Real VATs vs. the Good VAT: Reflections from a decade of technical assistance

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Abstract

I explore the distinction between real VATs and the good VAT in developing countries. The article draws on real-world examples from a decade of work on technical assistance and international projects in Africa, the Caribbean, Central and South America, Central Asia, the Middle-East and Persian Gulf regions. I will review several problem areas that illustrate the depth of the divide between real VATs and the good VAT: firstly, the Big-4 issues; secondly, situations when policy and administration clash; and thirdly, situations in which coordination between agencies breaks down. Big-4 issues include problems that plague many VATs in developing (and developed) countries: exemptions, non-export zero rating, multiple rates, and unsuitable thresholds. Frontier issues (real property, financial services, and imported services and e-commerce) sharply highlight the disconnection between policy wishes and administrative realities in developing countries. Tax policy and administration often clash in the areas of registration and segmentation, VAT withholding, handling of refunds, and the failure to generally apply the statutory provisions of the VAT law and regulations. Coordination problems involving VAT often arise between government agencies or ministries. Areas of conflict include: discretionary waivers; tax incentives; para-fiscal levies; coordination of import duties, excises and VAT; and (last but not least) data integration between customs and domestic tax administrations. I conclude with a few thoughts on how the VAT might move forward.

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1. **Introduction**

The value-added tax provides a critical source of tax revenue to developing countries. In fact, it is often the most reliable and most important source of revenue relative to other taxes in such countries. Yet, policy-makers and tax administrators in that context are often dissatisfied with the revenue yield of the VAT. The business sector usually understands the VAT but the public does not, or simply does not like it. This sets the stage for a hostile environment to good tax policy. On the surface, some of the dissatisfaction with VAT stems from the sometimes unfulfilled expectation that the VAT should more than replace sources of revenue foregone as a result of trade liberalization.\(^1\) Some of the dissatisfaction also stems from the fact that governments ask more of the VAT than just raising revenues in a relatively efficient way. Examples of other goals loaded on the VAT’s back include formalization, investment promotion, price control, protection, and promotion of competitiveness among others.

What does a high-level view of VAT show us? Kathryn James argues that *real VATs*—the actual real-world VATs we observe in the wild—differ markedly from the *good VAT*—the tax that satisfies a few well-defined norms: broad consumption base with a single rate and minimal exclusions; calculation of tax liability using the invoice-credit method; and levying VAT on a destination basis.\(^2\) This observation is absolutely inarguable in either developed or developing

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country contexts. It is this observation, rather than the reasons for the rise of VAT, which motivates my central question in this paper: why do real VATs depart so much from the good VAT in developing countries? An important subsidiary question is this: why are publicly-available sources such as government websites, tax policy intent, and VAT laws and regulations always insufficient to explain the actual performance of real VATs on the ground? I will present a review of those questions in light of my experience in technical assistance projects in Africa, the Caribbean, Central and South America, Central Asia, the Middle-East and Persian Gulf regions. The International Monetary Fund and its staff have recently published a couple of papers that candidly review the challenges of revenue mobilization in developing countries.3 Those provide a broader assessment than the present paper, but both emphasise the absolutely critical role played by tax administration.

The paper is organized as follows. In section 2, I review the Big-4 issues (exemptions, non-export zero rating, multiple rates, and unsuitable thresholds). In section 3, I review situations in which tax policy and tax administration clash. In section 4, I review situations in which coordination between agencies breaks down. I conclude the article with a brief discussion of the future of VAT in developing countries. In many ways, this article updates and extends earlier

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3 See: International Monetary Fund, Current challenges in revenue mobilization: Improving tax compliance, staff report, April 2015; D Kloeden, Revenue administration reforms in Anglophone Africa since the early 1990s, IMF working paper WP/11/162, July 2011; and M Keen and M Mansour, Revenue mobilization in Sub-Saharan Africa: Challenges from globalization, IMF working paper WP/09/157, July 2009.
joint work on the subject although the motivation is quite different. In order to save space and preserve confidentiality, references to individual countries will be omitted and the observed phenomena will be noted when they are sufficiently widespread.

2. **Big-4 issues**

The most important and frequently encountered departures from the good VAT include the following VAT design problems: numerous exemptions, non-export zero rating, multiple (reduced or high) rates, and unsuitable registration thresholds. Cnossen eloquently expresses the reality of many real VATs in developing countries: “Currently, many VATs are so riddled with exemptions and zero-rates on domestic goods that they resemble extended excise tax systems, while the standard rate is mainly confined to luxury goods”. The addition of registration thresholds to this list squares the circle of the biggest issues. The section concludes with a brief review of the treatment frontier issues in developing countries: real property, financial services, and imported services and e-commerce.

2.1 **Exemptions**

The exemption of a particular good or service or sector is perhaps the most automatic reflex in VAT policy. The intellectual leadership provided by the development of the VAT in the European Union has left an indelible mark in many countries that have relied on the EU design to establish their own VATs. As an example, one can think of the majority of the African countries. In fact, some regional organizations of African countries have even modelled their

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5 Cnossen, above n 1, at 1077.
VAT directives on the EU’s Sixth Directive.\(^6\) For historical reasons, VATs in the EU have exempted most goods and services provided by governments, supplies of real property and financial services, as well as some other goods and services such as agricultural and fishing inputs, cultural goods, newspapers and magazines, and so on. Many developing countries exempt all or many of the above supplies and some exempt more. Some countries also exempt government purchases. In some countries, most outputs and inputs in the agricultural sector are exempt.

