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Protecting VAT revenues

Stuart Adam, Institute for Fiscal Studies

‘Protecting the tax base’ conference, Stockholm, 13 June 2013

Outline

- Background: VAT revenues
- Zero and reduced rates
- Exemptions and the scope of VAT
- Non-compliance

Drawing on two major reviews of policy:

- The Mirrlees Review: http://www.ifs.org.uk/mirrleesReview
- *A retrospective evaluation of elements of the EU VAT system*: http://www.ifs.org.uk/publications/5947

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VAT revenues

- VAT is a big revenue-raiser. In 2010:
  - Averaged 22.0% (EU), 19.7% (OECD), of tax revenue
  - Averaged 7.6% (EU), 6.6% (OECD), of GDP
- Increasingly important as standard rates rise…

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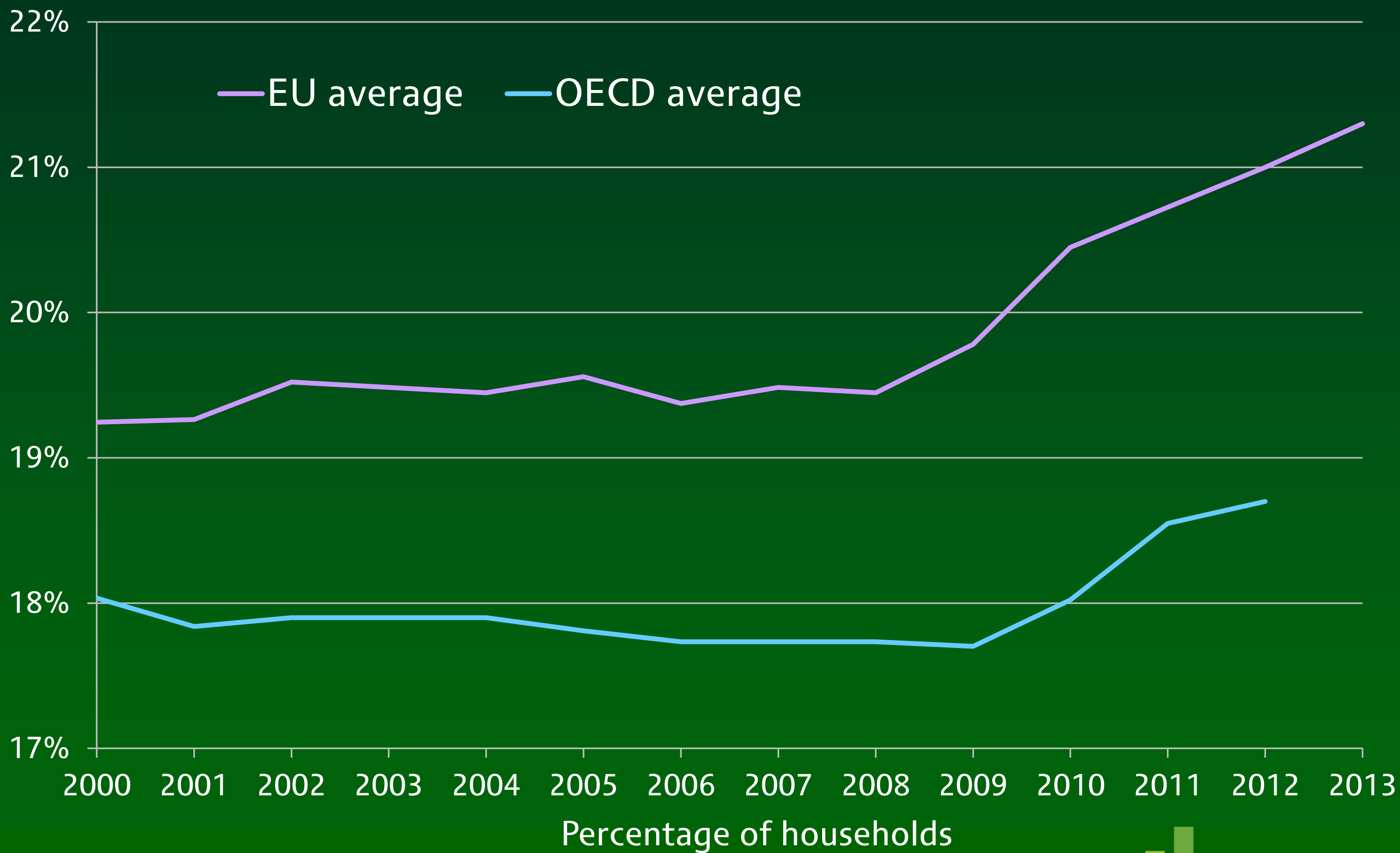
Increasingly important as standards rates rise…

