those countries is to fit the tax to the limited administrative capacity of the country in question. As Gillis *et al.* (1990:231) observed, among developing countries there are differences



in tax administrative capacity that correlate somewhat with difference in per capita GDP.

The comprehensive VAT has been successfully adopted mainly in middle-income and upper middle-income developing countries. The examples of the Republic of Korea and South Africa are good illustrative examples.

In the preceding chapter we have seen the way VAT was implemented and what has made it successful. A country such as Rwanda, which is implementing VAT system, has much to learn from the above countries. It is not only the case of successful countries that has to be considered, but also the case of countries that failed to implement VAT successfully in order avoid their pitfalls. The following chapter presents a brief general overview of the taxation system in Rwanda.



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# CHAPTER THREE:

## FISCAL SYSTEM OF RWANDA

### 3.1 Socio-political background of the fiscal system in Rwanda

#### 3.1.1 Introduction

Fiscal policy in Rwanda poses particular challenges to the national leadership as well as to the donor community (Ndikumana 2001).

The country is amongst the poorest in the world and has been weighed down by chronic ethnic conflicts since its independence. The ethnic crisis of the early 1990s resulted in the collapse of the economy and has weakened administrative capacity (Ndikumana, 2001). The fiscal crisis has been deepened by the crisis of production and trade. However, despite the crisis, Rwanda is slowly reconstructing its economy and its tax base. One of the most demanding tasks of fiscal policy is the management of public expenditures. It is the dilemma of allocating resources. First, authorities must assign public money between capital expenditures and regular expenditures. Second, they must choose how to allocate funds between military expenditures and civilian expenditures. This decision seems not to be easy and poses particular challenges in countries in conflict or evolving from conflict like Rwanda.

Military expenditures usually increase during conflicts and tend to remain high even after conflicts are apparently resolved (Ndikumana, 2001). In the mean time, revenues are low during and after conflict. This means that higher military expenditures are afforded at the expense of lower investment in socially productive sectors and higher budget deficits.

When looking at the macroeconomic performance and the macro-fiscal crisis, some key elements are essential to be mentioned: (Ndikumana 2001):

*"The decade of the 1990s has been characterised by both a deterioration of the politico-social conditions and the acceleration of economic decline in Rwanda. After a relatively steady growth in the second half of the 1970s, income in Rwanda has declined since the early 1980s. From 1970 to 1979, per capita GDP increased by about 2% annually. The following decade, the growth rate dropped to 0.25% before turning negative (-5%) in the 1990s. The decline in income was exacerbated by the 1994 genocide as agriculture and manufacturing production collapsed. Per capita income declined by a record 40%, from \$225 in 1993 to just \$154 in 1994.*

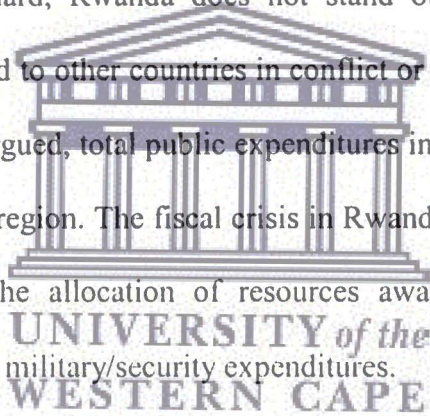
*Since 1995, income has increased as agricultural production resumed following the resettlement of the internally displaced population and the return of refugees starting in 1996."*

As observed in an IMF report (IMF 2000a: 69), the ethnic crisis in Rwanda has negatively affected all sectors of the economy, especially those that rely on high technology and skilled labour as well as export-oriented activities. For example, output in the transport and telecommunication sector in Rwanda declined by over three-fourths in 1994. During the same year, manufacturing production decreased by 35%, agricultural exports declined by 73%, while coffee exports dropped by

94%. Food production was basically stagnant in the 1980s, and started declining towards the end of the decade. The food production was increasing since 1995 in Rwanda due to improvement in internal security, (IMF 2000a: 69).

### *3.1.2 Various important fiscal issues*

From the perspective of the public expenditure, the allocation of resources is a crucial problem in a developing country such as Rwanda. From a sub-Saharan African (SSA) standard, Rwanda does not stand out as having an oversized government compared to other countries in conflict or evolving from conflicts. As Ndikumana (2001) argued, total public expenditures in Rwanda are lower than the average for the SSA region. The fiscal crisis in Rwanda has been characterised by a marked shift in the allocation of resources away from capital and social expenditures towards military/security expenditures.



In Rwanda, the increase in military spending was sparked by the invasion by the Rwandan Patriotic Front (RPF) in 1990. From an average of just over 5,000 in the 1980s, the army personnel increased to 30,000 in 1991 (World Bank 2000a: 65). Military expenditures increased by 122% in 1990 and 41% in 1991. The heavy investment in the defence equipment has come at great economic and social costs, especially marked by a large decline in capital expenditures.



In Rwanda, capital expenditures were at an all-time low of 16% of total government expenditures in 1994, down from an average of about 33% in the 1980s. Under the post-genocide regime, capital expenditures have increased steadily.

Another important aspect of fiscal policy that merits attention is the management of the civil service. Ethnic conflict has resulted in massive losses in human capital. In rebuilding the civil service, Rwanda must pursue two equally important and interdependent objectives. :

*“The first objective is to promote discipline, professionalism, and competence in the civil service. This may involve redesigning incentive structures, including compensation schemes, to make public sector jobs attractive to skilled workers. The second objective is to depoliticise public employment practices by instituting hiring and promotion procedures that are based on merit, transparency, and equal opportunity for all citizens.” (Ndikumana, 2001)*

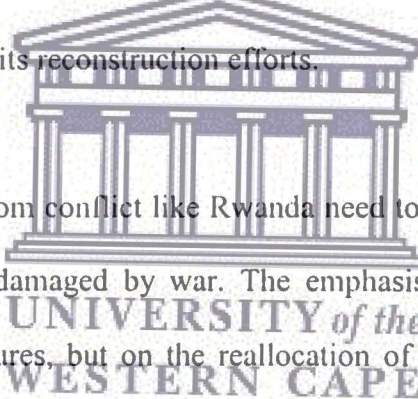
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As Rwanda struggles to overcome the legacy of chronic civil strife and rebuild its economy, it also faces a heavy load of foreign debt. In 1998, the stock of debt for Rwanda was \$1.23 billion (Ndikumana, 2001). The debt service to exports ratio for the same period was 20% for Rwanda, compared to 15% for the sub-continent. External borrowing increased considerably from the second half of the 1970s and exploded in the 1980s.

In Rwanda, from the 1970s to the 1980s, net debt flows increased from an annual average of \$27 million to \$64 million. Debt inflows continued to rise in Rwanda in 1990s, (Ndikumana, 2001).

The heavy debt burden constitutes a major handicap for development in general. The issue is even more pressing in the context of post-conflict reconstruction when the country needs to focus its scarce resources to providing badly needed social services and rebuilding the economic infrastructure.

Rwanda has qualified for debt relief through the Heavily Indebted Poor Countries Initiative (HIPC). The debt relief for Rwanda amounts to \$810 million in debt service or a 71% reduction in net-present-value debt. In that sense, the country must take advantage of this “millennial” gesture and increase its investment in economic infrastructure and improve social service provision. However, debt relief must not be considered as a substitute for aid. The country needs sustained aid flows to carry out its reconstruction efforts.



Countries evolving from conflict like Rwanda need to rebuild their economic and social infrastructure damaged by war. The emphasis must be not on reducing government expenditures, but on the reallocation of public money into socially productive investments (Addison and Ndikumana 2000:34). In particular, governments must shift expenditures away from security/military to revitalise education, health care, and other social services.

Rwanda has embarked on an economic reconstruction program including important fiscal reforms.

The Rwandan reconstruction programme explicitly integrated the poverty alleviation in its budgetary system. To reduce poverty, the Rwandan Government is trying to increase agricultural productivity. It is also improving gender equity,

and ameliorating social services infrastructure and delivery. The government has established an institutional framework (including a Poverty Observatory unit within the Ministry of Finance) for monitoring progress in social services delivery. There is reason for hope that there will be light at the end of the fiscal adjustment tunnel. Ndikumana (2001)

Having considered the challenges of the fiscal policy in Rwanda, the following sections look at the taxes that are in use in Rwanda and the appropriate tax capable of effectively contributing to economic development.

### **3.2 Taxation in Rwanda**



#### **3.2.1 Introduction**

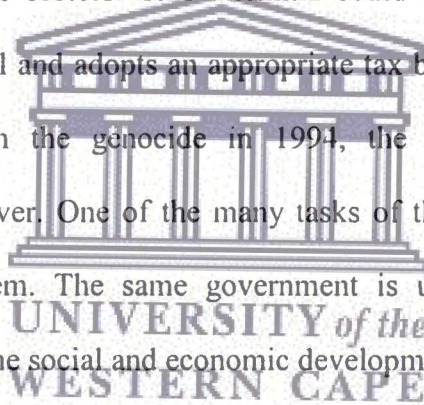
Before the colonialist occupation by Belgium, which dated from 1916\* Rwanda had a traditional tax system. The citizens of Rwanda-Urundi used livestock produce, harvest and labour to meet their different civic obligations. It is only after the arrival of colonialists and the introduction of Rwandan currency that there was a shift for their civic obligations from paying goods and services to the payment of money. As the Rwandan economy expanded, the taxation system also changed to satisfy the many objectives of the Rwandan State.

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\* 1916: Military occupation of Belgium while the official Belgian colonialism started in 1922.



Twenty years after independence in 1962, a general sales tax (ICHA) was introduced. During this period, the country was characterised by a difficult political crisis, which hindered its development. For a long time the fiscal policy has been challenged by the crises that Rwanda faced. Not only did the Rwandan economy collapse but also the administrative capacity was damaged. The allocation of revenue was another problem since the country had to choose between capital expenditure and regular expenditure, especially during the crisis, when military expenditures was given priority at the expense of lower investment in socially productive sectors. This dilemma could be resolved only when the Country is at peaceful and adopts an appropriate tax base. After ten years of war, which culminated in the genocide in 1994, the government of unity and reconciliation took over. One of the many tasks of the new government was to reform the tax system. The same government is undertaking many steps to positively influence the social and economic development of the country.



In 1997 proposals were made, on the advice of IMF (IMF, 1998) to replace the general sales tax (ICHA) with a VAT. Currently, this type of tax is internationally accepted as being more efficient and the Rwandan government is expecting to get more revenue to achieve its many goals. As it has been the case in other countries searching to achieve faster high level of income, the value added tax was seen as an appropriate tax and was implemented to increase government income.



### ***3.2.2 The revenue crisis of Rwanda***

Regarding taxation in Rwanda, there are three important categories of factors responsible for the revenue crisis: structural, policy and institutional factors, and the effects of civil war (Ndikumana 2001).

#### ***a) Structural factors***

The two main structural factors that constrain tax revenues in Rwanda are the weakness of domestic aggregate demand and the lack of diversification of the production system. In Rwanda, incomes are so low that the amount of taxes that can be possibly levied without discouraging consumption and investment is naturally low (Ndikumana, 2001). The manufacturing and cash crop sectors are the key generators of tax revenue.

With regard to the fiscal impact of conflict, Rwanda differs significantly from other 'post-conflict' countries whose export earnings are less dependent on labour-intensive products (like agriculture) and more dependent on capital-intensive products (like minerals and oil). In mineral or oil exporting conflict-prone countries (like the Republic of Congo), export revenues are likely to fluctuate less following population displacement (Uvin, 1998:20). In such countries, tax revenues from international trade will be less affected by conflict and fiscal recovery will be easier after conflict than in the case of agriculture-dependent country like Rwanda.

### ***b) Policy and institutional factors***

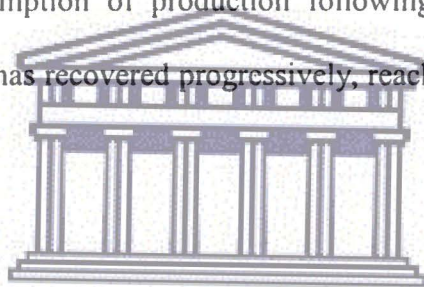
The institutional constraint to fiscal revenue creation in Rwanda is twofold: Firstly, the fiscal institution has a weak tax administration capacity. It lacks both skilled manpower and the appropriate technology for collecting taxes. This may lead to a decreasing tax revenue and hence diminish the State portfolio (Ndikumana 2001).

Secondly, the system is excessively merciful, granting widespread tax exemptions to public enterprises, diplomatic missions, non-governmental organisations and private investors, often on questionable grounds. These exemptions carry a high opportunity cost given that taxes on imports represent a large fraction of total fiscal revenues: about 23% of total revenues in Rwanda in 1998. The Rwandan government must reconsider these tax exemptions because they can seriously undermine its revenue collection, as was the case in Argentina a few decades ago.

The new Rwandan regime has embarked on major reforms of the fiscal system that include, among other measures, a significant reduction in tax exemptions (IDA & IMF 2000:26). These measures should improve tax collection in the coming years because taxes should be the most important source of income in Rwanda as is the case in the above-mentioned countries.

### ***c) Effects of civil War***

According to Ndikumana (2001), the third factor that contributes to the fiscal revenue crisis in Rwanda in recent years is the ethnic conflicts that have disrupted economic activity. Following the genocide in Rwanda, not only did the tax base collapsed, but the tax administration capacity was also eroded. This is mainly due to the fact that during the crisis, people do not produce as much as they can because of the insecurity; hence their per capita decreased which considerably affects the tax base. According to the IMF report (2000a: 72), in 1994, the volume of taxes collected declined by a surprising 75%, including an 81% decline in individual income tax and excise tax and a 70% decline in tax on international trade. With the resumption of production following improvement in internal security, tax revenue has recovered progressively, reaching and exceeding the pre-genocide level.



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### ***3.2.3 Different taxes in use in Rwanda***

The Rwandan taxation system's history can be divided into two major periods: that is the period before the independence and after the independence.

#### ***3.2.3.1 Taxation system before the independence***

Historically, the Rwandan taxation system evolved as the economy was changing. Before colonialism there was no currency in Rwanda, and the Rwandese used

different forms of taxes to comply with their civil obligations. These included harvests given to the King, some services such as building, the carrying of leaders and cultivating for them.

