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## Improving performance of VAT systems

***Jeffrey Owens, Director, Centre for Tax Policy and Administration at the OECD, on how improving performance of VAT systems is a priority in the context of the economic crisis***

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## THE GLOBAL TRADE PLATFORM

# Improving performance of VAT systems is a priority in the context of the economic crisis



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The global spread of Value Added Taxes (sometimes referred to as Goods and Services Taxes) has been the most remarkable development in taxation over the last 50 years. Operated in less than 10 countries in the late 1960s, VAT now raises one fifth of the world's tax revenue and still more countries are adopting it. The increasing importance of VAT as a source of government revenue is likely to continue as countries deal with fiscal consolidation pressures in the wake of the economic crisis while seeking to restore growth.

The key role of VAT in a post-crisis environment is generally recognized by governments and tax policy makers. In June 2009, OECD ministers declared that "Growth-oriented tax reforms would generally involve shifting revenue from corporate and personal income taxation or social security contributions onto consumption and property taxes, including housing taxation." Recent OECD analysis of growth-oriented tax reforms concluded that "A revenue-neutral tax reform that shifts the balance of taxation more toward consumption and recurrent residential property taxes could [...] strengthen the growth of output over the medium term." as "... corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable residential property being the least harmful." (OECD (2010), Tax Policy Reform and Economic Growth, OECD Publishing).

A growing number of countries that operate a VAT are considering fundamental reform to increase their revenue raising capacity and to address inefficiencies of the current system. It is a key priority for the OECD to actively support countries in this exercise, as well as ensuring that this interaction between VAT systems does not act as a barrier to world trade. This article highlights the key areas of attention.

## Definition and spread of VAT

VAT is essentially a tax that is charged on a broad range of transactions with a tax deduction mechanism allowing businesses to offset VAT paid on inputs against VAT paid on outputs. It is a tax on final consumption by households that is collected by businesses in a staged payment process: each taxable business pays VAT to its providers on its inputs and receives VAT from its customers on its outputs. Input VAT incurred by each business is offset against output VAT so that tax paid by businesses along the value chain does not bear on them but ultimately on final consumers only. VAT thus remains neutral for businesses. It does not distort the prices that they face in buying and selling from one another. In an international context, VAT neutrality is achieved through the application of the "destination principle" according to which exports are exempt and imports are taxed on the same basis and under the same rates as local supplies.

The capacity of VAT to raise revenue in a neutral and transparent manner has drawn all OECD member countries to adopt this broad-based consumption tax, except the United States, which continues to employ retail sales taxes at the state level (and below) rather than apply a federal consumption tax. Its neutrality principle towards international trade has also made VAT the preferred alternative to customs duties in the context of trade liberalisation. VAT it has now been implemented by more than 150 countries with several more considering implementation.

OECD member countries have relied increasingly on VAT as a source of revenues. Over the last twenty years, the share of VAT as a percentage of total taxation has grown by more than 65% passing from 11.2% on average in 1985 to 18.7% in 2008, this share remaining stable since 2000. This source of revenue is globally third in importance behind personal income taxes (26%) and social security contributions (25%) but far above corporate income tax (10%), specific consumption taxes

## Tax structures in the OECD area<sup>2</sup>

	1965	1975	1985	1995	2000	2008
Personal income tax	26	30	30	27	25	26
Corporate income tax	9	8	8	8	10	10
Social security contributions <sup>3</sup>	18	22	22	25	24	25
(employee)	(6)	(7)	(7)	(9)	(9)	(9)
(employer)	(10)	(14)	(13)	(14)	(14)	(14)
Payroll taxes	1	1	1	1	1	1
Property taxes	8	6	5	6	6	5
General consumption taxes	12	13	16	19	19	20
(of which VAT)	(2)	(9)	(11)	(17)	(19)	(19)
Specific consumption taxes	24	18	16	13	12	10
Other taxes <sup>4</sup>	2	2	2	3	3	3
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: OECD(2011), Consumption Tax Trends 2010, OECD Publishing

(10%) and property taxes (5%) (see table above). These ratios vary considerably between countries, but in 28 of the 33 OECD countries with VAT, the tax accounts for more than 15 percent of total taxation.

