

**Answers to technical questions raised during the panel discussion of Webinar 1:
“The VAT Experience”**

Disclaimer:

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Question 1. Please provide more guidance on the use and limitations of the c-efficiency ratio:

- **Is the data on c-efficiency ratios publicly available?**
- **Are tax expenditures captured as part of the policy gap?**
- **Why do some countries have a c-efficiency in excess of 1.0?**

Data and information on the C-efficiency in many countries is provided by in TPAF module on VAT, which is available here [link: <https://www.imf.org/external/np/fad/tpaf/pages/vat.htm>]. The OECD also regularly publishes a VAT performance measure for its members, the “VAT Revenue Ratio” [Link: https://www.oecd-ilibrary.org/taxation/consumption-tax-trends-2018_ctt-2018-en]. The c-efficiency is the ratio of the actual VAT to the product of the standard VAT rate to total final consumption, and so would equal unity for a perfectly enforced VAT applied at a single rate to all final consumption, [Ebrill and others [link: <https://www.imf.org/external/pubs/nft/2001/VAT/>].

C-efficiency can be decomposed into a policy and compliance gap (See: Keen (2013) [Link: <https://www.ntanet.org/NTJ/66/2/ntj-v66n02p423-446-anatomy-vat.html.html>]. The policy gap captures tax expenditures: The use of exemptions or zero-rating for final products or services will reduce measured C-efficiency. High c-efficiency can reflect a high level of compliance and good VAT design. However, deficiencies in VAT refunds might also increase c-efficiency. A high and growing stock of VAT credits or off-setting VAT refunds against other taxes without accurately reporting it would overstate VAT revenues, and therefore lead to a higher efficiency indicator, while in reality reflecting inefficient features of VAT administration. Other factors that can explain a measured C-efficiency above 100 percent include statistical mismeasurement of final consumption in the national accounts and VAT-liable exports, such as cross border shopping by nonresidents. Another example used to be the VAT on electronic commerce within the EU taxed at origin rather than at destination (before 2015).

Question 2 Does the VAT have the same role in the pandemic as in past economic crises? In the context of collapse in the consumption base due to the pandemic, what is the agenda for future VAT reforms?

While consumption taxes tend to be more stable than profit-based taxes (IMF 2020 [link: <https://www.imf.org/~media/Files/Publications/covid19-special-notes/en-special-series-on-covid-19-challenges-in-forecasting-tax-revenue.ashx>]), the consumption tax base, especially services, is strongly affected by social distancing measures introduced as part of the Covid-19 policy response. For this reason, simply reducing the VAT rate during the crisis was not recommended, since the price impact could do little to stimulate consumption in the face of lock downs and closures of certain businesses. In past crises, the overall level of consumption has been less affected, and the drop in VAT revenues was partly driven by consumption shifting toward necessities and government supplies, which are often taxed

at lower rates or exempt. (OECD 2020 [link: https://www.oecd-ilibrary.org/taxation/what-drives-consumption-tax-revenues_94ed8187-en]). How the COVID crisis may affect VAT design going forward will be discussed in our 2nd webinar on November 17th, 2020.

Question 3. What are good practices to ensure collection of VAT on e-commerce transactions and digital goods and service?

Approaches to the taxation of e-commerce have substantially evolved in recent years with countries seeking to adjust VAT rules to address challenges such as the intangibility of foreign supplies of digital goods and services to consumers and increases in imported parcels below traditional de-minimis tax and customs thresholds. Some administrative complexity is introduced by assigning obligation for VAT collection on B2C supplies to foreign suppliers. International guidelines (OECD 2017 [Link: <http://www.oecd.org/ctp/international-vat-gst-guidelines-9789264271401-en.htm>]) and country experiences for example in the EU [Link: https://ec.europa.eu/taxation_customs/business/vat/digital-single-market-modernising-vat-cross-border-ecommerce_en] and Australia [Link: <https://www.ato.gov.au/business/international-tax-for-business/gst-on-imported-services-and-digital-products/>] provide relevant practical guidance to inform reform efforts including options to leverage the prominent role of digital platforms in facilitating sales to final consumers.

