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Taxes have been with us for as long as civilization, so the VAT at 56 years old is relatively young. Although appealing in terms of revenues raised, the VAT has come to a turning point in its life as countries reflect on the need to raise revenue to deal with the significant increases in public debt caused by recent economic and financial crises.

A Brief History of VAT

German businessman Wilhelm Von Siemens is credited with coming up with the idea of a VAT in the 1920s.[1] What was only an idea has since been built into a system by the so-called father of VAT, Maurice Lauré, who was then the joint director of the French tax authorities. The VAT was implemented in France in 1954. Manufacturing-level VATs were introduced shortly thereafter in Côte d'Ivoire and Senegal in the 1960s,[2] around the time that these former French colonies became independent. Brazil, by the fiscal reform of 1965, introduced a traditional VAT that applied at all stages of production. The VAT's expansion was limited to less than 10 countries in the late 1960s.[3] In 1965 the VAT was not yet a worldwide success, as most general consumption taxes in the OECD were retail sales taxes.[4] By 1989, however, 48 countries, primarily located in Western Europe and Latin America but also including a handful of developing countries, had adopted a VAT.[5] The spread of the VAT in Europe was driven by the fact that it is a prerequisite for membership of the European Union (previously the European Economic Community). Its spread has accelerated since, with strong support from the IMF, as it has now been implemented in more than 140 countries, where it often accounts for one-fifth of the total tax revenue. In most countries it has been used to increase revenues, but in a few it has also enabled reductions in income taxes and excises.[6] Revenues generated by general consumption taxes (that is, VAT or goods and services tax) represented 18.6 percent of the total tax revenues of OECD countries in 2007 (compared with 13.5 percent in 1970) and up to 19.8 percent of the total tax

[1]Liam Ebril, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT*, IMF 2001, p. 4.

[2]*Id.*

[3]Stéphane Buydens, *Consumption Tax Trends 2008*, OECD Publishing, p. 23.

[4]''Policy Brief — Consumption Taxes: The Way of the Future,'' *OECD Observer*, Oct. 2007.

[5]John Norregaard and Tehmina S. Kahn, ''Tax Policy: Recent Trends and Coming Challenges,'' IMF Working Paper No. WP/07/274, IMF 2007, p. 37.

[6]For instance, New Zealand's 1986 reform introduced GST while the personal income tax marginal rate was reduced, although its base was broadened. In Singapore, GST was introduced in 1994 as part of a larger tax restructuring exercise, to enable Singapore to shift its reliance from direct taxes to indirect taxes. GST has enabled Singapore to sustain a lower income tax rate.

revenues of European OECD countries (compared with 15.2 percent in 1970).[7] The part of general consumption taxes as a percentage of GDP almost doubled between 1970 and 2007 (3.3 percent in 1970 compared with 6.7 percent in 2007 for OECD countries and 3.7 percent compared with 7.5 percent for European OECD countries).[8] Thirty-two of the 33 OECD countries have adopted the VAT.

Why Has the VAT Been So Popular?

The VAT raises revenue in a neutral and transparent manner.[9] Some suggest that ''a VAT is the most effective instrument for generating government revenue''[10] and that ''the marginal cost of raising funds for public purposes through VAT is generally lower than it would be if other taxes were employed.''[11] In former communist economies, key considerations were the need to replace levies on state enterprises and anticipating membership of the European Union.[12] The VAT's neutrality toward international trade has also made it the preferred alternative to custom duties in the context of trade liberalization (and decline in revenues due to the dismantling of trade barriers).[13] Exports are normally exempt from VAT while allowing the recovery of the corresponding input tax. Imports are normally subject to VAT. Since the corresponding input tax on exports is deductible, VAT does not affect the competitiveness of domestic firms to export. Further, VAT is relatively secure from serious fraud in a domestic market. The tax relies on a staged collection mechanism in which successive taxpayers are entitled to deduct input tax on purchases and have to account for output tax on sales. In the end, the tax collected by tax authorities should equal the VAT paid by the final consumer to the last vendor. It is argued that this is a particularly efficient tax because revenue is secured while collected throughout the chain of production, unlike a retail sales tax, under which all tax is lost if there is evasion at the final stage. Moreover, economists generally take the view that VAT encourages savings and investments because it is a tax on consumption and not income. Recent OECD work suggests that VAT is more pro-growth than an income or corporate tax.[14]

Reflecting on the VAT Design

Given that over 50 years have elapsed since the first VAT, it seems an opportune time to reflect on how the existing VAT systems could be reformed. We have been going through one of the worst economic crises in living memory, and governments will have to bring public debt to acceptable levels when exiting this crisis. Revenues from corporate taxes, personal income taxes, and social security contributions may be relatively low in the next few years and may take a significant time to recover. Many companies hit by the crisis will pay little corporate income tax because losses will be carried forward. Salaries will generally not increase, and many households have already lost or will lose employment. Social security contributions will probably decrease as a result of freezes on salaries and increases in unemployment. VAT should be relatively less affected, although revenues will suffer to some extent from reduced consumption.

The existence of multiple VAT rates will affect the efficiency of a VAT system and will increase complexity.

When reviewing existing VAT systems, one important element to consider is the number of different VAT rates implemented in many countries. The existence of multiple VAT rates will affect the efficiency of a VAT system and will increase complexity, which may in turn increase administrative and compliance costs.

Two Groups of Countries

Developed countries can be classified into two broad categories: countries that have introduced a VAT based on the French and then European model, and countries that have implemented a different VAT.

[7]Table 29 of *Revenue Statistics 1965-2008 — Statistiques des recettes publiques 1965-2008*, 2009 edition, OECD publishing, p. 91.

[8]*Id.* at Table 28.

[9]Buydens, *supra* note 3.

[10]Delfin S. Go, Marna Kearney, Sherman Robinson, and Karen Thierfelder, ''An Analysis of South Africa's Value Added Tax,'' World Bank Policy Research Working Paper No. 3671, Aug. 2005, p. 19.

