Answers to technical questions raised during the panel discussion of VAT Webinar 2:

"VAT and COVID-19: Impact, Response, and the New Normal"

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The technical answers reflect views of IMF staff and do not necessarily represent the views of the IMF, its Executive Board, or IMF management. They should not be viewed as technical advice or recommendation, as appropriate responses will be country specific.

1) What is good policy practice on VAT exemptions in response to the COVID-19 pandemic? Should measures be temporary?

Good policy practice with respect to VAT exemptions is to limit their use to what is strictly necessary to achieve the policy objectives being pursued. This maintains the integrity of the VAT's design, ensuring that VAT is only levied on final consumption and that production distortions are prevented as much as possible. That said, with exemptions for basic health care provided by the public sector being relatively common, some countries have adopted additional exemptions for medical supplies to mitigate the effects of the COVID-19 pandemic [See IMF Policy Tracker: https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19]. These measures cover, for instance, hospital-specific equipment, personal protective equipment, medicines, and, in some cases, raw materials for the production of medicines. The exemptions are typically introduced as a temporary measure (with an explicit sunset clause) and this is a good practice to minimize the risk of entrenching preferential treatment beyond the immediate crisis response period. In many countries, fiscal consolidation efforts will require reversal of COVID-19 related measures and options for expanding preferential treatment under the VAT will be very limited.

2) What are the options to reduce the use of exemptions and broaden the VAT base in the consolidation phase? How can the reform process be undertaken without hurting the most vulnerable in the population? Should private education and health be exempt of VAT?

Broadening the VAT base and removing reduced rates and exemptions is politically challenging, but the current crisis may provide opportunities to establish a link between ongoing efforts aimed at expanding the welfare state and reforming social safety nets with the broadening of the VAT base. Potential reform efforts could envisage the use of revenue gains from VAT base-broadening to increase benefits for, and/or reduce direct tax burdens on, low-income households. We will discuss options for improving the design of VAT while accounting for equity concerns in our 3rd webinar on January 12, 2021.

Private education and health should generally not be exempted from VAT as the benefit of the exemption generally accrues more to higher income earners. Taxing these supplies can therefore contribute to the progressivity of the overall tax system [See TPAF – "VAT Exemptions" https://www.imf.org/en/Data/TPAF]. And, a case can be made to avoid distortions between public and private sector service provision by making the public sector liable for VAT as well, potentially generating important efficiency gains [See Cnossen, 2020: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3598765].

3) **Is it advisable to reduce VAT rates to stimulate the economy in the recovery? How should the timing of a fiscal stimulus such as a temporary VAT rate reduction be determined?**

A few countries have already introduced general reductions of VAT rates and more governments are likely to consider temporary rate reductions in the recovery phase. It is unclear, however, that such rate reductions are advisable in the current crisis. First, uncertainty does indeed make the timing of introducing stimulus measures particularly challenging. The question of the ideal timing is perhaps best addressed by public health experts rather than VAT policy makers. Second, rate reductions potentially have little effect to stimulate consumption in the face of persisting health concerns and the (re)introduction of social distancing measures. Finally, it is also not clear to what extent VAT reductions will be passed on to consumers in the context of pandemic related supply constraints, while businesses will incur increased compliance burdens from (temporary) rate changes and differentiations.

4) **What are the implications of the growing importance of e-commerce in the pandemic for VAT revenue, policy design and administration?**

Consumption, especially of services, is strongly affected by social distancing measures introduced as part of the Covid-19 policy response, likely affecting the VAT base more than in past crises. The crisis is also changing consumer preferences and resulted in a surge in e-commerce including through online platforms. This is a particular concern in countries that have not yet adapted their VAT regimes to effectively capture VAT on sales from remote vendors. 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 collecting VAT on supplies of digital goods and services from abroad and increases in imported parcels below traditional de-minimis tax and customs thresholds. About 50–60 countries have now introduced measures, which primarily target online sales of services and digital products. Both observed compliance and revenue collections have reportedly exceeded initial budgetary estimates in many countries. 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.

5) **Many countries have introduced accelerated VAT refunds in response to crisis. What would be a reasonable period for VAT refunds in normal times? Three months? Six months?**

According to international good practices, a reasonable timeframe to process a VAT refund is 30 calendar days from the date on which a refund claim is made. Usually, implementation of a 30-day period requires a well-established risk-based verification process as part of a comprehensive VAT compliance strategy, supported by an automated risk assessment software and adequate provision of budget funds to pay legitimate refunds when they are due. Many countries also offer preferential (fast-track) treatments to VAT taxpayers with a sound compliance history (e.g., regular exporters with clean compliance records). Without relaxing risk-based protocols to monitor compliance, these countries were able to further accelerate VAT refunds in response to the pandemic.

