



**FISCAL AFFAIRS**

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

**IMF VAT WEBINAR SERIES**

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# Broadly, Three VAT Models

## ***Traditional VAT***

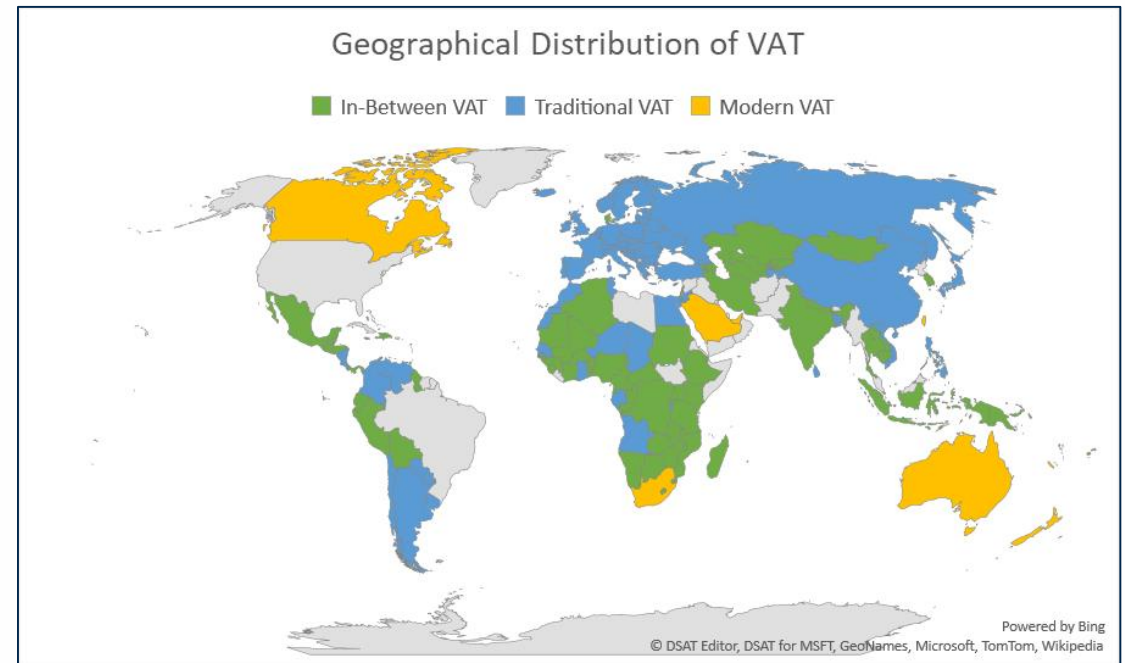
- Multiple exemptions creating a narrow VAT base
- Multiple rates with relatively high standard rate

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

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

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

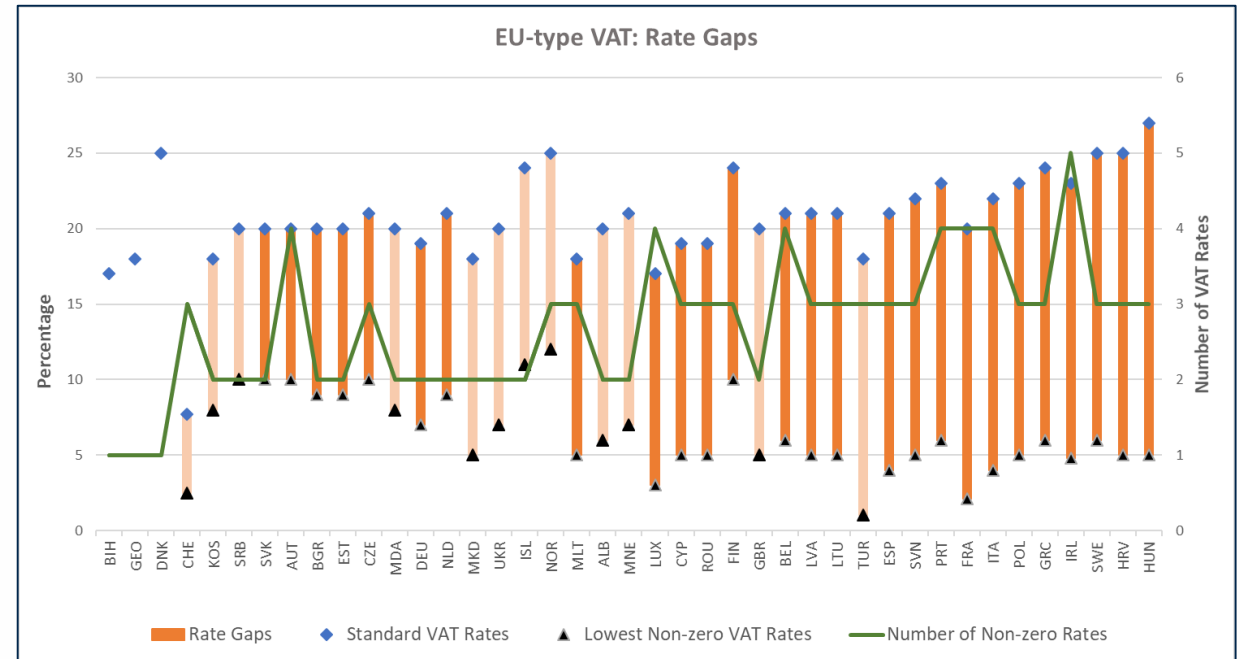
- Multiple exemptions (incl. to address implementation challenges)