Those exemptions tend to solidify with time and may give rise to exemption creep, i.e., their extension to other goods and services. The exemption creep phenomenon is most discernible from a VAT’s implementation to five or 10 years after. Many VATs began with minimal exemptions (e.g., financial services, government supplies) but then had exemptions added for a variety of reasons. Ultimately, exemptions are difficult to target effectively. Depending on economic conditions (price elasticities of demand and supply, competitive conditions, stage of exemptions, length of the production-distribution chain), it is difficult to predict the impact of exemptions on prices and identify the actual beneficiaries. This is even more difficult when both inputs and outputs are exempt. It is an understatement to say that exemptions are not well understood by policy-makers and the public.

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\(^6\) Communauté Économique et Monétaire de l’Afrique Centrale (CEMAC), and Union Économique et Monétaire Ouest-Africaine (UEMOA).
VATs in developing countries almost always exempt supplies made by governments and their agencies. This is unfortunately the standard treatment. It would take significant reforms to change that although there are good reasons and sensible ways for governments to charge VAT on some of their supplies, in particular those that compete with similar private sector supplies.\(^7\)

In the short term, a more serious problem arises due the widespread practice of governments in developing countries of legally exempting themselves from paying VAT on purchases. At first glance, this does not seem to be a major deal: after all, why would the government pay VAT to itself. As it turns out, the exemption of government purchases hinders the smooth operation of the VAT system:

- it forces government suppliers to treat the government differently than private sector customers if supplies are otherwise taxable;
- it forces government suppliers to absorb VAT paid on purchases made to render exempt supplies to the government;
- when government suppliers make taxable supplies to private sector clients, compliance costs increase because supplies must calculate input VAT allocations; and
- it increases the risk of self-supplies, i.e., the use of exempt goods and services purchased by the government but diverted away from government activities to personal consumption.

The solution to this unnecessary problem is for government departments and agencies to prepare expenditure budgets that are expressed gross of VAT (VAT inclusive). Of course, this should have no net impact on revenues. The point is to reduce compliance costs and revenue leakage from unintended VAT-free personal consumption.

The Ministry of finance in some countries prepares estimates of revenue foregone due to VAT exemptions. The work is mostly done on a piecemeal basis although it can be part of a larger evaluation of tax expenditures. Such exercises are good as the size of the numbers sometimes force a rethinking of the reasons to exempt. There is not a lot governments can do about unconditional exemptions (those required by international conventions, e.g., diplomats, international organizations and projects, repatriated personal belongings, etc.). Conditional exemptions are, however, compressible. Those include exemptions granted by decree or as part of investment agreements (I will return to those in the discussion of incentive regimes).

2.2 Non-export zero rating

VATs based on the destination principle (that is, the vast majority of them) require a consistent treatment of international trade: all domestic consumption, whether it originates from domestic production or imports, must be taxed; all exports must be zero-rated. Strictly speaking, the only instance of zero rating that is absolutely necessary concerns exported supplies.

Yet, many governments try to use the double-edged sword of zero rating domestic supplies. Examples of frequently zero-rated supplies include foodstuffs (sometimes basic, sometimes
processed, sometimes almost all foodstuffs), and some agricultural inputs including seeds, fertilizer, tools, and light equipment. I have recently seen the unusual situation of zero-rated of personal computer equipment and peripheral. I said *double-edged* sword for good reasons. Zero rating is a politically appealing tool: a government can then truthfully advertise to consumer that there is no tax on a good. The Quebec Sales Tax (a VAT) refers to a zero-rated supply as a “fourniture détaxée”, a clearer expression for the removal of the tax. There are major risks with more than marginal use of zero rating of domestic supplies, of course: a clear but easy to calculate loss of revenue; disputes with VAT registrants on classification of goods, even with positive lists; refunds; and opportunities for fraud. In addition, WTO non-discrimination rules requires that imported supplies be given the same treatment as domestic supplies so the VAT chain gets broken early, putting even more revenue at risk. Like in the case of exemptions, zero-rating creep can and does occur. Politically, those concessions are hard to reverse once consumers understand them.

The usual case for zero rating of foodstuffs is that the measure will alleviate the regressivity of the VAT. The question that arises is whether there are better mechanisms to deliver benefits to targeted groups (ostensibly, low-income households in this case). In theory, the answer is always yes: through the expenditure side. In practice, almost always yes even when the expenditure side cannot be counted on. Then, targeted subsidies, in kind assistance, tax credits, and so on can be used. In developing countries with poverty and unequal income distributions, the zero rating of foodstuffs provides much larger absolute benefits to mid- and high-income households than to
low income households. It is therefore an expensive and inequitable means of relief. The bulk of experience also shows that zero rating cannot provide a durable means of price control and cannot keep consumer prices and (especially) producer prices in check. This is especially difficult for countries that rely on imported foodstuffs. Refunds are the most serious unintended consequence of the zero rating of domestic supplies because the registrants that make those supplies will usually be in excess credit positions when they make taxable purchases but zero rate their supplies. In the food sector, difficulties are compounded by the co-existence of zero-rated and taxable supplies and the presence of numerous small and medium-sized suppliers which makes VAT administration, and especially audits, very challenging.

Some business inputs are subject to the zero rate in a number of developing countries. The point of those policies is simple: protect businesses against input price increases and make them more competitive. Given the existing web of exemptions and domestic zero rating in many developing countries, it is very hard to believe that selective input zero rating with VATs at rates in the 10 percent to 18 percent range can make much of a difference outside the very short run. The policies impede VAT administration by complicating audits since they break the relationship between output VAT and input VAT. Therefore, auditors cannot rely on benchmarks for similar firms and the industry. They must audit invoices or perform numerous diagnostic calculations from VAT return data. Zero rating of business inputs guarantees that some inputs will be diverted to personal consumption.