Question 4. What are good instruments to encourage voluntary compliance of small taxpayers? In which cases is it justified to use VAT on a cash as opposed to an accrual basis?

It is common practice to exempt small taxpayers from the VAT. This allows for the allocation of limited administrative resources to activities with the highest revenue potential. While a registration threshold introduces some economic distortions, these are typically small in comparison to savings in collection and compliance costs (See TPAF, VAT Threshold) [Link: <https://www.imf.org/external/np/fad/tpaf/pages/vat.htm>]. It is usually advisable to allow for voluntary registration for businesses below the threshold to ease these distortions. An increase in the number of small registrants also increases compliance management risks, however.

Cash accounting schemes that allow taxpayers to report their activities at the time payment is made, rather than when the supply is made or invoiced, are sometimes introduced as an option to reduce VAT compliance costs for small business and to encourage VAT registration. These schemes are not suitable for businesses that primarily transact with taxpayers registered for regular VAT. One example is the UK's VAT cash accounting scheme (Link: <https://www.gov.uk/vat-cash-accounting-scheme>). Reducing compliance costs with respect to filing requirements, can also help lower barriers to VAT registration. (See also TPAF – VAT and Small Business [Link: <https://www.imf.org/external/np/fad/tpaf/pages/vat.htm>]).

Question 5. What are key considerations for a small developing country that is considering implementing a VAT. How can it be determined that VAT is a viable option?"

Whether the economic and revenue benefits of introducing a VAT outweigh the costs associated with its introduction and administration depends on the country context. Heavy reliance on imports and limited domestic value added reduce the returns to introducing a VAT compared to simple import taxation. However, positive spillover effects of introducing the VAT can be considerable for the administration of

other taxes. VAT is based on self-assessment that can catalyze wider administrative reforms and help build institutional capacity [See IMF 2019 [Link: <https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/12/11/Macroeconomic-Developments-and-Prospect-in-Low-Income-Developing-Countries-2019-48872>]. A detailed discussion of the considerations for operating a VAT in small economies is provided in the TPAF VAT module on “VAT in Small Economies” [Link: <https://www.imf.org/en/Data/TPAF>].

Question 6. What are best practices of incentivizing industry sector without distorting the VAT mechanism.

Generally, the erosion of the VAT base through exemptions or zero-rating undermines the integrity of the VAT, complicating administration and facilitating evasion. There is no reason to use exemptions for investment in a well-functioning VAT system, because VAT charged on inputs should be fully recovered as a credit against VAT charged on sales. Exemptions for industry sectors are often introduced to address problems with the credit mechanism arising from imperfect VAT refund procedures.. However, in these circumstances, the administrative process should be improved, rather than introducing exemptions. Incentives for industry sectors can be provided more efficiently through the profit tax, where cost-based investment incentives can be considered. For a broad discussion on investment incentives please refer to: PCT 2015 [link: https://www.tax-platform.org/sites/pct/files/publications/100756-Tax-incentives-Main-report-options-PUBLIC_0.pdf].

Question 7. Is the Goods and Services Tax (a sales tax) neutral like VAT?

“GST” is typically just another designation for a value added tax (as opposed to a retail or manufacturer’s single stage sales tax.) A detailed comparison of the [Retail] Sales Tax and the VAT/GST is provided here: TPAF – Sales Tax vs. VAT/GST. [Link: <https://www.imf.org/external/np/fad/tpaf/pages/vat.htm>]. Single stage retail sales taxes can avoid the inefficiencies of turnover taxes, which are imposed at every level of production, and therefore cascade through the supply chain. However, while a retail sales tax and the VAT should produce the same revenue outcome in theory (with timing differences), there are important practical differences.

Question 8. Please explain why revenue is protected if the compliance chain breaks in a VAT.

The tax liability of a VAT arises on transactions taking place at different stages of the production process. If a trader evades VAT liability, the revenue lost corresponds only to the tax due on the value added at that stage – VAT paid by the trader on his/her purchases (input VAT) should have been already remitted to the tax authorities. In comparison, a single-stage retail sales tax is only imposed on final consumption and the revenue authority depends on the final seller for the entire tax collection.

