

Definition and scope of value added tax economics essay



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Value Added Tax is currently the most common form of consumption tax system used around the world. The Parliament Ghana passed the Value Added Tax Act, Act 546 on 16th March 1998 to replace the Sales and Services Tax with the aim of generating more tax revenue to reduce the government's overdependence on donor funds for economic development. VAT is well known to be an efficient way to raise tax revenue for both developing and developed countries. However the success of VAT depends on a well designed and implemented system of VAT administration. VAT requires efficient monitoring and verification systems to be successful. This study is aimed at identifying and addressing the administrative challenges facing the Value Added Tax Service and the effective implementation of VAT to collect more Tax revenue for Ghana. This chapter covers a review of literature on VAT administration and the challenges confronting efficient VAT administration. The chapter will also review provisions made in sections of the Value Added tax Act, (Act 546) concerning VAT administration.

DEFINITION AND SCOPE OF VALUE ADDED TAX

Value Added Tax (VAT) is defined as “ a tax applied on the value added to goods and services at each stage in the production and distribution chain”.
(http://www.gra.gov.gh/index.php?option=com_content&view=article&id=4&Itemid=22)

This implies that Value Added tax is levied at any stage in the production and distribution chain where value is added to goods and services unless specifically exempted in the Act. The applicable VAT rate is effectively applied on the value added at each stage. This is achieved by charging the

rate on the value of taxable output and deducting tax paid in taxable inputs. Value Added Tax is borne by the final consumer since the tax is added to the price of taxable goods and services. Section 1 of the Value Added Tax Act 1998, Act 546 provides that Value Added Tax must be charged on the following three categories of supplies unless otherwise exempted by the Act:

(a) Supply of goods and services made in Ghana

(b) Imported goods

(c) Imported service.

The tax is charged only on taxable supply of goods and services “ made by a taxable person in the course of his business” (Value Added tax Act, Act 546 1998)

. This implies that VAT is chargeable where:

The supply is taxable within the definition of the Act

The supply is made by a taxable person

The supply is used in the course of business of the taxable person.

THE SCOPE AND IMPORTANCE OF VAT ADMINISTRATION

VAT is well known to be an efficient way to raise tax revenue for both developing and developed countries. However the success of VAT depends on a well designed and implemented system of VAT administration. VAT requires efficient monitoring and verification systems to be successful. The

scope of VAT administration covers a range of related functions such as taxpayer identification and registration, invoicing controls, filing and payment requirements, refunds, VAT audits, penalties enforcement and any other incidental activities necessary for tax authorities to discharge the responsibilities entrusted to them (Jantscher 1990 P. 56). The success of VAT depends on many factors, prominent among which is the way in which the VAT laws are administered by the organs entrusted with the collection of the tax for the government.

Any weaknesses in how VAT administrators perform their duties will adversely affect the government's policy objectives as a whole. Tanzin and Pellechio (1995) (cited in Mikesell (2007)) observed that poor tax administration has implication on the manner in which taxation affects government's economic stabilization, resource allocation and redistribution of income. Most of the developing countries who have introduced VAT have copied the VAT systems of developed countries who have introduced VAT. It is important to know, however, that the challenges confronting developing countries in their VAT implementation are quite different from that of the developed countries they copy from.

According to Bird and Gendron (2005), developing and transitional countries, unlike developed countries, face the problem of fragmented economies, dominant informal sectors, low tax morale, rampant evasion, and lack of trust between tax administrators and taxpayers. It is clear from the above that no developing countries can create a successful VAT system by just thus, copying a successful VAT's design attributes of developed countries without considering the above tax administration and the socio-economic

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challenges of the country in question. Neville Howlett et (2006) were right in their assertion that, “ although the principles of the tax are broadly the same everywhere, the rules can be enacted and implemented differently in different countries so that the compliance burden on business varies considerably.” Eduart Gjokutaj supports this view that “ the consistent support and advocacy of this form of taxation by the IMF and others in a variety of countries, encouraged and facilitated the adoption of VAT by countries with much less developed economic and administrative structures than those in the original EU member states” http://ezinearticles.com/?expert=Eduart_Gjokutaj.

