Protecting VAT revenues

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Outline

• Background: VAT revenues

• Zero and reduced rates

• Exemptions and the scope of VAT

• Non-compliance

Drawing on two major reviews of policy:


- A retrospective evaluation of elements of the EU VAT system: http://www.ifs.org.uk/publications/5947
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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Average standard VAT rates

Percentage of households

EU average
OECD average

...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

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

* 2008 figures
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- VAT revenue ratio varies widely across countries
  - 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
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

<table>
<thead>
<tr>
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<th>Financial services</th>
<th>Whole economy</th>
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<tbody>
<tr>
<td>Germany</td>
<td>-4.8</td>
<td>-0.4</td>
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<tr>
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<td>Italy</td>
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<tr>
<td>Spain</td>
<td>-2.5</td>
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- 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
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?
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
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
VAT non-compliance

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Source: Adam et al (2011)
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  ➢ 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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