

Value Added Taxation in Developing Countries

edited by
Malcolm Gillis,
Carl S. Shoup,
and Gerardo P. Sicat

A World Bank Symposium

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The World Bank
Washington, D.C.

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and Development/THE WORLD BANK
1818 H Street, N.W., Washington, D.C. 20433, U.S.A.

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Manufactured in the United States of America
First printing June 1990

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Library of Congress Cataloging-in-Publication Data

Value added taxation in developing countries / edited by Malcolm
Gillis, Carl S. Shoup, and Gerardo P. Sicat.
p. cm. — (A World Bank symposium)
Includes bibliographical references.
ISBN 0-8213-1410-6
1. Value-added tax—Developing countries. I. Gillis, Malcolm.
II. Shoup, Carl Sumner, 1902– . III. Sicat, Gerardo P. IV. Series.
HJ5715.D44V35 1990 90-12348
336.2'714'091724—dc20 CIP

Preface

In recent years the value added tax (VAT) has come into wide favor as a desirable tax vehicle in developing countries. During national tax reforms the VAT has often been adopted to replace more complicated sets of taxes on the sale of commodities and services.

Because of the growing interest in the VAT, the World Bank organized a conference to evaluate the issues and principles relevant to developing countries. The principal objectives were to assess the experience of both developed and developing countries that have adopted this tax and to extract the useful lessons of experience to guide tax reform in developing countries. This volume contains papers from that conference. The chapters provide a cross-section of the issues and describe the state of knowledge on the VAT. Researchers and policymakers can thus gauge the direct relevance of a VAT to developing countries with different levels of administrative capacity. It is hoped that the collection will help foster improved taxation and efficient allocation of resources in developing countries.

Support and interest in this project was robust in the World Bank, especially from operational colleagues

who work on tax reform issues. From the beginning, encouragement was received from Anne Krueger and Gregory Ingram. Cooperation from the International Monetary Fund was extended by Vito Tanzi, of the Fiscal Affairs Department, and also Alan Tait, who directly contributed to the meeting.

The list of contributors attests to the number of international specialists and other experts who helped to make this meeting productive. In addition, the following fiscal economists and tax experts added substance to the discussion or to the planning of the conference: Richard Bird, Richard Goode, Arnold Harberger, Stephen R. Lewis, Richard Musgrave, and Oliver Oldman.

For bringing the manuscripts to final fruition, we would like to thank Daisy Paul, Indermit Gill, and the publications staff of the Bank.

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Summary

Carl S. Shoup

The chapters in this volume fall into four groups. The first three chapters are on general issues in value added taxation: choices to be made in selecting a particular type of value added tax (VAT), effects of value added taxation on the price level and on the balance of payments, and tax incidence and income distribution theory applicable to such taxation.

The second group of six chapters deals with certain lessons from, and certain unresolved problems shown by, experience in developed countries with the VAT: border tax adjustments, treatment of farmers and small firms, services in general, the financial sector, housing, and the possibilities for a VAT at the state level in a federal system.

Third is a group of five chapters on lessons learned in certain developing countries that have used a VAT. These cover two countries in Latin America (Argentina and Brazil), one in Asia (Republic of Korea), and one in Africa (Côte d'Ivoire) as well as the general Sub-Saharan region of Africa.

The last group covers certain administrative and compliance problems in implementing a VAT. A general survey is followed by chapters on the experience under Colombia's VAT, the development of a computer-supported VAT information system in Indonesia, and the chief administrative issues in the United Kingdom, with data on compliance and administrative costs.

General Issues on the VAT

In the initial chapter of the first group, Carl Shoup describes the main choices that must be made in constructing a VAT. For example, shall it be restricted to

consumer goods, or shall it also include the net addition to the stock of producer goods? Shall the tax be computed for each business firm by subtracting from that firm's sales the purchases it has made from other firms or, instead, by adding the amounts paid by the firm to its factors of production? This continues through eight sets of choices. The different aims are achieved by each choice within a given group. Not every possible choice within any one set is compatible with every choice in each of the remaining sets, and this incompatibility problem among choices is depicted in tabular form.

In what countries, if any, did the introduction of a VAT appear to cause a rise in the price level? In what others did it seem to accelerate an already existing inflation or, at the other extreme, have no effect on the price index? The same questions arise about an increase in the rate of an already existing VAT. Alan Tait gives examples of each of these cases in some detail and suggests grouping the VAT countries according to these categories. He concludes that clearly it is possible to introduce a VAT as a substitute tax without raising the consumer price index or accelerating its increase, depending on circumstances. A companion question is the effect of a VAT on the foreign trade balance. Here, general analysis suggests that the net advantage or disadvantage of introducing a VAT is unlikely to be large. These two analyses are backed up by tables of VAT revenue, country by country and year by year, as a percentage of total tax revenue and of gross domestic product (GDP).