During the colonialist period, a currency was introduced and some services such as military and justice services were set up. The taxes that were in use included individual tax and tax on the livestock. In addition, there was also a committee of Rwanda – Urundi put in place to establish customs duties. The traditional taxes were of such insignificant contribution to the development of the country.

### *3.2.3.2 Taxation system after the independence*

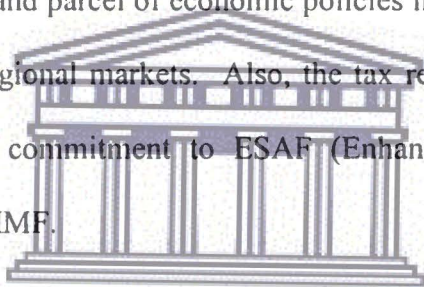
Before the VAT system was introduced, there were four major categories of taxes divided into many other small parts (Official Gazette of the Republic of Rwanda December 2000):

1. Taxes on net incomes and profits: these comprise personal income tax and income tax on companies,
2. Property tax,
3. Domestic taxes on goods and services: here we have turnover tax (ICHA), tax on beer, soft drinks, fuel, cigarettes, toll tax on roads, axle weight tax and tax on wines and liqueurs,
4. Taxes on external trade: Import duty, adjustment tax, exports duties on coffee, other export duties, demurrage charges (MAGERWA).



The above-mentioned taxes are still in use except the turnover tax (ICHA) that has been replaced by the value added tax currently in use since January 2001. The revenue from those different sources of tax is used to satisfy the needs of Rwandese (health, security, education etc.) through Government policies. However, because of the many political crises faced by Rwanda after its independence, the fiscal policy was strongly affected and has been inefficient most of the time.

The tax reform that the Rwandan government undertook, as discussed in the section 3.5, was part and parcel of economic policies intended to position Rwanda strategically in the regional markets. Also, the tax reform was required by IMF under the Rwandan commitment to ESAF (Enhanced Structural Adjustment Fund) programme of IMF.



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Three years ago, indirect taxes accounted for over 70% of the total tax revenues, with ICHA contributing 19% (Rwanda Revenue Authority, 1998:8). Therefore, there was a need to continue with some form of sales tax or consumption tax to increase the tax revenue collection. This revenue source could not be foregone without affecting the social and economic fabric of Rwanda. In addition, the existing consumption tax was used as a major government fiscal instrument to stabilise and stimulate the economy, as well as enhance Rwanda's competitiveness in the regional markets. However, because of its many shortcomings, the ICHA system could not meet all the government's requirements. Thus, Rwanda's only option was to reform the tax system. The

following section argues that the Rwandan revenue is too dependent on external revenue and need to be more independent. Besides, the domestic revenue is almost entirely composed of tax revenue as is shown in the table below (Table 1). Thus, the need of increasing the tax revenue to be self-reliant is very important for Rwanda

### **3.3 Revenues and Expenditures of Rwandan State for the 2001 fiscal year**

#### ***3.3.1 Rwandan Revenues***

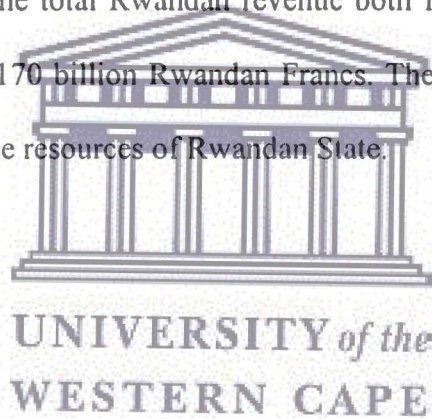
As you will notice it in the table (1) below, Rwandan government revenues are composed by two major categories of revenue: The domestic revenue and the external revenue. The domestic revenue is composed of two sources of revenues: tax revenue and non-tax revenue. The tax revenue is valued at 77 billion Rwandan francs (93% of the total domestic revenue) while the non- tax revenue is valued at 6 billion Rwandan Francs (7% of the total domestic revenue). Because the tax revenue is the only major source of domestic revenue (93%), it is very important to maximise the revenue from the tax using an appropriate and liable tax system. Even if the tax revenue contributes to about 93% of domestic revenue, the country still rely heavily on external revenue (51% of the total revenue compared to 49% for domestic revenue (Official Gazette of the Republic of Rwanda 2000). This means that the revenue from inside the country is still insufficient. Therefore, the value added tax is an appropriate tax capable of bringing in more revenue than the

old tax it replaced. Since VAT is operating, the revenue has steadily increased\*. In the case of the analysed countries in the previous chapter, experience has shown that VAT contributed greatly to their economic growth.

The total domestic revenue amounted to 83 billion Rwandan Francs.

On the other side, the external revenue is divided into two parts: External grants and foreign financing. The external grants are valued at 57 billion Rwandan Francs (65% of the total external revenue), while the foreign financing amounted to only 30 billion Rwandan Francs (35% of the total external revenue). The total external revenue amounted to 87 billion Rwandan Francs.

When put together, the total Rwandan revenue both from inside and outside the country amounted to 170 billion Rwandan Francs. The table (1) below shows the current situation of the resources of Rwandan State.



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\* I was not able to get actual statistics on VAT revenue because it is still confidential, but people from Rwanda Revenue Authority had assured that there was a steadily increase in tax revenue.

**Table 1. Internal revenue of the Rwandan State for the 2001 fiscal year**  
**(In Rwandan Francs millions)\***

<b>a) Tax revenue</b>	<b>76 880</b>	<b>93%</b>
<b>Taxes on net incomes and net profit</b>	<b>21 980</b>	<b>26%</b>
- Personal tax		
- Company tax	7 900	9%
<b>Property tax</b>	<b>14 080</b>	<b>17%</b>
<b>Domestic taxes on goods and services</b>	<b>700</b>	<b>1%</b>
<b>36 920</b>	<b>44%</b>	
- Turnover tax		
- Tax on beer	1 6 100	19%
- Tax on soft drinks	7 300	9%
- Tax on fuel	2 300	3%
- Tax on cigarettes	8 600	10%
- Toll tax on roads	1 700	2%
- Axle weight tax	560	1%
- Tax on wines and liqueur	60	0.1%
	300	0.4%
<b>Taxes on external trade</b>		
- Import duty	17 280	21%
- Adjustment tax		
- Export duties on coffee	13 200	16%
- Other export duties	2 080	3%
- Demurrage charges (MAGERWA)	0	0%
	900	1%
	1 100	1%
<b>b) Non- Tax Revenue</b>	<b>6 136</b>	<b>7%</b>
Fees and Fines	217	
<b>Net profits from Public enterprises</b>	<b>3 000</b>	<b>0.3%</b>
- BNR Profits	1 400	2%
- Dividends from state enterprises	1 600	2%
<b>Revenue from Public Property and Assets</b>	<b>976</b>	<b>1%</b>
<b>Revenue from Provinces</b>	<b>0</b>	<b>0%</b>
<b>Administrative fees</b>	<b>942</b>	<b>1%</b>
<b>Exceptional Non-Tax Revenue</b>	<b>1 000</b>	<b>1%</b>
<b><u>Total Domestic Revenue</u></b>	<b><u>83 016</u></b>	<b><u>100%</u></b>

*Source: Official gazette of the Republic of Rwanda. Year 39 n0 special of 31/12/2000*

\* 1US dollar equals 447 Rwandan Francs on 26<sup>th</sup> October 2001 (Source BNR; Central Bank in Rwanda)



**Table 2. External revenue of the Rwandan State for the 2001 fiscal year  
(In Rwandan Francs millions)**

<b>a) External Grants</b>	<b>56 845</b>	<b>65%</b>
- Current	21 645	25%
- Capital	35 200	40%
<b>b) Foreign Financing</b>	<b>30 450</b>	<b>35%</b>
- Project Loans	18 000	21%
- Budgetary Loans	12 450	14%
<b>Total External Revenue</b>	<b>87 295</b>	<b>100%</b>

*Source: Official gazette of the Republic of Rwanda. Year 39 n0 special of 31/12/2000*

From the preceding tables (1&2) we can easily notice that the external revenue is higher than the domestic one. The Rwandan Government relies more on external revenue than on domestic revenue to sustain its public finances as already mentioned.

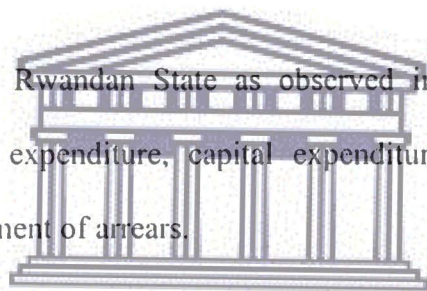
The fact that a country depends so heavily on external revenue to maintain its fiscal integrity may hamper its economy because most of the time the state will be paying its external debts and related interests for many years to come. However, if the revenue collected inside and outside the country is used to achieve development goals, which lead to rapid economic growth and a better ability to pay back, then the burden will not be very difficult to bear. We observed in the previous chapter that the tax administration and revenue allocation were a big

problem in a country evolving from conflict like Rwanda. The government of National Unity and Reconciliation is struggling to eradicate those problems in order to rebuild the country on a strong base.

In contrast, if the revenue collected is not used for development goals, then the burden of the external debt on the state will be very hard to carry.

### ***3.3.2 Rwandan Expenditures***

The expenditures of Rwandan State as observed in the table (2) below are allocated to current expenditure, capital expenditure, net lending for policy purposes and the payment of arrears.



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**Table 3. Expenditures of the Rwandan State for the 2001 fiscal year  
(In Rwandan Francs Millions)**

<b>I. Current Expenditure</b>	<b>108 144</b>	<b>64%</b>
a) Expenditure on goods and services	75 516	44%
- Wages and salaries	39 026	23%
- Other goods and services	24 729	15%
- Exceptional Social Expenditures	11 761	7%
b) Interest payments	4 836	3%
- Interest on Domestic debt	1 420	1%
- Interest on external debt	3 416	2%
c) Reimbursement of Principal amount of public debt	13 334	8%
-		
- Amortisation internal public debt	560	0.3%
- Amortisation external Public debt	12774	8%
d) Subsidies and current transfers		
- Subsidies to Public Authorities	14 457	9%
- Allowances to Public Enterprises	120	0.1%
- Subsidies to Households	10 311	6%
- Transfers and sectoral support	3 268	2%
- External contributions and transfers	134	0.1%
	624	0.4%
<b>II. Capital Expenditure and Net Lending</b>	<b>58 235</b>	<b>34%</b>
a) Capital Expenditure	56 835	33%
- On national resources	3 635	2%
- On projects, loans of the administration	18 000	11%
- On capital grants	35 200	21%
b) Net Lending	1 400	1%
- Reimbursement to Rwandatel	1 400	1%
<b>III. Payment of Arrears</b>	<b>3 932</b>	<b>2%</b>
<b>TOTAL EXPENDITURE</b>	<b>170 312</b>	<b>100%</b>

*Source: Official gazette of the Republic of Rwanda. Year 39 n0 special of 31/12/2000*

The current expenditure is higher than the capital expenditure. It is composed of four parts:

- 1) **Expenditure on goods and services:** This component comprises three major parts: The wages and salaries are the most important part of those three components. This expenditure amounts to 39 billion

Rwandan Francs (23%), while the second component is other goods and services, which is valued to 25 billion Rwandan Francs (15%). The third and last component of the expenditure on goods and services is exceptional social expenditures, which are estimated at 12 billion Rwandan Francs (7%).

**2) Interest payments:** according to the Rwandan budget, the interests paid are related to the domestic and external debts. It can be observed that the interest paid on the external debt is more than the double of the interest on domestic debt (3 billion Rwandan Francs compared to 1 billion Rwandan Francs). This is due to the fact that the revenues or resources from outside are higher than the domestic one. This is very frequently the case in the less developed countries like Rwanda

**3) Reimbursement of principal amount of Public debt:** This section is divided into two components: amortisation of the internal public debt and the amortisation of the external public debt. The latter is much higher than the former. The amortisation of external debt represents 8% of the total expenditure while the amortisation of internal debt is 0.3% of the total expenditure. This is again to stress how important the domestic revenue must be to prevent the country from ending up in the ruin because of the burden of the debts.

**4) Subsidies and current transfers:** This part comprises five elements amongst which allowances to Public enterprises are the most important part amounting to 10 billion Rwandan Francs (6% of the total expenditure). The second element is the subsidies to Households, which



are valued at 3 billion Rwandan francs (2%). The third component of subsidies and current transfers is external contributions and transfers amounting to 624 million Rwandan Francs (0.4%). The two last elements are transfers and sectoral support valued at 134 million Rwandan Francs (0.1%) and the subsidies to public Authorities valued at 120 million Rwandan Francs (0.1% of the total expenditure).

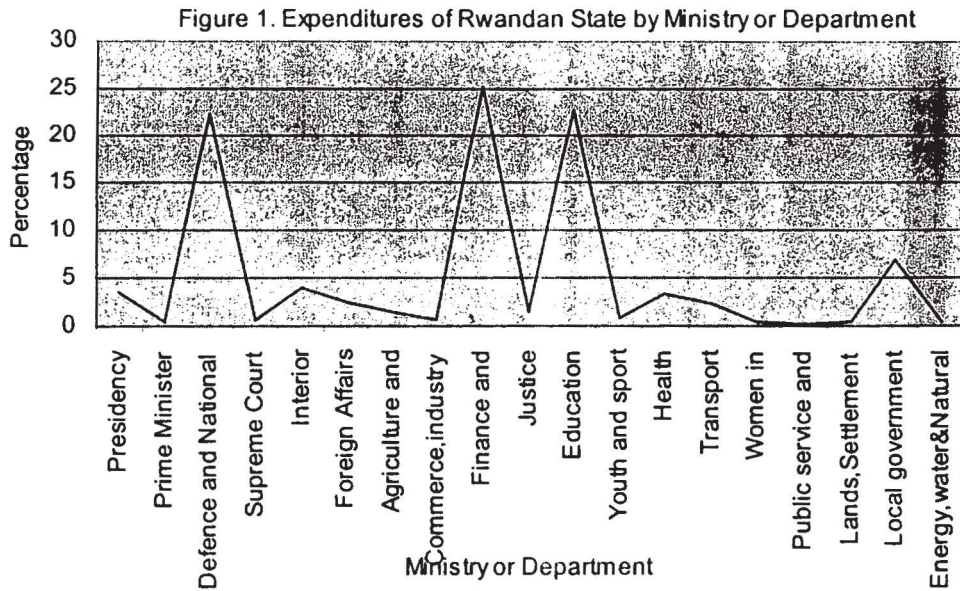
On the other side of Rwandan expenditure, we have capital expenditure and net lending, which are estimated at 58 billion Rwandan Francs (34% of the total expenditure). This section is divided into two parts. The major component is capital expenditure of 57 billion Rwandan Francs (33% of the total expenditure). The Net Lending is only valued at 1 billion Rwandan Francs (1% of the total expenditure).