Keen and Lockwood (2007) have observed that, in most developing countries, the main justification for introducing VAT is that the system “ would enhance efforts to mobilize much needed tax revenue through wider improvements in tax administration and compliance”(P. 235).

Many studies have concluded that Value Added Tax is better than possible alternatives in both developed and developing and transitional countries (Bird M. R, 2005). According to Bird (2005), “ so long as countries have general sales taxes, VAT remains the best choice in virtually all circumstances”. However, Bird (2005) points out that the idea that VAT is most effective tax for developing countries seeking to alternative sources of revenue due to loss of income through traditional sources is valid only if VAT can be administered efficiently (P. 237).

Many studies have concluded that VAT is currently the best way to for the government to collect general consumption tax. But all the studies agree

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that the benefit of VAT cannot be realized with an efficient and effective system of VAT administration. In connection with this, Jantscher (1986) has stated that “ the real tax system is that which is administered, not that which appears in the formal law” (P. 18).

THE INTRODUCTION OF VAT IN GHANA

The PNDC government saw the need to improve the tax system in 1990 mainly due to the drastic fall in revenue from her traditional revenue source. Following the decline in revenue from exports due to decreasing world market price for primary goods including Cocoa and gold, tax revenue from traditional sources started declining and this put pressure on the capacity of government to increase revenue to meet expansion in recurrent and development expenditure. Like most developing and transitional economies, another major reasons for Ghana to adopt VAT in 1998 to replace the Sales and Services Tax was the International Monetary Fund’s (IMF) strong recommendation on VAT to economic transition countries including Ghana. According to Terkper, (1998), the introduction of Value Added Tax in Ghana was in-line with the policy of the Economic Recovery Program (ERP) which was launched in 1983 and which sought among other things to rationalize the tax system.

The government therefore commissioned the Harvard Institute of International Development (USA) and the Crown Agent of the U. K. to conduct feasibility study in 1991. The study was to conduct a critical examination into the then existing tax system and suggest ways to improve it. The recommendations of the study led to the introduction of VAT in March

1995. The government introduced the VAT at the standard rate of 17.5%. Unfortunately, Ghana experienced rapid increases in the prices of goods and services immediately after the introduction of VAT. This led to public “anti-VAT” demonstrations in Accra and other major cities in Ghana. Clashes between demonstrators and government security agencies led to the shooting to death of some civilians. This ultimately forced the government to withdraw the VAT and reinstate the sales and services tax. The government did not abandon the VAT agenda because most developing and transitional economies had successfully introduced VAT. After three years of much wider public consultation, parliament passed the Value Added Tax Act 1998 (Act 546) to reintroduce the Value Added tax at a lower VAT rate of 10% in 1998.

PROBLEMS OF VALUE ADDED TAX ADMINISTRATION IN GHANA

Naiyeju (1996) contends that “the positive result received from any tax depends on how the tax is administered and the extent of how the tax law is interpreted and implemented as well as the publicity brought into it.”

Sections 36 to 53 of the Value Added Tax Act cover the administration of Value Added Tax. The sections outline the establishment of the Value Added Tax Service and the functions assigned to the various organs of the Service.

Cruce F (2011) has observed that there are six important conditions that need to be fulfilled in order to create a good VAT administration: “simple, clear, stable tax laws; adequate service and support to tax payers in complying with tax obligations; simple procedures of registration, filing, payment, and refund; effective collection enforcement; reasonable audit
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coverage, strict application of penalties; and provisions for independent review". <http://www.nek.lu.se/Publ/mfs/209.pdf>

An examination of the operations of the VAT Service indicates that Ghana has not fulfilled most of the above conditions. The Value Added Tax Act is quite simple and clear, but the VAT Service is not adequately resourced to provide the needed service and support to tax payers in complying with the provisions of the Act.

Also the registration and filing system as well as the payment and refund systems are too cumbersome especially for the small businesses. All papers must be filled manually as there is no electronic filing system. This implies that that registered businesses must walk to the nearest VAT Office to pick forms and also to file returns. VAT offices are located only in the regional capitals so tax payers in other towns must travel long distances each month to the regional capitals to file their returns. According to Cruce (2011) to encourage every eligible tax payers to register to collect VAT, the tax authorities must make sure that their registration procedures are as simple as possible; establish an efficient verification system to verify new registrants in order to avoid fraud

Regarding enforcement and audit, the VAT Service appears not to be doing enough when the taxpayer fails to pay a tax liability based on either a self-assessed tax return or an assessment resulting from audit activities. Baurer (2005) has outlined the following steps involved in collecting tax liability from defaulting tax payers:

Contacting taxpayers and requesting payment of all delinquent and current taxes that are due.

