WEBINAR NO. 6: VAT AND SECTORAL POLICIES

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Summary

- An ideal VAT system is characterized by a broad base, few exceptions, and a single rate. But in practice, the ideal model is rarely implemented—either for policy or administrative reasons, leading to special treatment for some sectors. This webinar delved into sectoral VAT policies through the example of four sectors that tend to receive VAT concessions or special treatment—agriculture, tourism, real estate and construction, and the public sector. Other industries—such as extractives or the financial and insurance sectors— warrant further in-depth discussions of their own.
- The assessment of sectoral VAT policies should consider practical implementation issues, as well as competitiveness and incidence considerations. The VAT is conceived as a sales tax with a credit/refund mechanism, aimed to be neutral on investment and production decisions. As a revenue source, the VAT is most effective when sector-specific policy concessions—such as exemptions, zero-ratings, reduced rates, etc.—are minimal. In practice, however, sector policies are sometimes needed to address compliance challenges or to ensure the appropriate functioning of the system. On the tax policy side, sectoral VAT policies tend to be introduced in response to concerns about the competitiveness of certain industries or to reduce the tax burden on consumers of merit goods and other necessities. Several countries also have free-zone regimes, which are intended to attract foreign investors by shielding them from dealing with the tax authority, highlighting interactions between tax administration and tax policy motives.
- The taxation of **agriculture** is challenging, because the sector is large in developing countries, faces peculiar political economy issues, and because small farmers often do not maintain books, making VAT compliance problematic. Policy options include taxing only large farmers, which would require introducing high VAT registration thresholds, different from the standard registration threshold, or exempting the sector. In both cases, farmers would incur VAT on their inputs which could then pass unto food prices paid by consumers. To alleviate this effect, countries that exempt farmers also tend to exempt key farming inputs, such as seeds and fertilizers, and specialized equipment and tools. All this makes the administration of the VAT very complex, with ambiguous outcomes for farmers.
- VAT rates on goods and services in the **tourism** sector are often subject to a “race-to-the-bottom”. Due to tax competition among countries, many have introduced VAT concessions in this sector, typically on the input side but increasingly on the output side as well (zero-rating of hotel and other tourism services), in particular where their tourism offerings are close substitutes for offers in other destinations (e.g. beaches, ski resorts, gambling). Since tourism is considered a source of export

earnings, some countries choose to give refunds to foreign tourists, for purchases of goods not consumed in the tourism destination, even though taxes collected from foreigners should be of less concerns to policymakers than those collected from residents. Digitalization is another contributing factor to the VAT issues in the tourism sector as it enables transactions to take place offshore (typically through use of online platforms) escaping or undermining local taxation. A similar problem arises in countries where transactions are mostly carried out by traditional small businesses which are unregistered (including in the form of peer-to-peer transactions), as is the case in Thailand. Against this backdrop, good policies include simplifying the system to ease compliance for small businesses, involving digital platforms in the VAT collection on transactions made through the platform and removing distortive exemptions. International coordination, analogous to the Pillar Two minimum tax, perhaps on a regional scale, could also help counteract the "race-to-the-bottom"—although this outcome has proven difficult to achieve in practice.

- **Real estate and construction** sectors are difficult to tax, as evidenced by their large VAT compliance gap across countries. Conceptual inadequacies about the value of consumption and what constitutes a transactional supply are particularly complex in these sectors. The definition of construction activities changes by country. Sometimes it is based on the activity reported by the registered firm, and sometimes it is based on the inputs it uses. Thus, sectoral policies can be exploited by firms operating in other sectors. In real estate, applying VAT to residential real property creates a distortion between new and existing houses when the VAT is introduced, as VAT has not been levied on the latter. Special treatments in construction and real estate generate significant costs in terms of revenue losses and high administration costs (reflecting enforcement difficulties and governance issues). Options to overcome these challenges include taxing the first sale of residential immovable properties (thus leaving subsequent sales exempt), all sales of commercial immoveable property used by businesses, and all purchases of construction inputs (building materials, parts, and maintenance services). The use of registration (stamp) duties on transactions between registered persons should be avoided.

- The case for special treatments for VAT in **public services** is not convincing and thinking has evolved on this issue since the 1990s, with examples provided New Zealand and Australia. Exempting this sector creates distortions and unfair competition between public and private sector firms or in outsourcing certain services by public entities. Services provided by the government and non-profit organizations should be taxed, and when services are provided for free, their corresponding funding (grant or subsidy) should be treated as taxable supplies, thereby permitting the inputs to be credited. The issue of mixed supplies also comes into play when public services have special treatment because of the requirement to apportion inputs—potentially increasing the administrative burden. In this sector, strengthening administration capacity should have a priority over introducing VAT concessions.

- Sectoral VAT policies are, in general, bad practice. Experience suggests that special VAT treatments generate large revenue losses and increase administration costs. Thus, the case for introducing special VAT treatments at the sectoral level is weak. But if they are necessary, special VAT concessions are less harmful when applied at the end of the supply chain. Exemptions in the middle of the supply chain (i.e., on business-to-business supplies), potentially unravel the whole VAT chain, which may lead to VAT cascading and leakage and sometimes having the opposite effect of what was intended. Against this backdrop, other policies, such as funding subsidies are better poised to support specific sectors while keeping tax administration simple and preserving the integrity of the VAT. Moreover, the incidence of sectoral policies is uncertain: if supply is very elastic, special VAT treatments could benefit producers more than consumers; if demand is very elastic and consumer prices rise, it is generally more effective to seek support for low-income consumers through direct transfers or lower income taxes.

- The registration threshold, which purpose is to minimize unnecessary administrative burden for small businesses, is one form of a sectoral policy that is used by nearly all countries with VAT. In the absence of compelling evidence for a differentiated sectoral treatment, a single threshold for all sectors of economic activity is typically recommended. However, thinking about this has evolved, and there might be a case for, for instance, two thresholds, which could help limit the use of other sector-specific policies.

- Governments need to develop concerted action to improve VAT compliance in all sectors, which ideally means a simple VAT system with minimal sectoral concessions. Cross country experience, including from Africa and Thailand, indicate that political constraints can inhibit initiatives to limit sectoral polices.