Who bears the burden of VAT? Is that tax at all progressive or inherently regressive? Charles McLure, Jr.'s chapter sets out the familiar conceptual and statistical

problems facing any effort to answer these questions. It is necessary to distinguish carefully between questions that call for general equilibrium analysis and those that do not and to be quite clear about the questions when using general equilibrium analysis. These warnings are cast in terms of taxes in general. For the VAT, there are certain common suppositions, such as general coverage, that are in fact not usually valid. As a consequence, a partial equilibrium analysis focused only on sales to consumers is not satisfactory, and a general equilibrium framework that allows for input-output relations is necessary—but this kind of analysis is yet to be done. All in all, McLure sets up enough warning signs to exercise the hardest traveler in this difficult territory.

Lessons from Developed Countries

How shall international trade be treated under a VAT? Shall imports be taxable and exports exempt (following the destination principle and taxing expenditures on final goods within the country) or the reverse (following the origin principle and indirectly taxing factor incomes earned within the country)? In a thorough treatment of interjurisdictional coordination of VATs, Sijbren Cnossen shows that the answer depends on attitudes toward interjurisdictional equity, locational neutrality, and administrative feasibility. He reaches a rather exciting conclusion, not at all in the traditional line of thought, about the last of these points: the destination principle may be implemented without border controls (contrary to established doctrine), so that there is no need to move to the origin principle just to eliminate such controls within a common market. Acceptance of this conclusion would relieve the members of the European Communities (EC) from the task of agreeing on a common level of VAT rates. Cnossen also analyzes the somewhat different coordination problem facing the states of the United States, which employ the retail sales tax rather than the VAT.

Small business firms, especially those without a fixed place of business, and farmers in general commonly find compliance with a VAT so onerous and evasion so easy that they are granted either exemptions or special regimes in all countries using this tax. John Due's country-by-country description and general analysis of the problem serves as a guide to any country introducing a VAT. The techniques include outright exemption, registration but no payment of tax, computation of tax by using sales or purchase data instead of using value added directly, and negotiation with tax officials. There are similar options for treatment of farmers.

These techniques are examined as they are used for VATs first in the European Common Market countries and then in other parts of the world, notably Latin

America. Retail, wholesale, and manufacturers' sales taxes are covered, and the several dividing lines available are critiqued (sales volume, capital investment or profit, mechanization in production, number of employees, and type of industry).

The sale of services, as distinguished from the sale of tangible goods, is an important part of any country's economy, yet it has largely been left outside the scope of the broadly based taxes other than the VAT. One of the virtues of the VAT is therefore commonly said to be this inclusion of services, which, in varying degree, is almost universal in countries using this tax. In the first comprehensive analysis of service taxation under a VAT, John Kay and Evan Davis conclude that the difficulties encountered under the VAT are not much greater, if not fewer, than under other types of tax, but that the experience in various countries shows that the effort has been worthwhile and that services can and should be included, even though special regimes may be necessary in certain cases. Indeed, complete exemption of all services would exclude from the tax some 45 to 78 percent of a country's GDP, as shown by a table for thirty-two countries (purely consumer spending on services is a much smaller proportion, but still very significant). Kay and Davis compare the ability of a VAT and certain other taxes to cover services adequately; examine the relevance of self-supply, location of supply, and public provision and purchase of services; and then consider eleven types of service under a VAT: retailing, health and education, postal service, secondhand goods, betting, insurance, travel agencies, advertising and the media, durable goods, housing, and financial services. Insurance, housing, and financial are noted only briefly, since they are covered in detail in other chapters.

Perhaps the most difficult sector of all to deal with under a VAT is financial services, notably banking and insurance services. In a comprehensive and detailed analysis, Malcolm Gillis concludes that truly satisfactory solutions have not yet been found in Europe and that the positive lessons for developing countries are therefore few. This is especially unfortunate, since inappropriate application of the VAT to financial services may easily inhibit development of the financial sector. This is made clear by showing the role of these services in developing countries. The European custom of exempting (zero-rating) banking services and insurance services provokes economic distortions—some favoring, some handicapping, those industries. The regimes of Israel and New Zealand provide no easy solutions. The particular difficulties of attempting to achieve neutrality are examined, with special attention to international capital mobility in an open economy, which is considered important enough in many developing economies to warrant close attention to the likely effect of a VAT in this area. Gillis examines the three options

for a developing country (full taxation, exemption, and zero-rating) and, after a detailed analysis, concludes that, apart from administrative considerations (chiefly, making tax refunds), the zero-rating technique is preferred. If this is administratively infeasible, four alternative regimes are suggested, but not urged.