Question 9. What are good practices with respect to goods consumed by low income households, is it to exempt these goods or to tax them at a lower rate? What alternatives are there to VAT exemptions when trying to help the low-income earners (poor)?

We will discuss these questions and options for improving the design of VAT to account for different objectives in our 3rd webinar on January 12, 2021. But, in brief: Equity concerns and distributional objectives need to be assessed in the context of the overall tax and benefit system. Reduced rates and

exemptions are widely used to mitigate potential adverse distributional impacts of a VAT, but they do so at a high cost and in a poorly targeted way. Country experience suggests that commonly, even if low-income households spend a larger proportion of their income on a good, richer households tend to spend more on this good in absolute terms. It is preferable to rely on other instruments to ensure progressivity of the tax system and to complement VAT with carefully-designed benefit programs (See IMF 2019 [Link: <https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/12/11/Macroeconomic-Developments-and-Prospect-in-Low-Income-Developing-Countries-2019-48872>]). At most, the exemption of a few basic unprocessed food items acquired and consumed by the poorest (with specifics dependent upon the country) are sometimes recommended.

Question 10. What is the potential for leveraging digital solutions for VAT compliance management?

There are many ways in which digitalization could be used to improve VAT compliance. For example, evidence suggests that the use of electronic invoicing increases reported sales and purchases by lowering compliance costs and strengthening deterrence. Public systems of digital bookkeeping and standardized protocols to submit electronically accounting information are examples of how digitalization enhance revenue administration capabilities for identification of VAT compliance risks. Moreover, combined with other information reporting obligations, all these innovations are enabling revenue authorities to pre-populate VAT returns (e.g. Chile, Italy, Spain) or even consider dismissing filing obligations, thus further reducing compliance costs. Biometric identification, for instance, is being used more frequently to enhance taxpayers' authentication limiting the opportunities for identity theft to be used to create fictitious VAT refund claims. Digital solutions based on machine learning, artificial intelligence and Robotic Process Automation provides a higher level of engagement with taxpayers, which in turn promotes voluntary compliance.

Question 11. How can administrations most effectively deal with the rise of fake invoices?

The issue of fake invoices should be addressed within the context of a coordinated strategy and countermeasures designed to combat noncompliance. This strategy should include the following elements: proactive pre- and post-registration checks that identify potential fraud and profile suspected businesses; the implementation of new laws that eliminate any ambiguity regarding the proper/improper use of tax invoices, including leveraging on technology such as the use of electronic invoicing; and a systematic, credible, prioritized, transparent process of cross-referencing purchase invoices back to sales that have been declared throughout the supply chain. Stronger sanctions are also needed to signal clearly that deliberate system abuse will not be tolerated. The strategy should also focus on specific audits and prosecutions with the help of dedicated teams specialized in/specialized teams dedicated to detecting and dealing with those who produce and use fake invoices.

Question 12. What is the role for customs in VAT compliance management and what are good practices for institutional coordination and/or integration of tax and customs in a single revenue agency?

Customs data is a critical source of information for of VAT administration. Good practices to enhance the role of customs in VAT compliance include interfacing of customs and tax administration systems to allow

for seamless sharing of import and export information (at a minimum), to validate (or where possible pre-populate) VAT declarations with customs information relating to VAT paid on imports, value of customs approved exports and related adjustments from post clearance audits (at the top end). This approach delivers improved compliance outcomes regardless of whether the customs and tax administration are separate entities or are integrated within a revenue agency.

Question 13. How can corporate tax information be leveraged to effectively manage VAT compliance?

Compliance issues will be discussed further in our 4th Webinar on March 16, 2021. Information in corporation income tax returns relating, for example, to turnover, capital allowance deductions, and other business expenses, could be cross-referenced to ensure accuracy of VAT reporting. Some tax administrations have taken steps, to ensure that digital systems used for recording sales transactions, for example, are a single point of reference for both taxes.

Question 14. How would blockchain adoption impact VAT policy and administration?