Interviewing taxpayers and third parties to secure information regarding sources of income and assets

Reviewing taxpayer financial records and third party data to determine the taxpayers ability to pay delinquent taxes

Determining the reason for non-payment

Determining if the taxpayer should be granted additional time to pay a tax liability based on financial analysis and granting installment payment privileges where applicable

Determining if a tax liability is collectible

Conducting investigations to locate taxpayers and/or taxpayer assets

Identifying assets of the taxpayer that can be attached or seized for non-payment of taxes due

Taking enforced collection actions when taxpayer refuses to pay voluntarily

Issuing attachment orders to banks to freeze and/or seize taxpayer accounts

Issuing attachment orders to third parties to secure funds due to the taxpayer

Conducting seizures of tangible assets as permitted by law (e. g., real property, machinery and equipment, motor vehicles, etc.)

Conducting public auction sales of taxpayer assets as permitted by law

Buttery (2006) has pointed out that most proponents of VAT describe the procedure for collecting VAT without taking into account the fact that suppliers and producers must supply the information required for assessment to the VAT Authorities. According to him, in order to reduce the administrative burden in terms of information requirements, exemptions are usually granted to small tax payers in the informal sectors. It is on this ground that Emran and Stiglitz (2005) challenged the view that the VAT tax base in developing countries is generally broader than tariffs.

Generally, the Value Added Tax Service has not yet lived up to expectation regarding the delivery of its mandate in the VAT Act. It appears there is no adequate machinery for effectively monitoring the collection and remittance of the value Added Tax to the government. Service lacks is not adequately resourced in terms of skilled manpower and technology to administer VAT efficiently.

It is therefore important to assess the efficiency with which the various organs of the Value Added Tax Service perform their functions. The study examines the operations of the VAT Service to ascertain the challenges confronting the Value Added Tax Service in performing an efficient VAT administration and explore ways of improving on the efficiency of the Service.

Ghana has designed a very comprehensive VAT Act but weaknesses in the administrative systems required to enforce the provisions of the Act have led to shortfall in revenue targets over the years. For example there is no <https://assignbuster.com/definition-and-scope-of-value-added-tax-economics-essay/>

efficient tracking system to identify organizations that become eligible to register to collect the Value added Tax. Most of the organizations who have registered to collect Value Added tax also fail to issue VAT receipts to customers who purchase taxable supplies from them as enshrined in the Act, even though their prizes are VAT inclusive. Many taxable persons also take cash to avoid having to issue VAT invoices. Such organizations, however, claim credit for VAT paid on their purchases leading to huge loss of revenue to the government.

The problem of VAT administration in Ghana is exacerbated by the composition and functions of the Value added Tax Service. A review of the functions of the Service shows that the service needs more people with managerial skill. The inability on the part of the Value added Tax Service to deliver adequately on the managerial aspects of their mandate leads to refusal to complete tax return form, fraudulent declarations, smuggling etc. These lapses in tax administration explain why Ghana's tax ratio continues to fall below the average of 17% of total revenue in Sub-Saharan Africa.

VOLUNTARY COMPLIANCE

Tax compliance has been defined as “ compliance with reporting requirements means that the taxpayer files all required tax returns at the proper time and that the returns accurately report tax liability in accordance with the internal revenue code, regulations, and court decisions applicable at the time return is filed” (Roth et al, 1989, p. 21)

VAT thrives on voluntary compliance and effective monitoring. According to Allan (2007), without due attention to VAT administration and staffing, the <https://assignbuster.com/definition-and-scope-of-value-added-tax-economics-essay/>

details of theories and generalizations about VAT are less effective. Bird (2005) added that many developing countries have encountered VAT implementation problems mainly because of “ lack of ‘ self-assessment’ based tax return practices, the difficulties in establishing efficient VAT administration and control systems, a large share of shadow economy and tax fraud”.