As it is observed on the table (3) above, the total expenditure of the Rwandan State is estimated at Rwandan Francs 170 billion. The table (4) below shows the budget allocated to each Ministry or department.

**Table 4. Expenditure of Rwandan State by Ministry (in Rwandan Francs million)**

Ministry or Department	Rwandan Francs	Percentage
Presidency	4049	3.6
Prime Minister	433	0.4
Supreme court	708	0.6
Defence and National security	25006	22.2
Interior	4554	4
Foreign Affairs	2808	2.5
Agriculture and Forestry	1696	1.5
Commerce, industry and Tourism	687	0.6
Finance and economic Planning	28423	25.3
Justice	1649	1.5
Education	25562	22.7
Youth and sport	936	0.8
Health	4147	3.4
Transport & Communication	2549	2.3
Women in development	451	0.4
Public service and Labour	373	0.3
Lands, Settlement & Environment	406	0.4
Local government & social affairs	7708	6.8
Energy, water & Natural resources	397	0.4
TOTAL	112546	100

Source: Official Gazette of the Republic of Rwanda 2000



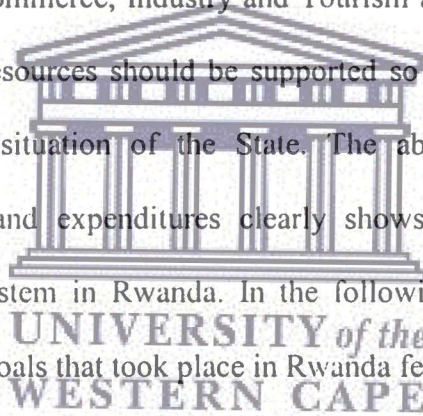
The above table (4) and figure (1), indicate that Rwandan expenditures vary from one Ministry to another. There are only three Ministries that have a share of more than 20% of the total expenditure while other ministries are below 10%. There are several factors for this big gap. What should be examined is whether these expenditures will contribute economically to redeem the various debts of the Rwandan State. After all, revenue from outside is higher than the one inside the country (51.2% against 48.7% Official Gazette of the Republic of Rwanda 2000).

With regard to the budget allocated to the Ministry of Defence and National security, the Rwandan State is trying to stabilise the country after damages caused by the genocide of 1994 and its many consequences. As started earlier, the country that has come through a war has a high military expenditure. However, if the peace is guaranteed in the Country, investors (both from inside and outside the country) will be stimulated to invest in the country, thus increase the National



income. The increased national income will in turn help to pay back the loans and to reinvest in order to expand the economy.

The budget allocated to the Ministry of Education will help in human investment while the Ministry of Finance is in charge of many goals amongst which to set up strategies for social and economic development. However, it is clear that if the external revenue decreases, the Rwandan government will not be able to sustain its expenditures. Hence the need to expand the domestic income and one of the solutions is to increase domestic revenue via taxation revenue. In addition, Ministries such as Commerce, Industry and Tourism and the Ministry of Energy, Water and Natural resources should be supported so to enable them to improve the socio-economic situation of the State. The above-discussed situation of Rwandan revenues and expenditures clearly shows that there is a need for reforming the tax system in Rwanda. In the following section, we present the different tax reform goals that took place in Rwanda few years ago.



### **3.4 Rwanda's fiscal reform goals**

During the era 1997-1999, the Rwandan government has committed itself to some important fiscal reform measures as summarised below by IDA and IMF (2000:115):



1. In 1997: Establishment of the *Rwanda Revenue Authority*, an autonomous institution, with its own budget. Its mission was to become a professional organisation characterised by integrity and efficiency, and is dedicated to upgrading the quality of service provided to the taxpaying public. Operational since January 1998, the RRA was and still is responsible for tax and customs administration, audit and investigation.

2. In 1998: Civil service reform was initiated. Its objectives included replacement of unqualified civil servants, the removal of 'ghost' workers and the adjustment (increase) in salaries.

3. In 1998: Establishment of an expenditure monitoring system, including monitoring of social sector budgets using selected performance indicators. A *Poverty Observatory* unit was established in the Ministry of Finance to monitor progress in meeting targets in poverty alleviation and social indicators. A social sector expenditure review was conducted in 1998/1999 focusing on education, health, water supply, sanitation, and other social services. While the evidence from the IDA and IMF survey and other sources showed widespread poverty, there was some evidence that budget allocations to social sectors were increasing: from 2.5% of GDP in 1997 to 3.8% in 1999 and 3.9% in 2000.

4. In 1998: Establishment of the *Central Project and External Financing Bureau*, whose mission was to improve the coordination of investment within the Ministry of Finance. With assistance from the African Development Bank, the government established a 3-year rolling public investment program aimed at strengthening the preparation and monitoring of public investment projects.

5. In 1998: Beginning of progressive reduction in maximum tariff rates from 60% to 40% in 1998 and to 25% in 1999.

6. In 1998/1999: Increase in some taxes to offset the decline in tax revenue. These include the turnover tax rate (from 10% to 15%).

7. In 1998: Coffee export tax converted into an ad valorem tax at 16%.

8. In 1999: Public enterprises subject to income tax.

9. In 1998-December 2001: target period for completion of privatisation of public enterprises.

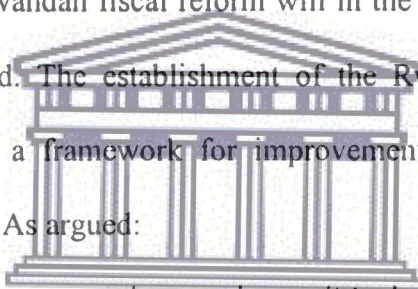
10. In January 2001: Implementation of a modern tax Value Added Tax at 15%.

Because of the many goals that Rwandan government committed itself to achieve, there was a need of an appropriate tax system that could secure and

maximise the tax revenue collection. As it was the case in countries such as Korea, South Africa and others, Rwanda introduced the VAT system to resolve its challenges.

### 3.5 Tax reform in Rwanda

A tax reform has two major objectives amongst which the reduction of the country's dependence on trade tax and the increase in tax collection efficiency. The steps taken in Rwandan fiscal reform will in the near future be productive if carefully implemented. The establishment of the Rwandan Revenue Authority (RRA) has provided a framework for improvement in the assessment of tax liabilities and arrears. As argued:



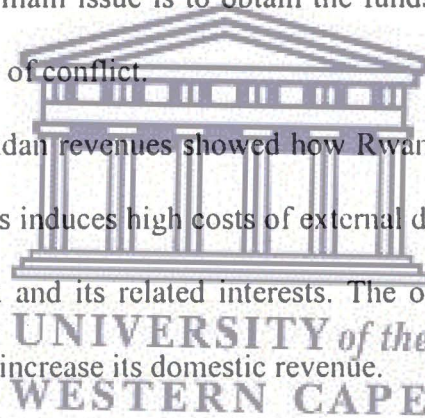
*"It is necessary to preserve and strengthen political and budgetary independence of the RRA and to maintain efficiency-enhancing incentive mechanisms (higher pay rates and other indirect benefits) that stimulate effort and accountability for the RRA staff. The reduction (even cancellation) of tax exemptions will also contribute to improving tax collection. Along with its efforts to increase revenue collection, the government must establish specific fiscal incentives to encourage private investment. This can help in the diversification of the economic activity, thereby broadening the tax base." (Ndikumana, 2001).*

The idea of introducing the Value Added Tax system in Rwanda emerged with the introduction of an independent board of taxation known as Rwanda Revenue Authority (RRA). This was launched in January 1998, but the Rwandan government announced its establishment in 1997 as mentioned above. The

initiative to introduce RRA was influenced by success similar bodies in Uganda, Ghana, Tanzania and many more. In Rwandan economic policy, there was a need of structuring the economy by stimulating or reforming the tax system so to accommodate the many programmes that need to be achieved by the State.

As discussed earlier, Rwanda was experiencing a political crisis for a long time (three decades after independence), and was trying to recover from the ethnic tragedy, which seriously harmed the economy. To resolve some of the consequences of the war, there was and still is a need for a steady income for the Rwandan State. The main issue is to obtain the funds to overcome the problems created by the history of conflict.

The section on Rwandan revenues showed how Rwanda is relying too heavily on external revenue. This induces high costs of external debt, because the country has to pay back the debt and its related interests. The only hope that the Rwandan government has is to increase its domestic revenue.



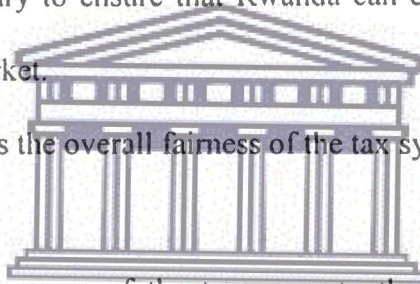
The tax revenue was found to contribute up to 90% of the total domestic revenue in recent years. It is therefore very important to maximise the revenue from that source, as it seems to be the only one that contributes steadily to the Rwandan economic growth. Because the government had to increase its revenue, but at the same time consider the situation of the taxpayers, the only appropriate tax reform that could accommodate everyone was deemed to be to broaden the tax base by introducing VAT. As we have seen, such a solution was also applied in countries such as Korea, Côte d'Ivoire, Argentina and South Africa because they wanted to



enhance their tax base. It is in this context that Rwanda introduced VAT in January 2001.

The introduction of VAT in Rwanda had three important goals as highlighted by RRA officials during the interview:

1. VAT ensures that Rwandan state can continue paying for programmes and services of Rwandese value, as well as contribute to deficit reduction effort.
2. VAT is an essential element of the government's plan to make changes necessary to ensure that Rwanda can compete effectively in the regional market.
3. VAT improves the overall fairness of the tax system.



In Chapter 4, the responses of the taxpayers to these arguments for VAT are considered. As in many other countries that introduced VAT, it will be shown that the taxpayers were not as positive to VAT, as were the authorities that introduced it.

The Minister of Finance and economic planning H.E Dr Donald KABERUKA in his 2000 budget speech to the National Assembly, tried to encourage Rwandan citizens to fulfil with their civic obligations amongst which taxpaying culture. He stated:

*"Paying taxes is a patriotic duty for which taxpayers should be proud to accomplish. Instead, or so it seems, complaints about high taxes are rampant. I would like here to state that, Government should continue*

*its policies of 'lower, simpler and broader taxation'. We shall seek to increase revenue by widening the tax base and improving administration rather than raising taxes. For this to happen, Government needs the support of Rwandans. Paying taxes is an investment in our security and in the future of our country and our children. Tax evaders are criminals who must be tracked down and adequately dealt with. Last month, Cabinet authorised publication of the top 100 taxpayers in the country. I would like to thank these nationals and enterprises that are fulfilling national obligations. I shall be tabling before this House a number of amendments to the Tax and Customs Law that raise penalties for tax evasion and we intend henceforth to make public names of tax evaders and smugglers."* (Ministry of Finance, 1999).

In addition, the Ministry of Finance and Economic Planning has set a number of tax reform goals (Rwanda Revenue Authority: 2000:1):

**1. Reliable tax:** The government of Rwanda levies taxes in order to finance programmes that are important to Rwandese. Without a reliable tax system, the government's ability to maintain these programmes and to rehabilitate the Rwandan society is impaired. The ICHA tax system was unable to meet the above-mentioned objective. The Rwandan Government thus decided to replace ICHA with VAT, which is more reliable. This is because VAT applies a uniform rate to a very broad base. The very nature of VAT, as a multi-stage structure serves to minimise avoidance and evasion activity. The capacity to collect and protect revenues is also strengthened through the VAT legislation. The VAT legislation makes particular provisions to avoid arrears. Taxpayers are required to pay VAT immediately, because the

tax is not a levy on taxpayer's own funds, but it is in the nature of a payment in trust from the taxpayer's clients.

**2. Economic growth and competitiveness:** According to Rwanda Revenue Authority (2000:2), the ICHA system was a serious impediment to economic activity and job creation in Rwanda. In particular, ICHA was seen not as an appropriate tax system that could encourage industrialisation and meet the competitive challenges posed by international market place especially as Rwanda was making tariffs adjustments to harmonise with the COMESA (Common Market of Eastern and Southern Africa) requirements.

A substantial amount of tax was imposed on domestic production of all goods and services, which in turn increased costs of Rwandese exports, making Rwandan products less competitive in the regional markets. At the same time, the previous tax regime favoured imports over domestically produced goods. Since VAT fully removes the tax component from the production process in Rwanda, it reduces the cost of investment and improves the ability of domestic producers to compete both in foreign markets and against imports from other countries.

**3. Fairness:** VAT was considered to be fairer than the tax system it replaced (ICA). The reasons for the fairness of VAT introduced in Rwanda are three fold (Rwanda Revenue Authority 2000:2):



- a) VAT is applied to a much broader base. This provides more equitable treatment of goods and services across sectors of the economy. It also reduces tax-based distortions of consumer's choices in the market place.
- b) Relative prices under VAT reflect more accurately the underlying costs of goods and services.
- c) Finally, it was argued that lower income earners are also considered.

Certain exemptions on the basic necessities are built in the system to ensure that lower income groups are not disadvantaged by the imposition of VAT on their basic needs. In a nutshell, they are better off as they benefit from government programmes enabled by tax revenues from VAT. However, this is not the point of view of many taxpayers who are complaining about the new tax system. It seems to taxpayers that the VAT that replaced ICIA is contributing to increase the prices and thus decrease their real earnings because many of their clients have a low purchasing power. The reason is that although VAT is a good tax, the rate of 15% is too high for most consumers. And some businessmen are giving up their activities because they are unable to compete since all businessmen involved in the same activity, are not all taxed thus have competitive prices.