# Focus on Design

## Why Exemptions and Reduced Rates?

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



# 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

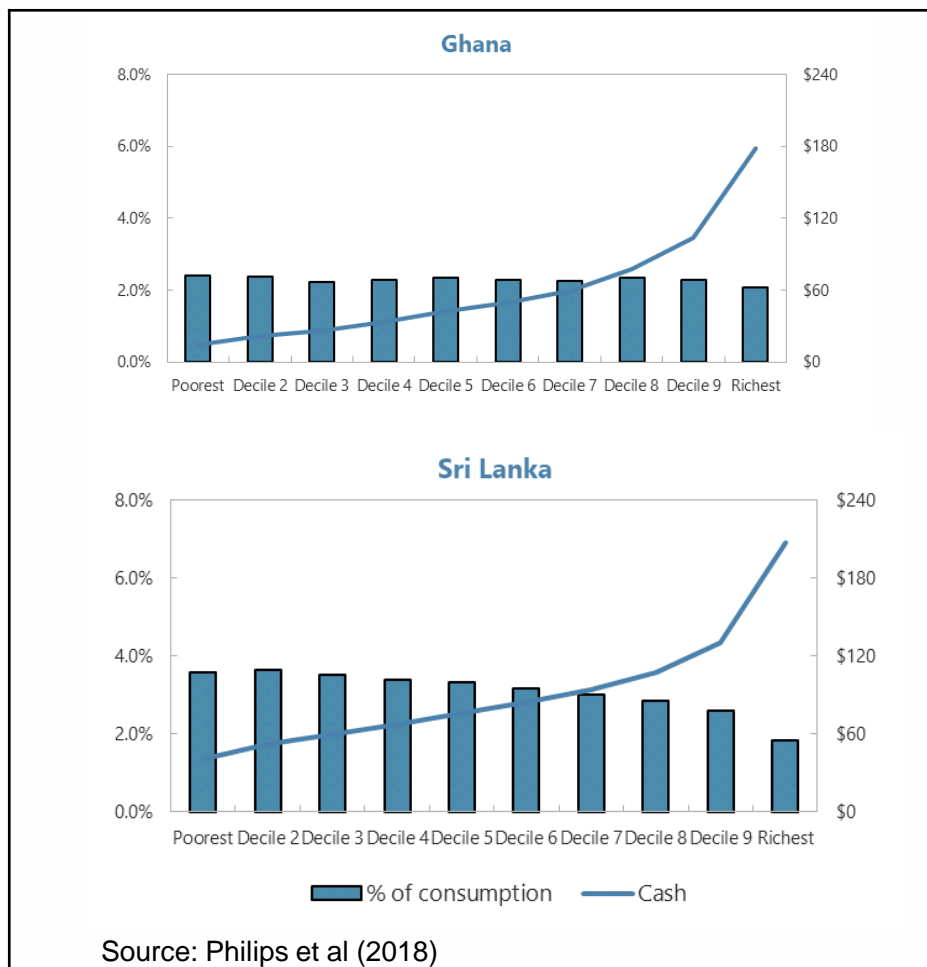
## Regressivity of VAT

- 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)



Source: Philips et al (2018)

# 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

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# To Ease VAT Enforcement?