One sector of the real estate market, housing and housing services, is covered by Robert Conrad, who notes problems arising under the current treatment in European VATs and suggests the alternative of a tax on housing rather than on flows of housing services. Housing causes problems under a VAT because of the prevalence of owner-occupied housing, which calls for some VAT provisions that will reach consumption yet not deny credit for VAT paid at a previous stage. In addition, housing involves small firms and self-construction, which raises administrative problems. The practice in the EC countries is quite mixed, for both housing purchased by the occupiers and housing supplied by rental. In the nine countries covered (that is, excluding the more recent members), housing sales are treated alike in the major provisions by only two countries; there is somewhat more, but far from complete, uniformity in leasing and letting. Much of this chapter is devoted to the proposed alternative: a VAT restricted to sales of housing, old or new, which creates no incentive to change the allocation of housing between owner-occupiers and renters.

Can states, in a federation, draw on the VAT? Satya Poddar compares three options:

- A national VAT, uniform across the country, with the states sharing the revenue according to some formula
- State VATs, levied on the financial base of each state, but using either the origin or the destination principle
- A joint national-state VAT, with the national tax levied uniformly across the country and the states setting their own rates.

Poddar favors the third option, because it allows each state to levy the rate it desires, while a uniform base is maintained across the country. The revenue-sharing option allows the total tax revenue to be allocated according to fiscal need and capacity, not just according to where the final sale occurs. It would also be the simplest to administer. The second option would give power to the states to determine just what should be taxed under the VAT in each state, but this would markedly increase administrative and compliance problems. The issues that would arise if all states used the origin principle under this option are examined, first, for the case in which the VAT rates are uniform across states and, second, for the case of variable rates across states. In this connection, the experience of the Brazilian

states with the VAT is reviewed. The analysis is repeated for the case in which all states use the destination principle, with special attention to the zero-rating of interstate sales and the tax-credit clearance mechanism to avoid a need for border control on such sales. This option of independent state VATs not linked to a national VAT is a complex one.

Lessons from Developing Countries

Experience with the VAT in certain developing countries is discussed in six chapters, each of which is devoted to a particular country rather than, as in the preceding chapters, to a particular problem. Osvaldo Schenone concentrates on four areas in the Argentine experience with the VAT: international trade, the type of VAT, regional and sectoral promotion, and agriculture. In the last area he shows that excluding farmers from the VAT (until 1983) distorted resource allocation despite the presumptive tax credit granted to users of agricultural products. Schenone also traces the history of the VAT in Argentina, where it replaced, not a turnover tax, but a sales tax on manufacturers, construction, and certain services, with limited provision for avoiding multiple taxation. Since this tax was never a main component of the tax system (in contrast to the turnover, "cascade" general sales taxes of the European countries), the VAT as a replacement tax has, not surprisingly, occupied a modest place in the Argentine system. The Argentine VAT is exceptional also because it is an income type of VAT, although the depreciation deductions it allows seem so generous that the tax becomes a hybrid income-consumption type of VAT. Evasion has apparently been a problem, judging by the facts that the VAT revenue as a percentage of GDP has been low (only about a fifth of the tax rate, even considering the exemptions) and that the base for the income type of VAT is, of course, considerably less than the gross national product (GNP).

Brazil is unique in employing two VATs: one at the federal level, restricted to manufacturers, the other levied by the states on all stages, including retail. Carlos Longo describes how these taxes came into being in 1967 and replaced federal wholesale consumption taxes and a state turnover cascade tax. He pays particular attention to the use of the origin principle by the states, which is exceptional among VAT jurisdictions, and concludes that the destination principle should be substituted. The numerous restrictions and special provisions in the states' VAT indicate some of the problems encountered in trying to use a VAT at this level. Yet the tax is thought to be well anchored in the state fiscal system, and chief issue seems to be whether the states shall be granted more flexibility in setting their rates and defining the tax base.

