

Rolling out Value Added Tax in Lao PDR: Issues for effective implementation

Introduction

The Lao PDR started implementing the Value Added Tax (VAT) in January 2010 to strengthen its financial management, improve its tax base and serve as an additional source of revenue for the government's central budget. Limited to fewer than ten countries in the late 1960s, VAT is now implemented by about 140 countries worldwide. Among industrialized nations, standard rates range from 5 percent in Japan to 25 percent in Hungary and in parts of Scandinavia.

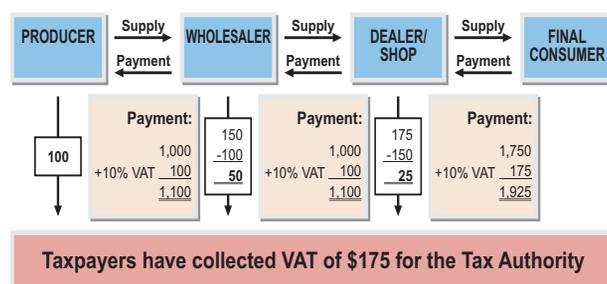
VAT is a tax on consumption, ultimately paid by final consumers. In principle, businesses should not bear the burden of the tax themselves since there are mechanisms in place that allow for a refund of VAT payments levied on intermediate transactions between firms.

The VAT system is based on tax collection in a staged process, with successive taxpayers entitled to deduct input tax on purchases and account for output tax on sales. Each business in the supply chain takes part in the process of controlling and collecting the tax, remitting the proportion of tax corresponding to its margin, i.e. on the difference between the VAT paid out to suppliers and the VAT charged to customers.

When implemented in Lao PDR, VAT will be charged at a rate of 10% on most goods and services when these are supplied in Lao PDR by registered VAT taxpayers* and also on most imports of goods (some goods and services are exempt) whether made by registered VAT taxpayers or not.

* Lao PDR based businesses with an annual turnover of at least 400 million kip (approximately US\$47,000) are obliged to register for VAT and comply with the VAT Law. This is also the case for businesses not based in Lao PDR that supply goods or services in the country, regardless of their annual turnover. Moreover, Lao PDR based businesses with annual turnover below 400 million kip can opt to register as a VAT Taxpayer.

Figure 1: Flow of VAT transactions in supply chain



This Business Issues Bulletin summarizes the VAT system and proposes a review of the collection and deduction mechanism in order to ensure the VAT system is efficient and does not unnecessarily burden taxpayers and tax administrators alike. Additionally, it provides suggestions to lower compliance cost by introducing electronic filing and payment, decreasing the frequency of returns and recommending that the tax authority adopt risk-based principles to administer taxpayers. Finally, to ensure that the primary stakeholders and public are able to comply with the new system, it is recommended that the tax authority carry out an extensive public information campaign to educate and target relevant stakeholders about VAT. These recommendations are based on best practices from other countries and current proposed policies.



International Finance Corporation
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The *Business Issues Bulletin* provides those interested in business issues with a short summary and analysis of a particular topic affecting the business environment in Lao PDR, and exposure to different opinions held by various stakeholders on the topic.

The *Bulletin* is supported by Finland, Ireland, New Zealand, the Netherlands and Switzerland.

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Refund procedures should be streamlined

VAT refunds are part and parcel of the VAT system because they result from the typical VAT deduction mechanism (input VAT offset against output VAT), combined with the application of a zero rate on exports. It is crucial that VAT refund claims are processed quickly because international experience shows delays in reimbursement of VAT to exporters amounts to a tax on exports. An effective VAT refund system is needed so that Lao exporters are not at a disadvantage in international trade and to encourage investment in export industries.

VAT is intended to strengthen Lao PDR's tax framework and generate revenues for the state budget by broadening the tax base without directly taxing producers by targeting consumption. However, the VAT system can be burdensome to both the taxpayer and tax administrators if it is not properly designed. At any stage of the production/distribution process input VAT can be higher than output VAT, resulting in a refund claim. An efficient and quick refund process is therefore essential. The refund processing time in most countries takes an average of 30 days and reliable exporters get their refunds without extensive checks and audits.

In the case of Lao PDR, the refund process of excess input tax is complicated due to certain legal restrictions. For example, non-exporting businesses cannot get a cash refund, since any tax credit not resulting from exports must be carried forward to the following months. This is problematic to businesses, especially those undertaking expansionary capital investments, whose input taxes constitute substantial cash flows.

