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# Value-Added Tax and Excises: Commentary

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## **Commentary**

**by**

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The value-added tax (VAT) was unquestionably the most successful fiscal innovation of the last half-century. No other significant tax, not even the income tax, spread so rapidly and quickly around the world to the point where VATs currently exist in over 150 countries, including of course all member states of the EU. Why was the VAT so successful? Essentially, because virtually every country -- apart from the always exceptional United States and a few small islands and oil-rich countries -- needs some form of mass consumption tax to support state activities, and experience has shown that the VAT is not only the least distorting such tax but also the one that can, despite some problems, be administered most effectively in most countries. Of course, not all VATs the same, and none is perfect (Bird and Gendron 2007).

In general, as Crawford, Keen, and Smith (hereafter CKS) show, in principle the VAT approach to imposing a consumption tax is perhaps the most economically efficient way in which countries can raise significant tax revenues. The marginal cost of raising funds for public purposes through VAT is generally lower than it would be if other taxes were employed. This economic advantage may cut two ways politically, however. By lowering the cost of taxation, VAT makes it relatively cheaper to expand the level of state activity -- an outcome that some may consider good and others bad. On the other hand, given any level of state activity, VAT does less damage to economic incentives than would equally productive alternative taxes. What more could one ask of a tax?

Picking up this theme, CKS suggest that the apparent increase in tax ratios associated with VAT in developed countries such as the UK reflects the reduced marginal cost of public funds. However, other factors are at work here than simply the lesser distortionary costs of VATs. Canada recently reduced its national VAT (the GST, in Canada) rate from 7% to 5%.<sup>1</sup> Most Canadian economists did not like this move, but it was certainly politically popular in large part because Canada's VAT is much more visible than in those found in other countries. In Canada, the GST is not included in product prices but is added on separately at the time of purchase: it is thus highly visible every time anyone buys anything. Everyone is aware of it every day, and, unsurprisingly, no one likes it. In economic terms, VAT in Canada as in most countries has the lowest MCPF of any significant tax (Baylor and Beausejour 2004). In political terms, however, matters are very different owing to the high visibility of the VAT. Some may argue that, since income taxes carry high political as well as economic costs and consumption taxes are lower on both metrics, a hidden VAT may yield a better revenue portfolio not just in enforcement terms but also in terms of bringing more closely together the marginal economic and political costs of raising public funds. On the other hand, it is hard to believe that it is a good thing for government revenues to grow more than they otherwise would simply because people do not understand how much tax they are paying. Little is known about these deep and murky waters.<sup>2</sup> Perhaps, however, it is more than time for those concerned with establishing sound tax policy to pay more careful attention to what may perhaps be called the reality of perception in shaping the design of tax instruments.

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<sup>1</sup> As Bird, Mintz and Wilson (2006) show, Canada is unusual in that it also has significant subnational consumption taxes some of which are VATs. On average, the level of consumption taxation even after the federal tax cut is about 13%.

<sup>2</sup> For a promising initial empirical foray, see Chetty, Looney and Kroft (2007)

The scholarly literature on VAT that is so well summarized and reviewed by CKS provides surprisingly little useful guidance to those responsible for VAT policy and administration. Much of this literature concerns matters that have already been decided in practice -- for the most part, fairly satisfactorily -- and are hence unlikely to be worth reconsidering in practice. Further discussion here of the essential policy irrelevance of such matters as the direct-indirect "tax mix" or "tax balance" question, the origin vs. destination issue, and the relative merits of VAT and retail sales taxes would thus serve no point. Only after clearing a good deal of such relatively unproductive theoretical underbrush do CKS get to the more salient policy issues with respect to VAT -- rates, exemptions, thresholds, enforcement, compliance, fraud, and the international setting.

What do we really know about these issues? Consider the summary picture of VATs in the OECD depicted in Table 2 of the chapter. About the only conclusion one can derive from the information in this table is that countries, it seems, can do almost anything they want with respect to rates, thresholds, coverage and enforcement (C-efficiency combines these two factors), subject only to a mild EU constraint in the case of EU countries. Since practice provides so little guidance, CKS understandably turn once more to theory for answers. As it turns out, however, apart from the issue of the threshold, where what seems to be an unanswerable case is made that the UK should certainly not lower it, there seem to be no very substantial answers with respect to the flesh and bones of any VAT -- rates, zero-rating and exemptions.

