



**FISCAL AFFAIRS**

# **Equity, Efficiency and Administration of the VAT**

**IMF VAT WEBINAR SERIES**

**JANUARY 12, 2021**

Ruud de Mooij  
Fiscal Affairs Department

# Broadly, Three VAT Models

## ***Traditional VAT***

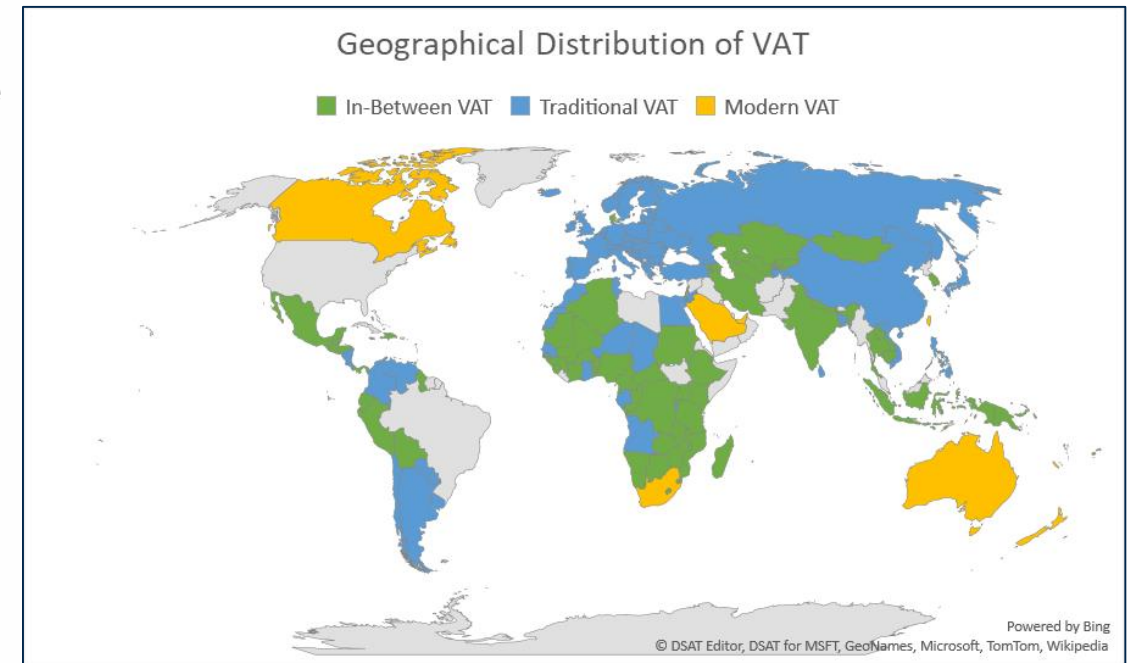
- Multiple exemptions creating a narrow VAT base
- Multiple rates with relatively high standard rate

## ***Modern ('model') VAT***

- Limited exemptions with a broad VAT base
- Single rate, typically below standard rate in traditional VAT's

## ***In-Between VAT***

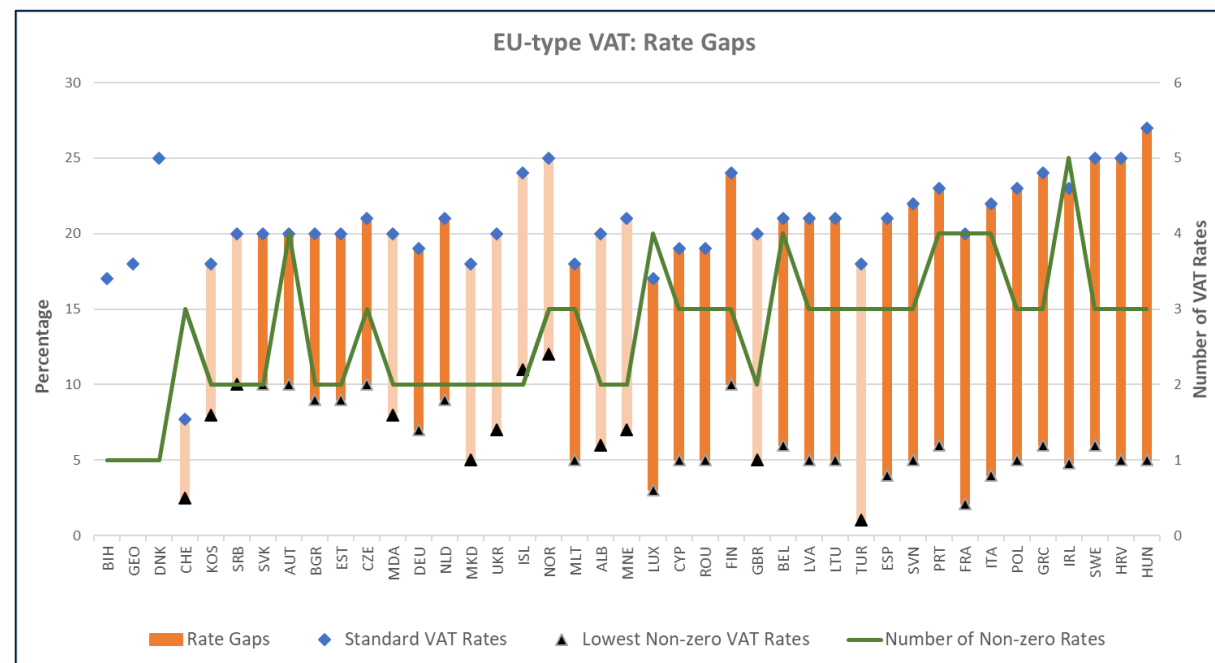
- Multiple exemptions (incl. to address implementation challenges)