Korea adopted a VAT in 1977 to replace a cascade type turnover tax and several taxes on particular commodities. Seung Soo Han describes the changeover procedure, which involved elaborate preparations to acquaint the business community with its obligations under the new levy. The preparations included a movie about the VAT, which was shown in all the movie theaters in Korea, and three trial runs on filing the new tax return, which engaged virtually every potential taxpayer. Much research went into framing this change in tax policy. Han's point-by-point description of the VAT tax base and the administrative techniques used to collect the tax afford an unusually clear picture of a VAT in operation. For each transaction computers cross-checked the purchase invoice against the sale invoice; in the second half of 1983, 20.9 million tax invoices were checked in this manner. The new tax also has many aspects to ensure equity, and it has influenced prices, exports, and investment. At a 10 percent rate and with a special regime for small taxpayers, the VAT yields about one-fifth of total national and local tax revenue. Clearly, it seems a permanent part of the tax system. Problems that remain include the sometimes fraudulent use of the small-taxpayer regime, the exemption of farmers, fishermen and the financial sector, and the untaxed personal services of lawyers and other professional people.

The VAT in the Côte d'Ivoire exemplifies the limited type of VAT that developed gradually and without much difficulty from a series of cruder taxes. It started as a cascade type of turnover tax in 1950; evolved into a production tax during 1957–59, while the country was a territory of the French West African Federation; and then, at independence, became a VAT that covers only manufacturing and other production, but which is supplemented by a tax on services that is on total receipts, not just value added. Betty Heian and Terry Monson describe this development in detail, present the structural features of these two taxes, give buoyancy and elasticity estimates (relatively high), and evaluate the taxes with respect to equity (they are progressive because the food segment of family budgets becomes less important as income increases, and agriculture and fisheries are exempt) and resource allocation (they are more nearly neutral than the predecessor production tax). These two taxes may possibly develop into one comprehensive VAT as the informal sector becomes more integrated with the modern sector. This may be gradual, however, since the Côte d'Ivoire remains primarily an agricultural nation that exports a large part of its output.

In their chapter on consumption taxes in Sub-Saharan Africa, Zmarak Shalizi and Lyn Squire develop some general rules of action to guide these countries toward a more extensive and better organized system of consumption. The VAT is noted only briefly, but the reader may infer the significant role it might play in

these countries in the kind of tax reform Shalizi and Squire advocate: building on existing instruments with noncascade features and coordinating trade taxes with domestic taxes to mimic a consumption tax. For example, they suggest increasing taxation of domestically produced consumer goods rather than imposing import duties on intermediate goods as a way to reduce effective protection; minimizing the number of tax changes over the years to reduce uncertainty; and, in particular, avoiding short-run tax measures that will ultimately have to be reversed if an acceptable consumption tax is to be constructed. Fifteen countries have some kind of tax that allows for exemptions or credits as a minimum on domestic interfactory sales and in some cases on imported inputs, which provides a beginning for a system that will meet the authors' objectives. The general propositions advanced are illustrated by the case of Malawi, which uses the "ring" system for its single-stage manufacturers tax.

Administrative Issues and Implementation of a VAT

In a detailed, highly organized analysis, Milka Casanegra de Jantscher describes the problems encountered in administering a VAT in developing countries. The relative importance of the VAT is given for each country in a table presenting GNP per capita, VAT revenue as a percentage of GDP and of total tax revenue, the VAT rate or rates, and the year of introduction. Three structural features of the VAT have major administrative implications: number and level of tax rates, exemptions and zero-rating, and the treatment of small enterprises. Introductory measures needed to ensure success with the tax include publicity, lead-in-time, certain organizational issues, and staffing requirements and training, as well as some miscellaneous problems. The main issues of VAT administration are: taxpayer identification, invoicing and bookkeeping requirements, rules for filing returns and making payments, auditing programs, refunds, and penalties. Collection costs are also a concern.

The broadly based neutral VAT found in textbooks is quite different from the VAT prevailing in most developing countries, and this difference results largely from administrative constraints: "in developing countries tax administration *is* tax policy." Multiple VAT rates, zero-rating with refunds, and numerous exemptions of specified goods can be accommodated only at high administrative and compliance costs.

Particular attention is given to the problems of small enterprises, taxpayer identification, invoicing and bookkeeping requirements, and selection of cases for audit. Despite all the obstacles, Casanegra concludes that some developing countries "are administering VAT with remarkable success."

