

### Questions VAT Webinar 3

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#### **1) Other than reducing the compliance burden for SMEs, what are the justifications for raising the VAT threshold?**

The VAT threshold is usually designed as an exemption threshold which results in businesses below the threshold paying VAT on their taxable purchases. Exempt suppliers are therefore still contributing to the VAT, but they are relieved from the compliance burden associated with the VAT, which tends to have a large fixed cost component and can be disproportionate for small business. Importantly, not just taxpayers' compliance costs, but also administrative collection costs are reduced when using an appropriate registration threshold above which all businesses have to be VAT registered. Raising the threshold can contribute to strengthening administrative efficiency when collection costs exceed the revenue potential of micro and small taxpayers. Moreover, it is important for policy makers to consider the impact of the VAT threshold on progressivity. In rural areas of low-income economies, poorer households often primarily purchase products from small traders that operate below the VAT threshold. A reasonably high threshold may thus help enhance progressivity (See Bachas and others 2020: <https://openknowledge.worldbank.org/handle/10986/33851>).

#### **2) For a country with no income tax, is it better to introduce VAT instead of income tax?**

The choice of tax instruments very much depends on country specific circumstances and policy objectives. While both instruments are aimed at raising revenue, the role and functions of the income tax and VAT differ. The VAT is a major source of revenue in most economies as well as a relatively efficient tax, generating small welfare losses (See: IMF TPAF – “Is the VAT efficient?” <https://www.imf.org/en/Data/TPAF>). The income tax is better suited than the VAT for targeting equity objectives. It can be designed as a progressive tax, considering personal characteristics of taxpayers to achieve redistribution. In light of these differences, most countries rely on both instruments to balance their tax regimes.

#### **3) How does the use of zero rating or reduced rates compare to VAT exemptions?**

Applying a VAT rate of 0 percent means that no VAT is charged, but suppliers are entitled to claim credit for all the allowable VAT paid on inputs used to produce supplies. This is the main difference between zero-rating (or the use of reduced VAT rates) and exemptions. Where an exemption applies, no VAT is charged on the final sale, but the VAT paid on inputs is not recovered.<sup>1</sup> Therefore, exemptions go against the logic of a pure broad-based VAT since they result in cascading (tax on tax). As the VAT paid on inputs is not recoverable, exemptions may, however, be less costly to revenue than zero-rates and can

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<sup>1</sup> Note that some VAT/GST systems use different terminologies; for instance “exemption without the right to deduct” (equivalent to exemption) and “exemption with the right to deduct” (equivalent to a zero rate) in the EU VAT system, or “input taxed supplies” (equivalent to exemption) in the Australian GST.

also be easier to administer as they do not give rise to refunds as is the case for zero-rates. That said, domestic producers of exempt products can face a competitive disadvantage compared to foreign suppliers of such products, who normally benefit from zero-rating in the country of export while the former will suffer higher production costs from any locally incurred unrecoverable input tax.

Generally, both the use of exemptions and of reduced rates and zero rating should be limited. Under a pure destination-based VAT, only exports should normally be zero-rated. Reduced VAT rates are often applied to goods and services that are commonly consumed by low-income households, but they are (i.) a poorly targeted instrument to achieve distributional objectives, (ii.) force taxpayers to separate records for purchases and sales based on the VAT rate that is applied, (iii.) invite disputes over the classification of goods and services, (iv.) can create tax planning opportunities, and (v.) complicate audits and increase VAT refund claims. (See also IMF TPAF – “Reduced and Increased VAT rates” <https://www.imf.org/en/Data/TPAF>). Similarly, in most situations, the case for exemptions to promote equity objectives is weak as other fiscal policies can be more effective and better targeted. In practice a limited number of well-defined exemptions are fairly common, for instance for financial and insurance services (See: IMF TPAF – “VAT Exemptions” <https://www.imf.org/en/Data/TPAF>).

**4) How should the tourism sector be treated under the VAT and are VAT exemptions or rate reduction a good approach to support the sector during the pandemic?**

The most appropriate general policy for the tourism sector is to subject all activities to the normal VAT regime at the standard rate (See IMF TPAF, “Taxation of Tourism” <https://www.imf.org/en/Data/TPAF>). A few countries have already introduced general or targeted (temporary) reductions of VAT to stimulate demand. It is questionable whether such rate measures are advisable in the current context for the tourism sector. The timing of introducing these reductions is challenging and the measure is likely to have little effect on consumption given that low demand is a result of health concerns and regulatory restrictions. Many goods and services consumed by tourists are also consumed by locals, further complicating the targeting of such measures. Moreover, temporary rate reductions tend to increase compliance burdens for businesses, which can be particularly important for small operators in the sector.