[11]Commentary by Richard M. Bird on the draft chapter of the July 2008 Mirrlees review of U.K. taxes: Ian Crawford, Michael Keen, and Stephen Smith, *Value-Added Tax and Excises*, Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, chaired by Sir James Mirrlees, *available at* http://www.ifs.org.uk/mirrleesreview.

[12]Norregaard and Kahn, *supra* note 5.

[13]Buydens, *supra* note 3.

[14]Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, ''Tax and Economic Growth,'' OECD Economics Department Working Paper No. 620, July 11, 2008, ECO/WKP(2008)28, pp. 42-45; Zdeněk Hrdlička, Margaret Morgan, David Prušvic, William Tompson, and Laura Vartia, ''Further Advancing Pro-Growth Tax and Benefit Reform in the Czech Republic,'' OECD Economics Department Working Paper No. 758, Apr. 19, 2010, ECO/WKP(2010)14, pp. 35-37.

The first group of countries, many of which are members of the EU, generally applies several reduced rates so that the tax basis subject to standard rate is somewhat limited. Articles 96 to 99 of VAT Directive 2006/112/EC of November 28, 2006, allow EU member states to have a standard rate that cannot be lower than 15 percent and up to two reduced rates that cannot be lower than 5 percent. Also, Chapter 4 of the VAT directive grants older member states ''reserved rights'' according to which they can continue applying a reduced rate lower than the minimum indicated in the directive if that rate was in place before 1991.

The second group of countries (including Australia, Canada, Korea, New Zealand, Singapore, and South Africa) has a much broader base at the standard rate. The 1986 New Zealand VAT reform introduced a broad-base VAT with a low single standard rate, a low registration threshold, and few exceptions and exemptions. New Zealand scores the highest on the OECD VAT revenue ratio.[15] South Africa implemented a VAT in 1991 that broadly follows the New Zealand model. However, at inception it zero-rated basic food items.[16] This was extended in 2001 to paraffin, an energy source used by most low-income households.[17] It has, however, a relatively high VAT registration threshold to simplify the system by excluding small firms.[18] Singapore, which introduced VAT in 1994, also has a broad base with a high threshold and a single rate. Australia introduced the GST in 2000.[19] It has a relatively wide base but has a number of zero rates (the Australian terminology is ''GST free supplies'') for health and medical care, educational supplies and child care, and food and beverages.

Developing countries seem to have largely favored single-rate systems. For instance, of the 21 African countries that adopted a VAT between 1990 and 1999, 14 have a single-rate system. Eight of the nine African countries that have adopted a VAT since 2000 have a single-rate VAT system.[20] Note that countries with a wider base at the standard rate frequently have a standard rate less than the EU minimum of 15 percent (10 percent in Australia, 5 percent in Canada,[21] 12.5 percent in New Zealand,[22] 7 percent in Singapore, and 14 percent in South Africa).

The main reason for introducing a different rate structure in Europe was the desire to alleviate the tax on goods and services that forms a larger share of expenditures of the poorest households. Many countries had a specific higher rate for luxury products, probably reflecting earlier sales taxes that were restricted to luxury goods. The EU rules obliged them to do away with that specific rate and apply only one standard rate. Some countries outside the EU still have a luxury tax, for instance, Algeria (with a rate between 20 and 110 percent), Chile (with a rate between 50 and 85 percent), Tunisia (with a rate between 10 and 700 percent), and Turkey (with a rate between 7 and 40 percent).[23]

However, some countries have moved toward a single standard rate. Switzerland began a public consultation in 2007 as part of an assessment of its VAT system 10 years after its introduction. Most respondents supported a substantial revision of the VAT system and a move to a unique standard rate. Proposals for reform were presented to the Swiss parliament in June 2008. The first part of the reform, a simplification of the administration of the VAT system, came into force in January 2010; it should reduce compliance costs for businesses, although this cost will be transferred to the Swiss tax administration. The second part of the reform, at this stage still only a proposal, would remove the three existing VAT rates (currently 2.4 percent, 3.6

[15]The VAT revenue ratio is an indicator that attempts to measure the gap between the revenues that would arise from a theoretically pure VAT system (a single rate with full compliance and full tax collection) and the revenues actually collected. It is defined as the ratio between the actual VAT revenue collected and the revenue that would theoretically be raised if VAT is applied at the standard rate to all final consumption (for the purpose of calculating the ratio, ''final consumption'' is deemed to be reflected by the figures of national consumption taken from national accounts — although several investment goods are not considered as consumption in national accounts whereas they are subject to VAT). The VAT revenue ratio should be considered only as an indicator as some factors may distort the measure (definition of final consumption, exemption, reduced rates, and taxation thresholds may affect the ratio, as well as other factors such as poor compliance or tax administration). Buydens, *supra* note 3, at 67-71.

[16]Go, Kearney, Robinson, and Thierfelder, *supra* note 10, at 2 and 6.

[17]*Id.* at 6.

[18]*Id.*

[19]*See* http://www.ato.gov.au/businesses/content.asp?doc=/content/00221985.htm.

[20]Norregaard and Kahn, *supra* note 5, at 38.

[21]Beginning January 2008, the GST rate is 5 percent in Canada (previously 6 percent). However, five provinces (Nova Scotia, New Brunswick, Newfoundland and Labrador, and — as of July 2010 — Ontario and British Columbia) harmonized their provincial sales tax with the GST to create the harmonized sales tax. The HST applies to the same base of goods and services as the GST. The HST rate is 13 percent (or 12 percent for British Columbia), with a 5 percent federal part and an 8 percent (or 7 percent for British Columbia) provincial part (http://www.cra-arc.gc.ca/tx/bsnss/tpcs/gst-tps/rts-eng.html, http://www.cra-arc.gc.ca/E/pub/gr/news74/news74-e.pdf, and http://www.cra-arc.gc.ca/E/pub/gr/news75/news75-e.pdf).

