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Understanding the Value Added Tax

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The Value Added Tax (VAT) is a tax on value addition in the process of supplying goods and services. Certain goods may be basic products while others may have been processed further before reaching the final stage. The import of goods is also considered as a component of value addition. Such goods may be supplied without further processing or may be used as raw materials or semi-manufactured items which may be processed further. In the case of services it may be difficult to identify such different stages of processing.

The basic feature of any VAT, which is considered as a tax on consumption, is the provision to leave out consumption outside the country. In such a situation the export of goods or services will not be subjected to any tax. Its main feature is to tax imports and to exempt exports. This is called the destination principle. In many cases the exemption of exports is effected through zero-rating. There can be other variations as well. A country may tax exports and exempt imports. This is called the origin principle. In such a situation the tax will fall on the production and not on the consumption.

The value addition may be computed by using the "addition" method or the "subtraction" method. The addition method equals the sum total of factor income. The subtraction method can be divided into two sub categories:

(a) **Value subtraction**
In this case the value of purchases is deducted from the value of sales and the tax rate is applied to the balance. This requires completed accounts on sales and purchases. This method is used in Japan to calculate the tax.

(b) **Tax subtraction or tax credit method**
In this case the tax on purchases is deducted from the tax on sales. Sometimes this method is called "invoice" method since the invoices are used as base documents. Many countries use this method of calculation.

The treatment of capital goods is also an important aspect of this calculation. If a "consumption type tax" is to be implemented the tax on capital goods should be eliminated. This is done by giving full tax credit for capital goods. However, such credit may be limited to the amount depreciated each year. In such situations the tax credit on capital goods will be distributed over a number of years. This method is called "income" type tax. If no deduction is allowed on capital goods such tax is called a "gross product" type tax.

Now let us consider a particular model and examine how it works.

Destination principle, tax credit or invoice method, consumption type:

Since the tax will fall only on local consumption, the goods/services consumed outside the country will be zero-rated. Since it is a consumption type tax full credit will be allowed on all capital goods. The tax on value addition will be ascertained by using tax invoices. This is the most important document in the calculation of tax. Each person who supplies goods and services will issue invoices showing the value of supply and the tax due on such supply. If you take a particular supplier the position may be summarised as follows:

Value		Tax(10%)
Supplies	- 5,000,000	500,000
Purchases	- 3,000,000	(300,000)
Value Added Tax	- 200,000	

These purchases may be capital goods or non-capital goods. If 1,000,000 of supplies are exports then the tax on such amount will be zero and in such a situation the value-added tax will be only 100,000. This will clearly show that exports or zero-rated supplies will not contribute anything towards the value-added tax.

In practice due to various reasons no country collects VAT on the total value addition. Due to administrative, social or economic reasons a portion of value addition may be exempted.

This can happen as a threshold exemption where the suppliers below such limit need not account for VAT or as specific exemption where certain goods and services have been exempted. In Sri Lanka in addition to both these exemptions a portion of wholesale/retail (local buying and selling) has been excluded from the tax base.

Now let us briefly consider a few other consumption or manufacturing taxes and compare them with a VAT.

(a) Manufacturer's sales tax: Here the tax base is the ex-factory price of the manufacturer and the wholesale and retail margins will escape taxation. Further, it is difficult to distinguish between the intermediate consumption and final consumption.

(b) Wholesaler's sales tax: Here the tax base includes the wholesaler's margin as well but still the retailer's margin is not captured. In addition to the difficulty with regard to the intermediate and final consumption the identification of pure wholesale may also be problem.

(c) Retailer's sale tax: Here the tax base is somewhat closer to a VAT base. However, the main difficulty in this type is the administration. It is very difficult to administer a large number of small retailers and as a result tax evasion and revenue leaks will take place. The identification of intermediate and final consumption may also be a problem.

(d) Turnover Tax: This is the tax adopted by many countries before they introduced a VAT. The main problem of the turnover tax is the "cascading effect" or the imposition of tax on tax. This tax gave much needed revenue for many countries including Sri Lanka but the cascading effect was a great threat to the economic development.

Implemented all over

Today there are about 120 big and small countries around the world implementing VAT successfully. The other important point is that only five countries have abolished this tax. Out of them three countries have re-introduced it with modifications. In recent times the IMF has also been instrumental in propagating VAT. In many structural adjustment programmes, they insist on the introduction of a VAT.

Then certain other countries that discussed the introduction of VAT have not done so up to now. In USA there was a big debate on this. In India they have introduced so called "MOD-VAT" which is really not a VAT. I think the main problem in the implementation of a VAT in these countries is their federal structure. In a federal structure it is very difficult to harmonise the taxes between states and the centre. There should be an acceptable arrangement of "fiscal federalism". I think this has been achieved to a certain extent in Canada where they have sorted out problems between the states and the centre satisfactorily.