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2.3 Multiple rates

The most complex rate structures include a standard rate, reduced rates for what are presumed to be necessities, and a high rate for what are presumed to be luxury goods. The zero rating of domestic supplies represents a limit case of multiple rates where the reduced rate equals zero. The case made for reduced rates on necessities such as foodstuffs is the same as for zero rating: to alleviate the regressivity of the VAT. Reduced rates again invite disputes over the classification of goods and services, with pressure from registrants to characterize them so that they qualify for the reduced rate. While the revenue loss from a positive reduced rate is not as severe as from zero rating, it can get worse over time as the policy also invites lower rate creep, i.e., demands to extend the reduced rate to other supplies or sectors.

The tourism sector provides a good example of lower rate creep as output supplies in the sector are subject to a reduced rate in a number of countries. Those policies are implemented with the sincere belief that the reduced rate will help restore competitiveness in the face of adverse market conditions. One unintended consequence of reduced rates is the increase in refunds in some situations. Those may occur when supplies are made at the reduced rate and purchases are subject to the standard rate with low value-added over the previous stage. This situation may then create further lower rate creep when the government concedes that a reduced rate on inputs might work better to curtail refunds. How complex can a rate structure get? For example, recent policy changes in France have created a structure with four VAT rates not including the
treatment of exports. Those rates vary by type of good and service. It is hard to see how a tax administration in a developing country can administer a system of this sort. In fact, multiple rates weaken the already weakest reed of administration in developing countries: audit.

If rate differentiation is seen as desirable or necessary, it is preferable to implement it using excises. The four major excisable goods (alcoholic beverages, tobacco, fuels, and motor vehicles) provide ample opportunities to do this. In addition, excises on motor vehicles and certain alcoholic beverages may contribute to the progressivity of the tax system. Excises are less visible to consumers and are harder to evade, and easier to administer. Yet, reviews of excise system in many developing countries often conclude that the excise base is severely under-exploited and that rate structures are often poorly designed. Major reforms in the excise areas may of course trigger opposition from well-organized industry groups.

2.4 Unsuitable thresholds

No VAT issue better illustrates the endogeneity of tax policy and tax administration than the setting of the registration threshold. Many tax administrators believe the threshold is a mere administrative decision. Experience shows otherwise: the setting of the level of turnover from

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10 S Cnossen, “Excise taxation in Australia”, chapter 10, Australia’s future tax and transfer policy, Melbourne Institute, 2010.
which VAT registration is mandatory is a tax policy decision that has heavy consequences for administration.

Detailed analysis of the size distribution of registrants in developing countries inevitably produces the same result: it typically shows that between 80 percent and 90 percent of VAT collections are produced by 10 percent to 20 percent of registrants. This is often referred to as the 80:20 rule. This shows that a relatively small number large businesses account for most of the collections while the rest come from a large number of small and medium businesses that collect little or no tax individually. I have recently encountered a case in which over half the businesses in the register barely contributed any collections, and some small businesses were registered only to be able to claim refunds (I will return to refunds later).

The above trade-off suggests that the thresholds in developing countries are set too low for the capacity of their tax administrations. In theory, the idea is to think of the threshold level so that the marginal benefit of changing the threshold (in terms of additional or reduced revenue) equal to the marginal cost of raising that revenue (in terms of collection costs, the sum of compliance and administrative costs). The 80:20 rule suggests that administrations spend resources chasing revenues where there almost none to be found and therefore neglect the audit of larger businesses that generate most of the collections. In many situations, raising the threshold entails a small sacrifice of revenue at the low end of the size distribution in exchange for a significant drop in the number of registrants.
Governments tend to set thresholds too low for several reasons. First, they are often obsessed with capturing all the businesses to ensure maximum compliance. They believe that so doing will accelerate the formalization of informal businesses. Second, they are sometimes concerned with equity and competitive arguments pitting unregistered small businesses under the threshold versus the others over the threshold. The reality is that the specific parameters of a tax cannot by themselves promote formalization and tax compliance. Ultimately, informality is not even the issue at all: provided that sensible tax policies are backed by a competent tax administration, a VAT can produce good revenue in an environment where a significant share of economic activity is accounted for by informal businesses.¹¹

The equity argument goes along the lines that it would be unfair that large businesses have to be responsible for all obligations while small businesses do not and can thus enjoy a competitive advantage. The 80:20 rule pokes a hole in this argument. In addition, unregistered business must pay VAT on their inputs which they cannot get credit or refund for (provided that inputs are subject to VAT). So they pay something. Moreover, small businesses that would gain by being registered can apply for voluntary registration if such a provision exists in the VAT law. A small business might want to register when it adds much of its value through purchased inputs (raw materials, machinery, etc.). In that case, being registered allows for the recovery of VAT on inputs. Voluntary registration would seem to restore equality of treatment between small and larger businesses. But it is not a given that there should be a voluntary registration threshold.

Equity considerations are not the only ones to bear on the policy decision to allow for voluntary registration or to set an actual turnover-based voluntary registration threshold. In the former case, the tax administration exercises discretion over which businesses can and cannot register voluntarily. In the latter case, the voluntary registration threshold specifies a level of turnover beneath the regular threshold but above zero. Businesses with turnover between the two numbers may register voluntarily subject to application and approval by the administration. Business with turnover below the voluntary registration threshold cannot voluntarily register. The first system is much simpler and practical and is usually the norm. For administrations with poor resources, managing voluntary registration may be yet another burden that they cannot afford. Rather than allowing for voluntary registration, the law might simply specify a lower regular threshold if the Ministry of Finance would like to rope in more small firms in the VAT system. Ultimately, it does not matter how the result is achieved. Prohibiting voluntary registration places the administration in an unfavourable light for businesses to see.