# Focus on Design

## Why Exemptions and Reduced Rates?

- Why countries have them?
- Revenue implications
- Why reform is needed?
- Why reform is so hard?



# Why Do Countries Have Exemptions or Reduced Rates?

## *To pursue equity objectives?*

- Regressivity/progressivity of the VAT

## *To make VAT more efficient?*

- Alleviate distortions / industrial policy
- Corrective role of tax

## *To ease VAT enforcement?*

- Certain items hard to administer
- Offset impact of poor VAT implementation



# Pursuing Equity Objectives through VAT?

## **Public Finance Textbook**

- No clear role for VAT, as other instruments are more efficient to pursue equity objectives (PIT, transfers) – if they exist
- VAT is a ‘money machine’ – to pay for (redistributive) spending
- Might change if ‘personalized VAT’ can be designed/enforced

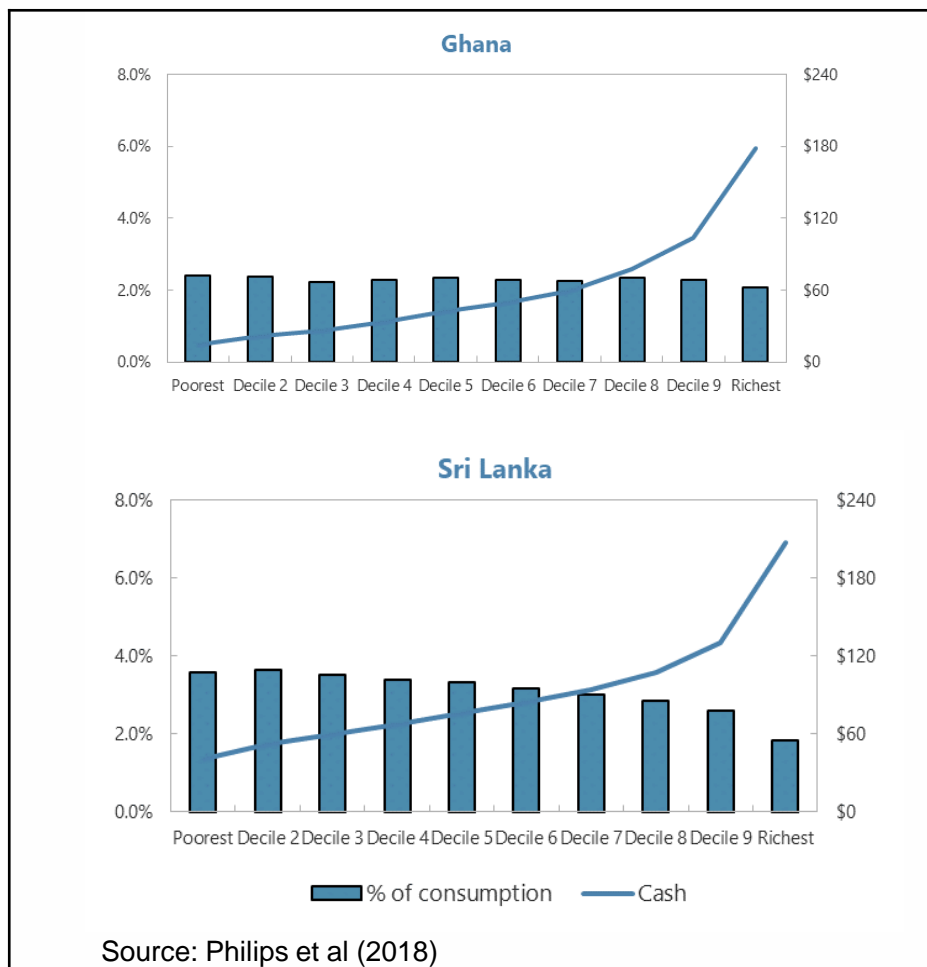
## **Regressivity of VAT**

- Annual versus lifetime income (or expenditure) – VAT not regressive when based on expenditure
- Exemptions/reduced rates blunt instruments – lion share of relief goes to the better-off
- VAT incidence – exemptions/reduced rates might not lower consumer prices but increase profit margins