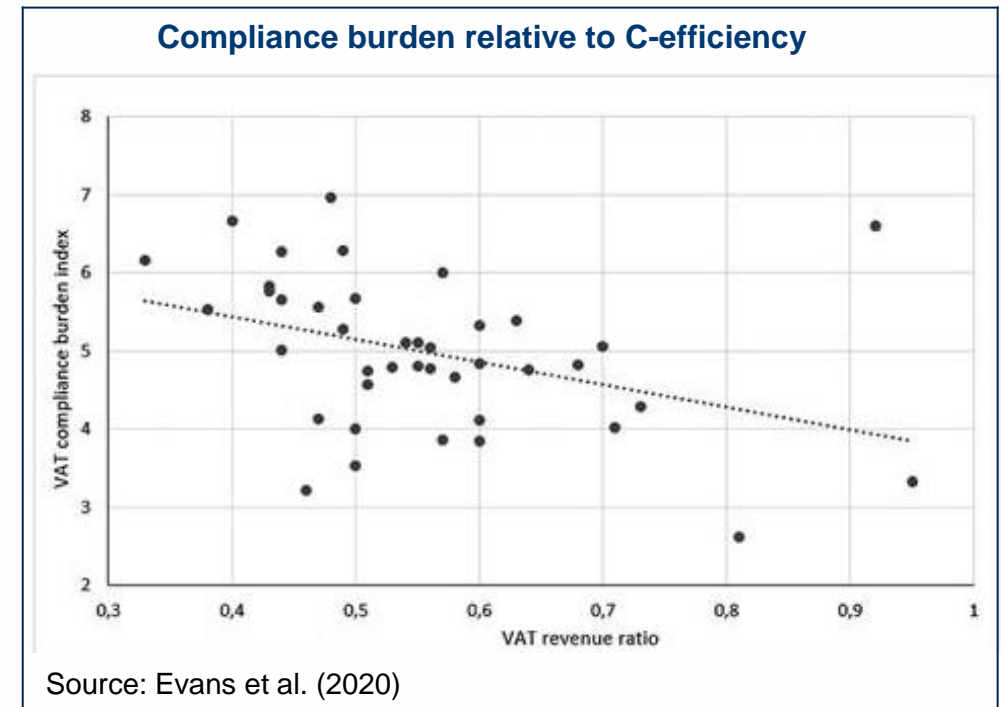
## VAT Textbook (e.g., IMF's "The Modern VAT")

- 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**

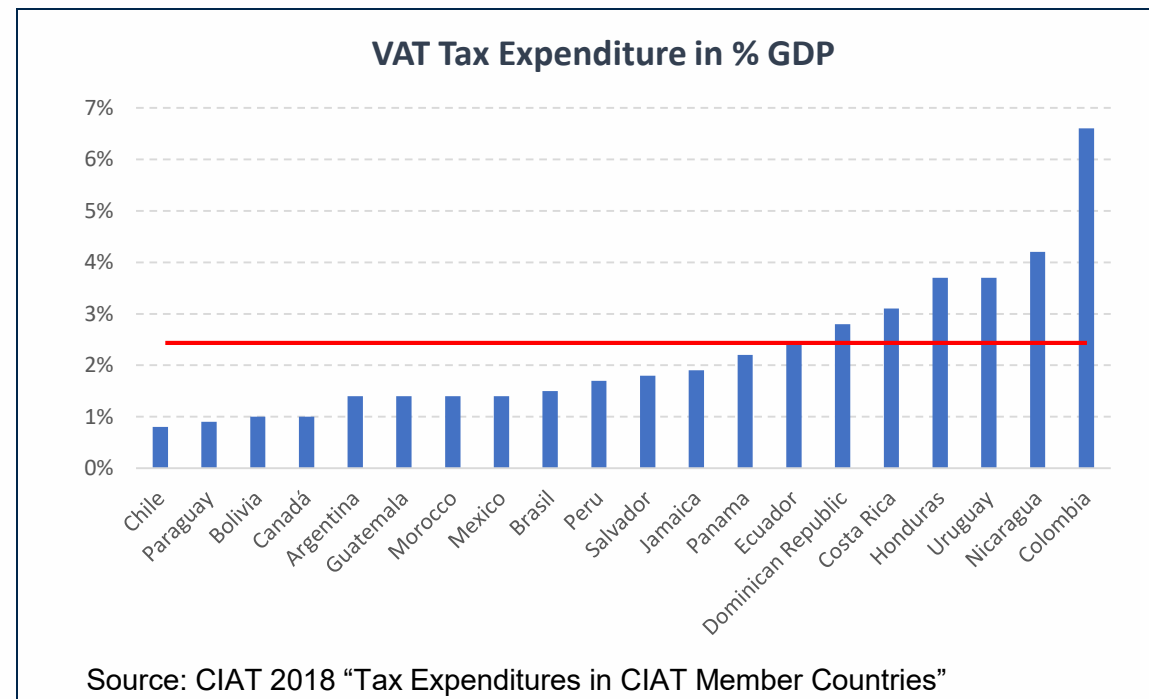
- In principle, have ambiguous revenue effects – intermediate vs. final stage

## **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**