Average standard VAT rates



Sources: Taxation Trends in the European Union 2013; OECD Consumption Tax Trends 2012

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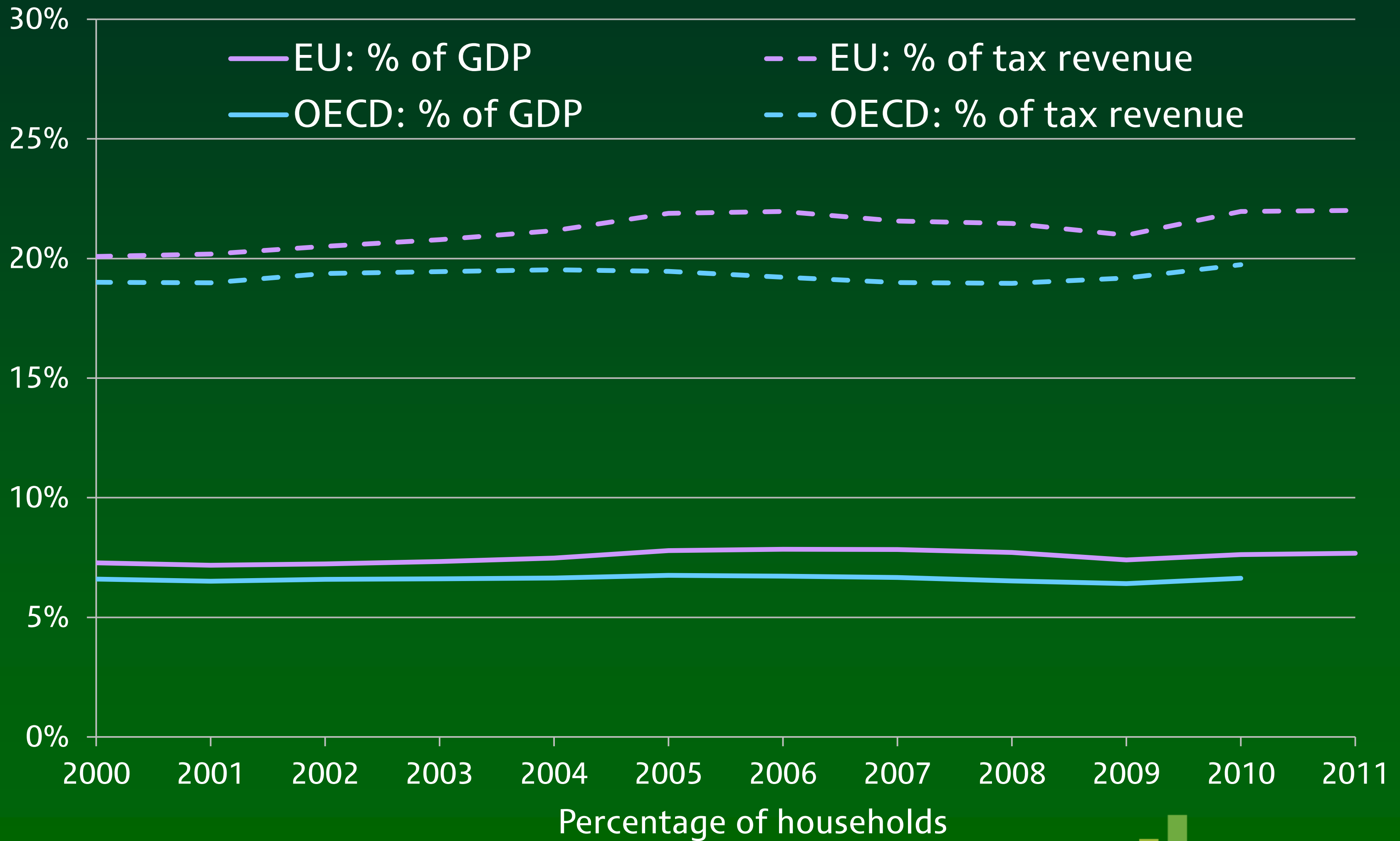
…but revenues responding less than you'd guess…