Nevertheless, some taxpayers do appreciate VAT system in that it is simpler, broader and better than ICIA. It also increases the revenue of the State, avoids tax evasion and above all, the refunding system is highly appreciated by registered vendors. All these characteristics of VAT were not found in the old tax system.



### 3.6 Conclusion

When looking at the Rwandan taxation system, it is clear that Rwanda had to reform the tax system and adapt it to the changing economic situation that it faces. Although the fiscal system was seriously undermined by the crisis of the early nineties, a reform of the fiscal system can significantly strengthen the development prospects of Rwanda. In this chapter, I described how Rwanda is creating a proper public finance system using an appropriate tax system. As it was highlighted, the Rwandan government relies more on external revenue than on domestic revenue. For this reason, it was necessary to increase the national revenue. And one of the solutions was to increase the national resources via taxation revenue. VAT was found to be an appropriate tax to enhance the fiscal revenue in Rwanda, as was indeed also the case in countries such as South Africa, Korea, Côte d'Ivoire and others that adopted the VAT system.

It is not sufficient to argue the general public finance case for VAT. In the case of Rwanda, as indeed in any country that introduces a new tax, attention must also be paid to the perceptions of the citizens who are responsible for paying this tax, and to the views of those implementing the tax reform. When VAT was introduced in Rwanda in January 2001, taxpayers complained regardless the arguments of the Rwanda Revenue Authority that VAT was a good tax. The following chapter will consider the responses and perceptions of taxpayers, revenue collectors and policymakers to the introduction of VAT.

# **CHAPTER FOUR:**

## **VALUE ADDED TAX SYSTEM IN RWANDA:**

### **PROBLEM OR SOLUTION TO THE**

### **DEVELOPMENT ISSUE?**

#### **4.1 INTRODUCTION**

The introduction of the new tax system known as value added tax in Rwanda in January 2001 was not without challenges. On the one hand, those responsible for implementing the tax were excited to introduce VAT, while on the other hand those responsible for paying it did not understand the reasons for the new tax system. The question is whether VAT was introduced at a proper time or whether there was a need to wait until more taxpayers understood the system? Another question is whether VAT will lead to economic development because of many theoretical arguments in favour of it, or will it simply hinder development because of the many problems experienced in practice? There is no clear answer, as it emerges from the chapter. However, many arguments favoured the introduction of the VAT system in Rwanda because of its advantages over the sales tax that it replaced (ICHA).

This chapter is a result of interviews conducted and of a seminar on VAT in Rwanda. These interviews, as was reported in the first chapter, were conducted

from January to March 2001, and from May to June of the same year. They focused on three categories of individuals: the taxpayers, revenue officials and policy makers. As for the seminar, it was held in Butare on Saturday, 16<sup>th</sup> of June 2001. It started at 9h00 and ended at 17h00. A Hundred people were invited to the seminar, but only 50 persons attended. As was the case with the interview, different groups were invited: policy makers, revenue officials, and taxpayers in general including registered vendors, final consumers not registered for VAT purpose and academics. The results of the interviews and seminar are discussed below.

In this chapter, the research gives an account of how the interviews were conducted, examines the VAT system in Rwanda, how it works, the reasons for its introduction and finally the impact of it on the development from the points of view of taxpayers, tax collectors and policy makers.



#### **4.2 Account of how the interview was conducted**

The interviews were conducted in two steps. First from January to March, revenue officials and some taxpayers were interviewed. In May and June, policy makers, other taxpayers and the remaining revenue officials were interviewed. The total number of interviewed people was 80 of whom 20 were revenue officials, 10 policy makers and 50 taxpayers. During the interview, two methods were used. First, a questionnaire guide was used for the interview (see appendix 1) for a

category of people who did understand the meaning of the interview and accepted to be interviewed. Second, in the case of those who seemed not to be ready for the interview, I talked to them informally to get their views with regard to VAT. The results obtained were translated from Kinyarwanda (my mother tongue) to English in order to analyse them.

The results were recorded following two methods. For those a questionnaire guide was used, I summarised their responses immediately and completed it the evening when I had time. However, for those a conversation method was used, I could not write any thing during the interview but only when I was alone in order to allow them to relax and to bring them to be somehow honest with me. This second method was exclusively applied to taxpayers. The major reason for this method was that when you tell them that you want to interview them, especially on a topic such as taxation, the first idea in their mind is that you want to report them to the revenue officials and that they will as a result no longer be able to continue hiding themselves so to avoid paying tax. As a result, they will cheat you and try to respond the way they think they should. Additionally, because of the fact that many of them are not educated, they do not understand the usefulness of an interview.

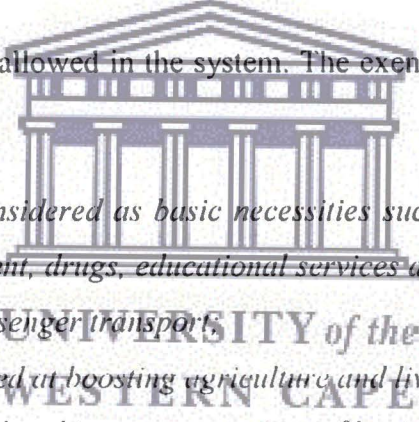
#### **4.3 How does a VAT system work?**

The VAT in Rwanda operates like in other countries where it is adopted. Any person conducting or intending to conduct an enterprise must apply to be



registered as a taxpayer. An enterprise is a business in the broad sense that includes a) ordinary businesses (shops, contractors, lessors, manufacturers and wholesalers), b) trades and professions (builders, engineers, doctors, accountants and attorneys), c) activities of non-profit bodies (welfare organisations, societies, associations and sporting clubs). The last category must make sure that they regularly and continuously supply goods or services on which VAT is chargeable. Besides, VAT in Rwanda operates on a threshold. This means to register for VAT purpose, a turnover of Rwandan Francs of 15 millions per annum is required for obligatory registration, while taxpayers below this level may voluntary register if they wish so.

Some exemptions are allowed in the system. The exempt supplies are categorised below (RRA 2000:6):

- 
- a) Supplies considered as basic necessities such as health services, medical equipment, drugs, educational services and materials, funeral services and passenger transports;*
  - b) Supplies geared at boosting agriculture and livestock;*
  - c) Some financial and insurance services of basic nature; and*
  - d) Goods imported and covered under the investment Code."*

The VAT in Rwanda is similar to that of the other countries. According to Rwanda Revenue Authority (Implementation project 1999:4) and South Africa Revenue Service (Guide for Vendors, 1995:2), when a taxpayer is supplied with goods or services by another taxpayer, the supplier of those goods or services will levy VAT. The VAT levied by the supplier is the **INPUT TAX\*** of the taxpayer

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\* The input tax is a tax payable by a vendor on supplies made to him where the goods or services concerned are acquired to him for the purposes of consumption,

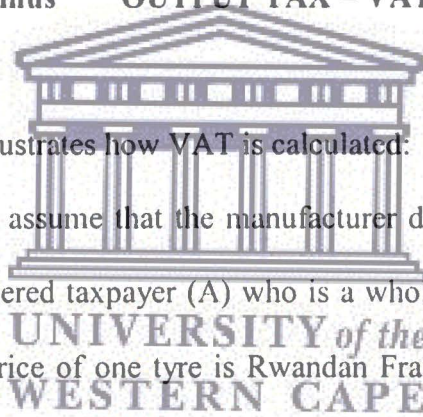
who receives those goods and services. When the latter vendor in turn supplies goods or services to other persons (taxpayers), VAT must be included in the price charged for those goods or services. This is the **OUTPUT TAX\*\*** of the taxpayer.

Where output tax exceeds input tax, the difference is the VAT payable to the Rwanda Revenue Authority. That is:

$$\text{OUTPUT TAX} \quad \text{Minus} \quad \text{INPUT TAX} = \text{VAT PAYABLE}$$

Where input tax exceeds output tax, a refund will be made to the taxpayer by the Rwanda Revenue Authority. That is:

$$\text{INPUT TAX} \quad \text{Minus} \quad \text{OUTPUT TAX} = \text{VAT REFUNDABLE}$$



An example below illustrates how VAT is calculated:

For simplicity, let us assume that the manufacturer does not pay any production cost. Assume a registered taxpayer (A) who is a wholesaler of a taxable item for instance tyres. The price of one tyre is Rwandan Francs 10 000 excluding VAT (15%). Mr. A has to pay a total amount of Rwandan Francs 10 000+ 15% of 10 000=11 500. Because he has to make a profit on his business, Mr A sells the item at 12 500(VAT excluded)+15% of 1000(mark up or value added)=12 650. Because the VAT payable to the receiver is the output tax minus input tax, therefore the VAT payable is 12 650-12500=150.

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use or supply in the course of making taxable supplies. (Deloitte & Touche 1995: 11)

\*\* The output tax is a tax levied when a vendor supplies goods and services in the course of conducting any business activity. (Deloitte & Touche, 2000:10)

#### 4.4 Reasons for the introduction of VAT in Rwanda

The introduction of VAT in Rwanda was due to many considerations. In addition to the above-mentioned advantages of VAT system in chapter three, the Rwandan State expected a lot from the system. These considerations included the following (interview with revenue officials and policy makers):

**1. VAT is a modern tax and encourages exports.** Because VAT exempts exports, something, which ICHA could not do, the former should be preferable to the later,

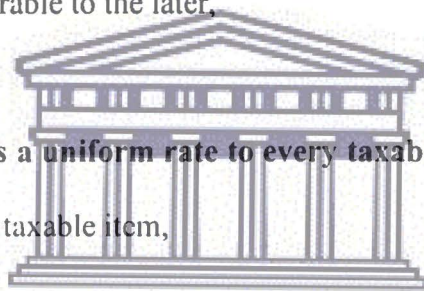
**2. VAT applies a uniform rate to every taxable item:** A 15% rate is applied to each taxable item,

**3. VAT leads to job creation.** Unlike ICHA, VAT stimulates investments and thus induces job opportunities,

**4. It reduces the costs of investment.** VAT fully removes the tax component from the production process in Rwanda and thus reduces the cost of investment,

**5. Moreover, it is highly recommended by IMF and World Bank.**

As argued in the IMF report (March, 1998), the *quid pro quo* for reforms such as the reform of tariffs would be an increase in the rate

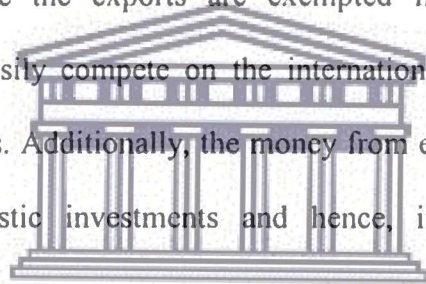


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of ICHA and would broaden the tax base to include goods that were subjected to consumption tax only.

**6. VAT operates on a threshold.** To register for VAT purpose, a vendor must have a turnover of 15 million per annum Rwandan Francs. This is an obligatory registration while a voluntary registration requires less than 15 million.

**7. VAT promotes exports and competition in the international markets.** Since the exports are exempted from VAT, Rwandan product can easily compete on the international market because of their low prices. Additionally, the money from exports can be used to increase domestic investments and hence, induce the economic growth.



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#### 4.5 A comparison of VAT and ICHA: Similarities and differences

The table below gives the comparison between the two-tax systems VAT and ICHA.

**Table 5. Comparison of ICHA system and VAT system**

<b>Impôt sur chiffre d'affaires (ICHA=GST)</b>	<b>Value added tax (VAT)</b>
ICHA was a cascading tax. Tax was charged on tax thus inflating prices.	VAT system avoids cascading,
Rate was 15% ICHA was a tax on turnover. Taxpayers were not sure whether ICHA is a tax on turnover or on consumption.	Rate is 15% VAT is a tax on consumption
Penalties were applied for under declaration. Taxpayers complained that tax officers had too much flexibility which often led to a lack of fairness and unequal treatment of taxpayers	Stringent but streamlined penalty regime,
Payment was made in cash or into Bank accounts	Payment is made in cash or into Bank accounts, (Customs and VAT department),
Instalments were sometimes allowed subject to interest and penalties,	Instalments are likely to be allowed with interest and penalties,
Tax base was limited. Some products were excluded (petroleum products). More ICHA came from customs department that is; collected on imports,	Larger base. VAT broadens the base of the ICHA, while preserving its best features. More VAT collection is anticipated after customs,
Taxpayers were less informed and ICHA – law was complex,	Taxpayers are more informed on VAT through public education and simplified interpretation of law,
The ICHA system was not harmonised with COMESA trading partners systems and did not confirm to Cross-Boarder Initiative (CBI),	VAT system moves a step closer to harmonisation in COMESA and confirming to the Cross-Boarder Initiative (CBI)

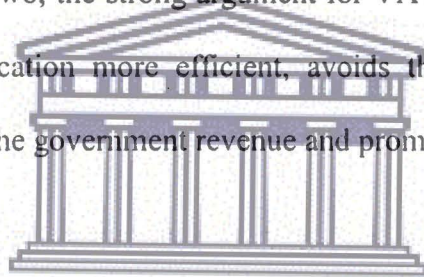
A drop in tariffs to conform with CBI implied a significant drop in the government tax revenue unless compensated by expanding the tax base. ICHA did not render itself to such a possibility,	VAT is likely to compensate for revenue loss due to harmonisation and CBI. All goods and services (except a few exempt ones) are subject to VAT,
ICHA was a single-stage tax. It acted as deterrent to multi-stage production,	VAT is a multi-stage consumption tax. It encourages multi-stage production and attracts foreign investments,
Payments of ICHA at customs were treated as advance ICHA payment,	Payments on imports are treated as INPUT tax deducted from OUTPUT tax to get VAT due to RRA,
Most business paying ICHA were based in Kigali (Capital city of Rwanda),	Most businesses paying VAT are based in Kigali but there is a push to widen this taxpayer base to upcountry,
There was no separate ICHA administration within the Tax Department. This increased the possibility of tax evasion and avoidance. Control and collection procedures were poor.	A better system of control and collection is proposed supported by an up-to-date computerised system.