The discussion of thresholds often intersects that of special treatment of certain sectors such as agriculture. In many developing countries, agriculture gets preferential tax treatment for many reasons, some political and some practical. Many agricultural outputs are exempt from VAT. More problematic, many agricultural inputs are also exempt or zero-rated. This undermines the functioning of VAT and creates inequities between sectors. In addition, output and input concessions create unpredictable effects on prices, with some components of the supply chain (e.g., large chain supermarkets) large enough to actually charge VAT.

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Agriculture and food businesses illustrate the unnecessary duplication of special regimes. In situations in which the agricultural sector is made up of many very small producers and traders and a few large processors, wholesalers and retailers, a properly set threshold will already exempt most businesses from VAT anyway. Some countries sometimes appear unhappy enough to have businesses below the threshold so that they set up presumptive turnover taxes for businesses that post turnover below the threshold. Such taxes are a disguised attempt to effectively reduce the threshold and therefore face the trade-off noted earlier. It is hard to demonstrate that the extra revenues are worth the collection costs. More importantly, the non-creditability of presumptive turnover taxes shifts a modern tax (the VAT) back to an archaic gross receipts system whose shortcomings are effectively addressed by a VAT. Worse, those systems create interactions with other income and business taxes via a mess of alternative and/or minimum taxes and many administrations’ obsession to harmonize thresholds across all taxes when they can.

2.5 Frontier issues and concluding remarks

The above review of the Big-4 issues suggests that much of the potential improvement in VATs in developing country rests with the cleaning up of those frequently encountered design flaws. Yet, it is customary for tax administrations in developing countries to devote resources to more complex technical aspects of VAT such as real property, financial services, and imported services and e-commerce. Those are truly frontier issues for any developing country VATs. Those countries usually face institutional and resource constraints that make effective VAT policy and administration of such areas very difficult. For instance, some countries have laws on the books for reverse charges on imported services by registrants and related rules such as place of supply rules. Yet, they are not in a position to effectively enforce such rules. None of those
issues have good solutions in a developing country context. Their administrations should still focus on the minimum requirement of establishing clear deeming rules for imports and exports, and of course deal with the big-4 issues discussed above. I will not discuss frontier issues any further.

The big-4 issues are challenging to tackle because they present analytical, technical, and resource challenges. Those may pale in comparison to political challenges. Any cleaning up of major design issues will eliminate some entitlements and hence will be fought. As always, continuing education of all stakeholders of the tax system is very helpful. With reforms, marketing, advertising, and public relations become critical inputs and are needed to persuade consumers and businesses that the reforms are proposed for the greater good. This is something governments do poorly and there is a deep pool of historical examples to prove it. One proof is that the standard VAT advice package of a broad base, single rate, limited exemptions, only export zero rating, and high threshold is almost never followed literally anywhere.

3. When tax policy and administration clash

Much technical assistance on VAT treats tax policy and tax administration separately. For example, a tax administration mission may proceed and then be followed by a tax policy mission. The reverse order is also possible. There tends to be some certain cyclicality to this work and either type of mission can inform the other. Hybrid missions that consider both do take place but then their scope can be quite broad, which may undermine the focus of the advice. Governments also experience this kind of separation between policy (understood as VAT design
here) and administration. Discussion will focus on often encountered examples: registration and segmentation, VAT withholding, refunds, and the failure to apply statutory provisions.

3.1 Registration and segmentation

The traditional VAT design literature offers little policy advice on registration, often treating this as an administrative matter. As argued in the above discussion of thresholds, policy and administration are inseparable. Rules on registration and de-registration are fairly standard. Many countries also have provisions for voluntary registration, a good thing if it can be administered properly.

Policy also has little to say about the segmentation of registrants. Here, I depart from the common administrative practice of referring to taxpayers when meaning businesses registered for VAT. The former term perpetuates the misleading impression that businesses pay VAT whereas their role is to collect it on behalf of the revenue authority. Tax administration must understand the actual and potential (in the sense of including businesses that should be registered but are not) registrant population in order to do a good job administering VAT. One way of furthering understanding of the population is to segment the existing sample of registrants by level of turnover and analyse the contribution to VAT collections produced by different segment. This process is essentially the same as the analysis of the size distribution of registrants discussed in section 2.4 above. Segmentation may help target administrative efforts as compliance by large businesses presents challenges that are very different from those presented by small businesses. In some countries, large taxpayers units (LTUs) are one of the concrete segmentation tools. Typically, the LTU is responsible for data collection and maintenance for
large registrants as well as the administration of all taxes, not just VAT. In theory, more complicated models and methods are possible.\textsuperscript{13} In practice, data limitations constrain possible analyses to be rather crude. They should be conducted no matter what.

Another way of deepening understanding of the registrant population is to carefully track the impact of changing the registration threshold and/or the voluntary registration threshold on the size and composition of the sample of registrants. This highlights the information gathering capabilities of threshold decisions. Essentially, threshold changes help soften the information asymmetry between the tax administration and potential registrants. For the reasons discussed in section 2.4, it is never optimal for the administration to have the sample of registrants mimic the population. Rather, it should have an idea of the difference between the two at a given threshold level. When the law provides for penalties for the failure to register, the job of the administration is to bring non-compliant businesses in the register and assess penalties. Frequent changes in the threshold are not desirable but governments should still periodically index the threshold for inflation to prevent entry in the register of businesses that are too small to be worth dealing with. While space limitations prevent further discussion of threshold indexation, I must add that indexation is a policy decision that that can have impacts that are beneficial to weak administrations by preventing inflation-driven growth in the small business component of the register.