## **Other dimensions of VAT equity**

- Horizontal equity – VAT can tax informal sector
- Intergenerational equity – VAT vs. Income Tax
- Gender equity – unclear/ambiguous effects

**Incidence and Cost of VAT Exemptions and Reduced Rates**  
(In 2011 PP USD and percent of consumption)



# To Make VAT More Efficient?

## ***Public Finance Textbook***

- Labor distortions may call for differential VAT rates – but empirics generally unclear/ambiguous
- Merit goods argument (e.g., education/health) – but generally subsidized directly
- Corrective role of tax? – better addressed with excises
- VAT exemptions cause multiple production distortions (tax cascading; vertical integration; outsourcing)

## ***Incentives for certain businesses?***

- VAT threshold to reduce compliance burden on SMEs
- VAT incentives to attract business? – generally ill-suited

## ***Broad-base-low-rate VAT policy***

- Macro regressions suggest is good for growth



WP/19/96

## **IMF Working Paper**

The Value Added Tax and Growth: Design Matters

by Santiago Acosta-Ormaechea and Atsuyoshi Morozumi

IMF Working Papers describe research in progress by the author(s) and are published to elicit comments and to encourage debate. The views expressed in IMF Working Papers are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

INTERNATIONAL MONETARY FUND

# To Ease VAT Enforcement?

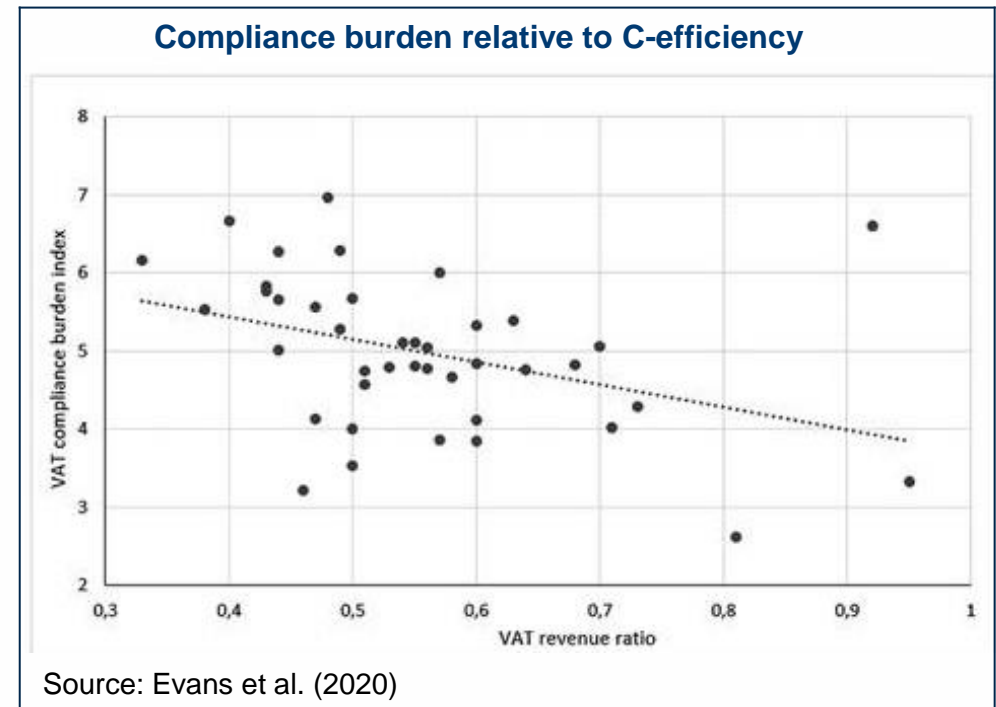
## *VAT Textbook (e.g., IMF's "The Modern VAT")*

- Self-enforcing VAT chain (incentives for voluntary compliance) – superior to one-stage retail sales tax
- Exemptions and reduced rates increase complexity and amplify non-compliance
- Reduced rates amplify VAT-refund problems
- Yet, some services hard to apply VAT to, e.g., margin-based financial services, life insurance – justifying exemption