[22]The GST rate in New Zealand will increase from 12.5 percent to 15 percent beginning October 1, 2010.

[23]U.S. Council for International Business (USCIB), *available at* http://www.uscib.org/index.asp?documentID=1676.

Standard Rates and Reduced Rates in OECD Countries

	Implemented	1976	1980	1984	1988	1990	1992	1994	1996	1998	2000
Australia	2000	-	-	-	-	-	-	-	-	-	10.0
Austria	1973	18.0	18.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Belgium	1971	18.0	16.0	19.0	19.0	19.0	19.5	20.5	21.0	21.0	21.0
Canada	1991	-	-	-	-	-	7.0	7.0	7.0	7.0	7.0
Chile	1975	20.0	20.0	20.0	20.0	16.0	18.0	18.0	18.0	18.0	18.0
Czech Republic	1993	-	-	-	-	-	-	23.0	22.0	22.0	22.0
Denmark	1967	15.0	22.0	22.0	22.0	22.0	25.0	25.0	25.0	25.0	25.0
Finland	1994	-	-	-	-	-	-	22.0	22.0	22.0	22.0
France	1968	20.0	17.6	18.6	18.6	18.6	18.6	18.6	20.6	20.6	20.6
Germany	1968	11.0	13.0	14.0	14.0	14.0	14.0	15.0	15.0	16.0	16.0
Greece	1987	-	-	-	16.0	18.0	18.0	18.0	18.0	18.0	18.0
Hungary	1988	-	-	-	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Iceland	1989	-	-	-	-	22.0	22.0	24.5	24.5	24.5	24.5
Ireland	1972	20.0	25.0	23.0	25.0	23.0	21.0	21.0	21.0	21.0	21.0
Italy	1973	12.0	15.0	18.0	19.0	19.0	19.0	19.0	19.0	20.0	20.0
Japan	1989	-	-	-	-	3.0	3.0	3.0	3.0	5.0	5.0
Korea	1977	-	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Luxembourg	1970	10.0	10.0	12.0	12.0	12.0	15.0	15.0	15.0	15.0	15.0
Mexico	1980	-	10.0	15.0	15.0	15.0	10.0	10.0	15.0	15.0	15.0
Netherlands	1969	18.0	18.0	19.0	20.0	18.5	17.5	17.5	17.5	17.5	17.5
New Zealand	1986	-	-	-	10.0	12.5	12.5	12.5	12.5	12.5	12.5
Norway	1970	20.0	20.0	20.0	20.0	20.0	20.0	22.0	23.0	23.0	23.0
Poland	1993	-	-	-	-	-	-	22.0	22.0	22.0	22.0
Portugal	1986	-	-	-	17.0	17.0	16.0	16.0	17.0	17.0	17.0
Slovak Republic	1993	-	-	-	-	-	-	25.0	23.0	23.0	23.0
Spain	1986	-	-	-	12.0	12.0	13.0	16.0	16.0	16.0	16.0
Sweden	1969	17.65	23.46	23.46	23.46	23.5	25.0	25.0	25.0	25.0	25.0
Switzerland	1995	-	-	-	-	-	-	6.5	6.5	6.5	7.5
Turkey	1985	-	-	-	10.0	10.0	10.0	15.0	15.0	15.0	17.0
United Kingdom	1973	8.0	15.0	15.0	15.0	15.0	17.5	17.5	17.5	17.5	17.5
Unweighted Average		16.0	16.9	17.9	17.3	16.7	16.5	17.6	17.8	17.9	17.8

Standard Rates and Reduced Rates in OECD Countries *(continued)*

	Implemented	2002	2004	2006	2007	2008	2009	2010	Reduced Rates*	Specific Rates in Specific Regions
Australia	2000	10.0	10.0	10.0	10.0	10.0	10.0	10.0	0.0	-
Austria	1973	20.0	20.0	20.0	20.0	20.0	20.0	20.0	10.0/12.0	19.0
Belgium	1971	21.0	21.0	21.0	21.0	21.0	21.0	21.0	0.0/6.0/12.0	-
Canada	1991	7.0	7.0	7.0	6.0	5.0	5.0	5.0	0.0	13.0
Chile	1975	18.0	19.0	19.0	19.0	19.0	19.0	19.0	-	-
Czech Republic	1993	22.0	22.0	19.0	19.0	19.0	19.0	20.0	10.0	-
Denmark	1967	25.0	25.0	25.0	25.0	25.0	25.0	25.0	0.0	-
Finland	1994	22.0	22.0	22.0	22.0	22.0	22.0	22.0	0.0/8.0/13.0	-
France	1968	19.6	19.6	19.6	19.6	19.6	19.6	19.6	2.1/5.5	See note
Germany	1968	16.0	16.0	16.0	19.0	19.0	19.0	19.0	7.0	-
Greece	1987	18.0	18.0	19.0	19.0	19.0	19.0	19.0	4.5/9.0	3.0/6.0/13.0
Hungary	1988	25.0	25.0	20.0	20.0	20.0	20.0	25.0	18.0/5.0	-
Iceland	1989	24.5	24.5	24.5	24.5	24.5	24.5	25.5	0.0/7.0	-
Ireland	1972	21.0	21.0	21.0	21.0	21.0	21.5	21.0	0.0/4.8/13.5	-
Italy	1973	20.0	20.0	20.0	20.0	20.0	20.0	20.0	4.0/10.0	-
Japan	1989	5.0	5.0	5.0	5.0	5.0	5.0	5.0	-	-
Korea	1977	10.0	10.0	10.0	10.0	10.0	10.0	10.0	0.0	-
Luxembourg	1970	15.0	15.0	15.0	15.0	15.0	15.0	15.0	3.0/6.0/12.0	-
Mexico	1980	15.0	15.0	15.0	15.0	15.0	15.0	16.0	0.0	11.0
Netherlands	1969	19.0	19.0	19.0	19.0	19.0	19.0	19.0	6.0	-
New Zealand	1986	12.5	12.5	12.5	12.5	12.5	12.5	12.5	0.0	-
Norway	1970	24.0	24.0	25.0	25.0	25.0	25.0	25.0	0.0/8.0/14.0	-
Poland	1993	22.0	22.0	22.0	22.0	22.0	22.0	22.0	0.0/7.0	-
Portugal	1986	17.0	19.0	21.0	21.0	21.0	20.0	20.0	5.0/12.0	4.0/8.0/14.0
Slovak Republic	1993	23.0	19.0	19.0	19.0	19.0	19.0	19.0	10.0	-
Spain	1986	16.0	16.0	16.0	16.0	16.0	16.0	16.0	4.0/7.0	See note
Sweden	1969	25.0	25.0	25.0	25.0	25.0	25.0	25.0	0.0/6.0/12.0	-
Switzerland	1995	7.6	7.6	7.6	7.6	7.6	7.6	7.6	0.0/2.4/3.6	-
Turkey	1985	18.0	18.0	18.0	18.0	18.0	18.0	18.0	1.0/8.0	-
United Kingdom	1973	17.5	17.5	17.5	17.5	17.5	15.0	17.5	0.0/5.0	-
Unweighted Average		17.9	17.8	17.7	17.8	17.7	17.6	18.0		