See: TADAT field guide [https://www.tadat.org/fieldGuide] (indicator P8-28-2 of the TADAT field guide), Macroeconomic Developments and Prospects in Low Income Developing Countries—2019 [https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/12/11/Macroeconomic-Developments-and-Prospects-in-Low-Income-Developing-Countries-2019-48872]

6) **What would be the main challenges that a country could face during the digitalization process of the VAT administration?**

The main challenge is to break with paradigms such as the need for paper-based documents or physical signatures to support VAT administration. Although mainly connected to traditional standards that govern public sector operations, it is also connected to generational gaps in tax administrations senior management, as well as in taxpayers who may wish to retain a paper-based record as evidence of their transactions with the tax authorities. Digital transformation brings substantive change. Tax administration staff will need to receive proper support to develop new skills, abilities and competencies (e.g., data analytics capabilities) and taxpayers should be brought along too. The digitalization process also requires new tax laws and regulations for granting legal validity to digital documents and procedures, which sometimes clash other legislation such as the one on data privacy. Technology itself poses its own challenges as it requires appropriate decisions in terms of telecommunication infrastructure, storage capacity, data security protocols, etc. Without a proper IT strategy, tax administrations could fail in their attempt to digitalize VAT administration. To fully take advantage of the availability and processing of more reliable, timely, and accurate information from a digital-driven economy, digital technologies need to be integrated in taxpayers' everyday life. Finally, digital transformation requires a comprehensive compliance risk management framework to adopt solutions that best mitigate VAT compliance risks (e.g., e-invoicing, e-bookkeeping, pre-populated VAT returns, technology-based audits and verifications).

7) **What are good experiences and practices in administering zero-rated VAT on export?**

Under a pure destination-based VAT, exports should not be taxed to ensure the neutral treatment of international trade. A common mechanism for achieving this is by taxing supplies for export at a rate of zero. This preserves the exporter's claim for related input tax credits (ITC), which may result in the exporter being entitled to refunds. A timely refund of excess ITC is crucial to reducing the VAT-induced cash-flow burden on exporters and preserve the neutrality of a destination-based VAT. Countries facing difficulties managing VAT refunds are tempted to instead exempt exporters' imports (e.g. raw material, machinery), creating a bias against domestic production and opening opportunities for abuse. Some countries have adopted postponed VAT accounting schemes, which allow authorized importers to defer the payment of import VAT to their periodic VAT return (and claim a corresponding credit in the same return). Ultimately, what a zero-rated VAT on export requires is a risk-based and fully automated VAT refund management, which allows tax administrations to grant preferential (fast-track) treatments to regular exporters with a sound compliance history. Finally, while tax administrations can rely on customs controls in relation to goods to manage VAT refund risks. Other strategies are needed to manage refunds in relation to exported services, including international exchange of information arrangements.

See: TADAT field guide, Macroeconomic Developments and Prospects in Low-Income Developing Countries—2019 [https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/12/11/Macroeconomic-Developments-and-Prospects-in-Low-Income-Developing-Countries-2019-48872]

8) **How can the compliance gap for VAT be measured in practice?**

The VAT gap is the difference between potential VAT revenues of an underlying economic tax base and actual VAT revenues. The VAT gap can be decomposed into two components: the policy gap and the compliance gap. The compliance gap consists of the difference between the amount of VAT potentially payable under current policy and the amount collected by the government, expressed as a proportion of the former.

The FAD's Revenue Administration Gap Analysis Program (RA-GAP) uses a top-down approach to estimate unpaid VAT by sector and aggregating this to arrive at an estimate of the overall compliance gap (and policy gap). For a description see Eric Hutton (2017), 'The Revenue Administration – Gap Analysis Program: Model and Methodology for Value-Added Tax Gap Estimation.

Using national accounts data (supply and use tables), potential VAT revenues can be calculated by estimating the tax applicable on imports, adding the tax applicable to the domestic output, and subtracting any credits for tax applicable to the intermediate demand and gross fixed capital formation (inputs). VAT collected (net of refunds) is determined using tax administration data on accrual basis. The compliance gaps can be decomposed into two parts, a collection gap and an assessment gap. The collection gap is the difference between the actual collections and the total amount of VAT declared or assessed as due by the tax administration, while the assessment gap is the difference between the amount of VAT declared or assessed and the potential VAT.