\textsuperscript{13} For a sophisticated theoretical study of partitioning that relates to thresholds, see R Kanbur and M Keen, “Thresholds, informality, and partitions of compliance”, (2014) 21 International Tax and Public Finance 536.
The reality of administration shows that segmentation and information gathering along the lines described above usually do not take place. Administrations collect a lot of data from VAT returns but the data sit in databases and files, when they are not compiled manually. Administrations are preoccupied with the day to day reality of administering VAT and often do not have the resources or incentives to conduct such analyses.

### 3.2 VAT withholding

Poor tax compliance behaviour, weak self-assessment, and deep distrust between the business sector and the tax administration provide the breeding ground for administrative shortcuts. VAT withholding is one of those. Administrations are sometimes (rightly) concerned that small registrants that make supplies to large registrants may not remit the correct amount of VAT collected to the revenue authority. They also may be concerned that audits of many small suppliers are too demanding and difficult. The shortcut is to assign the responsibility of withholding the VAT to the purchaser of the supply. Purchasers will tend to be large registrants that file monthly returns while sellers will tend to be small businesses that file quarterly returns. For those reasons, withholding may improve accrued collections in the short run.

Take the example of a large telecommunications company that buys office supplies from a small registered supplier. Under normal VAT rules, the small supplier charges and collects VAT on the supplies. With its next return, it must remit the difference between VAT collected on supplies and VAT paid on its own inputs to the revenue authority. With withholding, the mechanics are turned upside down. The supplier shows the VAT due on its invoice but the purchaser of the supply does not actually pay the VAT portion of the supply to the seller. Instead, the purchaser
keeps (withholds) the VAT portion of the transaction and is responsible for accounting for this tax as output VAT collected and remitting it to the authorities with its next return. In this case, the purchaser is the large telecommunications company and it is legally assigned the role of withholding agent. The presumption is that the large business will be more compliant than a large sample of small suppliers.

VAT withholding has a host of unintended consequences. In the long-run, it does absolutely nothing to develop voluntary compliance and self-assessment. It simply institutionalizes the distrust between the small business sector and the administration. It also empowers withholding agents with a responsibility they should not have. The policy also effectively takes the normal audit function off the hook and shifts the emphasis to auditing refunds. The proper model is to assume compliance and to audit the business if non-compliance is suspected after review of the VAT return.

Withholding produces two results that are particularly perverse. First, it makes auditing of withholding agents harder because it breaks the relationship between VAT collected (output VAT) and VAT paid on purchases (input VAT). VAT collected now consists of two pools: VAT collected on the agent’s own supplies and VAT withheld. The relationship between output VAT and input VAT therefore no longer relates to the nature of the operation and its value-addition potential. This renders data from past audits and industry benchmarks irrelevant. It creates obvious fraud opportunities whereby not all output VAT is declared. Situations also arise where government-operated enterprises refuse to remit the VAT withheld to the Treasury.
The second perverse consequence of withholding is the generation of excess credit positions for suppliers since they no longer collect VAT on supplies important supplies to withholding agents. Those suppliers still pay VAT on inputs but do not have a sufficient amount of output VAT to produce positive remittances. This means that those suppliers should be entitled to refunds. Those suppliers happen to be much more numerous, smaller, and harder to audit than large registrants tasked with the responsibility of withholding. The policy also breaks the link between output VAT and input VAT and renders benchmarks useless. The practice exacerbates the most difficult issue facing tax administrations in developing countries: refunds. Ultimately, VAT withholding dissimulates, rather than solves, deeper problems in administration.14

3.3 Refunds

In an ideal world, refunds are limited to registrants whose main activity consists of exports. This helps focus the audit of refund claims to businesses that mainly operate in the export sector. In the messier real world of developing countries, refunds arise from exports but also for other possible reasons: (a) zero-rated domestic supplies (see section 2.2 above); and (b) ex post rebates of VAT on purchases by non-profit organizations and charities that make exempt supplies. Tax administrations pay particular attention to refund claims, as they should. No matter the circumstances, they do not like to make refunds and tend to be slow at making them, if they refund at all. Refunds are subject to a host of restrictions that mean delays for claimants, with no payment of interest on outstanding refund claims, and sometimes long carry-forwards of excess credits to subsequent periods. Those practices penalize compliant businesses and cause cash flow problems.

14 For further discussion of this point, see Bird and Gendron, above n 4, at 190.
Over the years, several notable administrative strategies have been developed to mitigate the problem of refunds. Those include:15

- zero-rating supplies to exporters;
- large-scale cross-checking of invoices;
- certification of refund claims by CPAs;
- preferential treatment of good compliers;
- payment for large purchases through the banking system;
- VAT bank accounts; and
- deferring accounting for VAT on imported capital goods.

The last measure is probably the one encountered the most often in developing countries and there is much to recommend it as a practical solution in those circumstances. Depending on the context, some or all of those administrative measures (with the exception of zero rating of inputs, as noted in section 2.2) can help. They do not address the underlying problem if the refunds are not due to export. In that case, the measures address the symptoms, not the cause. They are no substitute for a vigorous risk-based audit program for refund claims as well as regular returns.