Source: OECD tax database; national delegates; position as of January 1 of every year — position as of January 1, 2010.

*A number of countries apply a domestic zero rate (or an exemption with right to deduct input tax) on certain goods and services. This is shown as 0.0 percent in this table. This does not include zero-rated exports.

Country Notes

Austria: A standard rate of 19 percent applies in Jungholz and Mittelberg.

Canada: The provinces of Newfoundland and Labrador, New Brunswick, and Nova Scotia have harmonized their provincial sales taxes with the federal GST and levy a GST/HST of 13.0 percent. The provinces of Ontario and British Columbia have proposed to harmonize their provincial sales taxes with the federal GST effective July 1, 2010. The proposed rates of GST/HST for the provinces is 13.0 percent and 12.0 percent, respectively. Other Canadian provinces, with the exception of Alberta, apply a provincial tax to certain goods and services. These provincial taxes apply in addition to GST.

Chile: In June 1988, the VAT rate decreased from 20.0 percent to 16.0 percent. In July 1990, the VAT rate increased from 16.0 percent to 18.0 percent. In October 2003, the VAT rate increased from 18.0 percent to 19.0 percent.

France: Rates of 0.9 percent, 2.1 percent, 8.0 percent, and 13.0 percent apply in Corsica. Rates of 1.05 percent, 1.75 percent, 2.1 percent, and 8.5 percent apply to overseas departments (DOM). There is no VAT in French Guyana.

Greece: Rates of 3.0 percent, 6.0 percent, and 13.0 percent apply in the following regions: Lesbos, Chios, Samos, Dodecanese, Cyclades, Thassos, Northern Sporades, Samothrace, and Skiros.

Mexico: A VAT rate of 10.0 percent applies in the border regions. (The border zone is usually up to 20 kilometers south of the Mexico-U.S. border.)

Portugal: The standard VAT rate in the islands of Azores and Madeira is 14.0 percent; reduced VAT rates in these areas are 4.0 percent and 8.0 percent.

Spain: Rates of 2.0 percent, 5.0 percent, 9.0 percent, and 13.0 percent apply in the Canary Islands. The standard VAT rate increased from 16.0 percent to 18.0 percent and the reduced rate from 7.0 percent to 8.0 percent on July 1, 2010.

percent, and 7.6 percent[24]) by a unique and lower standard rate of 6.1 percent. It would also remove 20 of the 25 existing exemptions — although the exemption regarding financial and insurance services would remain. According to independent studies,[25] the implementation of a unique VAT rate should reduce business compliance costs by at least 20 percent and up to 30 percent,[26] and this may increase growth by 0.1 percent to 0.7 percent.[27]

The View of the Economists

OECD reports since the 1980s have clearly supported the view that, other things being equal, a broad-base, single-rate VAT is ideal.[28] This view is supported by recent studies. The 2007 Copenhagen Economics study[29] and the 2008 draft chapter of the Mirrlees Review of U.K. taxes[30] supported the view that a broad base with a single standard rate would enable significant revenues to be used while decreasing tax administration costs for governments and compliance costs for businesses. This is generally supported by the view that VAT is not an appropriate tool for manipulating social behaviors.

OECD reports since the 1980s have clearly supported the view that a broad-base, single-rate VAT is ideal.

In many countries, however, the implementation of one or several reduced rates is traditionally justified by the assumption that the poorest households spend a high proportion of their income on essentials. A report from the World Bank showed that poor South African households spend most of their income (61 percent) on food, whereas high-income households spend 15 percent.[31] Thus, the poor would suffer more from a VAT on food; reduced VAT rates reduce the supposed regressivity of the tax and achieve some level of redistribution to the poorest households. But this neglects the view that the wealthiest also benefit from these reduced rates. The rich typically consume more of the necessities than the poor.[32] It also distorts consumer choice. The draft chapter of the July 2008 Mirrlees review stated, ''Finding the political will to implement such change needs to begin with a recognition of the fundamental unfairness — and wastefulness — of the existing rate structure.''[33] In New Zealand, evidence available at the time of the 1986 VAT reform showed that upper-income households spend twice as much as low-income households on food.[34] One academic said that

[24]Following a referendum on September 27, 2009, these rates will increase respectively to 2.5 percent, 3.8 percent, and 8 percent, effective January 1, 2011, to December 31, 2017 (http://www.estv.admin.ch/mwst/themen/00155/index.html?lang=fr).

[25]Press release of the Département fédéral des finances of the Swiss Confederation, June 26, 2008.