In practice no VAT is quite as good as it might be for a number of reasons: less than general coverage, less than optimal rate structure, and less than perfect administration. In the EU, for example, there are three major components of the base where coverage is arguably less than ideal -- real property, the PNC (public, nonprofit, charitable) sector, and the financial sector. CKS discuss the last of these sectors in some detail and provide an excellent overview of the relevant literature.<sup>3</sup> But they do not provide any clear guidance as to just what, if anything, the UK, the EU, or anyone else should do with respect to the treatment of the financial sector -- or for that matter the other two troublesome sectors mentioned above. The reader is, perhaps unintentionally, left with the feeling that it is all just too difficult to find an acceptable solution and we should perhaps just give up.

Of course, this characterization is not entirely fair. With respect to the financial sector, for example, CKS clearly do think that something should be done, perhaps along Australian lines. However, we are left up in the air as to exactly what should be done and what the costs and consequences of changing the present treatment might be. Similarly, with respect to real property, while an offset to first-time buyers is suggested, again the eager reader is left in the dark with respect to the critical details. Finally, when it comes to the equally troublesome issue of the public and non-profit sectors, neither any discussion of the nature of the problem nor even a hint of a possible solution is to be found. Even after decades of experience around the world with a variety of approaches, there is much more that we do not know than we know about the relevant parameters and behavioral responses determining such matters. These are the sorts of issues that consume the time and efforts of VAT policy designers everywhere. The absence of any solid theoretical or empirical framework within which to make such decisions is presumably

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<sup>3</sup> For a similar overview of the PNC question, see Gendron (2005).

why CKS do not discuss such issues more fully. Still, it is striking that when they come to the concluding section of the chapter not a word is said about any domestic aspect of VAT.

A more positive approach might have been to note that the EU model in general (and perhaps the UK version in particular) is very much a "first-generation" VAT. Since a second-generation VAT demonstrating that it is both possible and desirable to have much more comprehensive coverage has been on display in Australia and especially New Zealand for some years, it would have been interesting to consider more systematically the pros and cons (if any) of moving closer to this model in the UK. Such an exercise might also have made clearer the extent if any to which such improvements in the UK VAT are or may be restricted by EU rules. Finally, since New Zealand is not the last word when it comes to VAT, it would also have been interesting if the authors had set out their view of the structure of an "ideal" (third generation?) VAT or at least reviewed more systematically how EU rules might need to be altered to enable member states to improve their national VATs.

The analytical discussion in the chapter of some other issues such as the distributional aspects of VAT and the treatment of cross-border transactions seems more directly relevant to VAT policy and administration in the UK and more widely. However, the discussion of these issues also leaves a number of important questions unanswered -- and in some cases even unasked.

One such question relates to VAT rate structure. Neither the inconclusive optimal tax literature nor the interesting empirical estimates provided by CKS (which reject, though not

strongly, weak separability) provide particularly useful guidance on this point. In the end, the rule implicitly suggested for policy-makers, at least in developed countries like the UK, appears to amount to little more than the old rule of thumb that a uniform rate is likely to be as good, if not better, than any "scientific" differentiation – let alone the politically-driven differentiation that actually prevails in the UK, as in most countries. As CKS demonstrate, there is little case for differential rates on distributional or incidence grounds. Moreover, although CKS do not stress this point, there is considerable experience (though apparently no solid evidence) suggesting that multiple rates increase compliance and administrative costs and perhaps facilitate evasion..

If both theory and practice suggest that rate differentiation (like domestic zero-rating for consumer goods) seems to make little sense, why are these features so pervasive in VAT is around the world? The answer may lie deep in the murky waters of perception, electoral psychology, and the political economy of taxation and hence be well beyond the scope of this chapter. Still, given the existence of such differentiation in the UK VAT, it would have been useful to see, for example, a discussion of whether it makes any difference how 'reduced' (compared to the standard rate) the 'reduced' rate is. For example, if the lower rate is "too low" it may, like zero rating, generate both excessive refunds and an attractive opportunity for evasion. In principle, presumably the optimal reduced rate for VAT -- admitting that, however deplorable it may be, most countries seem to end up with such a rate -- should be susceptible to the same kind of analysis as the optimal threshold.