For the above reasons, the Lao tax authority should consider removing restrictions on refunds. This would not only benefit all VAT taxpayers, but would also bring the Lao VAT system in line with international best practice and make the country more competitive in international trade. This would in turn encourage greater foreign and domestic investment and benefit the economic development of the country. Such a move would also allow for a much more simple VAT return and would reduce compliance costs for VAT taxpayers as well as administrative costs for the Lao tax administration.

Compliance costs should be minimized

Tax compliance costs are defined as all tax-

related costs incurred by the private sector other than the taxes paid to the government. For tax-paying businesses, the core legal compliance costs include time costs, cash outlays related to tax obligations, and payments to others such as professional accountants. Complex tax payment processes tend to lead to high compliance cost with the result of dissuading businesses from moving out of the informal sector or discouraging them from complying.

Compliance costs for the VAT system include registration of taxpayers. Although the consumer ultimately pays the tax, it is the registered VAT taxpayers that are responsible for tax collection and passing funds on to the tax authority (after deduction of input VAT). For the process of tax collection to run smoothly, it is imperative that the tax authority knows at all times who the producers and traders are, who collects the tax and where taxpayers can be found for guidance, assistance and, if necessary, audit. Registration is aimed at ensuring that the tax authority has all the information it requires about the taxpayers. International best practice shows that a quick and easy registration process will help encourage businesses to participate in the formal tax system.

A typical challenge related to VAT implementation is weak administrative procedures for a complex process. In Lao PDR, initially, there will be approximately 2,000 businesses that meet the threshold to become registered VAT taxpayers. Similar to other countries, the Lao tax authority may find it difficult (i.e. insufficient staffing levels) to cope with many VAT taxpayers, especially in terms of ensuring that they all receive equal and proper quality treatment.

Furthermore, studies have shown that the less the filing frequency, the lower the compliance cost for the taxpayer. Monthly filing is not only a burden in itself and but it also results in more audits and visits by the tax authorities. Frequent and discretionary audits both expend the administration resources of tax authority and inflict more time and cost burden on businesses, especially the bona fide ones. The challenge for the tax authority is aggravated by its inability to use IT systems to capture and adequately process the significant amount of data required in the VAT returns submitted by the large number of VAT taxpayers. With an adequate IT system in place, the tax authority would be able to use data for the purpose of risk analysis to focus on the high-risk group of business taxpayers.

To strengthen the administrative capacity of the tax authority and help reduce compliance cost of taxpayers, the following recommendations should be considered. First, computerizing tax systems has proven to save time and cost for both businesses and the government. According to Doing Business 2010, nearly 70 out of 183 countries offer online filing and payment systems. As VAT becomes more widespread, the tax department should consider introducing online filing and payment systems to reduce the time taxpayers must spend filing VAT returns.

Second, later on when compulsory VAT registration* is extended to smaller businesses, submitting monthly VAT returns will no doubt be a cumbersome, if not challenging, procedure for some of these businesses. Therefore, when extension of VAT coverage to include smaller businesses is contemplated, quarterly or bi-monthly VAT returns would be more realistic given their low compliance capacity. This will pose less of a constraint for businesses with a turnover below a certain threshold (but the possibility of monthly VAT refunds should be maintained as an option, especially for those concerned with cash flow).

Third, the tax authority should adopt risk-based principles in administering taxpayers. This would focus on ensuring VAT taxpayers have effective financial reporting systems in place and are reporting correct sales and VAT payment amounts. Administering taxpayers using risk analysis will bring about dual benefits. It will both help the tax authority optimize its administrative resources by focusing on the high-risk taxpayers while business taxpayers will benefit from fewer audits and inspections by tax authorities.

Need for public education

Since the success of VAT depends on voluntary compliance and self-assessment, tax authorities must make an effort to ensure that all VAT taxpayers have easy access to complete and correct information about what is expected of them. This includes providing sufficient assistance to enable businesses to comply with their obligations under the VAT system. The tax authority has engaged a communications firm to design numerous informational materials and a nation-wide media

* Under the current VAT legislation, small businesses are able to become VAT taxpayers on a voluntary basis. In practice only small businesses exporting most of their turnover would have an interest in being VAT taxpayers as this would allow them to have their input VAT refunded.

campaign to explain the benefits of VAT. Other plans include a customer service window and a telephone hotline to respond to taxpayers' questions and concerns. It is important that these activities be intensified to ensure effective roll-out of the new VAT system in 2010.