Gjokutaj (2011) has said that, VAT is the recommended Tax for countries that need a simpler tax, but VAT does not always work well in developing countries principally because they are not yet “ so tax educated society ready for self-assessment”. He adds that the voluntary compliance by tax payers depends largely on “ the degree of existing trust between officials and taxpayers and how quickly that trust can be built up sufficiently to support a self-assessment system”.

Most countries that have efficient VAT administration systems have over 70% voluntary compliance rate (Agyemang Duah 2011, p. 231). Sweden which aims to be the country with the best tax administration in the OECD by 2012 have a focus on compliance, cost efficiency and effectiveness, e-filing, and tax gap measurement and management. http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/key_documents/011_851_en.pdf

According to Cruce (2011) to encourage every eligible tax payers to register to collect VAT, the tax authorities must make sure that their registration procedures are as simple as possible; establish an efficient verification system to verify new registrants in order to avoid fraud. Knowledge about

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the causes of non-compliant behaviour by citizens and businesses is also very important. According to the 2010 edition of the European Commission's Compliance Risk Management guide for Tax Administration, "criminal sanctions are not the appropriate response (and may have an adverse effect) when non-compliance is caused by complex legislation or a lack of knowledge on the part of the taxpayer." The paper therefore recommends that tax administrators should match their compliance strategy to the taxpayer's attitude and motives..

According to Alcantara et al (2010) countries that have adopted electronic filing and payment systems have drastically improved their voluntary compliance. They have also concluded that the frequency with which VAT returns are required and the amount of information requested have a significant impact on the time it takes to comply and that compliance takes longer where extra documentation has to be submitted with the return (Page 9). In addition, they established a correlation between the VAT compliance ease time taken to receive VAT refund. According to their study "where it takes longer to receive a refund, it takes longer to comply."

The study examines the procedures put in place by the VAT Service to encourage voluntary compliance and make recommendations for improvement

THE STRUCTURE OF TAX ADMINISTRATION

The efficiency of VAT administration also depends on the powers given to the revenue authority charged with VAT administration. According to Allan

(2007) there is "the Potential for cross-checking VAT and income Tax liability <https://assignbuster.com/definition-and-scope-of-value-added-tax-economics-essay/>

if VAT and income tax are placed under the same organization. He claims that " as each trader's sales is someone else's purchase, the invoices required for a credit invoice VAT theoretically allows the authorities to cross-check a trader's purchases by adding up the supplier's sales. Therefore the data on purchases and sales in VAT returns should provide a valuable input to the calculation of profits for the purpose of income taxation, thus improving the administration of direct taxes (p. 234).

Agyemang Duah (2011) has, however, expressed doubts about the efficiency of tax administration if the scope of the tax administration is expanded by placing both VAT and income tax under one wing of tax administration.

In Ghana, although both VAT administration and income tax have been placed under the Ghana Revenue Authority, each tax is administered by a separate organ with little coordination between them. Income tax is administered by the Internal revenue service whilst VAT is administered by the Value Added tax service. The VAT Service has many organs but the highest decision making body of the Service is the Revenue Agencies Governing Board. The Board has the following functions:

To ensure the effective, efficient and optimum collection of all taxes penalties and interest due to the state.

To control the management of the Service

To recommend to the Minister of Finance policies for the effective management of VAT as well as any exemptions required.

To pay amount collected by the service into the consolidated fund.
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To pay amount collected by the service into the consolidated fund.

Appoint, promote and discipline employees of the Service.

Prescribe the terms and conditions of service of employees (Value Added Tax Act, Act 546, 1998)

A review of the operations of the VAT service shows that the VAT system in Ghana is organized along geographical lines as existed in the erstwhile sales tax regime.

Baurer L (2005) explains the three main ways to structure tax administration namely “ by type of tax; by type of taxpayer; or, by operating function”. He adds that in countries that are in their early stage of development, tax is usually organized by type of tax but the structure chosen by a particular country must support her implementation strategy.