[26]Ramboll Management GmbH, ''Messung der Bürokratiekosten der Merhwertsteuer-Gesetzgebung auf Basis des Standard-Kosten-Modells,'' Sept. 2007.

[27]Frank Bodmer, ''Die volkswirtschaftlichen Auswirkungen der MWST und einiger Reformszenarien,'' Apr. 27, 2007.

[28]*See, e.g.*, Robert P. Hagemann, Brian R. Jones, and Robert Bruce Montador, ''Tax Reform in OECD Countries: Economic Rationale and Consequences,'' OECD Economics Department Working Paper No. 40, Aug. 1987, OECD Publishing, pp. 34-37.

[29]''Study on Reduced VAT Applied to Goods and Services in the Member States of the European Union,'' final report written by Copenhagen Economics, June 21, 2007. Taxation Paper No. 13 of the European Commission, dated October 13, 2008, reproduces the 2007 Copenhagen Economics study. Copenhagen Economics study's main conclusion is that moving toward a more uniform VAT rate structure has considerable advantages — a single rate can improve economic efficiency, reduce compliance costs, and smooth the functioning of the market. Carefully targeted reduced VAT rates, although they may provide specific benefits, should be understood only as an adjustment (and should be limited to specific sectors in which services are easily substituted by do-it-yourself or underground economy work or sectors that employ many low-skilled workers).

[30]Crawford, Keen, and Smith, *supra* note 11. This draft chapter of the July 2008 Mirrlees review of U.K. taxes, chaired by Nobel prize-winner Sir James Mirrlees and commissioned by the Institute for Fiscal Studies, says there are better redistributive instruments available than fine-tuning rates. It says that reduced rates and *a fortiori* zero rates should be abolished and that the revenues raised should be used more directly as a redistributive instrument to help the poor. It says also that moving to a single VAT rate would not only raise revenues but would also cut administration costs. In the United Kingdom, ''ending all current zero and reduced rates (except for housing and exports) while increasing all means-tested benefit and tax credit rates by 15 percent would leave the poorest 30 percent of the population better off, on average, and raise £11 billion that could be used to help them further or for some other purpose.'' Although this study focuses on the U.K. and may not be completely relevant when applied to other jurisdictions — as the U.K. applies zero and reduced rates more extensively than other countries — it does raise some good arguments.

(Footnote continued in next column.)

[31]Go, Kearney, Robinson, and Thierfelder, *supra* note 10, at 10.

[32]''Policy Brief — Consumption Taxes: The Way of the Future,'' *OECD Observer*, Oct. 2007.

[33]Quote from the executive summary of the draft chapter of the July 2008 Mirrlees review of U.K. taxes; Crawford, Keen, and Smith, *supra* note 11.

[34]Ian Dickson and David White, ''Tax Design Insights From the New Zealand Goods and Services Tax (GST) Model,'' Working Paper 60, Apr. 2008, Centre for Accounting, Governance,

(Footnote continued on next page.)

''the concessionary treatment of food tends to give twice as much relief to high-income groups than to low-income groups.''[35]

And economists do not necessarily share the view that VAT is regressive. Some believe that the impact of the tax should be assessed over the lifetime of an individual and not on an annual basis. In theory, annual income is low when an individual is young, because that individual is still in school or is just starting employment. It should peak in middle age and then start decreasing in old age because of a loss of efficiency or retirement. Analyzing the impact of VAT on the basis of annual income thus presents a more regressive result for the young and old, whereas the same analysis carried out over a lifetime's income might lead to a different conclusion.[36] This analysis assumes, however, that all individuals have the same life expectancy and earn on average the same income. The salary of a lower qualified person may not reach a peak at middle life.

The 2007 Copenhagen Economics study raises some theoretical elements in favor of reduced rates provided that specific circumstances are met. It suggests that reduced rates applied in carefully targeted sectors may provide some benefits, for instance when the locally supplied services sector employs many low-skilled workers. In turn, this might shift do-it-yourself work or elements of the shadow economy to the formal sector. The study recognizes that in an internal market (such as the EU), lowering a VAT rate may well distort cross-border trade slightly when the origin principle[37] is applied to most business-to-consumer supplies because it invites consumers to purchase products in the low-VAT-rate state.[38] However, this should not be the case when reduced rates are applied only to locally supplied services.[39]

The Lessons of 50 Years

Many countries have examined these distribution issues, and their experience suggests that VAT rate reductions might not be conclusive. In 2001, South Africa extended zero rating to paraffin (a fuel used by most poor households), but this proved to be inefficient as suppliers absorbed most of the benefits and did not pass it on to consumers as intended.[40] In 2009, France dropped the VAT rate from 19.6 percent to 5.5 percent for supplies of restaurant and catering services[41] on the assumption that restaurants would reduce prices substantially, raise wages, or create new jobs (and would improve compliance).[42] According to the French National Institute for Statistics and Economic Studies (INSEE), prices for restaurant services decreased by only 1.1 percent in July, 0.2 percent in August, and 0.1 percent in September, and they actually increased by 0.1 percent in October.[43] INSEE also noted that only 30 percent of the VAT cut has been passed on to customers. According to the French Conseil des Prélèvements Obligatoires, a body in charge of evaluating the economic, social, and financial effects of social and tax contributions, this would create only 6,000 jobs in the long run,[44] but the government stands to lose up to €3 billion in revenue in a full fiscal year from the cut.[45] This would equate to each new job in the sector costing French taxpayers €500,000. The VAT cut may have saved jobs in a restaurant industry potentially severely affected by the economic crisis, but this appears difficult to quantify. More recently a survey reported that the reduced VAT rate granted in Germany to the hotel industry as part of a tax cut from 2010 has not been passed on to consumers. Prices seem to have remained the same.[46] It is sometimes suggested that the money

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and Taxation Research, School of Accounting and Commercial Law, Victoria University of Wellington, p. 6.