The average standard rate of VAT/GST within the OECD has remained relatively stable at 18% on 1 January 2010 up from 17.8% in 2000. In Europe, the average standard rate of VAT rose from a little over 19% in 2000 to more than 20% in 2010. However, the OECD average is bound to increase significantly as a rising number of member countries have introduced rate increases or have announced plans to do so in response to financial consolidation pressures. In parallel, many countries have started to take base broadening measures. Between 1 January 2010 and mid 2011, not less than 10 OECD governments have increased rates or have announced plans to do so.

## Improving the performance of VAT

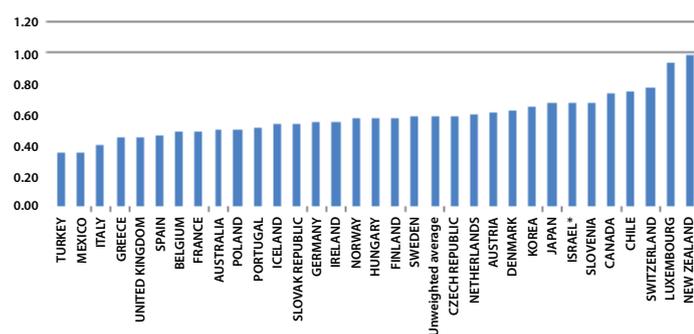
Raising the standard VAT rate has often been considered as the easiest way to increase revenues from the tax, particularly at a time when many governments are seeking ways to address large fiscal deficits. Some countries have even explicitly linked rate increases to the objective of fiscal consolidation. For instance the Slovak Republic has temporarily increased its VAT rate until the deficit will be reduced to below 3% and in Poland the VAT rates will automatically increase if the public debt to GDP ratio increases above a certain level.

However, raising the standard VAT rate has its own limits particularly in countries where the rate is already relatively high. In addition, when the standard VAT rate is increased (other things remaining equal) the amount of revenue forgone due to the application of reduced rates and exemptions also increases. It may be a better option for governments to consider reform to improve the performance of the VAT systems without having to increase the standard rate. This could include broadening the tax base, limiting the use of reduced rates and exemptions, more efficient tax administration and better compliance.

Research at the OECD of the VAT performance in OECD countries suggests such reform may be a significant option to improve the revenue raising capacity of VAT. The OECD uses the "VAT Revenue Ratio" as an indicator of VAT performance. This ratio expresses the VAT that is actually collected in a country as a proportion of the revenue that

would be raised if the standard rate were applied to all consumption. Across the OECD, the unweighted average ratio appears to be just 0.58, meaning that 42% of the potential VAT revenue is not collected.

### VAT Revenue Ratio in OECD countries (2008)



Source: OECD (2011), *Consumption Tax Trends 2010*, OECD Publishing.

Although the VAT Revenue Ratio has to be interpreted with care and erosion of the tax base may be caused by a variety of factors, it suggests that there is significant potential for raising additional revenues by improving the performance of VAT systems without having to increase the standard rate.

One way of increasing the ratio would be to broaden the tax base such that goods and services that are now subject to zero and reduced rates would gradually be taxed at the standard rate. A reduction of standard rates may even be considered in certain cases as the tax base would be broadened. VAT preferential treatments are still widely used in OECD countries, mainly for equity or social objectives (basic essentials, health, education...). However, studies generally indicate that reduced rates are not an effective way of achieving such distributional objectives. The benefits for better off households in absolute terms will be greater, as their consumption of the tax-favoured goods and services will most likely be greater than that of poorer households. Thus poorer households may benefit from reduced rates but better off households even more. A more effective policy may be to broaden the tax base and to use measures that are directly targeted at increasing the real incomes of poorer households to achieve distributional objectives.