Hasseldine (2007) is of the opinion that VAT “ is best administered by an organization which is organized along functional lines with each official focusing on carrying out one function instead of delivering all functions to a taxpayer”. According to him, a functional design permits greater standardization of identical work processes, facilitates simplification of procedures for taxpayers, reduces taxpayer costs and enhances compliance and enables greater productivity. The study examines the current structure and scope of the VAT Service to identify any organizational lapses that may be contributing to inefficient VAT administration.

THE VAT GAP

The VAT gap has been defined as “ the difference between the net VAT liability and total VAT collections” (Durner and Sedon, 2010). VAT gap results from fraudulent activities such as, evasion, failure to register, under-reporting of sales, false claims of input credits. It has also been argued that ignorance on the part of Vendors and buyers also lead to non-compliance, as opposed to fraud or evasion. According to Alan T (2010), Value Added Tax is expensive to administer because “ much money is collected only to be returned, and fraud is possible through suppression of sales figures, barter transactions, understated debtors, false invoices, multiple claims, and fictitious businesses.” The main objectives of VAT administration are: “(1) to ensure that total VAT collections are as close as possible to the total amount of VAT due, and (2) to keep costs related to the administration of the VAT as low as possible” (Durner and Sedon, 2010).

Agyemang Duah (2011) contends that, a significant portion of the VAT gap in Ghana is the result of lack of proper books of accounts upon which the VAT Service can perform any meaningful VAT assessments and audit. It is estimated that the VAT gap of Ghana is 40% whilst European countries like Ireland and Spain have VAT gap of only 2% (Durner Sedon, 2010; Agyemang Duah (2011). The study will examine the extent to which the above problems militate against efficient VAT administration in Ghana and explore ways of reducing the VAT gap.

VAT ADMINISTRATION AND SMALL TAX PAYERS

Domenico (2005) has stated that the task of administering VAT for a large number of small traders creates a considerable challenge because

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compliance costs of a VAT system as a percentage of business turnover, is considerably higher for small compared to larger businesses. Cruce (2011) argues that “ VAT is primarily a tax on the formal sector and hence inappropriate for circumstances where the informal sector is significant’. The Ghana tax base, like most developing countries, is dominated by the informal small tax payers.

It is in the light of the above that Ghana introduced a standard VAT rate of 3% for the informal sector of the economy in the year 2007. The aim was to simplify the VAT procedures for the small tax payers. Under the standard scheme, qualifying retailers are allowed to pay 3 percent (3%) of their annual turnover as VAT. Taxable persons under this scheme are not allowed to deduct any input tax from the VAT collected on their output.

The 2012 budget statement also proposes the establishment of a single tax rate for VAT and income tax for small tax payers. It has been argued that such a simplified tax system will help to reduce tax evasion and compliance cost for small tax payers.

However, in the view of Shome1 (2004) “ a single tax does not reduce evasion except by definition since, by design, it requires small taxpayers to pay less tax than their theoretical tax potential”. He also argues that a single tax also leads to inefficiency since it reallocates resources from the higher rate tax sector to the lower-taxed sector. Modern tax experts therefore recommend tax simplification rather than separation between large, medium and small taxpayers”. Shome1 (2004) further states that “ the ultimate goal for tax practices to fully reflect the original intentions of tax policy as

expressed in the tax statute could be achieved if the complexity in the tax structure is reduced through a continuous process of tax simplification” rather than using a single tax rate. The government of Ghana therefore needs to have a second look at the proposal for a single tax rate as proposed in the 2012 budget. The study will explore the benefits and challenges of a single tax system proposed by the government by reviewing similar systems adopted by other countries.

ASSESSING VAT ON SERVICES

According to section 10 of the Value Added Tax Act, “ the supply of taxable services is subject to VAT and NHIL at the standard rates of 12. 5% and 2. 5% respectively...The recipient of the service is required to account for VAT and NHIL by means of a reverse charge”. The Act also provides that “ registered recipient would be entitled to reclaim the amount of VAT and NHIL paid, subject to certain restrictions”. However the administration of Value added Tax on importation of taxable service presents one of the most difficult challenges to the VAT Services. Because services are intangible and difficult to quantify, the success of VAT administration depends largely on the faithfulness of the taxable persons. Monitoring the purchase and sale of services is very difficult since no inventory of services is available for stock taking.