[35]Sijbren Cnossen, ''A VAT Primer for Lawyers, Economists, and Accountants,'' *Tax Notes Int'l*, July 27, 2009, p. 319, *Doc 2009-12253*, or *2009 WTD 141-11*.

[36]Neil Warren, ''A Review of Studies on the Distributional Impact of Consumption Taxes in OECD Countries,'' OECD Social, Employment, and Migration Working Paper No. 64, June 26, 2008, p. 24.

[37]Under the origin principle, the place of taxation of internationally traded products is the location of the supplier — as opposed to the destination principle where the place of taxation is the location of the customer.

[38]Taxation Paper No. 13 of the European Commission dated October 13, 2008, reproduces the 2007 Copenhagen Economics study, p. 18.

[39]*Id.* at 37.

[40]Go, Kearney, Robinson, and Thierfelder, *supra* note 10, at 6.

[41]The Council of the European Union reached political agreement in its 2,931st meeting on March 10, 2009, that all member states should have the option to apply reduced VAT rates on a permanent basis in certain sectors, including restaurant services (press release 7048/09 (Presse 54)). The scope of the reduced rates was extended to the housing sector, to supply of restaurant and catering services (excluding, however, alcoholic beverages), and to labor-intensive services (such as personal care services, gardening, minor repairs including shoes, clothes, computers, or watches). The category of pharmaceutical products, medical equipment for the disabled, and books was widened. Books in particular include any media that reproduce the same information content as printed books (but not games).

[42]French notice 3 C-4-09 dated June 30, 2009, has commented on the modalities according to which this VAT rate change will apply as from July 1, 2009.

[43]''Conjoncture française,'' INSEE, Dec. 2009, *available at* http://www.insee.fr/fr/themes/indicateur.asp?id=29.

[44]*L'Expansion*, ''TVA réduite dans la restauration: sept ans de négociation pour quel résultat?'' Dec. 1, 2009.

[45]*La Tribune*, ''Nicolas Sarkozy défend la TVA à taux réduit pour la restauration,'' Nov. 24, 2009.

[46]Ulrika Lomas, ''German Hoteliers Fail to Pass On VAT Reduction,'' Jan. 12, 2010, Tax-News.com, http://www.lawandtax-news.com/asp/German_Hoteliers_Fail_To_Pass_On_VAT_Reduction_____41129.html.

saved from the VAT cut has been invested in renovation work or acquisitions instead of being passed on to customers. Do these cuts really create opportunities for investment and increased employment, economic growth, and improved quality of services? The response is far from clear.

Multiple Rates: Issues

Practical experience also shows that VAT rate reductions may affect compliance. Recent OECD studies suggest that a multiple VAT rate structure with numerous exemptions would be more difficult for taxpayers to comply with and for the revenue bodies to administer than a VAT with a single-rate structure and few exemptions.[47]

VAT rate reductions might not be conclusive.

Further, rate differentiation may increase legal uncertainty. Similar products may be subject to the standard or reduced rate depending on the ingredients. In the United Kingdom, for instance, this has led to endless disputes regarding the classification of, for example, food products such as potato crisps (normal rate) or biscuits (reduced rate),[48] depending on the amount of potatoes in the products, and of teacakes as chocolate-covered biscuits (normal rate) or as regular biscuits or cakes (reduced rate).[49] In the absence of any clear criteria, this may create opportunities for tax optimization and conflicts between businesses and authorities fighting over costly borderline cases.[50] It may also open up opportunities for fraud when products are deliberately misclassified.[51] A study recently published by the European Commission showed that substantial amounts of VAT revenues are lost in the EU (12 percent of the theoretical liability for 2006 — more than €100 billion) as a result of VAT noncompliance, tax planning and avoidance, and fraud.[52]

Reforms: Part of a Broader Package

More work must be done in the coming years to assess the regressivity of the tax and of the effects of reduced rates on the wider economy. However, regressivity is a question that should not be addressed in isolation. Even if VAT is regressive in itself, it should be considered alongside other taxes. What is relevant in the end is the impact of the overall tax and benefit structure. Therefore, any review of existing VAT systems should be done within the context of the whole government budget.

New Zealand's introduction of GST in 1986 was made in conjunction with a reform of the personal income tax. The base was broadened for the personal

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[47]''Information Note — Developments in VAT Compliance Management in Selected Countries,'' OECD Forum on Tax Administration: Compliance Sub-Group, Aug. 2009, *available at* http://www.oecd.org/dataoecd/49/17/43728444.pdf.

[48]In the United Kingdom (VAT Act 1994), although food products are generally zero rated for VAT purposes, potato crisps, and other similar products made from potatoes, are normally charged with VAT at the standard rate. This, of course, creates confusion, because a food product containing potatoes may be subject to two different VAT treatments.

This opened a two-year controversy regarding the VAT treatment of Pringles. The question was whether Pringles are a potato crisp (as they contain potato) or a kind of biscuit (because they are manufactured from dough). A potato crisp is subject to VAT at the standard rate whereas a biscuit is normally zero rated. The High Court, regarding an appeal of a 2007 decision from a VAT & Duties Tribunal, decided in July 2008 [[2008] EWHC 1558 (Ch)] that Pringles cannot be said to be made from potatoes because they contain only 42 percent potato. To attract VAT the product must be wholly or substantially wholly made from potatoes. The Court of Appeal disagreed in May 2009 [[2009] EWCA Civ 407] and ruled there was ''more than enough potato content'' in Pringles ''for it to be a reasonable view that it is made from potato'' (section 33 of Lord Justice Jacob's judgment). Pringles now are liable for VAT at the standard rate.