Experience shows that countries whose VAT law contains generous non-export zero-rating provisions, VAT rebates to exempt persons, or VAT withholding experience severe and

persistent problems with refunds as well as growing stocks of unpaid refunds. Those problems can be mitigated by the rooting out of fraudulent claims. In the absence of structural reforms, this is a recipe for perpetual turmoil. Harrison suggests a number of best practices for the management of refunds in developing and transitional countries.\textsuperscript{16} Those include a mixture of well-known standard tax policies and core administrative policies. In fact, most administrations in developing countries do not follow \textit{any} of those best practices. An important example is the “Verification of VAT refund claims should be a component of a wider audit program”.\textsuperscript{17} That is when the program actually exists. I have recently encountered a situation in which almost all VAT audits in a given year were refund audits. In this case, fears of refunding disabled an already very weak audit program.

Adding fuel to the fire, many non-export refund problems arise from claims by numerous small businesses involved in the food trade and any other trade in which final supplies are zero-rated. Those sectors are typically very hard to audit to begin with (small traders, cash transactions, poor books and records). The practice of refunding VAT to exempt non-profit organizations and charities also opens up the refund through to numerous small organizations. If their supplies are exempt, they should not recover VAT on purchases just like any other exempt or non-registered person. And last but not least, I must reiterate the role of VAT withholding as a refund generator. The practice should be called \textit{VAT reckoning}: after the bump in accruals, refunds come.

\textsuperscript{16} Harrison, above n 15, at 156.

\textsuperscript{17} Harrison, above n 15, at 157.
The only real solution to refund problems not caused by exports is to reduce the scope of zero-rated domestic supplies. The complete elimination of zero-rated supplies outside foodstuffs (e.g., washing machines, computer equipment, paper towels, etc.) is recommended and makes good sense. The case of foodstuffs is much more politically sensitive. A compromise position is to subject all processed foodstuffs and less important unprocessed foodstuffs to the standard rate, and convert a small list of previously zero-rated raw and unprocessed foodstuffs into exempt supplies. This compromise eliminates refund claims. In addition, it does not treat very small suppliers any differently: they would be under the threshold anyway so their supplies would be exempt. Provided that their inputs are subject to the standard rate, some VAT is collected from the sector in question. The exemption of a small list of raw and unprocessed foodstuffs is preferable to a reduced rate for reasons of ease of collection and administrative simplicity.

3.4 Failure to apply statutory provisions

Perhaps the most widespread pathology of real VATs on developing countries is the fact that numerous statutory provisions of the VAT law and regulations are not applied in practice. Over time, there has been some convergence in the drafting style and contents of a typical VAT law. Administrative and operational convergence have not followed suit, however. The way VAT is operated on the ground varies wildly from country to country and often departs very significantly from stated policy and the letter of the law. To the outsider, this is the most vexing problem. Interest and penalty provisions provide an excellent case in point: they are very rarely applied in developing countries. There can be many explanations for this but one comes up frequently: courts often rule in favour of registrants. So rather than have the law amended, the administrations give up and simply do not apply the provisions. In some cases, payment stacking rules for interest (interest, penalties, principal) are also not applied. Excessive discretion on part
of the commissioner of revenue is one source of departure from statutory provisions. It is sometimes encountered in matters of registration in order to limit voluntary registration (not necessarily a bad thing in light of the foregoing discussion). The end result of all those departures is that actual administration goes counter to policy intent and the policy side rarely responds.

4. **When coordination breaks down**

Real VATs in developing countries also depart from the good VAT due to instances in which coordination between government agencies does not take place or breaks down. Sometimes, open conflicts arise.

4.1 **Who is responsible for VAT policy?**

At the top, the very first source of tension concerns the primary responsibility for VAT *tax policy*. In the idealized model of a proper division of labour, the Ministry of Finance has primary responsibility for the design of tax policy, including all the analysis, modelling and simulation work that is required to elaborate policy. In that model, the tax administration gets consulted and provides feedback and data. In practice, the Ministry of Finance sometimes does this work, sometimes it does not. More often than not, the administration is in effect tasked with developing policy. One major problem with this model is one of perspective and incentives. Finance has a broader perspective and is responsible for taxation as well as revenue and expenditures. The tax administration has much narrower goals.
In a typical conflict scenario, the Minister of Finance first signs a decree (or statutory instrument) to zero-rate several additional foodstuffs and add to an already long list of zero-rated foodstuffs. The administration must deal with the change but does not obtain additional resources to do so. More work on refund claims diminishes the administration’s effectiveness in raising revenue. Finally, the Minister of Finance blames the administration for the poor revenue performance. And so it goes. This poor coordination follows the policy cycle: clean VATs at inception work quite well, but then concessions pile up and the administration has difficulties operating the VAT. Some reforms clean things up, and the cycle starts again. It is also important to mention that the Ministry of Finance is usually responsible for the budgets of the revenue authority. I have never met representative of a revenue authority who said they had enough resources to do their job. One can see that chronic underfunding of tax administrations seems to be the rule in developing countries, with acute shortages of qualified personnel, computer hardware and software, and so on. Political support is not always present.

There have been some positive developments though. Ministries of finance are more open to the good practice of preparing VAT tax expenditure estimates. Sometimes tax administrations conduct the analyses of revenue foregone due to exemptions and non-export zero rating. Ultimately, the Ministry of Finance must be responsible since the tax expenditures result from policy deviations from the reference VAT design.
4.2 Discretionary waivers

One situation in which VAT operations depart from statutory provisions is illustrated by the granting of discretionary waivers. A waiver is defined as the elimination of the obligation to collect tax. Waivers are granted for a number of reasons. Discretionary waivers are granted at the discretion of the Minister of Finance and usually through a decree or statutory instrument rather than a law passed by the legislature. The beneficiary may receive a letter of exemption to prove its entitlement. It is important to place limits on what constitutes a waiver. For example, VAT exemptions that are mandated by international organizations and conventions, exemptions for diplomats, re-import of personal belongings, etc. are called unconditional exemptions. They do not depend on the Minister’s discretion. The tariff usually enumerates the line items in question.