Average VAT revenues



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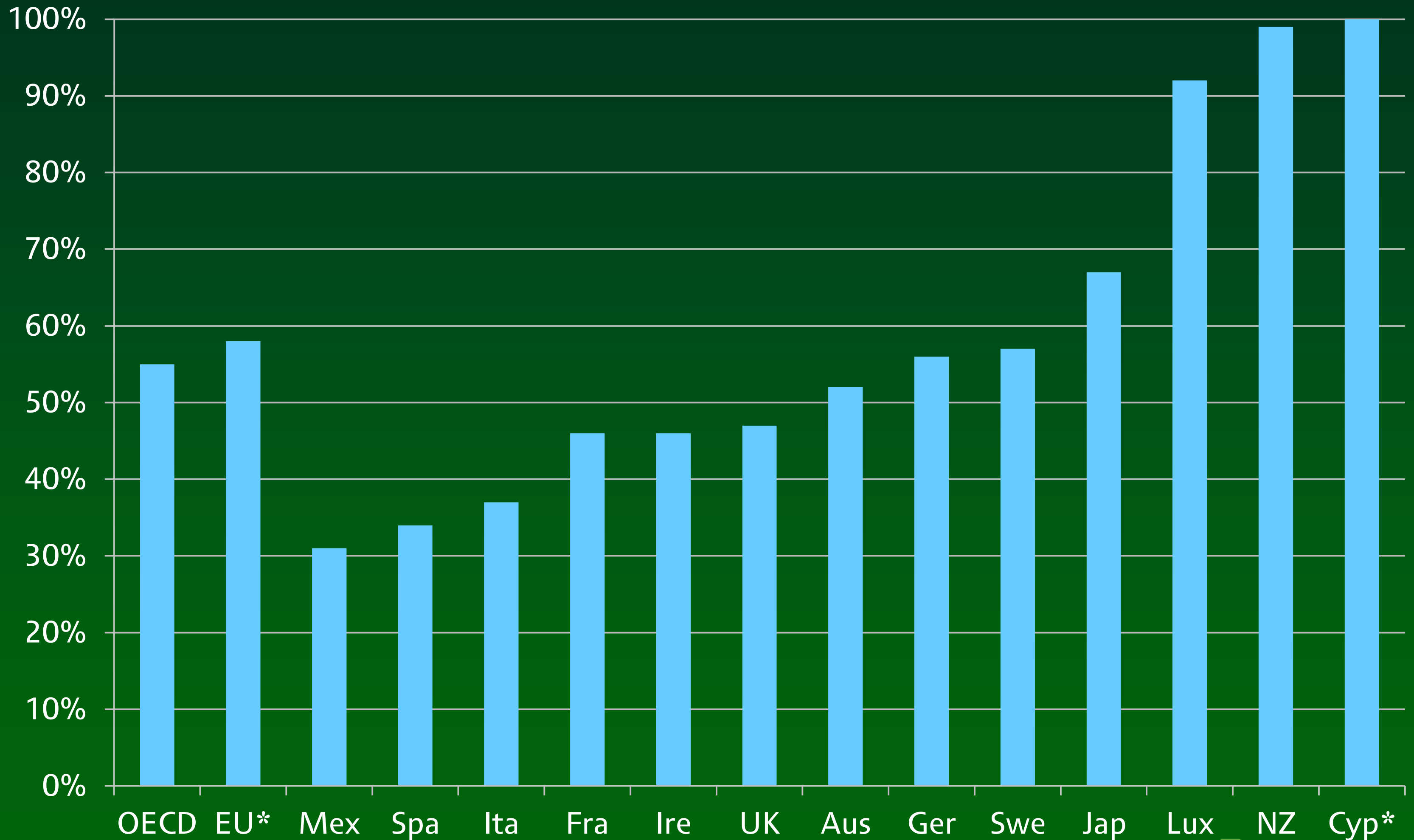
- …but revenues responding less than you'd guess…
- …because actual VATs some way from a 'textbook' uniform VAT
  - Zero and reduced rates, exemptions, non-compliance
  - Best summarised by VAT revenue ratio: EU & OECD averaged 58% in 2008
  - 1ppt rise in EU standard rates associated with 0.4ppt rise in effective rates
- VAT revenue ratio varies widely across countries