In contrast, the chapter by Guillermo Perry and Alba Lucia Orozco de Triana describes the structure and administration of the VAT in one country, Colombia. Structural problems and issues of equity and economy are discussed, but the chapter concentrates on administration and compliance. Three dates are important: 1968, when a single-stage tax was applied at the manufacturing level; 1974, when the value added technique was introduced for this tax, which incorporated a refund system and included some services; and 1983, when coverage of the VAT was extended to the retail level, with still more services included. The authors compare tax structure and administration from one period to the next and give particular attention to comparing the VAT before and after it was extended to the wholesale and retail sectors. In that comparison they emphasize the issues of neutrality and control and conclude that, with respect to these two issues, it might have been better if the 1983 reform had extended the VAT only to wholesalers, perhaps adopting a mixed wholesaler-large retailer framework. The regressive effects of a single VAT rate are unacceptable in a country such as Colombia, yet, when the tax is extended to the retail stage, administrative problems make it impossible to have considerable differences in rates.

The chapter by Hamonangan Hutabarat and Malcolm Lane is the most technically focused in this section and is based on the experience of the authors in helping implement major income tax reform and introduce a VAT at the manufacturers level. The important decisions that had to be made are shown step by step: the development of an identification numbering system for all taxes, both direct and indirect; the choice of a vendor for the hardware and the software acquisitions (in Indonesia, the single most important consideration was the support capability of the vendor); the decision to centralize data entry at one location on a mainframe computer or to decentralize it to the sixty-nine district tax offices through microcomputers (the latter was the only practicable method in a large country such as Indonesia); and so on. During this process the fundamental principle of simplicity should be adhered to as closely as possible.

The Indonesian Department of Finance faced an immense task, even with all the assistance that IBM (the vendor) could supply. Planning for growth in the future requires knowledge of the ease with which a given type of system can be transformed into a larger one; for example, can the software on a given microcomputer be moved easily to a minicomputer, and must the documentation be translated into the language of the country where it is to be used? Typically, there will be no off-the-shelf software that will meet tax computerization needs, so the Finance Department's technical personnel face the awesome task of writing it. If a floppy disk is accidentally destroyed, has the taxpayer informa-

tion been recorded elsewhere as a backup? Cross-checking vendor tax and vendee tax credits has been quite difficult on a comprehensive scale (as described for Korea, above), despite the powerful computer system, and, when implemented, cross-checking will be restricted to certain types of cases. The chapter ends with a checklist of eight essential measures to be taken before starting the system, a list of pitfalls to be avoided in computerizing for a VAT, and a summary of principles to be followed. "Perhaps the most important lesson learned in the computerization efforts in Indonesia is that microcomputers are by far the easiest computer systems to master and use in a developing country where there is a shortage of technical personnel."

The chapter by Cedric Sanford and Michael Godwin on compliance costs—the costs to the taxpayer of complying with the tax law and regulations on record keeping and filling out tax returns—is unusual in that the subject has been little studied. The first half of the chapter uses data obtained from a 1977–78 survey on compliance mailed to some 9,000 business firms registered under a VAT, which yielded some 3,000 usable returns. Information on administrative costs, in contrast, was derived largely from published sources. The standard tax rate at that time was only 8 percent, compared with 15 percent in 1984–85, when the second study of these costs was made, so cost as a percentage of tax revenue could be expected to drop, even though it increased somewhat in absolute terms.

In the earlier period, aggregate compliance costs for the British VAT were estimated at 9 percent of the tax revenue. Administrative costs were only 2 percent of the tax revenue. Compliance costs were far higher for small firms when expressed as a percentage of sales: some thirty times higher for firms in the £10,000 to £20,000 range than for those with taxable sales of more than £1 million. The compliance costs are offset somewhat by certain cash flow and managerial benefits that firms should obtain from the VAT (here again the authors explore effects that are not commonly analyzed). Estimates for the later period are based on published materials and on assumptions about the results of certain changes in the British VAT in the interim. In 1984–85 the estimated cost of compliance was 5 percent, and the official administration costs represented 1 percent of tax revenue.

Two other topics are covered in analyses based on the structure of the tax rather than on statistical studies: the effectiveness of the VAT, compared with a retail sales tax, in assuring that the tax does not get into export prices, and the superiority of the VAT in minimizing evasion. On the first problem the VAT is probably superior to any other tax, including the retail sales tax, but the two taxes are much closer together on the matter of evasion, despite the self-policing aspects of the VAT. The conclusions of this study are for industrial

countries, chiefly for the United Kingdom, but many of the problems discussed will be accentuated in developing countries. In any event, the VAT is not a tax to be operated at low rates—the overhead costs are too high for that. The British experience suggests that

there is no reason to proclaim that a VAT is better or worse than a retail sales tax, except that the sales tax is to be preferred if the tax rate is low, the VAT if the rate is high.

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Part I

General Issues on the Value Added Tax