Revenue & Customs Brief 32/09, issued May 29, 2009, *available at* http://www.hmrc.gov.uk/briefs/vat/brief3209.htm; ''Appeal Judges Decide Pringles Are Potato Crisps,'' *The Telegraph*, May 20, 2009, *available at* http://www.telegraph.co.uk/news/newstopics/politics/lawandorder/5355898/Appeal-judges-decide-Pringles-are-potato-crisps.html; ''Pringles Too Much Like Potato Crisps to Escape VAT, Appeal Court Rules,'' *The Times*, May 20, 2009, *available at* http://business.timesonline.co.uk/tol/business/law/article6328935.ece; Robin Pilgrim, ''Pringles Liable to U.K. VAT, Court Rules,'' LawAndTax-News.com, May 26, 2009, *available at* http://www.tax-news.com/news/Pringles_Liable_To_UK_VAT_Court_Rules_____36913.html.

[49]*See* Michel Herman and Alex Spence, ''Marks & Spencer Tastes Victory in Tax Tussle Over Teacake,'' *The Times*, Feb. 5, 2009, *available at* http://business.timesonline.co.uk/tol/business/industry_sectors/retailing/article5663183.ece; and European Court of Justice, *Marks & Spencer plc v. Commissioners of Customs and Excise*, C-309/06, Apr. 10, 2008.

[50]*Supra* note 38, at 31.

[51]Buydens, *supra* note 3, at 51.

[52]''Fight Against Tax Fraud: Commission Publishes a Study on the VAT Gap in the EU,'' IP/09/1655, Oct. 30, 2009; ''Study to Quantify and Analyse the VAT Gap in the EU-25 Member States,'' Sept. 21, 2009, report produced by Reckon LLP following a study commissioned by the European Commission, *available at* http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/combating_tax_fraud/reckon_report_sep2009.pdf. The Reckon report provides estimates of the VAT gap, which is the difference between the theoretical net VAT liability for the economy as a whole and the actual accrued VAT receipts. Please note that the VAT gap is not only due to VAT fraud but may include VAT not paid as a result of tax planning, avoidance, and unpaid VAT liabilities due to insolvencies.

income tax and the marginal rate was reduced. Benefits were also increased to compensate for any inflationary impact from the GST's introduction. The 2010 New Zealand reform announced in the budget for 2010-2011 follows the same track: The VAT rate is increased from 12.5 percent to 15 percent from October 1, 2010, while income tax rates are reduced.[53] Within the EU, the decision of the U.K. government in 1979 to increase the VAT standard rate in the United Kingdom from 8 percent to 15 percent was also seen as a package, because when the VAT was increased, the basic rate of income tax was cut from 33 percent to 30 percent and the top rate from 83 percent to 60 percent.[54] Germany also followed an overall approach when it raised its standard rate from 16 percent to 19 percent in January 2007 while reducing social contributions by 2 percentage points — although this decision may also be perceived as a transfer of taxation from shareholders to final consumers or as a competitive devaluation at export (because social contributions were reduced while exports are not subject to VAT).

The existence of a reduced rate — although distorting the economy — may render a standard rate more acceptable to taxpayers.

This global approach allows for further consideration of the question of the VAT's regressivity. According to James Poterba of the Massachusetts Institute of Technology, combining a broad-based VAT with a steeply progressive income tax avoids, to some extent, negative effects on the poor.[55] The World Bank has noted that South Africa's overall tax system is progressive, whereas the South African VAT is mildly regressive.[56] ''The progressiveness of the complete tax system should be taken into account and one should not look at the distributional impact of VAT in isolation,'' according to the World Bank report.[57] In New Zealand, the reform was successful because compensating assistance was applied via the income tax and social welfare systems. The revenue generated by the introduction of the GST allowed financing of this redistribution policy.

However, it is interesting that a base-broadening reform would only increase revenue in jurisdictions where taxpayers are relatively compliant and tax administrations have sufficient means of control. Countries where the level of avoidance and fraud is relatively high should focus first on increasing compliance to prevent revenue losses. Broadening the base is likely to be a valid option when collection mechanisms are performing sufficiently.

Informed Political Debate

Tax is the expression of a political consensus.[58] It reflects the amount of resources that citizens agree to put in common. Citizens need to be informed and consulted, and will have to agree on the need to review an existing tax system. Every country's perception of tax is different, and not every tax is perceived in the same manner. Being right might not be sufficient if the reform is not understood. Consider a historic example: Against all odds Michael VIII Palaeologus, a Byzantine emperor of the 13th century who took back Constantinople, managed to avoid any successful counterattacks from the Latin states by uniting the Orthodox and Catholic churches. But this union — although probably politically clever — strongly affected the religious identity of his population, which, as a result, showed little support for his policy. In some countries, some degree of deviating from the economic ideal may be needed to receive public support for the existing VAT system. The existence of a reduced rate — although distorting the economy — may render a standard rate more acceptable to taxpayers. This could be particularly relevant

[53]For instance, the basic personal income tax rate is cut from 12.5 percent to 10.5 percent, and the top rate from 38 percent to 33 percent. The corporate income tax rate is changed from 30 percent to 28 percent. New Zealand Inland Revenue, *available at* http://www.ird.govt.nz/news-updates/campaign-budget-2010.html?id=homepage.

[54]*See* Neil Warren, ''The UK Experience With VAT,'' *Revenue Law J.*, Vol. 3, 1993.

[55]Testimony of James Poterba, Professor of Economics, Massachusetts Institute of Technology, before the U.S. Senate Committee on Finance, Aug. 3, 2006.

[56]Go, Kearney, Robinson, and Thierfelder, *supra* note 10, at 19.

[57]*Id.* at 5.