VAT revenue ratios, 2009

VAT revenue as % of total consumption expenditure



* 2008 figures

Sources: OECD Consumption Tax Trends 2012; Adam et al. (2011)

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➢ Broaden VAT bases & reduce VAT gaps to raise revenue more efficiently

  ➢ And so that any future rate increases raise more revenue, more efficiently

Arguments for VAT rate differentiation

- Zero and reduced rates are generally progressive
  - Though rich still benefit most in cash terms
- They can encourage ‘virtuous’ consumption (and discourage ‘sins’)
  - Though the argument for interfering with free choices must be clear
- But rarely a well-targeted instrument for either of these objectives
  - Other taxes and transfers target rich and poor more directly – spending patterns are a poor proxy
  - Are only purchases by final consumers worth encouraging/discouraging?
  - Is benefit of ‘virtuous’ consumption proportional to price?
- Can offset disincentives to work created by taxation in general
  - Sound argument for lower rates on time-saving goods and services e.g. childcare

The costs of VAT rate differentiation

- Adds complexity
  - Compliance costs, boundary problems, refunds,…
- Distorts spending patterns and therefore reduces welfare
  - In principle, government could compensate every household for the abolition of zero and reduced rates, and still have revenue left over
  - But what could be done in practice?

Removing zero and reduced rates

- On its own, removing zero and reduced rates would be regressive
  - And weaken work incentives: price rises make earnings less valuable
- Could use part of the revenue to increase means-tested transfers
  - But weakens work incentives further, + other drawbacks of means-testing
- A subtler package can protect work incentives while avoiding regressivity, on average, over a lifetime
  - Lifetime perspective matters: spending can’t exceed income forever!
  - Still winners and losers among individual households
- Can’t simultaneously protect poor, maintain work incentives and raise significant revenue
  - A careful revenue-neutral package would still be very beneficial
  - But the politics look fiendishly difficult

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Exemptions and non-deductible VAT

- *"the cancer of the VAT system"* – Maurice Lauré
- Exemptions are anathema to VAT and highly distortionary
  - B2C sales under-taxed; B2B sales over-taxed
  - Incentive to self-supply / vertically integrate
  - Distorts competition between exempt and non-exempt bodies, and between exempt bodies in different countries
  - Partial exemption adds to compliance costs & avoidance opportunities
- Look at the three biggest areas
  - Financial services
  - Public services and the public sector
  - Firms below the registration threshold

VAT and financial services

- Exemption causes serious problems
  - Financial services too cheap for households, too expensive for firms

	Effect of allowing deduction of input VAT – % change in output prices of:	
	Financial services	Whole economy
Germany	-4.8	-0.4
France	-5.6	-0.5
Italy	-3.7	-0.3
Spain	-2.5	-0.1

  - Bias towards sourcing from low-tax countries
  - Bias towards self-supply / vertical integration
  - Difficulty allocating inputs between taxable and exempt activities
- Can't be taxed through standard VAT mechanism
- But there are equivalent alternatives…

Source: Adam et al. (2011)

A VAT-equivalent tax on financial services

Three approaches:

1. Cash-flow tax
   - Tax all cash inflows to the bank; deduct all outflows
2. Tax Calculation Accounts
   - Tax excess (shortfall) of interest on loans (savings) from a ‘normal’ rate
3. Financial Activities Tax
   - Tax banks’ remuneration + (a particular measure of) profits

- Various ways these could be implemented:
  - Transaction-by-transaction or based on firms’ consolidated accounts?
  - Zero-rate B2B transactions (a Retail Financial Services Tax)?
  - Destination-based or origin-based?