**“A growing number of countries that operate a VAT are considering fundamental reform to increase their revenue raising capacity and to address inefficiencies of the current system”**

### Closing the VAT gap

At a time when many OECD governments are facing deficits of an average of almost 9% of GDP and recalling that VAT/GST accounts on average for almost 20% of tax revenues, it is increasingly unacceptable that the revenue loss from VAT fraud and avoidance is running at 10% or more of potential VAT revenues (as is suggested by a study conducted for the European Commission in 2009; see below). This is not just caused by criminal activities but also by tax evasion and aggressive tax planning.

The EU Commission published a study in 2009 which set out to quantify and analyse the so-called VAT gap for each member state. This is the gap between what is collected in VAT and the estimated amount that full compliance should deliver. The VAT gap includes fraud and other factors such as legal avoidance and unpaid VAT from insolvencies. The study estimated the gap at €106.7 billion in 2006 within the EU-25. This represents an average of 12% of the net theoretical liability, although several member states are above 20%.

The most common type of VAT/GST fraud is the “missing trader” or “carousel” fraud. It arises when a business makes a purchase without paying VAT (typically a transaction for which tax self-assessment applies), then collects VAT on an onward supply and disappears without remitting the VAT collected. It is common with high-value

goods sold across borders, such as computer chips and cell phones. But the fraud has more recently moved into services that are bought and sold like goods. In Europe, fraud with CO<sup>2</sup> emission allowances caused more than €5 billion losses in tax revenues in 2009. In addition, new technology assisted types of fraud create new challenges for tax administrations. This includes the use of “zappers,” or automated sales suppression devices that are used for skimming cash sales that pass through point of sale systems and electronic cash registers and that have caused significant loss of tax revenue notably in Canada and the US.

Governments have introduced series of measures, incl. new mechanisms for self-assessment, increased cross-border information exchange, international enforcement agreements and additional reporting requirements for businesses. These do not appear to have brought a satisfactory solution. The EU Commission has indicated that it is prepared to consider more radical measures, notably in the method for VAT-collection.

The OECD supports governments in their combat against VAT fraud notably by bringing together officials dealing with VAT fraud in OECD countries and non-OECD economies and by providing a platform for tax administrations to exchange information on fraud on avoidance and aggressive tax planning schemes.

### Addressing VAT obstacles in international trade

At a major tax policy conference held earlier this year in Washington, addressing the new challenges arising out of the ongoing economic crisis, OECD Secretary General Angel Gurría indicated that the development of internationally agreed principles for the application of VAT on international trade is a key priority, particularly in the area of services and intangibles. He pointed out that “The current international environment for consumption taxes, especially with respect to trade in services and intangibles, is creating obstacles to business activity, hindering economic growth and distorting competition”.

The current globalisation process is spreading more widely and includes a growing number of countries. China in particular and the other BRICS countries (Brazil, Russia, India, Indonesia and South Africa) have become major trading partners for most OECD countries. Within international trade, services trade has grown strongly in recent years. A significant feature of globalisation has been the growth of multinational enterprises (MNEs). Intra-firm trade, ie. cross-border trade between MNEs and their affiliates, accounts for an increasing share of international trade (see (OECD 2010), *OECD Economic Globalisation Indicators*, OECD Publishing).

Combined with the spread of VAT globally, the growth of cross-border economic activities has increased the interaction between VAT systems leading to an increased risk of double or multiple taxation or, in the inverse case, double or multiple non-taxation.

The most common reasons for double taxation and unintentional non-taxation are the use of different rules to determine the place of taxation and different interpretation of similar rules, different characterization of transactions and non-recoverability of tax. As explained above, VAT in principle aims to tax consumption of goods and services within the jurisdiction where the consumption takes place. According to this principle, exports should be zero-rated and VAT should be charged at import in the country of destination. This principle is generally easily applicable for international trade in goods. However, the application of the destination principle for international trade in services is more difficult and differs across jurisdictions and may lead to double taxation or unintentional non-taxation. The strong growth of international trade in services and the spread of VAT globally created an urgent need for internationally agreed principles on the application of consumption taxes to the cross-border supply of services and intangibles.