Although a series of intensive training courses on VAT implementation has been provided to designated staff of the Tax Department and to representatives of other government agencies, the tax authority should consider hosting in-depth taxpayer education programs targeting the private sector. Forming a partnership and dialogue with the private sector is needed to understand private sector concerns and make improvements to the system. Greater taxpayer education would also gradually lead to the creation of a well functioning customer service unit for taxpayers to raise questions and concerns directly to the tax authority. If well informed, taxpayers can assist in disseminating VAT information and will be less apprehensive about complying with new VAT requirements.

Conclusion

Taxes are essential to the growth of an economy, particularly as a source of funds to build the country's infrastructure and offer adequate public services for its people. The Lao tax authority has taken a significant step to improve the tax base by launching VAT. VAT replaces the current turnover tax which has multiple rates and the typical drawback of taxing businesses at each stage of the production process. However, for VAT to be successful, procedures need to be simplified and the capacity of taxpayers to comply and the tax authority to monitor need to be strengthened.

To make the new system equitable and user friendly the government needs to keep in mind the following. First, current legal restrictions should be modified. Second, compliance costs for businesses should be kept at a minimum through effective administration by introducing electronic filing of VAT returns as a way to reduce the time needed to file returns. Third, it is necessary to ensure a transparent process by making VAT information widely available and by providing effective taxpayer education.

Viewpoints

In line with the current worldwide trend to move from direct taxes to indirect taxes, VAT implementation in Laos will strengthen the tax system and bring it on par with regional practices. Given the increased fairness of VAT, its introduction is considered one of the key conditions crucial to building a better business environment in the Lao PDR. For this reason, the private and public sectors should not be apprehensive about VAT. Our goal is to ultimately make VAT transparent and beneficial to all. Hence, I agree that a more targeted information campaign, tailored to respond to the needs of each of our different stakeholders, especially the taxpayers, will be useful once VAT is in full implementation.

This Business Issues Bulletin raises many valid concerns and in due time, issues such as the proposal to modify legal restrictions on refunds may be reviewed and considered by our national leaders. For VAT to be implemented successfully compliance is key and improvements to the Tax Law should be aligned with the VAT Law.

Mme. Manivone Insixiengmay, Director General Tax Department

While VAT is intended to be a more transparent and straightforward tax system, without an effective and efficient administrative process it will become a major compliance burden for businesses, which will discourage them from complying. One way to mitigate this is to provide detailed information about VAT refunds and returns in order to help businesses understand the new regulations fully. A second is to provide workshops with business associations to understand the filing process and also to hear concerns and suggestions from the private sector on how to make VAT an effective system to not only create private sector growth but also help the government and the country.

Mr. Khanthavong Dalavong, Secretary General Lao National Chamber of Commerce and Industry

Despite its popularity around the world, implementing VAT is not simple. There are a few key factors that will determine VAT's success in Laos. Tax authorities must have: (i) clear and easy to understand regulations, instructions, guidelines and other pertinent materials for VAT taxpayers; (ii) an IT system to handle all administrative tasks;

and (iii) tax officers and taxpayers must understand and appreciate that VAT is a consumption tax (i.e. tax is paid by consumer and where it is consumed). Additionally, because taxpayers will serve as key tax collectors from end users they need taxpayer education in order to adequately comply with requirements under the law.

Furthermore, unlike other countries, putting certain restrictions on refunds poses constraints to businesses and increases their operational expenses. If these restrictions are not lifted, it could make businesses in Laos less competitive in the international market. Nevertheless, in the long run, we believe VAT will bring greater benefits to the country and business operators than the previous business turnover tax.

Mr. Thavorn Rujivanarom, Tax Partner Tax and Legal Services PricewaterhouseCoopers (Lao) Ltd.

The VAT that is being implemented in the Lao PDR will be a challenge for the registered taxpayers as well as for the tax authorities. Indeed, the legal restrictions and requirements imposed on VAT deductions and refunds compelled the tax authorities to make the monthly VAT return form far more complex than it should be. This will complicate compliance for all taxpayers, even those that will never be in a position to request a refund. As a result, this year's achievement of cutting down the time needed to comply with tax requirements by 198 hours per year in the World Bank's Doing Business study could easily be wiped out, at least for VAT taxpayers. I, therefore, fully endorse the recommendation that the Lao PDR authorities should seriously consider removing unnecessary restrictions on VAT deductions and refunds.

I am very pleased to note that the tax authorities are committed and ready to ensure that actual VAT refunds will be paid to exporters within the shortest time possible. I wish the Lao tax authorities success with the introduction of the VAT. This experience could propel the Tax Department's operations as a whole onto a higher level and should be an important step in its evolution towards a modern Revenue Collection Organization.

Mr. Andre Vinck, VAT Advisor World Bank and Ministry of Finance, Tax Department, Lao PDR