➢ Needs detailed study to find the most practical option

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A VAT-equivalent tax on financial services?

- Reform is likely to be complex
- But remember this is removing difficult boundaries, not adding them
- And don't forget how complex & unsatisfactory the current system is!
- Unfamiliarity and politics likely to be the biggest obstacles
- Quid pro quo:
  - Remove existing surrogate taxes (e.g. UK's insurance premium tax)
  - Drop the financial transactions tax?

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Public services & the public sector

- What is the rationale for exempting services in the public interest?
  - Distributional goals? Encouraging their use?
  - Argument that VAT is an inefficient tool is even stronger here!
- Exemption of public-sector bodies looks increasingly dated
  - Public-private boundary blurred by privatisation, liberalisation, outsourcing, public-private partnerships, etc
  - Exemption distorts public-private competition
  - Public sector bodies should base decisions on market prices
  - VAT is not equivalent to changing funding / administered prices
  - Incentive to self-supply is once again a concern
- Studies indicate how exemption can be removed, and the benefits
  - Australia and New Zealand provide practical examples

VAT registration thresholds

- A more defensible form of exemption
  - Admin & compliance costs of full regime excessive for smallest firms
  - Though might a flat-rate scheme be preferable to exemption?
- Registration thresholds vary widely
  - From zero in a few countries to £79 000 (€92 800) in the UK
- Optimal threshold depends on many factors:
  - VAT rate
  - VAT administration and compliance costs
  - Share of value added in turnover
  - Marginal cost of public funds (‘deadweight loss’ from taxation)
  - Cost of distortions: artificially staying below threshold, competition between firms above and below threshold, self-supply incentives,…
  - ➢ Virtually impossible to quantify in practice

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VAT non-compliance

- Fractional collection should make VAT more robust than an RST
- Yet the estimated EU ‘VAT gap’ was €107bn (12% of liabilities) in 2006
  - Not all of this is fraud: also error, negligence, avoidance, insolvency, etc.
- Varies widely between countries and over time

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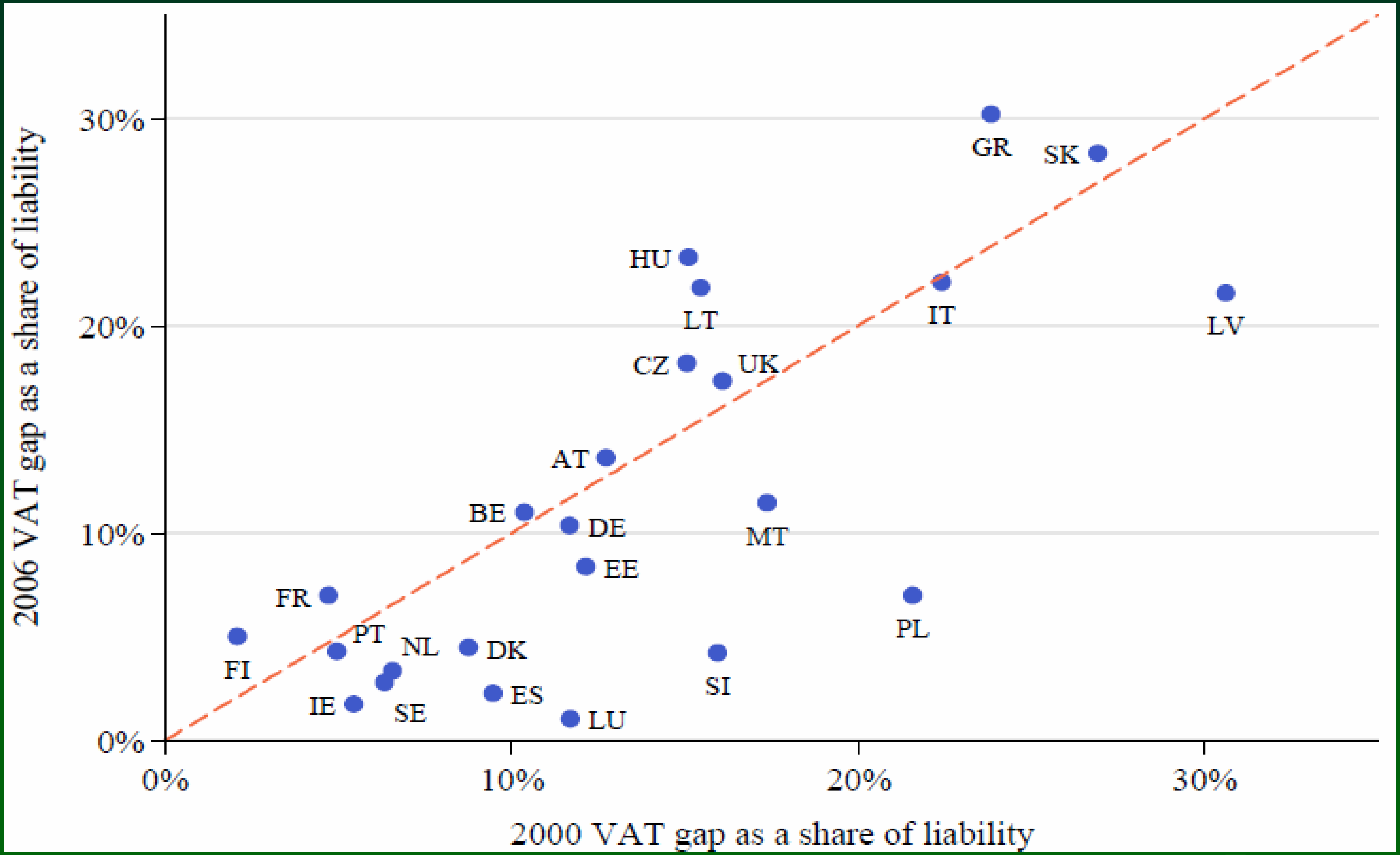