In contrast, conditional exemptions are those granted at the Minister’s discretion—those are usually not codified in the VAT law or regulations—and can apply in a variety of situations: exemption for the President of the Republic; exemption for specific imported capital goods; exemption under an investment agreement (tax incentive), exemption of supplies to a particular organization or person, and so on. Most conditional exemptions provide some kind of favourable treatment to some businesses while others do not benefit from it. As such, they undermine the equality of treatment of businesses under the VAT system. They also undermine revenues since goods imported as exempt have may never attract VAT once released in the domestic economy since there is no input VAT to claim and no cross-checking possible between import VAT and VAT on purchases by importers. Ultimately, serious benefit-cost analyses are rarely, if ever, performed to support conditional waivers.
4.3 Incentive regimes

Tax incentive regimes in developing countries often contain a discretionary conditional VAT waiver component, in addition to customs duty waivers and sometimes excise tax waivers. Those waivers can work at either or both ends: waiver of taxes on purchases, and/or waiver of taxes on supplies. Those regimes are sometimes called investment agreements because businesses that invest in selected sectors (e.g., export, tourism, free zones, etc.) are offered a portfolio of tax incentives that include waivers of various indirect taxes (as above), income tax holidays and sometimes other forms of subsidies.

Given that VAT is a consumption tax, the inclusion of VAT in incentive regimes is puzzling. It should not be seen as a business cost but it often is. Part of the explanation is that the VAT is often misinterpreted by businesses as a cost of production although a well-designed VAT should be paid by consumers only. Part of the explanation is that businesses perceive the ability to not charge VAT on supplies as a competitive advantage over businesses that have to because they are not part of a similar investment agreement. Those perceptions are not all that wrong as some VATs with extensive domestic zero-rating (on both outputs and inputs) and important exemptions resemble an extended excise system on luxury goods much more than a VAT.\(^\text{18}\)

There are several problems with including VAT in incentive regimes. First, the destructive tax competition that results undermines the best broad-based tax (along dimensions of yield, 

\(^{18}\) Cnossen, above n 1 , at 1077.
efficiency, and administrability) available to developing countries. It can also undermine entire sectors when uncoordinated incentives in a region results in a massive loss of tax revenue to interests not based in the region. One can think here of incentives in the tourism industry in the Caribbean region.

Second, the benefits of incentives are questionable and hard to measure. Given the loose administration and monitoring of many of these regimes in developing countries, one can doubt the claims to benefits. The costs are clear upfront as well as down the road, revenues are foregone and possibly in increasing amounts if ventures do well. Businesses which are often quite large disappear from the normal tax system with little prospect for transition to the normal system. In some situations, incentives such as income tax holidays may last longer than the average life of a project. This leads to a hold-up problem for the government as beneficiaries of incentives sometimes threaten to pull out of a country unless a new round of incentives is given to continue operations. Some businesses carry out the threats as is evidenced by the presence of abandoned resort properties in some countries. Recent extensive research on the subject does not support the hypothesis that tax incentives are effective in achieving meaningful economic objectives.19

Finally, the waiver of normal tax obligations under incentive regimes and investment agreements removes businesses that would be excellent VAT collectors from the system, thereby exerting more pressure on other large businesses and small businesses in the normal system to produce VAT collections for the authorities. The waiver of taxes on project inputs also create fraud opportunities whereby inputs not needed may be resold VAT-free in the domestic economy. Some investment agreements include quotas of various construction materials, the number of bricks or cinder blocks, for example. Who will count those once a project’s construction is completed?

4.4 *Para-fiscal levies*

Situations arise in which government agencies other than the Ministry of Finance are responsible to collect major taxes such as the VAT on transactions that relate to activities under their purview. This practice, although not widespread, is sometimes encountered in sectors such as forestry, mining, petroleum, tourism, and telecommunications (for the excise). These levies may be earmarked for specific purposes. This makes no difference however as the process is faulty and unaccountable. It can be very challenging for the Ministry of Finance to monitor those collections. The main problem therefore is that there is no guarantee that some or all tax collections will reach the Treasury. It is best practice to have all taxes under the responsibility of the Ministry of Finance. Other ministries can certainly continue to collect user fees and royalties if they wish.
4.5 Coordination with other indirect taxes

The three most important indirect taxes play different roles which affect the calculation of taxes assessed. Cnossen clearly contrasts those roles.20 “Viewed in combination, the protective (and revenue) function of import duties should be given priority, followed by the revenue and resource allocation function of excises, and lastly, by the revenue role of consumption taxes”. As a result, the taxes are cumulative. This favourable arithmetic produces a good result for the treasury. Tariff and tax calculations in customs information systems usually perform those calculations properly. In some cases, unintentional programming errors cause the amounts of tax assessed to be too low (usually). Conditional tax waivers on all three taxes or any combination thereof reduce the revenue potential of indirect taxes. Revenue losses of this type are highly problematic in developing countries given the weakness and lack of coverage of the income tax, especially in respect of real property ownership, capital income, and professional income.21 Customs is the fastest and safest way of securing revenue. Perhaps the physical distance between the Ministry of Finance (government district) and the Customs office (port) explains the lack of common understanding of this absolutely critical point.