Source: Rwanda Revenue Authority 2000

With regard to the above table (5), one notices that VAT has many advantages over ICHA. For both taxpayers and tax collectors, VAT has been found to be the more appropriate tax system. That's why the VAT has been introduced in the tax system in Rwanda to replace the turnover tax, ICHA. However, some of the disadvantages of ICHA listed above are due to the implementation of the system by the revenue officials. The fact that taxpayers are not as well informed about ICHA than VAT seems to be the responsibility of the officials in the revenue office and not a problem with the system itself. Similarly, had there been a separate ICHA administration, tax evasion and avoidance would not have been such a simple matter. In my view, the same revenue service should resolve

problems that related to their system of administration and they should not always blame ICHA for everything that went wrong.

Nonetheless, the merits of operating a VAT system far outweigh its demerits. Many reasons were put forward favouring the VAT tax reform and abolishing the previous sales tax, ICHA. However, the major reason was the need for increased and reliable tax revenue that will enable the government to perform its duties properly and increase economic growth and competitiveness in international market. The arguments favouring VAT were also applicable in the other countries that have introduced VAT in last decades. For instance, in the case of the analysed countries in chapter two, the strong argument for VAT, was that the VAT system allows resource allocation more efficient, avoids the bias caused by the non neutrality, increases the government revenue and promotes investments.



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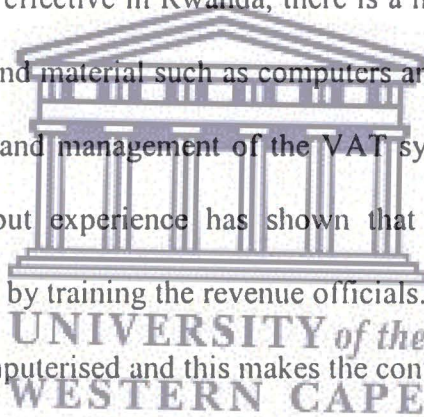
#### **4.6 VAT implementation in Rwanda: practical implications**

When looking at the reality during the implementation of VAT in Rwanda, we clearly observed that although the system faces some constraints, it is an appropriate tax for Rwanda. Rwanda Revenue officials managed to get many more registered vendors than previously under ICHA. And with the system of tax invoice and bookkeeping; they have reduced tax evasion significantly. But they still have much to do to encourage all taxpayers to enter into the system, because there are some fraudulent taxpayers who pretend that their turnover is less than the threshold level of 15 million Rwandan Francs per annum. Furthermore, those



who are not registered for VAT purposes, increase the prices at the expense of consumers pretending that they have to pay VAT. This causes many taxpayers, especially consumers, to blame VAT for high prices. During the interview, both Officials in the Rwanda Revenue Authority and policy makers were proud of the VAT performance, because it seems that they have collected more revenue than expected from VAT during the few months the system had operated. One of the reasons is because VAT operates on a broad base and therefore involves many taxpayers than Under ICHA, although both systems had a same tax rate.

To make VAT more effective in Rwanda, there is a need for qualified workers in the revenue service and material such as computers and transport to allow them to improve the control and management of the VAT system. Other countries faced the same problem but experience has shown that countries like Korea have resolved the problem by training the revenue officials. In the case of South Africa, many sectors are computerised and this makes the control easier.

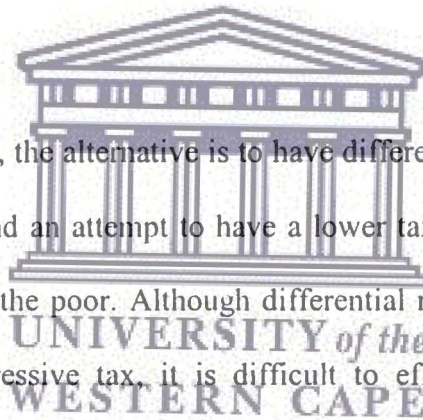


When it comes to the issue of progressivity and regressivity, the VAT system in Rwanda as well as in many other countries especially in those analysed, was found to be regressive as mentioned earlier in chapter two. Because low income people spent a large proportion of their income on consumption, and therefore pay proportionally more tax, they are effectively paying a higher tax rate on their income, at least with regard to VAT, than the high-income group.

Referring to my own observations, it is noticeable that although low-income



group spend the total of their revenue on consumption and therefore experience a heavy burden of tax, they receive fewer advantages from the government comparing to the higher income groups. This can be illustrated by the case of infrastructures. For example, because of the limited budget of the State, the government has to prioritise where the infrastructures have to be built. No doubt the focus will be in towns and those able to cope with the life in town will benefit from the infrastructure. Thus, it is most likely the higher income groups who will benefit from it, while poor people is struggling in rural area and township. Therefore, there is a need for a subsidy for vulnerable groups to sustain their livelihoods.



To be less regressive, the alternative is to have different rates of VAT on different types of products, and an attempt to have a lower tax, or no tax at all, on goods primarily bought by the poor. Although differential rates could ensure that VAT becomes a less regressive tax, it is difficult to effectively implement such a system. It opens the door to dishonest vendors who could pretend, when reporting to the tax authorities, that they are selling primarily those goods with low or zero VAT rating, while they are in fact selling goods on which the higher rates are applicable. This can considerably affect the government revenue and thus undermines one of the reasons for introducing VAT. This proposed solution is also difficult to apply because in practice, it will complicate the tax administration and control. Often it is more effective to have a single rate VAT and to then subsidise the goods bought by the poor.

## 4.7 VAT towards development?

### 4.7.1 Taxpayers viewpoint

From the taxpayers' viewpoint, it was, in the interviews conducted in Rwanda and at a seminar organised there, found two different opinions about the impact the introduction of VAT could have on economic development. The VAT system can either help or hinder development. Most of the consumers are very poor. This means that they don't have the means to satisfy all their needs, even their basic needs. As a result, those who managed to do their own businesses do not profit from their activities, since expected consumers are not all able to buy their goods and services because of their low purchasing power. In addition, business people have to pay a tax on products, of which the prices are already too high for the consumers. consumers will keep on complaining and only a few can afford the higher price.

With regards to VAT, the system of bookkeeping is very hard for the taxpayers. As mentioned during the seminar, the requirement that they must keep their records for three years is placing too big a burden on them. But, this complaint is due to the fact that they are not used to preserve their records. No doubt, once they are used to the new system, they will favour it because it helps them to have a better overview of their businesses. This system also facilitates the giving of

proper information to the tax collectors. However, a problem that should be mentioned with regard to bookkeeping is that many businessmen are not trained. Thus, there is a need to train them to do accountancy; otherwise they will be obliged to engage someone else at a high cost.

The VAT rate is considered to be too high, because many taxpayers cannot afford it. This is also linked to the fact that business people argue that only few consumers are able to afford goods at the pre-VAT prices. Consequently, some businessmen claimed that they could not survive under the new tax system, and have, instead, decided to close down their activities.

A different type of problem mentioned was that taxpayers do not know how the tax money is being used. They don't see a direct link between what they have paid and the things they would want government to do. From the policymaker, it makes sense not to earmark taxes. All revenue collected from different sources are put together and then used according to the government objectives to satisfy priority programmes. Thus, it is, under this system, not possible to show that the revenue from taxes was used to attain a specific goal.

According to taxpayers, the state revenue is not efficiently administrated. They argue that the state revenue is used in an irresponsible manner, which undermines taxpayers' morality. The policymakers acknowledged that there are some cases of mismanagement of the public revenue, but pointed out that commissions have been appointed to eliminate all those weaknesses. They referred to the



anticorruption commission, the general audit and above all, the good governance commissions, which was intended to help with the management of State revenue.

The last problem the taxpayers raised is the problem of not being aware of the tax law and not knowing how to calculate taxes. As mentioned early, this is also related to the illiteracy of many Rwandan citizens because the available information related to the taxes can be found at a local level that is at each Province.

In the light of all these issues, we can now return to the question whether the introduction of VAT is likely to encourage or hinder economic and social development. One of the responses was that the introduction of VAT would hinder development. The taxpayers' argument was that the VAT was a burden for many. This resulted in fraudulent manoeuvres, which culminate in tax evasion and avoidance. Those unable to evade and avoid the tax, if they find the burden to be too heavy, they just drop out. As a result, tax revenue will decrease and the government will not attain all its goals. The mismanagement of state revenue can also hinder the development of the country. Although tax revenue may be high, if there is mismanagement, the tax revenue will help to enrich some people while undermining the livelihoods of many others. As a result, the gap between poor and rich will remain large and poverty in Rwanda will be perpetuated.

The opposing view is that the introduction of the VAT system will facilitate development. Although taxpayers face many problems in paying tax, many of



them recognise that the VAT system is beneficial to them and is likely to lead to the development. They also agree that the money that Government uses must come from its citizens. Since VAT is a broad based tax, it provides each citizen with the chance to participate in capacity building of the country. Some of the advantages they receive from tax revenue are summarised below:

**1. Wages and salaries:** When workers are remunerated, they can be stimulated to work hard and thus to contribute to the development. This is more effective if the remuneration is consistent. However, the public sector in Rwanda is known to pay its workers less money than the private sector. This is due to the fact that the country is not financially strong. It is argued that if the tax revenue increases, then the workers will be better off. However, one thing to remember is that the ones who pay taxes earn the least money. In paying taxes, they reduce their real disposal income and thus deepen their poverty. But if tax revenue is used to achieve development goals, it will in the long run contribute to alleviating poverty. Nevertheless, there is a need to subsidise the needy people to allow them to survive. But one must not ignore the limited financial capacity of the country.

**2. Public health care:** Hospitals and clinics were constructed to take care of the health of Rwandan citizens. Because, the objective of the State is to alleviate poverty, the public hospital's services are cheaper than the private ones and sometimes free of charge for indigent people.

**3. Security of the country and its inhabitants:** since the independence, the country was plunged in conflict because of the ethnic crisis. Ten years ago, the Rwandan State was very unstable and was involved in the war. This culminated in the genocide in 1994 where more than a million of Rwandese were killed and others left the country. This was reason that there was a need to increase the security budget, especially during the crisis to allow the government to achieve related goals. However, after the crisis, the priority should shift to other goals. The current government policy is to stabilise the country by protecting all Rwandese in general, and in particular widows and orphans of the genocide, and to repatriate those who are still outside the country so that all together we can build our country. The security service is not only important for these groups, but for all Rwandan residents. Development goals are also served when people do not live a traumatised life because of insecurity. The local and foreign investments in the country could possibly increase because more spending on security leads to greater stability in the country.

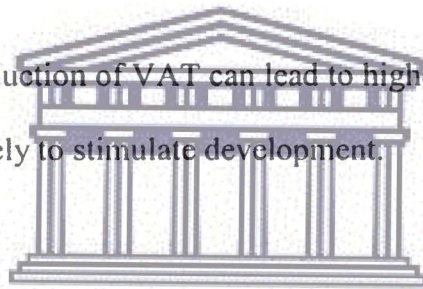
**4. Development activities:** VAT can also lead to development activities if it stimulates investments in the country. Since exports are exempted, businessmen can develop industrial sector within the country and try to satisfy both the domestic and international market. From those activities, job creation can emerge.

**5. Human investment:** Education has been found to be the best way

of investing in human resources. This type of investment leads to the development of the country in the long run. Education has an indirect impact on development. If people are educated, they can develop themselves and the country, presuming, of course, that they stay in the country.

**6. Infrastructures:** the tax revenue is also used to build infrastructure. If the infrastructure is maintained in a good condition, there will be easy communication between provinces and positive externalities will be realised.

As a result, the introduction of VAT can lead to higher revenue and if this revenue is well spent, it is likely to stimulate development.



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#### 4.7.2 Tax collectors and policymakers' viewpoint

From the point of view of tax collectors and policymakers, the VAT system should stimulate economic and social development. The reason being is that they have many expectations of the VAT system. These expectations are the following:

**1. It will increase the state revenue:** The fact that VAT operates on a broad tax base will bring in more money and thus increase the government portfolio. The development issue comes into play, when the revenue collected is purposely used to achieve development goals.

It is in that sense that each Ministry and Department is allocated a budget to attain and satisfy its targets amongst which the development's objectives.

**2. The refund system under VAT:** when a vendor has paid a tax on its purchases, he will get a refund for the input tax paid. This will allow him to be competitive against big companies, who have all activities integrated, and therefore not paid a sales tax in the interim stages.

**3. To promote exports:** The VAT system promotes exports, since exports are exempted from the tax. There are many advantages to be gained from exports amongst which a larger market and the earning of foreign exchange. Furthermore, the Government intends to financially support those involved in export activities, in order to encourage more businessmen to compete in such activity.

**4. VAT system stimulates investments:** because of its nature of being a tax on consumption, there may be a tendency to save more and invest more in the productive sector.

**5. VAT in Rwanda exempts basic foodstuff** in order to allow the poor households to satisfy their primary needs without much difficulties.



These were not the only expectations of tax collectors and policymakers. They also argued that VAT would bring in about 23 billion Rwandan Francs for 2001 year, while ICHA brought only 15 billion Rwandan Francs in the year 2000. During the interview, the Rwanda revenue officials stated that, although VAT was introduced at a same rate than ICHA, it is highly increasing the Rwandan revenue than expected.

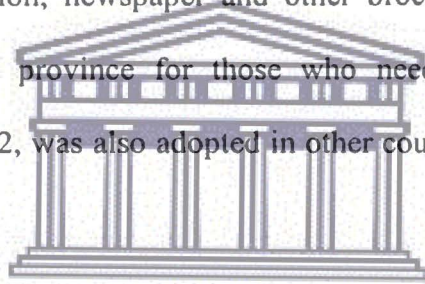
The informal sector was identified as a major area of tax evasion. The informal sector will be included in the new tax system so that all businessmen will have to charge similar prices for similar goods and services.

The government of Rwanda recognises that in addition to a thriving economy, other requirements for a successful VAT system are a culture of bookkeeping, compliance in paying taxes and an appreciation of the taxation system by the taxpayers. A taxpaying culture must be grown and nurtured in Rwanda. All stakeholders in the Rwandese society must share this responsibility.

The success of VAT will also depend on how all stakeholders in the tax system share responsibilities and accountability, as well as how they execute their duties. The government of Rwanda will continue to strengthen institutional capacity of Rwanda Revenue Authority and review the tax policy aimed at enhancing smooth operation of VAT.