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  - Not all of this is fraud: also error, negligence, avoidance, insolvency, etc.
- Varies widely between countries and over time
- Behavioural factors:
  - Trust in institutions, prevalence of corruption, effective courts, etc.
- Policy factors:
  - VAT rates, base, thresholds, special schemes, refund regime, etc.

Forms of VAT evasion

- Most VAT fraud is domestic
  - Typically understating taxable sales and/or overstating creditable inputs
  - Working cash-in-hand and not recording sales that ought to be taxable
  - Failing to register despite being liable
  - Faking invoices for input purchases
  - Wrong categorisations (taxable vs zero-rated sales & purchases; inputs to exempt vs taxable activities; inputs from registered vs unregistered suppliers; etc)

- Single market with no frontier controls creates particular challenges
  - Export zero-rating breaks the VAT chain: exporter has large refund, importer large liability
  - Disappear without paying VAT owed

Approaches to countering VAT fraud

- Reduce rates (so less at stake), broaden base (so less scope for misclassification & refunds)
- Administrative tightening
  - Increase auditing, check registrations and refund claims, etc.
  - Quicker payments, slower refunds
- Joint liability
- Greater international co-operation and information exchange
- Reform VAT treatment of cross-border transactions
  - Reverse charging
  - End zero-rating of exports and move to uniform-rating (VIVAT, CVAT)
- Reform the collection mechanism
  - Data warehouse, split payments, automated/real-time cross-checking, etc.

A final thought

- VAT reform should be about more than protecting revenues
- Simplicity and efficiency are beneficial in their own right
- Broadening the base is desirable even if it raises no net revenue
- Compliance costs are a significant issue for taxpayers
  - Estimate range from 2% to 7-8% of revenues
  - Particularly important for small businesses and cross-border trade

Conclusions

- VAT raises a lot of revenue – making it work well is important
- Ever more important as VAT considered for fiscal consolidation
  - The bigger it is, the more important it is to design efficiently
  - Is it the right tax to raise further revenue (or even existing revenue)?
- Removing exemptions should be a priority
  - Make VAT a consumption tax!
- Removing zero & reduced rates would also help (to a lesser degree)
  - Can achieve objectives with less complexity and distortion
- Scale of VAT gaps remains a concern
  - Calls for a combination of approaches – but beware of compliance costs
  - Either start planning for a technological solution
  - Or look to move away from zero-rating exports

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