[58]Tax is the expression of a political will. The English Bill of Rights of 1689 and the French 1789 Déclaration des droits de l'homme et du citoyen have enacted the principle of the consent of people for taxation. The first French revolution had been provoked by the gathering of a tax assembly, ''*les Etats Généraux*,'' to approve new tax measures when the King's power was becoming weaker and being challenged by the nobility and the clergy (the assembly not having gathered since Louis XIII in 1614). Before that, the American Revolution found its origin in new taxes (the 1764 Sugar Act, the 1765 Stamp Act, the 1767 Townshend Acts, and the 1773 Tea Act) imposed by the British in North America because they needed resources to pay their indebtedness resulting from the Seven Years' War. Herein lies the origin of the phrase ''no taxation without representation,'' which became popular in American circles, as many colonists were not willing to pay since they had no representation in the English Parliament. The Declaration of Independence on July 4, 1776, also embodies the principle that governments derive their powers from the ''consent of the governed.''

when the standard rate is significantly higher than the reduced rate. When the standard rate is already relatively low, the psychological impact of a reduced rate may be less significant. In New Zealand there was no VAT before 1986, but there was a wholesale tax that omitted around 67 percent of the potential indirect tax base.[59] The country relied significantly on international trade taxes, and tax reform had become urgent for budgetary reasons. The New Zealand public was consulted on tax policy and legislation. This open political debate not only informed the citizens but helped build trust with the government.[60] So the New Zealand GST included a wide base and a single standard rate. Taxing all products, including food and clothes, made more revenue available to redistribute and supplement income to the poor. The public was so convinced of the merits of this approach that the party that proposed introducing exemptions in 1987 lost the subsequent election.[61]

Compensating the Losers

This may lead to the conclusion that VAT might not be a social tool, whereas targeted benefits financed by a broader base (or, as the case may be, a combination of a broader base and an increase of the standard VAT rate) would provide greater benefit for the poor without benefiting the wealthy. The key might be to compensate those who think of themselves as the losers of a reform. In New Zealand, horizontal equity — like treatment of people in similar circumstances — was supported by a stronger degree of redistribution through one-off benefit adjustments when the reform was introduced and then through compensatory income supplementation.[62] Similarly, New Zealand's 2010 tax reform seeks to compensate for the higher VAT rate by increasing allowances to senior and retired people, families, or students.[63] In Switzerland, part B of the reform proposal (that is, broader base and a single rate) should be fully compensated for 40 percent of households (that is, the low-income households) by social measures financed by 0.1 percent of the VAT revenue. According to the Swiss government, redistribution policy will be better achieved with a single VAT rate rather than with reduced rates and exceptions.[64]

[59]Dickson and White, *supra* note 34, at 4.

[60]*Id.* at 10.

[61]*Id.*

[62]*Id.* at 11.

[63]New Zealand Inland Revenue, *available at* http://www.ird.govt.nz/news-updates/campaign-budget-2010.html?id=homepage.

[64]Press release of the Département Fédéral des Finances of the Swiss Confederation, June 26, 2008.

More Work to Be Done at the OECD Level

Over the last 20 years the OECD has worked on VAT primarily on cross-border and compliance issues. The time has come to broaden this focus. This was the motivation behind ''High Level Conference on the Future of VAT: Value Added Taxes: Looking Back — Looking Forward,'' organized in September 2009 by the OECD and hosted by Switzerland. One topic discussed was that of improving the economic efficiency of the VAT. In the communiqué issued following the conference,[65] senior tax officials from 25 OECD countries, the European Commission, and five major nonmember economies stated:

> In particular when seeking to bolster revenues, countries may want to consider broadening the existing tax base as an alternative or an addition

[65]The Lucerne communiqué is available in its full version on the OECD website at http://www.oecd.org/dataoecd/19/12/43669264.pdf.

The communiqué also stresses the need to ease VAT compliance for businesses:

> VAT does not seek to tax businesses themselves, except in well defined cases. However, business has the responsibility to collect the tax, which can involve significant compliance costs. We noted their concerns over complexity and, in particular, over a lack of certainty in the administration of the tax. We support the OECD initiative to develop Guidelines for the international issues affecting VAT and look forward to their publication.
>
> Noting that complexity can lead to poorer compliance, we encourage all countries to ensure that simplification of VAT is carried through in the years ahead. However, simplification should be carried out in a way that does not open up opportunities for fraud against VAT. In particular, we encourage tax administrations to ensure that they provide business with certainty and clarity in the way that the tax is applied. We also encourage tax administrations to ensure that penalties for genuine mistakes made by business have regard to the net amount of revenue lost.

Of course, another important issue is the need to combat VAT fraud and other abuses:

> We note that VAT has been subjected to systemic attacks in recent years, often by those involved in a variety of criminal activities. Some of these frauds involve international trading and we encourage the OECD to develop further work in this area, including the availability of rapid exchange of information between countries. We welcome the changes to Article 26 of the OECD's Model Tax Convention that now allows for exchange of information on specific taxpayers under bilateral treaties for indirect, as well as direct, taxes. We would also encourage countries to enter into multilateral exchange of information agreements such as the Joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters. We also would encourage OECD countries to participate in the OECD's Secure Exchange of Consumption Tax Information System (SECTIS) that allows for exchange of information on generic tax frauds and avoidance schemes.

> to a possible increase of the standard VAT rate. We recognize the political difficulties and the economic impacts attached to increases in taxes, be it through a widening of the base or an increase in rates, but also noted that, appropriate consultation, communication and management, often as part of wider tax reform, can help minimize the political cost associated with major changes to VAT systems.

After more than 50 years, VAT may now be at a turning point in its life. It is time to choose between making cosmetic or more dramatic changes, to think of how to override political difficulties by building political acceptance, and to put some new flesh on the VAT model. There is, therefore, a need to study the impact of VAT base-broadening reforms in the wider economy and particularly on growth, while governments will need to bring public debts to acceptable levels when exiting the recent crisis. As well as increasing revenues, it should reduce compliance costs.[66] Achieving this will require more rigorous analysis but on firmer empirical results. And it will require political leadership — politicians that lead rather than follow and are prepared to take the time to explain to citizens the changes in VAT required to move it into the 21st century. The OECD is the right place to undertake such studies and researches. ◆

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[66]Sijbren Cnossen, ''Administrative and Compliance Costs of the VAT: A Review of the Evidence,'' *Tax Notes Int'l*, June 20, 1994, p. 1649, or *94 TNI 118-9*.