In addition, some questions were addressed to revenue officials and policymakers with regard to VAT (see appendix 1).

With regard to difficulties faced by tax collectors, the VAT system as it has been observed during the first few months of its implementation appears to be more efficient than the ICHA. So far, the revenue collectors' observation is that they do not face many problems in collecting VAT. This is because the VAT procedures are very clear and easy to follow, compared to the preceding turnover tax. However, the major problem is that taxpayers do not understand the system and think that VAT is an additional tax. But, to resolve this issue, revenue officials try to educate people by using all means of communication, such as seminars, radio broadcasting, television, newspaper and other brochures on VAT and relevant information in each province for those who need it. This approach, as we discussed in chapter 2, was also adopted in other countries such as Korea and had good results.



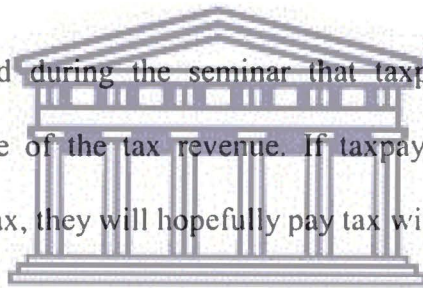
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Another problem facing revenue officials, but not crucial as the first one, is that of insufficient staff. Because the VAT system requires a strong control, some revenue remained uncollected because of insufficient personnel. The taxpayers concerned with VAT do not always report and declare their revenue to the officials. Thus, there is a need to increase the number of revenue officials and train many tax collectors to allow them easier control of the VAT system. To be more efficient, there should be a computerised system to control the functioning of the VAT. Because VAT was presented good results, the Government has promised to meet the requests of the Rwanda Revenue Authority. The government of Rwanda seems to have the will to implement VAT successfully and is slowly

but surely building up the institutions, such as Rwanda Revenue Authority to execute their duties with minimum amount of difficulties.

With regards to procedures, there are fixed procedures followed in collecting tax. Especially for VAT, because of the invoice tax system, it is easy to know how much value was added and therefore how much VAT will be charged. For the moment, according to the officials interviewed, there is no need to change the VAT procedures, because they have not failed yet. In fact, they seem to be working.

It has been observed during the seminar that taxpayers do not get concrete feedbacks on the use of the tax revenue. If taxpayers are aware of the goals achieved from their tax, they will hopefully pay tax without so many complaints.



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The question to establish whether VAT was introduced at a proper time, or not is straightforward. Rwandan society as observed earlier has had a fiscal obligation since its independence. The Rwandan society was therefore used to pay taxes. But the only missing thing was the education system to bring taxpayers to be proud of paying tax, in order to contribute to the capacity building of the country. Besides, Rwanda could not continue to rely more on external revenue than on domestic one. Consequently, the introduction of VAT in Rwanda was not done early.

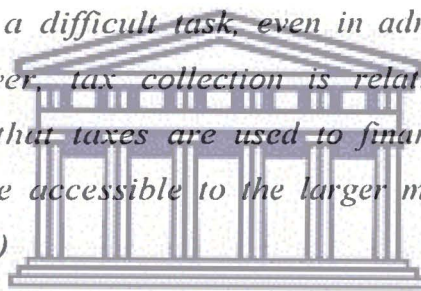
In conclusion here, like taxpayers, tax collectors and policy makers, I believe that VAT system can only lead to the development of Rwanda if the tax revenue is



well spent on socio-economic development goals and if taxpayers are aware of how the money from the tax is used. Consequently, Rwanda has chosen an appropriate tax system by implementing VAT provided that its administration will be efficient.

#### 4.8 Conclusion

*“Effective taxation requires state-society reciprocity in which the population is rewarded for tax payment via public service delivery. Tax collection is a difficult task, even in administratively advanced countries. However, tax collection is relatively easier when the population feels that taxes are used to finance socially productive programs that are accessible to the larger majority of the people.”*  
(Ndikumana 2001)



The value added tax system in Rwanda seems to likely be a successful system. Its introduction in Rwandan was a big challenge to taxpayers who were ignorant of the new tax system. Accordingly, they thought that VAT was an additional tax that will impose a heavy burden. Consequently, there still is a need for more education to bring all taxpayers to understand and accept the new tax system. VAT was introduced to replace the general sales tax ICHA because of its many merits over ICHA. VAT avoided the cascading effects that were present in ICHA system; it also has a broad tax base while ICHA was limited to certain sectors. There were many expectations from the VAT system amongst which the increase of revenue in order to allow the government to achieve its many goals. Something to remember here is that the Rwandan government is trying to be financially self-



reliant and reduce its debts. The only one major source of domestic revenue in Rwanda is the tax revenue, which contributes to over 90% of domestic revenue in 2001. This is why the tax system has to be more appropriate to respond to the government programmes. And VAT was seen to be an appropriate tax system in Rwanda.

However, when looking at the impact of VAT in the development process in Rwanda, there are arguments for and against VAT's role in development. With regards to the qualities of VAT system, taxpayers, tax collectors and policy makers agree that VAT can lead to the development. Some of the reasons induce: VAT stimulates investments, promotes exports and above all generates more tax revenue than ICHA, which can be used to attain development goals. However, to play a role in the development, there is a need of a good management system of the revenue generated.

In taxpayers' view, the government revenue was seen to be mismanaged. They suggested that the state revenue must be dealt with care to ensure the achievements of different goals amongst which the development ones. Under this condition, each and every Rwandan Citizen will benefit from the outcome of their efforts of paying tax. On the other hand, the government is concerned with the problem of mismanagement of the state revenue and has committed itself to combating corruption. For that purpose, the Rwandan state has set up some commissions such as good governance and anti-corruption commission to control the management of the state revenue. As VAT is continuing to increase the tax revenue, we hope that its outcome will greatly contribute to resolve many financial problems of the Rwandan government.

# CHAPTER FIVE:

## SUMMARY, CONCLUSION AND RECOMMENDATIONS

### 5.1 Summary

Taxes are seen to be an important source of revenue in all countries. They are obligatory contributions by citizens to the economy of their country. But to be more efficient, there is a need for an appropriate tax system. Internationally, Value Added Tax is known to be a good tax and all the countries investigated in this dissertation have adopted it. In Argentina, VAT was implemented in 1974; in Korea in 1977, in Côte d'Ivoire in 1960, in South Africa in 1991 and finally in Rwanda it was introduced in January 2001.

We have observed that the VAT system can be efficient depending on what type of VAT adopted. The different countries analysed had adopted different types of VAT and this contributed to the success or failure of their tax system.

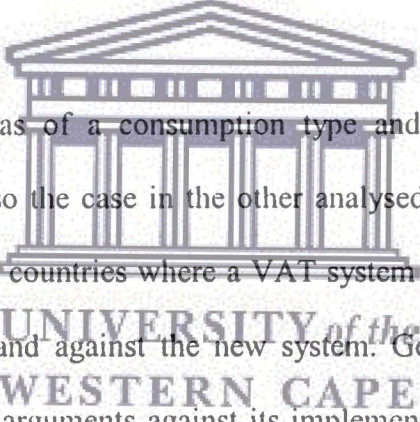
In the Argentinean, VAT was expected to bring in many taxpayers and did indeed increase the number of firms compared to the sales tax it replaced.

As in many other countries where VAT is levied, Argentina taxes imports and exempts exports. However, the VAT adopted in Argentina was of an income type

and did not have as good results as expected. It has been also noticed that in Argentina VAT did not apply to all sectors. Some of the sectors like the agricultural sector were exempted from the VAT system. And this undermined Argentina's tax system. As Osvaldo *et al.* (1990:117) concluded:

*"The imperfections of the VAT in Argentina are not related to the external sector. They are instead caused by the type of VAT adopted, the use of exemptions to promote regional or sectoral objectives, and the exclusion of certain sectors from the system"*.

The fact that some sectors are excluded from the VAT system undermined the neutrality of the tax with regard to resource allocation.

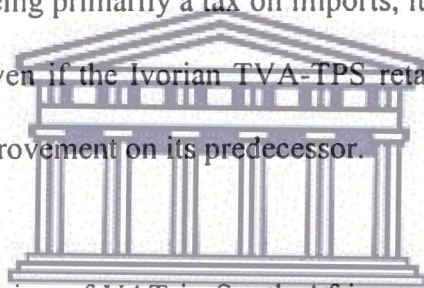


The Korean VAT was of a consumption type and did significantly increase revenue. This was also the case in the other analysed countries in this study. In Korea, as in the other countries where a VAT system was introduced, there were often arguments for and against the new system. Generally, the arguments for VAT outweighed the arguments against its implementation. Some arguments for the VAT were the following: VAT allowed an efficient allocation of resources, increased Government revenues; it promoted exports, stimulated domestic investment and savings and reduced the non-neutrality of taxes. Some of the arguments against VAT in Korea and in other countries were: the regressivity of VAT; and the system of bookkeeping, which has put a burden on the taxpayers. Additionally, taxpayers thought that VAT was a tax likely to increase prices. Because small businesses in Korea were an important component of its economy, there was an escape clause for such businesses. They did not have to pay the entire VAT rate, but these businesses were subjected to a specific rate of 2%, in



contrast to the larger businesses that were liable for a 10% VAT. The VAT system in Korea has contributed to the steady growth of indirect tax revenue and is now the single most important source of government tax revenue.

In Côte d'Ivoire, as was the case in Korea, VAT was beneficial for the economy. The Ivorian TVA-TPS was more neutral than the preceding production tax. The TVA-TPS avoided the cascading effect bias towards vertical integration. The new tax system offered improvements in neutrality, and equity, and eased the tax administration. It did not involve significant rate increases over its production tax predecessor. From being primarily a tax on imports, it became an important tax on domestic activity. Even if the Ivorian TVA-TPS retained some non-neutrality, it was a noticeable improvement on its predecessor.

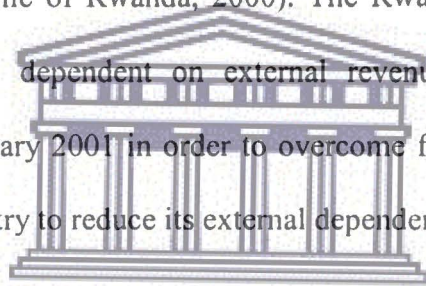


In 1991, the introduction of VAT in South Africa was intended to achieve many goals. However, the South African opposition did not ease the task of VAT introduction. In South Africa as was the case in other countries where VAT was introduced; the common reason for criticising VAT was its regressivity. Nevertheless, despite this, VAT in South Africa had many advantages over the general sales tax it replaced. This is not a particularity of South Africa, but was also the case in Rwanda, Korea and Côte d'Ivoire. The revenue officials in South Africa Revenue Service faced many challenges in collecting tax, but successfully coped with these.



After the independence in Rwanda, the taxation system that prevailed in 1960s was undermined by the political crisis of the time. The Rwandan government introduced the Value Added Tax system because of it being so strongly recommended by the Brettonwood institutions such as the IMF and the World Bank. The introduction of VAT in Rwanda was also expected to increase government revenue.

In Rwanda the revenue from taxes did contribute to over 90% of the total domestic revenue in 2001 fiscal year, but only 45% of overall revenue (Official Gazette of the republic of Rwanda, 2000). The Rwandan government has for a long time been too dependent on external revenue. The VAT system was implemented in January 2001 in order to overcome financial difficulties that the country faced and to try to reduce its external dependency.



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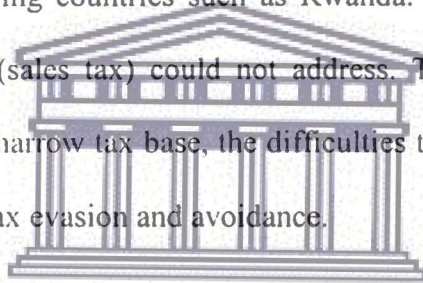
According to taxpayers, revenue collectors and policy makers, VAT in Rwanda is likely to contribute to economic development.

However, some shortcomings were found in the system of tax administration and also in the taxpayers' culture of paying tax. The government is trying to resolve these problems by setting up commissions such as an anti-corruption and a good governance commission. The Rwanda revenue authority is trying to train people on VAT issues in order to encourage them to contribute honestly to the capacity building of the country. The evaluation of VAT after few months of its introduction seems to be very satisfactory. According to revenue officials, it has

already brought in more than expected revenue. And this influenced the Rwandan state to support the Rwanda Revenue Authority to efficiently achieve its targets.

## 5.2 Conclusion

In this study, the focus was on the value added tax system in Rwanda, but with reference to other countries such as Argentina, Korea, Côte d'Ivoire and South Africa. Internationally, VAT was recommended as an appropriate tax system, especially in developing countries such as Rwanda. It resolved many problems that the old system (sales tax) could not address. These problems include the cascading effect, the narrow tax base, the difficulties to control taxpayers, and the high possibilities of tax evasion and avoidance.

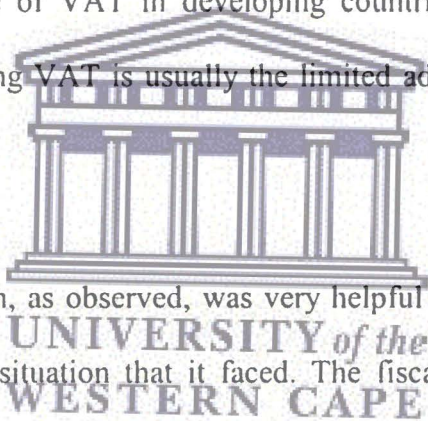


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In countries analysed in this study, VAT was in most cases successfully introduced, but failed in the case of Argentina. The success of the VAT system is clearly dependent on the type of system adopted. Unlike other countries, Argentina implemented an income type of VAT. This and the exemptions given to some sectors caused the failure of VAT in Argentina.

The Korean, South African and Ivorian cases adopted a consumption type of VAT and as a result, the new tax system had a positive impact on their income level and development.

