Equity, Efficiency and Administration of the VAT

IMF VAT WEBINAR SERIES

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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?

![EU-type VAT: Rate Gaps](chart.png)
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

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**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
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

Source: CIAT 2018 “Tax Expenditures in CIAT Member Countries”
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)

<table>
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<th>Region</th>
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<tr>
<td>Sub-Saharan Africa</td>
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Source: Tax Policy Assessment Framework
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