9) **What measures did countries put in place to ensure business continuity of tax administration and to enhance productivity of staff members?**

To ensure business continuity during the pandemic, revenue administrations (RAs) adopted several measures to protect staff and taxpayers' health while maintaining the operation of the revenue system. [See: Business Continuity for Revenue Administrations: https://www.imf.org/-/media/Files/Publications/covid19-special-notes/en-special-series-on-covid-19-business-continuity-for-revenue-administrations.ashx]. Whether part of robust Business Continuity Plan or simply ad-hoc efforts to ensure business continuity, actions focused on limiting physical interaction, allocating workforce to most critical activities, ensuring continuity of international supply chains, enhancing communication and taxpayer assistance, implementing government (stimulus) policies, and protecting revenues and safeguarding compliance.

10) **What are good VAT simplification measures that can be considered by developing countries during the COVID-19 pandemic and beyond?**

Efforts to reduce taxpayers' VAT-related compliance costs are important to promote voluntary compliance (particularly by small businesses). On the policy design side, VAT registration thresholds are used to exclude small business whose VAT compliance cost as a proportion of their turnovers can be very high. Compliance costs can also be reduced by avoiding the use of multiple rates—including zero rates—on domestic consumption, exemptions and multiple special schemes (e.g., domestic reverse charging, VAT withholding or flat rate scheme regimes). Some countries have adopted simplified schemes for calculating VAT liabilities (e.g., simplified input tax credit calculation) and cash accounting regimes as options to further reduce VAT compliance costs. On the administration side, many countries introduced simplified reporting requirements (e.g., reducing filing frequency, simplifying tax returns) and eased record/book-keeping obligations for small business. More advanced countries have even started pre-populating VAT returns, based on automated large-scale cross matching of information. Other simplification measures based on IT enhancements include the availability of electronic methods for VAT payments, digital service delivery preferably through self-service channels (e.g., on-line services, automated processes), and digital engagement/communication with taxpayers.

11) What measures could be implemented to avoid a decline in the VAT revenue collection given the COVID crisis?

Countries took a range of measures to protect VAT collection during the phase of immediate response. First, VAT policy responses were time-bound, sector/segment-specific and sometimes optional to not concede too much tax revenues. Second, tax administrations sustained enforcement actions towards the most critical compliance risks and redirected efforts to address new emerging risks (e.g., abuse of relief measures), intensified monitoring of the largest taxpayers, particularly those businesses less impacted or even booming, broadened control coverage for tax withholding, and promoted the use of installment payments. For the reopening and recovery phases countries should take additional measures to avoid a decline in the VAT revenue collection. VAT will continue to be a revenue efficient tax instrument to support fiscal consolidation efforts. Limited fiscal space in many developing economies limits options for expanding preferential treatment under the VAT (e.g., cut VAT rates). Given the surge in e-commerce, adopting VAT regimes (both the legal framework and administrative processes) to capture VAT from remote vendors is a priority in countries that have not yet done so. When COVID-19 is contained and lockdown measures are loosened, revenue administrations will have to be ready to reinvigorate their operations, restore the normal functioning of the revenue and trade systems, safeguard tax collection, and enhance overall compliance. Tax administrations need to resume control of filing and payment obligations and compliance enforcement activities (e.g., risk analysis, management of large taxpayers/trades, and audits), keeping enhancements on taxpayer/trader communication and services. This can be expected to be a staged process, over a long period of time, as restrictive measures will most likely only be gradually phased out.

For further information see:

https://www.imf.org/-/media/Files/Publications/covid19-special-notes/special-series-on-covid-19-tax-issues-an-overview.ashx

Tax and Customs Administration Responses

https://www.imf.org/-/media/Files/Publications/covid19-special-notes/special-series-on-covid-19-tax-and-customs-administration-responses.ashx

Revenue Administration: Reinvigorating Operations to Safeguard Collection and Compliance:

https://www.imf.org/-/media/Files/Publications/covid19-special-notes/enspecial-series-on-covid19revenue-administrationreinvigorating-operations-to-safeguard-collection-a.ashx

12) Further questions also discussed during the first webinar:

- ***Is there any difference between VAT and GST?***

“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].

- ***Could you kindly elaborate the concept of VAT C-efficiency? How can C-efficiency be improved in an LDC country where about 60% businesses and shops are in informal sector?***

Data and information on the C-efficiency in many countries is provided by the 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_19990979]. The c-efficiency is the ratio of the actual VAT to the product of the standard VAT rate and total final consumption (net of VAT), 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.hmtl.html]. Better compliance management and a broadening of the VAT base can contribute to improving VAT C-efficiency.

- ***What are successful experiences in taxing financial services with the VAT? Which type of financial services has been taxed?***

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 accurately tax (and credit) on a transaction-by-transaction basis, as result of which many countries have traditionally largely exempted the sector from VAT or applied 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]