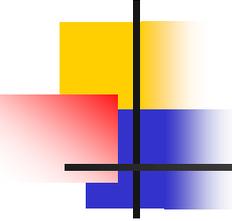


VAT Lessons from European Experience by Sijbren Cnossen

14 July 2016, 9:45 – 10:15 hrs.

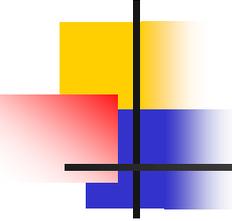
Two topics:

- Requirements for a “best practice” VAT
- What is wrong with the EU (and your?) VAT?



Requirements for a best-practice VAT

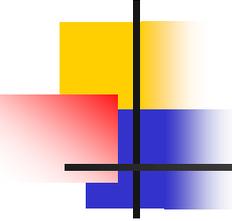
1. VAT should be revenue productive
2. Its impact should be neutral
3. VAT should be applied on a destination basis
4. VAT should be simple
5. Collection costs should be low
6. And so should compliance costs



Five lessons from European experience

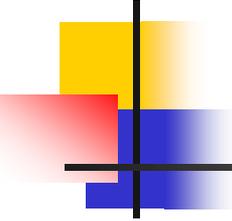
Five lessons from European Experience

1. Limit number of exemptions
2. Beware of rate differentiation
3. Provide for high threshold
4. Coordinate VATs in common markets or federations
5. Target enforcement controls



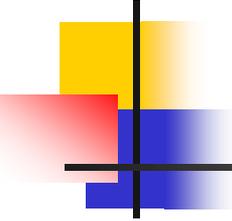
Lesson 1: Limit number of exemptions (1 of 2)

- Europe exempts health, education, culture, gambling, postal services, public broadcasting, finance, insurance, housing, agriculture
- Exemptions were introduced because it was considered “not done” to tax (semi-) public bodies
- This was a serious mistake, because exemptions cause under- or over-taxation, can become tax on exports, distort input choice, penalize outsourcing, and promote “exemption creep”
- Also, exemptions greatly increase administrative and compliance costs



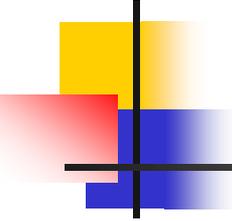
Lesson 1: Limit number of exemptions (2 of 2)

- Advice: confine exemptions to primary education, housing (except if newly created), life insurance, and perhaps financial services
- Merit good argument not valid if activity subsidized
- Regressive effects can be offset through income tax and social-benefit adjustments, or by using revenue to finance universal health care or targeted education subsidies



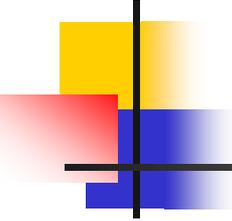
Lesson 2: Beware of rate differentiation (1 of 2)

- Europe started with highly differentiated rate structures to mimic burden distribution of old turnover taxes, which discriminated in favor of foodstuffs and other “worthy” products
- Zero or lower rates mainly benefit the rich and complicate administration
- SA Katz Commission: “Providing relief to the poor through exemptions and VAT zero rating is likely to be unsound tax policy and ineffective social policy”



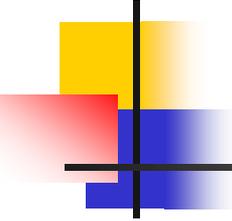
Lesson 2: Beware of rate differentiation (2 of 2)

- Advice: tax all food for human or animal consumption, consumed on or off premise, at –
 - standard rate
 - at lower-than-standard but positive rate, except alcoholic beverages and soft drinks (second-best)
- Do not zero-rate foodstuffs and new housing
- Zero rate major agricultural inputs
- Do not introduce higher-than-standard rates



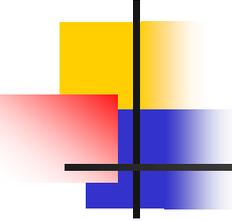
Lesson 3: Provide for high threshold (1 of 2)

- Most EU countries have no or low thresholds (€5,000) on the philosophy that every business should be on the tax roll
- Low thresholds greatly increase administrative and compliance costs (80% of VAT revenue is collected by 20% of registered firms)
- Compliance costs are disproportionately higher for smaller businesses



Lesson 3: Provide for high threshold (2 of 2)

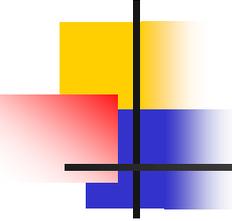
- Advice: threshold of, say, \$100,000 would reduce number of potential registrants to perhaps less than 40%
- Exempt small businesses would account for less than, say, 3% of total VAT receipts, but since they would be taxed on inputs, VAT revenue foregone would be less than 1%



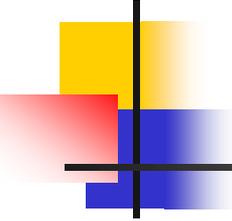
Lesson 4: Coordinate VATs in Regional Economic Communities

- European as well as Canadian experience indicates that states/provinces can operate their own VATs without or alongside a federal VAT
- REC members should zero rate exports to other states and tax imports from other states (destination principle)
- Cross-border audit controls are useful in REC

Lesson 5: Target enforcement controls



- European experience indicates that VAT fraud and evasion accounts for some 11-12% of collections under a full compliance VAT
- VAT fraud is dominated by shadow economy fraud (4-5%), contrived insolvency fraud and abuse of tax credits (4%), but not by carousel fraud (1-3%)
- Carousel fraud lower in RECs in view of border controls



Conclusion

Don't do what the Europeans did, but examine VATs in countries, such as New Zealand, Singapore, and South Africa which have broad-based VATs (with very few exemptions), impose a single rate, and have a sizable threshold