## *Other arguments*

- Sometimes, exemptions aim to address poor VAT implementation\*, e.g., problems with VAT refunds – yet are often ill-suited to do so

*\*VAT administration issues are topic of Seminar 4*



# Exemptions/Reduced Rates Cause Revenue Loss

## ***Exemptions***

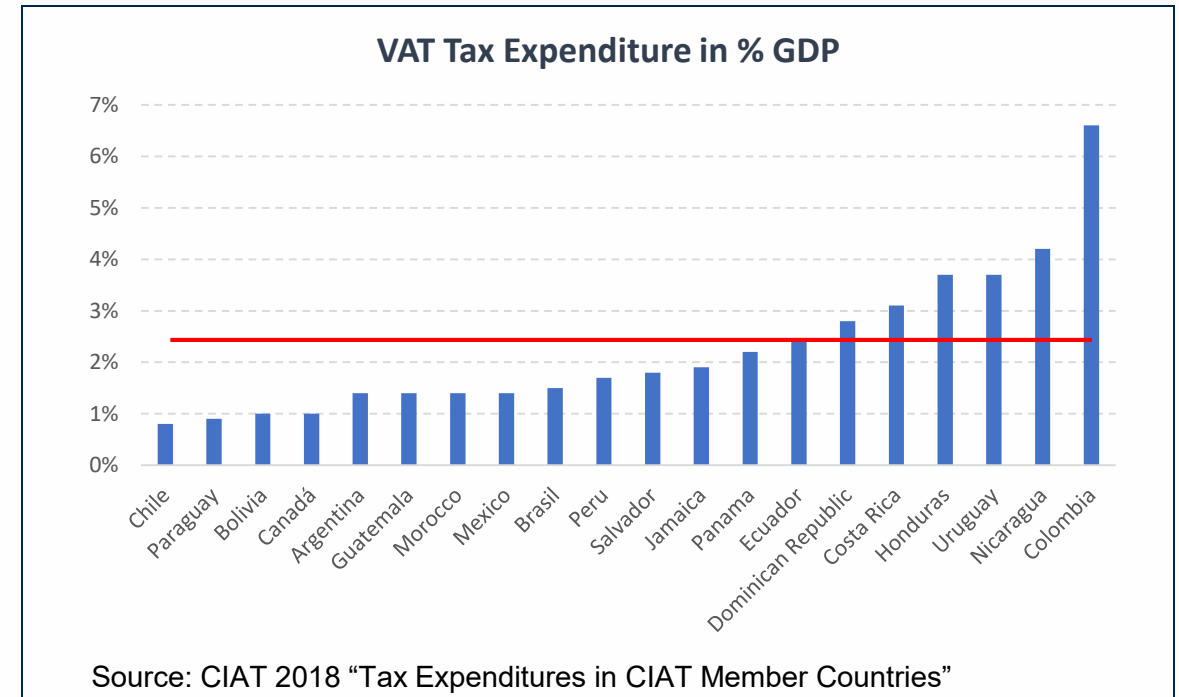
- In principle, have ambiguous revenue effects – intermediate vs. final stage

## ***Domestic zero/reduced rating***

- Unambiguously reduce revenue at final stage

## ***VAT tax expenditures***

- Estimated direct revenue loss sometimes > 2 percent GDP
- Ignores effect on efficiency and compliance





# Despite Good Intentions: Reform of Exemptions/Rates Needed

## ***Revenue mobilization ...***

- Hard to achieve SDGs without VAT improvement

## ***Reducing inequality***

- Through social spending funded by VAT

## ***Alleviate distortions***

- Mostly production distortions from exemptions

## ***Simplify collection***

- Addressing non-compliance and reduce collection costs

C-efficiency, unweighted averages (2018)

East Asia & Pacific	0.73
Advanced Economies	0.62
Europe & Central Asia	0.61
Latin America & Caribbean	0.56
World	0.51
Lower Middle Income	0.50
Middle East & North Africa	0.49
Sub-Saharan Africa	0.39

Source: Tax Policy Assessment Framework  
<https://www.imf.org/en/Data/TPAF>

# Why Is Reform So Hard?

## ***Political economy***

- Special interests prevail over general public interest
- Misperceptions over equity/efficiency impacts
- VAT considered in isolation – spending essential (w.o. earmarking)

## ***Reform management***

- Lack of dedicated leadership and communication strategy
- Status quo bias/path dependency
- Right timing can be hard – macroeconomic conditions

## ***Knowledge/capacity***

- Lack of analysis, e.g., information about tax expenditures; GAP analysis; economic distortions; incidence
- Inadequate implementation capacity at revenue administration
- Lack of appropriate spending instruments, e.g., to pursue equity



**Thank you**