The broad, neutral and less regressive VAT seems to be the perfect choice for a tax system. However, because of the social, economic and administrative problems, there is a need for deviation from that simple structure. No country has achieved, or will attempt to adopt, such a perfectly broad and neutral VAT. The need to reduce regressivity in the structure of the tax for reasons of equity in income distribution leads to pressures to include zero-rating for some essentials and for goods designed for some special groups. It also leads to have higher than the standard tax rates for other goods that are considered non-essentials or luxuries. The commitment to certain social and economic policies will determine the use of multiple rate of VAT in developing countries. However, the main problem when introducing VAT is usually the limited administrative capacity of the country in question.



The Rwandan tax reform, as observed, was very helpful for Rwanda to adapt to the changing economic situation that it faced. The fiscal system was seriously undermined by the crisis of the early nineties, and a reform of the fiscal system was needed to strengthen the development prospects of Rwanda.

As already mentioned, the Rwandan government relies heavily on external revenue. Thus, it was necessary to increase the national revenue. VAT was found to be an appropriate tax to enhance revenue in Rwanda, as was indeed the case in countries such as South Africa, Korea, Côte d'Ivoire and others that adopted the VAT system.



In Rwanda, VAT was introduced in January 2001 at a rate of 15% to replace the general sales tax ICHA because of its many merits over ICHA. VAT was found to avoid the cascading effects that were present in ICHA system; it has also a broader tax base while ICHA was limited to certain sectors. There were many expectations from the VAT system, amongst which that it would increase revenue.

However, when looking at the impact of VAT on the development process in Rwanda, arguments were presented for and against VAT. With regards to the qualities of VAT system (such as its potential to stimulate investments, promote exports, increase the government revenue etc), taxpayers, tax collectors and policy makers agreed that VAT could encourage economic development of Rwanda. However, there was also a need for good management of the revenue generated. In taxpayers' view, the government revenue was not well administered. They suggested that the state must deal with more care with the revenue it receives to ensure the achievements of developmental goals. If this is done, each and every Rwandan Citizen will benefit from their efforts to pay tax. The government was also concerned with the problem of mismanagement of the state revenue and has committed itself to combating corruption and to good governance.

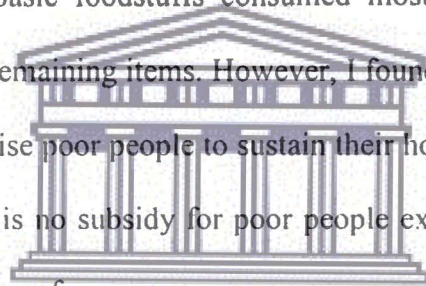
In the introductions, some questions were raised with regard to VAT implementation in Rwanda:

1. Given the low level of income of the majority of Rwandan citizens, is the VAT rate affordable to them? As we have observed and according to taxpayers during interviews



and the seminar, the rate of 15% was been found to be high because most of the taxpayers have low income.

2. Should this rate be the same on all goods or is there a need for different rates according to the ability to pay for goods? (For example, a high VAT rate on luxury goods that are purchased by high-income group and a low VAT rate for the remaining goods of course with exemptions for basic foodstuffs). With regards to multiple rates under VAT system, I realised that this is difficult to adopt since it complicates the tax control and administration and allows taxpayers to make false statements. I suggested zero rating tax for basic foodstuffs consumed mostly by low-income people and a standard rate for the remaining items. However, I found that it was also necessary for the government to subsidise poor people to sustain their households. The current situation in Rwanda is that there is no subsidy for poor people except for medical fee for the most indigent people with proof.



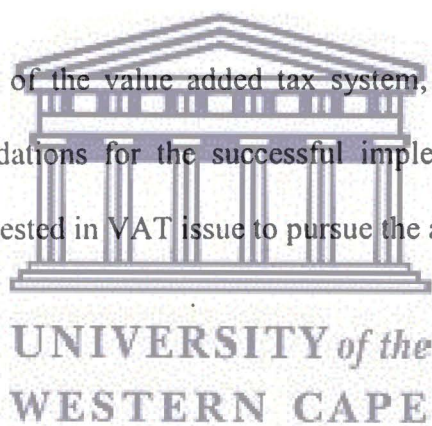
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3. What has been done to ensure that the taxpayers do not consider the tax to be a burden but also to be beneficial? With the introduction of VAT, the Rwanda Revenue Authority, tried to inform people about the system through the use of radio and television broadcasting, holding seminars, newspapers etc. But evidence shows that this attempt to educate the people was insufficient, since all taxpayers are not fully informed about VAT.

4. How could it be ensured that the tax revenue collected is efficiently used? There are no concrete feedbacks on how the tax revenue collected is used, and this shortcoming is likely to be among the reasons for taxpayers hating taxes in general.

5. Which lesson should Rwanda learn from the experience of other countries with the introduction of VAT? As stated earlier, there are many lessons that Rwanda could learn from the experiences of other countries. That is why we have chosen to analyse not only those who succeeded with the implementation of VAT, but also one that failed to get good results, so that Rwanda could avoid its mistakes.

Due to the relevance of the value added tax system, I cannot end this study without proposing recommendations for the successful implementation of VAT and inviting other researchers interested in VAT issue to pursue the analysis further.



### **5.3 Recommendations**

Because the value added tax is about improving the socio-economic condition of Rwanda, it is in my view important to support the system from all the sides. It is in the light of its role in our society that I formulate the following proposals:

1. To taxpayers, I invite them to be proud to pay tax. However, many taxpayers do complain about complying with their civic obligations. As patriots, Rwandese should enjoy contributing to the capacity building of the country and know that their efforts do not profit only an individual case (taxpayer or policy maker) but

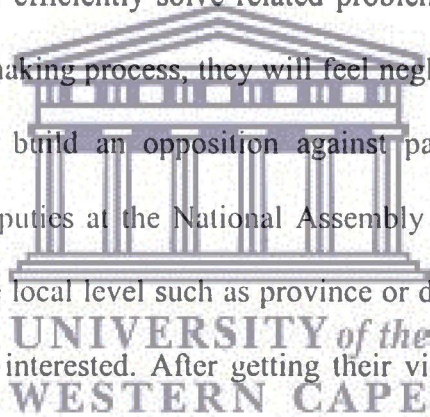
the entire community. To make this possible, they should control how the revenue from their taxes is used, asking for feedbacks. The research suggests that taxpayers should also seek for information related to taxes, so that they can be aware of what is happening. To ease their tax burden, I will suggest taxpayers to invest in the more productive sectors so that after paying tax, they can successfully continue their businesses.

2. To Revenue officials, the research recommends that they improve their education system. Firstly, they should keep on informing all taxpayers, using all means available, as it was done in the Korean case, in order to keep all the partners in taxes up to date. Secondly and most importantly, they should train their workers to be more efficient and avoid the temptation to corruption. Thus they can actively contribute to the social and economic growth of the country. This, if successful will encourage taxpayers to be honest with themselves and to sincerely comply with their obligations. In their campaign to increase public awareness of VAT, Revenue officials should also involve taxpayers who understand the system and are willing to help them. In my view this is important, because once someone who is involved in the same activity is paying its tax without problem, he can easily convince other potential taxpayers under the same conditions to enter the system. Revenue officials should reward honest taxpayers giving some prize and severely punish those who evade and avoid taxes.

3. To policy makers, there are also proposals to enhance the good results from the tax system they introduced. It was mentioned that in Rwanda taxpayers do not get



proper feedback on how the money raised through taxes are utilised. This leads taxpayers to question the usefulness of taxes and attempt to avoid paying them. My suggestion is that policy makers should inform the taxpayers of different programmes that have to be achieved from their tax revenue. Additionally, they should get good feedback on how the money from their pockets was spent and what was achieved. I will even go further and suggest that taxpayers should be involved in decision making especially where they are themselves concerned, example in fixing the tax rate. Thus, by involving taxpayers in the decision making with regards to tax issues, they will feel more concerned and integrated in the system, and try to efficiently solve related problems. Otherwise, if they are outside the decision-making process, they will feel neglected and strangers to the system and therefore build an opposition against paying taxes. This can be feasible by asking Deputies at the National Assembly and policy makers in the Ministries to go to the local level such as province or district and discuss the tax issues with taxpayers interested. After getting their views, the decision will be made at a national level. However, this can be efficient only if taxpayers are full aware of the necessity of taxes to a country. Therefore an appropriate tax education is needed. In Korean case, to make VAT more comprehensive to taxpayers, they have used methods such as showing movies in the whole country, which reflect and tackle each and every issue of VAT. To those taxpayers who do not comply with the rule, penalties must be applied. The computer system is also helpful to ease the control for revenue officials. In Korea, again, a registration system using taxpayer identification numbers was introduced, which greatly eased the process of computerisation. If Rwanda Revenue Authority applies all

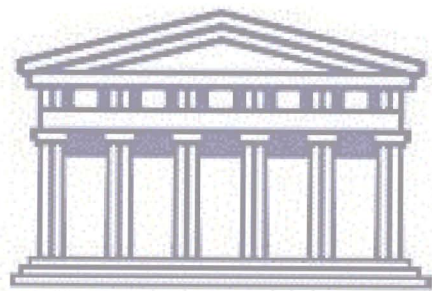




the methods used in successful countries, the results will be much better.

4. To researchers, I recommend the following:

With regards to the above recommendations, they should look at the practicability of involving taxpayers in decision-making and the feasibility of the above-mentioned proposals.



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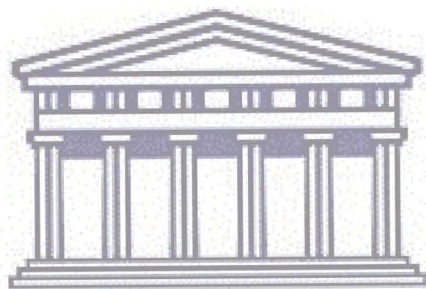
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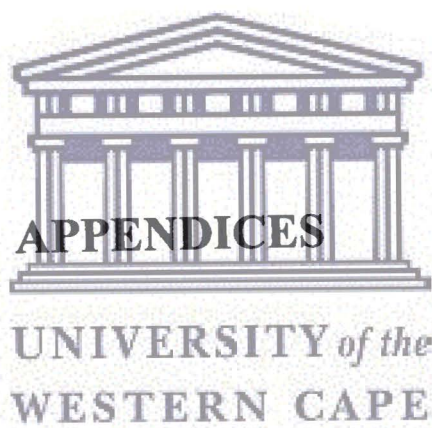
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## **APPENDIX 1: QUESTIONS GUIDE OF INTERVIEW**

### **1. QUESTIONS TO OFFICIALS IN THE REVENUE OFFICE.**

- How do you find the evolution of Rwandan taxation system since its independence?
- What are the difficulties faced by the tax collectors? If any, what have you done to avoid them, and what more do you think should be done?
- Are there any fixed procedures, which are being followed in the collection of taxes?
- Do you think there is a need for change in those procedures?
- What are the reasons for a shift from “ICHA” to VAT? Please discuss the benefits and the problems, both in theory and in practice of these two different systems.
- What campaigns have you had to explain VAT to the people paying it?
- At what rate is VAT to be introduced or, at what rate has VAT been introduced?
- This rate is higher than the ICHA rate was. Does this mean that VAT will impose a heavier burden on the taxpayer than ICHA?
- Have this been explained to the taxpayers? Do they understand how VAT will actually work?
- What were the criteria used to come to that rate
- Is the VAT rate too high or too low? Please motivate your answer. Will VAT bring in more or less tax than ICHA did? Please motivate your answer.
- What do you think about the progressivity/regressivity of VAT?



- Do you think the introduction of VAT is being done in a way (or has been done in a way) that the taxpayers understand its benefits?
- If yes, what in particular has been done (or is being done) that helped taxpayers to understand the new system?
- If no, what do you think should have been done (or should be done) to help them to understand and accept the new system?

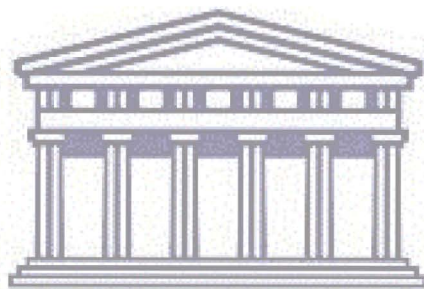
## 2. QUESTIONS TO TAXPAYERS

- Do you see taxes as a benefit or a burden for you? Please motivate your answer?
- What are the difficulties that you encounter in paying your tax?
- What do you expect from the Government after you have paid your tax?
- Do you think VAT is more appropriate than the "ICHA" system? If yes/no why?
- What VAT rate do you think will be affordable to you?
- Do you think the tax administration is effective?
- How do you think tax administration can be improved?

## 3. QUESTIONS TO POLICY MAKERS

- How do you use the revenue collected from tax?
- What are the developmental goals you hope to achieve with the tax revenue?
- How can you ensure that the tax collected is efficiently used?
- What do you do to bring taxpayers to consider tax not only as a burden but also beneficial to them?
- Are there any concrete feedbacks to taxpayers how the tax is used so that they may not avoid and evade tax?

- Is the tax burden on the poor and on the wealthier comparable to the benefits they respectively receive from Government expenditures?
- Are taxpayers involved in the process of fixing the tax rate? If not, why not?
- If yes do you take their opinion into account?



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Jeanne  
Seraphine Mukecuru  
Symphrose  
Kayitaba  
Kayitankore Bernard Narcisse  
Mme Rufangura  
Bosco  
Annonciate  
Mme Runyange  
Maman Gisèle  
Anselme Karayenzi  
Maman Patrick  
Chantal  
Guido Nsonera  
Athanase  
Tharcisse  
Mudenderi Sylvestre  
Silas Mureramanzi  
Uzziel Ndagijimana  
Steve Boshya  
Mugisha Fred  
Africa Fulgence  
Rwamasirabo Olivier  
Rutayisire Ngango Emmanuel  
Chantal Rwakazina  
Rutaremara  
Kamanzi Richard



**APPENDIX 2: Dates of interviews and seminar and list of interviewees and participants in the seminar.**

**a) Dates**

From January to March 2001, the first interviews were focused on some taxpayers and revenue officials.

From May to June 2001, the second interviews were directed to policy makers and the remaining taxpayers and revenue collectors.

On 16<sup>th</sup> of June 2001, the seminar was held in Butare city at the National University club. It started at 9h00 and ended at 17h00.

