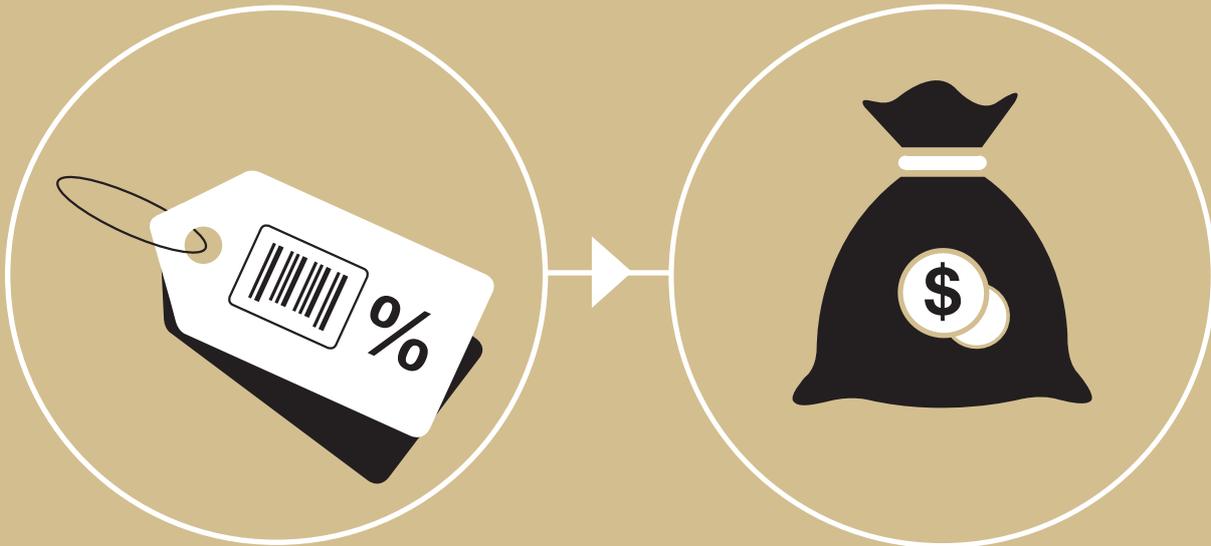


# Value-Added Tax (VAT)

## Progressive Taxation Briefing



## What is Value-Added Tax?

VAT is an indirect tax levied on the value added by producers, suppliers, and service providers at each point in a supply chain. Its cost is usually passed on to the consumer. Some countries use a goods and services tax (GST) instead, but it is similar.

The tax was pioneered in France in the late 1950s, after being tried first in the then-French colony of Côte d'Ivoire, though the first comprehensive version of the tax was actually adopted in Brazil in 1967.<sup>1</sup> Since then, VAT has been adopted by most rich countries and, particularly since the 1980s, has spread widely across low- and middle- income countries. VAT and other sales taxes often account for a third or more of developing countries' tax revenues.<sup>2</sup>

### ► The spread of VAT

While there are several methods of calculating and collecting VAT, almost all countries which have a VAT use the 'credit invoice' method to collect it. This means that a business charges VAT on its sales of goods or services to its customers and has to pay this VAT to the government, but they can get a tax credit or refund for the cost of VAT paid on the inputs which go into those goods or services. This is the most popular method in part because the amount of VAT has to be included in all invoices along the supply chain, creating a paper trail which is easier for tax authorities to follow in verifying what tax has been paid and what credits are due to businesses.<sup>3</sup>

The cost of VAT is passed down the supply chain, by being included in sales prices, until it reaches the consumer who cannot pass on this cost. For this reason, VAT is usually considered to be borne by the consumer. VAT is different from a traditional sales tax because the latter is paid at the

point where the customer buys the product, whereas VAT is paid by all the firms along the supply chain.

When companies pay more VAT on their inputs than they can pass on via their sales, they can usually claim VAT refunds or credits against future obligations. Because reporting on and collecting VAT has a cost for firms and for the government, it is common for the smallest companies to be exempted from VAT and to pay a turnover tax (a tax on their gross sales) instead. The latter is simpler to account for because it rests on the company's records of its turnover rather than a string of invoices which need to be checked.