**5) What are the main considerations for implementing and operating a VAT in low-income countries with high levels of informality?**

As informal producers bear unrecovered VAT on their inputs when importing or making purchases from registered traders, the VAT can create an incentive to register and formalization at the final stage of production can contribute to formalizing entire production chains. On the other hand, since purchases from informal suppliers do not generate VAT credits, segmentation of formal and informal sectors may be deepened. Circumstances and appropriate policy solutions differ across countries, including low-income economies. There are, however, a couple of general observations that may be relevant: The more difficult the circumstances, the simpler the design of the VAT should normally be. Limited administrative capacity in environments with high informality strengthens the case for a modern, broad-based, low rate VAT with very limited use of exemptions and zero-rating (aside from exports). And, to account for administrative and compliance cost in the context of limited capacity and high informality, the registration threshold above which all businesses must be VAT registered may need to be set at a comparatively higher level, with small businesses below that threshold often being offered to opt for simplified presumptive tax regimes. (For further discussion See de Paula and Scheinkman (2010) “[Value-Added Taxes, Chain](#)

[Effects and Informality](#)” and Pomeranz (2015) “[No Taxation Without Information: Deterrence and Self-Enforcement in the Value Added Tax](#)”).

**6) What measures are needed to compensate poorest and middle-class households when broadening the VAT base or removing reduced VAT rates?**

Well-targeted social assistance programs including the expansion of coverage of in-kind benefits (e.g. health, education) or cash transfers can contribute to mitigate distributional impacts of VAT reforms. As these measures are normally focused on the first deciles of the income distribution, additional measures are sometimes implemented to also compensate middle-class households, for example, through the personal income tax. Other measures rely on advances in digitalization to temper the regressivity of the VAT, while retaining the policy and administrative advantages of a broad-based VAT levied at a single rate. Examples include schemes where those eligible to purchase goods and service free of VAT do so using a biometric ID card, or schemes where the benefits are delivered through crediting an e-card in the amount equivalent to the monthly VAT liability calculated on a presumptive basis. These individualized/personalized VATs can, however, amplify VAT refunds. A more direct approach is to use biometric identification to target cash compensation like in India and Thailand. (See IMF, 2019: [Macroeconomic-Developments-and-Prospect-in-Low-Income-Developing-Countries-2019](#)).

**7) How can public confidence in effective redistributive/spending policies be strengthened to facilitate VAT reform?**

Rising income inequality in advanced and developing economies coincides with growing public support for income redistribution. VAT reform should ideally be undertaken and framed as a component of broad redistributive fiscal policy reforms in a combination with other measures, including social assistance/expenditure programs. Repayments of tax paid on consumption in real time to low income households based on e-invoicing platforms already adopted by many countries could help build trust and confidence that revenue gains are indeed effectively redistributed (For a detailed discussion see Fera and Walpole, 2021: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3723750](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3723750)).

**8) How can coordination between different government bodies be improved when granting/monitoring VAT exemptions?**

Coordination can start by creating a working group, commission, or task force, led by the Ministry of Finance. Typically, this should entail relevant line ministries, investment bodies, and revenue agencies (tax and customs). Systematic evaluations by these bodies are needed to facilitate informed decision making. This commonly includes an inventory of VAT exemptions, estimates of their cost, analysis of their effectiveness, etc. These evaluations should inform the development of a shared policy approach in consultation with relevant stakeholders in Civil Society, the Business Community, Academia, and the development partners. A strategy on VAT exemption policies should also be developed and included in the context of broader strategic reform efforts such as the development of Medium-Term Revenue Strategies or Medium-Term Fiscal Frameworks. Very generally, VAT exemptions should be subject to a legislative process and consolidated in the tax law, granted based on rules rather than determined in discretionary decision making, and be subject to a transparent monitoring and evaluation process. (For more details See PCT, 2015, section Guidance in the use of Tax Incentives: [Options for low income countries' effective and efficient use of tax incentives for investment](#)).

**9) What are the special aspects to consider for an efficient VAT refund process for extractive industries (EI)?**

Access to an effective and prompt VAT refund mechanism is of critical importance for the EI due to the intrinsic features of the sector: high capital spending (high levels of input VAT), long investment periods with long lead-times before extraction or production (which may never materialize where exploration is unsuccessful or extraction economically unviable), and high level of exports when extraction or production do materialize. The latter two features imply that input VAT can often not be recovered through crediting against output VAT—in particular during exploration and investment phases—which leaves companies with no option but to seek refunds of their excess tax credits. Long or indefinite carry-forward periods are not suitable for extractive industries as there is little to no expectation that they would ever have enough output VAT to recover VAT paid. Yet, delayed recovery – due to mandatory carry-forward or delayed payments of refunds (or both) - results in substantial cost to taxpayers and discourages investment—or increases pressure for ad-hoc exemptions or special reliefs. It is fundamental, therefore, to have in place an adequate VAT refund system, including a risk-based verification –pre-refund audits of high-risk cases and post-refund verification of lower-risk cases, timely availability of funds to pay all legitimate refunds claims, options to offset excess VAT credits against other tax liabilities and an accelerated procedure for taxpayers with good compliance history (e.g. exporters). This has to go hand-in-hand with effective anti-fraud strategies managed as part of a comprehensive risk-based VAT compliance strategy (See United Nations 2017: [Chapter 9 of Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries](#)).