**b) Names of some participants and interviewees.**

Munyaneza Philemon

Mbarushimana Jean de Dieu

Nkurunziza Martin

Abraham

Esperance

Rutayisire

Patricia

Sebukangaga

Emmanuel Gakwaya

Josepha

Raphaël

Jeanne

Semuhungu Vincent

Mukashema Immaculée

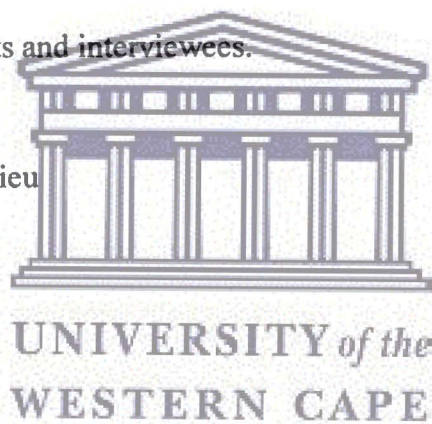
Claude

COPABU

Jeph Mimosa

Gahenda

Mugengana





### APPENDIX 3: AN INTERNATIONAL COMPARISON OF VAT SYSTEMS

COUNTRY	YEAR OF IMPLEMENTATION	SINGLE RATE: STANDARD RATE	MULTIPLE RATE STRUCTURE	LIST OF EXEMPTIONS	ZERO-RATINGS	REDUCED RATE: LIST OF ITEMS	LUXURY-RATED: LIST OF ITEMS
Argentina	Jan 1975		16, 25	18% on publications Water delivery services Milk Medicines Private property sales Life & Retirement insurance International cargo & passenger transport Property rentals Educations and health services Stock exchange transactions Sporting events Service of directors & syndicates	Exports		27% on power, natural gas and water
Austria	Jan 1973		10, 20, 32	Banking & monetary operations Sales of real estate Insurance business Educational services by private schools Literary, musical & journalistic activities	Exports Processing for foreign customers cross-border transportation of goods Cross-border transportation of persons by ship or aircraft services provided by social security institutions	10% on basic foods and farm products Printed material, e.g magazines	32% on passenger, estate cars, motorcycles, aircraft, sailing and motorboats and yachts, furs, perfumes and jewellery
Bangladesh		15		Food Clothing Transport			
Belgium	Jan 1971		6, 17, 19, 25, 33	Exports Sale/lease of real estate Deposit and acceptance of funds Insurance brokering Services of lawyers & medical Education & library services Theatrical, musical, other artistic performances Sport facilities		1% Gold 6% Basic Goods: foodstuffs, travel costs, books & soap 12% very limited use	

COUNTRY	YEAR OF IMPLEMENTATION	SINGLE RATE: STANDARD RATE	MULTIPLE RATE STRUCTURE	LIST OF EXEMPTIONS	ZERO-RATINGS	REDUCED RATE: LIST OF ITEMS	LUXURY-RATED: LIST OF ITEMS
Bolivia #	Oct 1973	13		None	Exports		
Brazil *	Jan 1967		17, 25	Samples, agriculture supplies industrial products, taxi services specified imports, fuel for Brazilian ships Exports of finished manufactured goods		13% on exports of primary and semi-finished products	
Canada	Jan 1991	7		Basic groceries, health care and financial services			
Chile #	Mar 1975	18		Letting of unfurnished houses Nonbusiness sales Occasional sale of fixed assets Interest to banks & financial institutions Most loans Cultural and sporting events Hotel services, school tuition	Exports Marine and air transport services & services to nonresident entities		Luxury items subject to sales as well as VAT
China	Jan 1984		8 - 43				
Colombia	Jan 1975		4, 12, 15, 20, 35	Certain services, export sales and selling of specific exempt goods			20% smaller cars 35% Wines, spirits, larger cars 45% private aircraft and cars over US\$35,000
Costa Rica	Jan 1975		11, 5 - 75	Basic foodstuffs Medical products Real estate Various other goods			
Côte d'Ivoire *	Jan 1960	25					
Cyprus	Des 1992	8		Rents Banking Medical services Immovable property transactions	Exports Sale and leasing of large aircraft and commercial ships Newspapers and magazines		
Czech Republic			5 - 23	Financial, insurance, education, health care		Food, energy, heating and most services	

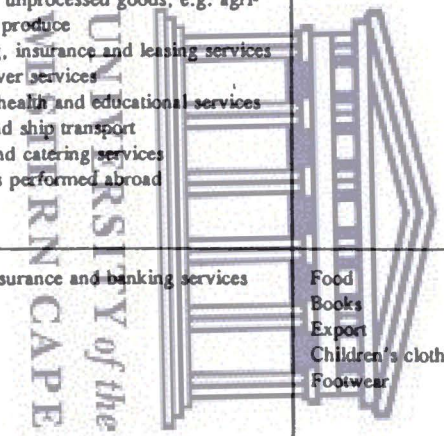
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COUNTRY	YEAR OF IMPLEMENTATION	SINGLE RATE: STANDARD RATE	MULTIPLE RATE STRUCTURE	LIST OF EXEMPTIONS	ZERO-RATINGS	REDUCED RATE: LIST OF ITEMS	LUXURY-RATED: LIST OF ITEMS
Denmark	July 1967	22		Public health services, and hospital treatment, social and most educational services, cultural activities, nonprofessional sports, passenger transportation, sale and leasing of real estate, insurance, banking	Exports Sale and leasing of large aircraft and commercial ships Newspapers and magazines		
Ecuador #	July 1970			Basic foodstuffs, medicine, books, magazines, newspapers and agricultural products, capital contributions to companies, sales of business transfer of assets upon inheritance mergers, donations to nonprofit organisations and share transfers			
Finland	Oct 1990	21:21					
France	Jan 1968		5.5, 18.6, 22	Transport Services on real estate Software Banking activities Rent or sale of trademarks Education and medical and dental services Stock exchange transfers Direct sales from primary producers of agricultural and forestry products	Exports Related banking and insurance	Food products and medicines Books Water Other listed products	
Germany	Jan 1968		7, 15	Medical services Sales of land and buildings Lease and rents from letting land & lodgings Financial and insurance services			
Greece	Jan 1987		8, 18, 36	Most banking, insurance and services of state-owned organisations		Agricultural goods, food printed material and art	
Guatemala	Aug 1983	7		Exports Services provided by banks and other financial institutions			



COUNTRY	YEAR OF IMPLEMENTATION	SINGLE RATE: STANDARD RATE	MULTIPLE RATE STRUCTURE	LIST OF EXEMPTIONS	ZERO-RATINGS	REDUCED RATE: LIST OF ITEMS	LUXURY-RATED: LIST OF ITEMS
Honduras	Jan 1976	7					
Hungary	Jan 1988		15, 25	Sales of land, financial services, postal, social and educational services	medicines export	Basic food products Medical instruments Works of art	
Indonesia	Apr 1985	10		Export of goods Retail sales under Rp. 1 billion Sales of unprocessed goods, e.g. agricultural produce Banking, insurance and leasing services Manpower services Social, health and educational services Land and ship transport Hotel and catering services Services performed abroad		Relief: Capital equipment, spares, raw materials for approved investment projects Capital equipment for manufacturing Purchases of goods and services for export Imports used for aid-funded projects Temporary imports of equip. for oil and gas industry	10%, 20% and 35% depending on type of goods
Ireland	Nov 1972		10, 12.5, 21	Most insurance and banking services	Food Books Export Children's clothing Footwear	Construction services Immovable goods Most newspapers Hotel and other accommodation Fuel for heating and lighting Hotel and restaurant meals Certain agricultural services Telecommunications services Adult clothing and footwear Repair and maintenance of vehicles and machinery	
Israel *	July 1976	16			Export transactions		
Italy	Jan 1973		9, 19, 38	Exports		Agriculture, fishery, food products, magazines and books Foodstuffs, soap, telephone and broadcasting, textiles, restaurant meals, hotel services records, musical instruments, antiquarian books and livestock	38% on cars over 2,000 C.C furs and photographic equipment

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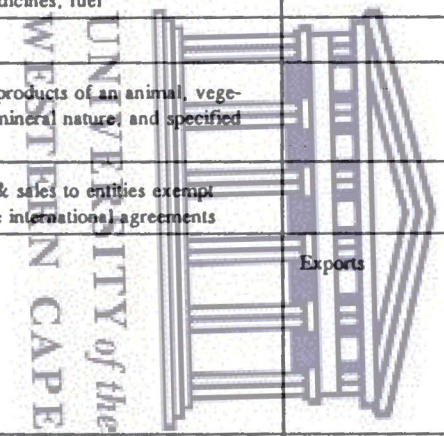


COUNTRY	YEAR OF IMPLEMENTATION	SINGLE RATE: STANDARD RATE	MULTIPLE RATE STRUCTURE	LIST OF EXEMPTIONS	ZERO-RATINGS	REDUCED RATE: LIST OF ITEMS	LUXURY-RATED: LIST OF ITEMS
Japan	Apr 1989		3, 6				
Kenya	Jan 1990		18, 25, 100		Exports		
Kazakhstan	Jan 1992	28					
Korea *	July 1977	10		Financial and insurance services Real estate, sold or leased Professional services by lawyers, accountants and tax consultants Basic necessities: foodstuffs, passenger transport, education medical and health services, postal and public telephone services, books, newspapers and magazines	Exports and other goods and services which earn foreign currency International transportation	Business with small turnovers	
Luxembourg	Jan 1970		3, 6, 12	Management fees for investment funds Bank operations Insurance and most financial services Medical and health services	Export	Professional services and works of art Most food and milk products, hotels	
Madagascar #	Jan 1969	15					
Mexico *	Jan 1980		6, 15, 20	Sales of land Credit instruments Residential construction Banking services Medical services Types of public entertainment Most activities of government agencies	Certain agricultural goods Listed basic foodstuffs Exports of goods and services		
Netherlands	Jan 1969		6, 18.5	Insurance & banking, immovable property Leasing & renting of immovable property, Services by hospitals, physicians, psychologists, dentists social & cultural activities Education services Services by composers, writers & journalists Trade unions	Exports International transport of goods Activities within bonded warehouses or equivalents	Foodstuffs, pharmaceutical goods, books, magazines, newspapers, agricultural products, public transport	

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COUNTRY	YEAR OF IMPLEMENTATION	SINGLE RATE: STANDARD RATE	MULTIPLE RATE STRUCTURE	LIST OF EXEMPTIONS	ZERO-RATINGS	REDUCED RATE: LIST OF ITEMS	LUXURY-RATED: LIST OF ITEMS
Nicaragua *	Jan 1975		6, 15				
Norway	Jan 1970	20					
Panama	Mar 1977	5		Inheritances, legacies, gifts, transfers of shares, exports, transfers on free zones, food, medicines, fuel			
Paraguay	Jan 1991	10		Exports			
Peru #	July 1976	16		Primary products of an animal, vegetable or mineral nature, and specified services			
Philippines	Jan 1988	10		Exports & sales to entities exempt under the international agreements			
Portugal	Jan 1986		8, 17, 30		Exports		Basic food products without transformation, Pharmaceutical products Books & educational products Electricity Diesel/Fuel Hotel accommodation
Russia	June 1991		8 - 28	Financial & insurance services, gambling, education provided by state schools & universities and funeral services	Goods & services exported from Commonwealth of Independent States, rented living accommodations property acquired while privatising	Certain foodstuffs	
Senegal	Mar 1961 - 1980		7, 20, 30, 34, 50	Long list			30% 34% on oil products 15% on telephone services
South Africa	Sept 1991	14		Banking and insurance	Export basic foodstuffs		



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Spain	Jan 1986		6, 12, 33	Most banking activities, Exports & related services, Insurance Certain consulting services & transactions relating to industrial property		Basic necessities	
Sweden #	Jan 1969	25		Health care & dental care social services Education Banking & financial services Insurance services Artistic creations Concert Performances Cinematic, theatrical & operatic National & local radio & TV mail services	Daily newspapers Prescription medicines, aviation fuel	Food, hotel & restaurant services & public transport	
Taiwan *	Apr 1986	5			Exports services to foreign countries International transportation: air or sea Sales to government agencies or state enterprises Sales to the U.N, consulate generals & embassies Sales between bonded warehouses & export processing zones	1.5 % annual sales volumes between Baht 600,000 and Baht 1,200,000	
Trinidad	Jan 1990	15		Insurance Certain banking services Stock brokerage Education Medical & dental services			
Tobago	Jan 1990	15		Insurance Certain banking services Stock brokerage Education Medical & dental services			

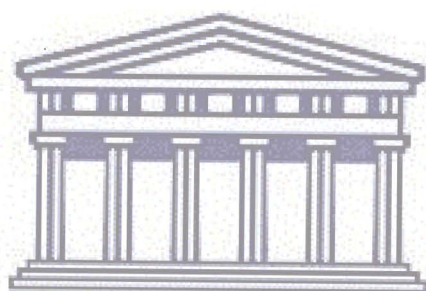


COUNTRY	YEAR OF IMPLEMENTATION	SINGLE RATE: STANDARD RATE	MULTIPLE RATE STRUCTURE	LIST OF EXEMPTIONS	ZERO-RATINGS	REDUCED RATE: LIST OF ITEMS	LUXURY-RATED: LIST OF ITEMS
Turkey *	Jan 1985		1, 12, 20	Banking & insurance companies			
United Kingdom #	Apr 1973	15		Insurance, postal services Banking Certain property transactions education & health services	Exports Basic necessities: foods, books fuel for private consumption buildings for domestic charity & children's clothing Some services of social nature		
Uruguay	Jan 1968		1, 5, 20	Broad scope, all stages of production and trading imports, local sales and services rendered	Farm products, real estate, credits agricultural machinery, cigarettes, oil, milk, newspapers, books, interest on bank deposits, transportation of people real estate leases and banking services		Necessities food such as fish and meat Medicines Interests of loans granted to individuals Hotels activities

Sources: VAT Monitor - 1993; Coopers & Lybrand, *International Tax Summaries - 1993*; Deloitte & Touche International, *International Tax and Business Guide*, various issues; International Monetary Fund, *VAT: Administrative and Policy Issues*, October 1991; Unit for Fiscal Analysis, Department of Finance.

Notes: Rates shown in bold type represent the standard rates.  
 # Countries that have changed from multiple rates to a single rate.  
 \* Countries that have changed from single rate to multiple rates.





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