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21 For a fascinating discussion of professional income, see Keen, above n 11, at 25.
4.6 Data integration between administrations

The classic VAT coordination problem occurs between the domestic tax administration and customs. The objectives, methods, systems and cultures between the two organizations differ considerably, especially when the two organizations are separate departments. Even in the agency model with both administrations under one roof, major differences persist. The distinction does not matter much. One cumulative result of all those differences is that the relationship is sometimes chilly and cooperation sub-optimal. A silo mentality often prevails so conceptually-speaking, the challenge resides in linking the silos.\(^{22}\)

In developing countries, customs administrations often enjoy several advantages over the domestic tax administration: well-accepted global processes, modern information systems (e.g., ASYCUDA World, or Automated System for Customs Data), a culture of rigour and strong work ethic, and strong autonomy and powers.\(^{23}\) Domestic tax administrations rarely have all of these characteristics. This may contribute in making communication and coordination difficult. In terms of protection of revenue, domestic tax administrations have a lot to gain in outstanding work by the customs administration. Even more important, domestic tax administrations have a lot to gain by understanding and using customs data for domestic VAT enforcement. Yet, this

\(^{22}\) I owe this expression to Richard Bird.

\(^{23}\) Customs administrations also face challenges with revenue mobilization, if not as serious as for domestic tax administrations. See: G Montagnat-Rentier and G Parent, *Customs administration reform and modernization in francophone Sub-Saharan Africa, 1995-2010*, IMF working paper WP/12/259, October 2012; and J Zake, *Customs administration reform and modernization in anglophone Africa—Early 1990s to mid-2010*, IMF working paper WP/11/184, August 2011.
understanding and sharing face an enormous constraint: data and systems are very rarely integrated between the two organizations. There are good reasons for this situation. Due to the lack of global standards, customs information systems have evolved much faster and many countries use a version of ASYCUDA. Domestic systems are a hodgepodge of components and systems, some dating back to the mainframe era. In addition, many of the processes behind domestic tax information systems are manual and vulnerable to human error. In this context, it is very difficult to cooperate to prevent fraud on: imported VAT; VAT obligations once imported goods are released in the domestic economy; and bogus re-export with VAT refunds. Undervaluation of imports is a major customs issue that is best addressed by cooperation between customs administrations, not domestic ones.

The ideal notion of a data integration project is to create a platform through which automated reports prepared using customs or domestic tax data can be exchanged electronically and easily between the two administrations with a minimal amount of time lag. Given the current environment, the benefits and costs of this enterprise are distributed asymmetrically: domestic tax administration have more to gain than customs, but also face higher costs and barriers due to their technological backwardness and lack of advanced information technology, equipment, and human resources and skills. The advantages of integration are many. An example of a single transaction can illustrate. If a domestic tax administration can obtain the electronic customs documentation that shows the VAT an importer paid on a shipment of goods that passed through customs, it can then cross-check the input VAT credit the importer will claim on its next VAT return to ensure that the numbers match. Domestic tax administrations will never have the resources to conduct such cross-checking on a large scale. They may, however, focus on
shipments of goods that have a high value to weight ratio such as mobile phones, small electronics, cigarettes, etc.

Customs administrations can also make operational changes to strengthen VAT control. Examples include: full coding of goods requesting exemptions; developing VAT control strategies that are aligned on customs processes; adding the tax identification number of importer on customs declarations; and creating detailed importer profiles. Of course, extensive waivers of indirect taxes at customs undermine all the benefits from improved VAT control and data integration, however rudimentary or advanced.

5. Conclusion

Kathryn James’ hypothesis that the rise of VAT cannot be explained by its own merits is really a matter of perspective.\(^{24}\) The VAT’s own merits for outside observers (lawyers, economists, academics, etc.) differ from its merits to policy-makers and bureaucrats. For the latter group, the VAT is appealing for its revenue potential and, more importantly, for being an ideal vehicle to attempt to meet objectives other than raising revenue. The VAT is an easy target for appropriation by interest groups.

The VAT is poorly understood by consumers, much more so than the income tax. Politicians may not understand VAT well but they understand that the VAT—as implemented in developing countries—is better understood but disliked by businesses, especially small ones due to the fixed

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\(^{24}\) James, above n 2.
nature of compliance costs. The VAT is not immediately visible to consumers but they are well aware of it when they look at their invoices and from complaints by trade organizations and media stories about the VAT punishing the poor (VAT is regressive) and small businesses (VAT imposes high fixed compliance costs). Every business owner is also a consumer.

Politicians who peddle additional zero rating of domestic supplies rely on the VAT is regressive narrative and inflict permanent damage to their best tax. I am always amazed when I read local newspapers and find (usually negative) stories about the VAT. As a result, any perception of benefit conferred through the VAT (zero rate on this, zero rate on that) is also highly visible. Conventional wisdom on VAT has been that it is less vulnerable to rent-seeking than income taxes, property taxes, resources taxes and royalties, and so on. Judging from the real VATs we see, especially in developing countries, the conventional wisdom no longer persuades. In contrast, changes in the income tax have a much less widespread popular appeal because the majority of the low-income population in a developing country would not pay it anyway. As I have concluded elsewhere:25

The observation that real VATs differ from the good VAT in a qualitative (only) sense is not that important. What is important is that the VAT is a highly adaptable and scalable revenue tool. Developing countries with different industrial structures have different real VATs…. In countries with no capacity to levy a decent income tax… a flawed VAT may be the best to hope for, at least for now.

25 Gendron, above n 2, at 8.
Given the abuse the good VAT has been subjected to in so many countries, it is truly remarkable that so few countries have abandoned the tax permanently. This is faint praise and it does not acknowledge how much work is left to be done improve so many of the real VATs in developing countries. They will do well to actively engage in a vigorous and sustained continuous VAT improvement program. It is worth it.