Recently, increasing attention is being paid to some of the important relatively unexplored implications of the way in which VAT is commonly administered through the so-

called invoice-credit system. Since input VAT cannot be credited by those not registered as VAT taxpayers, to the extent that taxed inputs -- for example, imports -- are purchased by "informal" enterprises, VAT offers a simple and effective way to tax the informal sector. Silver linings seldom come without accompanying clouds, however. Viewed from another perspective, the effective imposition of VAT on enterprises outside the VAT system, like the relatively high compliance costs imposed on small firms within the system, creates a barrier to the growth of the important --and often politically favoured --sector of 'small business.' Unfortunately, although the treatment of small businesses, both within and outside VAT system is a matter of increasing interest in many countries, including the UK, the issue is not discussed in this chapter. In response to these conflicting concerns, a growing number of countries in Europe and elsewhere seem to be introducing gross receipts taxes on small business sometimes within the framework of the VAT and sometimes as a separate "simplified" levy. Such composite transactions taxes deserve closer attention than they appear to have received to date anywhere.<sup>4</sup> Similarly, the costs and benefits of the various special schemes for small business found in many VATs, including the UK, also need closer examination.

Instead of going into such knotty and largely unresolved issues in VAT design, CKS devote a substantial fraction of the chapter to a particular form of VAT fraud currently giving rise to concern in the EU and more generally to the related question of how best to apply VAT to cross-border transactions. Since the UK has much more extensive zero rating than almost any other developed country it is surprising that the possible linkage between this feature of the UK

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<sup>4</sup> A related issue is how VAT on real property interacts with other taxes that impact the sector in differential ways such as local property taxes, capital gains taxes, inheritance taxes, and, in many countries, special transfer taxes imposed on real property sales. Once again, important policy decisions are being made about an important economic sector with little guidance from either theory or empirical analysis.

VAT and the much discussed problem of "carousel fraud" is not even mentioned. However, the exposition of the evasion game is clear, and the discussion of possible solutions good. CKS find all the solutions currently on offer -- such as reverse charging -- to be wanting and end by throwing the issue into the more general VIVAT hat discussed next.

On the whole, the chapter is careful not to simply restate the per case for the particular alternative mechanism for cross-border trade that some of the authors have argued at length in earlier works (Keen and Smith 2000). As an EU outsider, however, I still find it difficult to understand the emphasis on 'symmetry' in most EU discussions of these matters, including this chapter. In reality, there must always be some 'asymmetry' in any VAT since any VAT 'includes' some and 'excludes' others involved in transactions. Those within the system are treated differently than those outside. The relevant question in the EU, from the perspective of any member state, is whether those in other member states are 'in' or 'out.' (Those outside the EU are always 'out' of course.) It is true, as CKS note, that 'in' may have importantly different manifestations -- whose rate applies, who administers what -- but no matter where the lines are drawn with respect to either the basic in/out or the degree of 'in-ness' there is always a line and hence always arbitrage possibilities, and marginal costs and benefits of being on one side or the other. Much of the problem in discussing these matters sensibly in the EU (or anywhere else) is that what is best -- and for whom -- depends on relationships between various empirical characteristics about which we know little or nothing.

In the end, CKS conclude, perhaps unsurprisingly, that the best solution at least for the UK and the EU is the VIVAT approach. Indeed, it appears that the central idea of this approach,

a uniform "intermediate" rate, is becoming more widely accepted in Europe. Nonetheless there remain many important unanswered questions about the system: the appropriate level of the intermediate rate, the politically significant issue of compensation for "losing" member states, the increased weight this approach places on the distinction between the characteristics of end-users and the related apparent need for an accessible real-time EU VAT registration base. In tax design in tax implementation, the devil is always in the details, and there remain many details about which there is a high degree of uncertainty with respect to this issue.

To conclude, CKS provide on the whole an excellent review of the current state of the theoretical and the (considerably less impressive) empirical literature on the VAT. Like the literature on which it draws, however, the chapter does not provide either clear answers to many of the critical questions facing those concerned with designing and implementing VATs in the UK and around the world or much guidance to where they might look to find such answers. For better or worse, VAT practice is way ahead of VAT theory in the sense that practitioners are daily facing and dealing with problems with little or no theoretical or empirical guidance. Both practitioners and scholars have much to learn from each other with respect to VAT: they need to talk to each other more both to learn what the relevant questions are and to obtain the information that may in the long run enable either VAT reality to come closer to the ideal VAT of theory or VAT theory to come closer to dealing with the problems confronting VAT in reality. There is much to be done, and this chapter provides an excellent starting point from which to begin doing it.

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