A blockchain provides a secure and shared database to participants. It can alter record keeping requirements and the availability of records to the tax administrator. This could lead to more efficient VAT collection and better compliance management, drawing on real-time access to the history of transactions. In the long-run, widespread adoption of blockchain technology may even allow for a reliable tax account to be maintained for the entire chain of transactions. In this scenario, there would be no more need for a VAT to be charged at each stage of the production. Tax could simply be calculated and imposed on final consumption (IMF 2018 [Link: <https://www.imf.org/external/pubs/ft/fandd/2018/03/pdf/gupta.pdf>]). Opportunities for leveraging digital tools in combatting VAT fraud will be discussed further in our 4th Webinar on March 16, 2021.

Question 15. VAT is often exempted for aid-funded projects. How can we mitigate abuse of this policy?

While it is relatively common to provide VAT and customs duty exemptions for imports and supplies related to aid-funded projects, these exemptions are not advisable from a tax policy perspective. They can prove costly in terms of revenue forgone by the host country, impose a significant administrative burden, and undermine the overall efficiency of a VAT by distorting the pattern of economic activities (See TPAF - Taxation of Non-Profit Organizations [Link: <https://www.imf.org/en/Data/TPAF>] and Caldeira and others (2019) [Link: <https://link.springer.com/article/10.1007/s10797-019-09573-6>])

Question 16. What is the world experience in administering VAT through VAT withholding?

Domestic withholding requirements, assigning the responsibility to account for and remit VAT to purchasers of the supplies, are sometimes introduced. This is based on presumption that large businesses that purchase supplies from small suppliers will be more compliant. There are, however, important administrative complexities resulting from this approach which often result in more taxpayers being in a net credit position. This will be discussed further in the 4th Webinar on March 16, 2021.

Question 17. What is the experience for administering VAT in the Financial Sector?

An important share of financial institutions' revenue results from the spread between the interest rates offered on savings and charged on loans. These implicit charges are difficult to tax and many countries exempt the sector from VAT or apply VAT only on the transactions where explicit service fees are charged (transaction fees, trading commissions, etc). For a detailed discussion on the taxation of the financial sector please refer to TPAF - "Taxation of Financial Services" [Link: <https://www.imf.org/en/Data/TPAF>]

Question 18. Chile and New Zealand have been able to implement an efficient VAT system. Why did other countries not manage to implement similar regimes/How can other countries achieve the same outcome?

There are several factors that can explain the good performance of VAT/GST in Chile and New Zealand, these include: (i) a broad base of application of the tax.; (ii) a single standard rate; and (iii) a comparatively high level of taxpayer compliance. In applying the standard rate to almost all goods and services, the VAT(GST) in New Zealand comes close to an ideal VAT without exemptions and zero rating only applied to exports. The introduction of VAT in 1986 was combined with other reforms, including payments and targeted support to low-income households. This helped build public acceptance for the tax (See Bengé and others (2013) [Link: <http://ntanet.org/NTJ/66/2/ntj-v66n02p479-498-lessons-us-new-zealand-gst.pdf?v=%CE%B1>]. In relation to tax compliance, naturally tax morale and economic stability cannot be disregarded as explanatory elements. But these elements would not be an advantage to control VAT/GST compliance if the tax administrations did not exhibit good institutional performance. New Zealand's state entities are recognized worldwide for their public management model, with clear goals and accountability, and with their "user-centric approach", of which their Tax Administration is a clear example. The Chilean Tax Administration, for its part, has also been an outstanding example among state entities in the Latin American region after a sustained modernization process that began in the 1990s. Both entities thus share a strong orientation towards the application of management tools for reaching results. Finally, it should be noted that both institutions have been world leaders in the use of technology for tax compliance purposes, from the digitalized tax returns remitted by Internet to the offer of online accounting services for SMEs and pre-filled VAT returns in the case of Chile. In New Zealand, although an official estimate is not available, some external studies would place the tax evasion rates at values of only one digit. The Chilean Tax Administration publishes an estimated VAT evasion rate of 21 percent over its potential revenue for 2018.