Administration of VAT on Services is even more complex when service is bought or sold from another country. Although services are economically equivalent to goods, their VAT border-crossing treatment differs. The current VAT Act does not have enough provisions to deal effectively with services

whose location of supply or purchase is difficult to ascertain. The procedures for assessing taxable services in Ghana will be assessed through interviews and observation.

VAT REFUNDS

Another challenge of VAT administration in Ghana concerns VAT refund claims. Refund claims arise when a taxable person pays more VAT on purchases than it collects on sales. Tax payers always complain that there is too much delay by the VAT Service in processing VAT refund Claims. VAT officials are of the view that VAT refund delays are driven by the need to protect government revenue from the risks of false purchases invoices, falsified export documents, and understated taxable sales. According to Bird (2010) best practice in VAT refunds involves “ a risk-based system of selective inspections and audits...which allows most refunds to be paid promptly, subject to post-refund audit, and heavy penalties for false documentation.” He argues further that this system is highly cost-effective, because the revenue risk from promptly paying low risk claims is small compared to the opportunity cost of having skilled tax personnel scrutinize every refund petition. Portugal has adopted a simplified VAT refund process using computerized risk-assessment and automatic payment for low-risk claims. Kenya has a system where their revenue authority pays all VAT refund claims that are certified by a professional accountant, with severe penalties for fraud by the accountants. Bird (2010) argues that this increases compliance cost to the tax payer since it amounts to out-sourcing the verification process at the taxpayer’s expense. Based on their review of VAT refund procedures in 36 countries, Harrison and Krelove (2005) identify the <https://assignbuster.com/definition-and-scope-of-value-added-tax-economics-essay/>

following features of an effective VAT refund system suitable for developing and transitional countries:

The number of VAT payers should be kept at a level that can be realistically managed.

VAT registration applications should be subject to proof of identity and other basic checks.

Suitable forecasting and monitoring systems should be established to anticipate refund levels and ensure that sufficient funds are available to meet all legitimate refund claims.

Refunds should be processed within a reasonable statutory period (e. g., 30 days from the refund claim), and the tax authority should report publicly on its performance.

Interest should be paid on late refunds.

Excess VAT credits should be offset against VAT and other tax arrears.

Immediate refunds should always be paid promptly to exporters.

Verification of VAT refund claims should be integrated into a wider audit program, with pre-refund audits being limited to high-risk cases only.

Preferential treatment should be given to regular exporters with sound compliance histories.

Appropriate sanctions should be consistently applied to taxpayers who falsely claim refunds.

Taxpayers should be entitled to appeal, on reasonable grounds, of a decision to withhold a refund.

The tax administration should provide clear information to taxpayers about their rights and obligations and the procedures for making a valid refund claim

The study assess the VAT refund procedures used by the Value Added Tax Service to see the extent to which they apply the above best practice principles and make recommendations for improvement.

OFFENSES PENALTIES

Sections 56 to 72 of the Value Added Tax Act provide a comprehensive list of offenses and penalties for failing to comply with the various provisions of the Act. Offenses relating to taxable persons include: “ failure to register, failure to issue tax invoice, presentation of false or misleading statement, falsification and alteration of documents, evasion of tax payment, failure to maintain proper records and obstruction of officers of the VAT Service”.

There Act also provides for offenses relating to Tax officials. Penalties range from various fines to imprisonment. Cruce (2011) has explained that penalties for VAT defaulters “ should be enforced rigorously and instantly and should be enforced without exception in order not to undermine the credibility of the system”. He contends that this requires an efficient and

well-functioning auditing procedures and tax-officials with the requisite
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investigating skills. Grandcolas (2010) has also added that the level of VAT compliance depends on the design of the VAT, the quality of the system of VAT administration and the consistent enforcement of penalties for default. Evidence from initial investigations indicates that many taxable persons fail to comply with the various provisions of the Act because penalties or offences are not enforced on defaulters. Agyemang Duah (2011) has established a relationship between tax compliance and the effectiveness of tax enforcement including the probability of detection and the size of fines. The study explores the extent, to which the offenses and penalties are enforced, the reasons for any lapses and how the situation can be improved.

VAT ON INTERNATIONAL TRADE

Generally, VAT is levied using the ' destination basis. On this basis, imports are taxed in the country where