VAT has spread rapidly and widely across developing countries and has become one of the biggest revenue earners for governments. Between 2012 and 2016, for example, Uganda raised more than a third of its total tax revenues from VAT while Ghana raised about 29%.<sup>4</sup>

The adoption of VAT partly reflects the dominant ideology of open markets and free trade urged in recent years by donors and international bodies, notably the International Monetary Fund (IMF): this ideology assumes that taxes on consumption are less “distorting” of investment decisions than taxes on income or capital. The spread of VAT in the last thirty years has often gone hand in hand with the lowering of corporate income tax rates and the proliferation of tax incentives for investment.<sup>5</sup> VAT often replaced trade taxes which developing countries have been under pressure to reduce (though they are still a big source of income for some).<sup>6</sup>

VAT may also be attractive to governments because as a tax with a very wide reach across society, it may meet less resistance from politically powerful vested interests than taxes which fall more narrowly on the wealthy, such as taxes on corporate and personal income and on property. That said, VAT increases which are seen as excessive have triggered protests from citizens, such as those in South Africa in July 2018.<sup>7</sup>

Governments often favour multiple rates, although they make the administration of the tax more complex, because they enable VAT to be used as a policy tool to promote or deter particular kinds of business activity or consumption. It is common for a country's annual budget to bring numerous small tweaks to the VAT regime, leading to a proliferation of small differences in classification.

Commonly consumed items such as basic foods or domestic fuel may be **exempted** from VAT, meaning that the tax is not due at all or is **zero-rated**. The latter means that VAT is charged, but at zero percent so that the item is in practice VAT-free. Under either classification, VAT may still be charged on the inputs which go into producing an item. If an item is exempt, however, then the supplier will not be able to collect refunds on the inputs which go into producing an item, meaning that the extra cost may be passed on to consumers in the form of higher prices (possibly higher than if VAT was charged), while under a zero-rating, each business in the supply chain may claim a refund. However, an exemption system may be easier for tax authorities to operate because there are no VAT refunds to track.<sup>8</sup>

## ► VAT, poverty and gender

VAT is commonly thought to be regressive, meaning that poorer people pay a higher proportion of their income in tax. This is because poor people generally spend more of their income than the rich. Since women make up more of the poor than men, there is a concern that consumption taxes like VAT therefore fall disproportionately on women.

The actual effects of VAT on the poor are not always clear-cut, however, because VAT falls on a wide range of goods and services and its effects depend on which ones the poor use and which ones are either exempted from the tax or zero-rated. Governments commonly use exemptions and zero-rating to relieve the tax burden on the poor (and for other purposes, as discussed below). The targeting of exemptions and zero-rating by governments is not always very accurate, however, so it may be that items relied on by the poor should be exempted but are not, as ActionAid and others have demonstrated in campaigning to remove VAT from women's sanitary towels.

A further source of complexity in assessing the incidence of VAT (that is, who ultimately pays it) is that many smaller firms in a developing country may not be subject to VAT, or may simply not be registered to pay the tax. Where those selling to consumers are not registered, as is often the case for informal sector kiosks, for example, it can mean that the poor who buy from them are relieved of some of the VAT burden they might otherwise pay.

Relieving VAT on items widely used by the poor remains an important goal for civil society groups but because of the complications presented by exemptions and zero-ratings, it may be better in some contexts to retain the broad base of taxpayers and instead call for a reduction in the standard 'headline' VAT rate to reduce the burden.

heavily consumed by the most marginalized people in society, looking at both men's and women's consumption, and then seeking to exempt or zero-rate items used by the poor while raising VAT on items mainly consumed by the wealthy. The responsibility should be on governments to carry out this analysis, although civil society groups may be able to catalyse government action by producing their own impact assessments.

## How can VAT be made more progressive?

### ► Understanding what the poor consume and what is currently taxed

Making VAT more progressive means governments doing further analysis of which goods and services are most

Since VAT is charged on a wide variety of goods and services, it is necessary to know what the poor actually consume, as well as knowing which items are subject to VAT and which are exempted or zero-rated. Researchers have often used household data to work out what the poor consume, but this kind of data may not show what is going on inside households: for example, the roles of men and women in making decisions about spending, as ActionAid has previously pointed out. This is a good reason (though by far not the only one) to collect more and better data on the economic activities of individuals within households.

## Recommendations

### ►► Governments should:

- *Continuously assess how far VAT exemptions and zero-ratings match the actual consumption patterns and needs of the poorest citizens, with a particular focus on the needs of women in poverty. Such impact assessments should be published so that they can be used by civil society.*
- *Exempt from VAT or zero-rate those goods and services that are disproportionately used by the poorest and remove exemptions from items used mainly by better-off citizens.*
- *Give more resources to tax administrations to ensure VAT compliance and combat VAT fraud or misreporting.*
- *Reduce headline VAT rates as more revenue is raised from other, more clearly progressive, taxes.*

This is one of a series of briefings on Progressive Taxation published by ActionAid International in October 2018. You can find them at [www.actionaid.org/taxpower](http://www.actionaid.org/taxpower)

### ► Endnotes

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**ActionAid** is a global movement of people working together to achieve greater human rights for all and defeat poverty. We believe people in poverty have the power within them to create change for themselves, their families and communities. ActionAid is a catalyst for that change.

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