Main Features of VAT

The value addition is calculated through an indirect method by using "output tax" and "input tax". Output tax is the tax chargeable on the supplies made. Input tax is the tax paid by the supplier on the acquisition of goods and services to make such supplies. The difference between these two amounts is the tax on value addition. Therefore, the correct calculation of output tax and input tax is crucial for the VAT system. As explained earlier if the credit system is adopted the calculation of output tax and input tax will be done on the basis of relevant invoices. That's why the tax invoice has become so important in this method of taxation.

Another important aspect is the coverage and the appropriate rates of tax. Nowhere in the world has the total consumption expenditure been covered under VAT. It is practically impossible. However, many countries have reached nearly 80 percent of the private consumption expenditure under their VATs. The limitation on the coverage will depend on the level of threshold exemption, other specific exemptions and exclusions and probably on the level of evasion.

The appropriate rate or rates will depend onthe coverage and the revenue requirements. We have decided to apply two rates. The 10 percent rate will be applied to certain goods and services where the base may be 1/5 of the total coverage. The balance 4/5 of the coverage will be at the 20 percent rate.

Social reasons

Then, it will be important to determine the number of rates. Some favour multiple rates for social reasons. Multiple rates will not only complicate the tax administration but also make tax compliance difficult. Therefore, the best system may be a single rate system and if necessary two rates. Social concerns may be addressed outside the VAT system. Today 63 countries have got single rate systems and 26 countries two rates.

Many countries try to maintain the status quo that prevailed before the VAT by adopting multiple rates and a large number of exemptions. However, many countries, especially European countries have realised that by having multiple rates and more exemptions they have not achieved the expected results but their VAT systems have become complicated. Many countries that adopted VAT in the recent past have opted for a single rate [illegible] ly due to [illegible] ces of [illegible] ving multiple rates.

Another important feature in any VAT system is the exemptions and zero ratings. The UK has adopted both exemptions and zero ratings for local consumption. But many countries zero-rate only the consumption outside the country.

The idea of zero rating is to provide the goods and services entirely free of tax. When the local consumption is also zero-rated it goes against the basic principle of consumption tax. It should be a tax on the consumption of goods and services within the country. Therefore, any zero rating should be limited to the consumption outside the country.

Tax-free

On the other hand the exemption will not entirely provide tax-free goods as believed by many. Depending on the nature of exemption a certain amount of tax will be included in the final price of such goods or services. That's why it is said, "exemption means a lower rate of tax". Therefore, the goods/services to be exempted should be selected very carefully. As far as possible the exemption should be granted to the final consumer items. If the exemption is given to intermediate goods/services while the final supply is liable to tax, it may create a "cascading" effect and as a result there may be a price increase.

Finally, I wish to touch on two other important aspects of a VAT. No taxpayer likes to pay tax. But some taxpayers do not mind paying VAT. Businessmen prefer a VAT to the other taxes. That is because VAT does not impose any additional burden on businesses if they can claim all their input taxes. Although they may incur some cost on compliance in many cases they enjoy a hidden cash flow benefit as well. The tax administration will also find the VAT is easy to administer than most other taxes. However, this will also depend on the systems and procedures adopted. The so-called "self policing" nature of a VAT will help the tax administration to a great extent.

Issues

A key concern about VAT is its regressive nature. Whether the VAT is regressive has to be examined in the context of [illegible] regime. [illegible] should not [illegible] considering only the VAT. If you consider only the VAT, naturally it would look regressive in relation to the income of the people. Since the same tax rate may be applied to all goods and services an element of regression can be seen when one compares the tax with the income of the consumers. That means those with lower incomes may be paying more tax as a percentage of income than those with higher incomes.

However, the VAT may be less regressive than other consumption taxes such as excise duties and turnover taxes. It may be appropriate to quote from the Taxation Commission Report -1990.

"There is no conclusive evidence showing regressive incidence in the overall tax system, except perhaps in the area of specific indirect taxes such as excise duties.

The overall fiscal incidence tends to produce progressive results in the Sri Lankan context, particularly due to large current transfers including subsidies to low income groups".

That was the situation under more regressive indirect taxes.

Inflationary

The next issue is whether the VAT is inflationary. Since the VAT in Sri Lanka will replace the existing GST and NSL in a revenue neutral manner the inflationary impact may not be there. There may be a change in relative prices but not in the overall price level. The experience of countries that introduced VAT to replace more regressive consumption taxes has indicated that no considerable increase in price levels had taken place. However, certain countries such as France, Korea, the Netherlands and Norway adopted price controls for short periods while certain other countries entered into agreements with major producers and dealers to avoid unnecessary price increases.

Another general issue raised by many countries was whether the VAT will become a money machine? (However, in Sri Lanka we may not worry about this) Since the VAT will generate a steady flow of revenue for any government it is assumed that a VAT will create strong governments with a wide area of control. Average revenue [illegible] five percent of GDP.

A major issue is the exclusion of wholesale/retail activities from the VAT. In fact this exclusion is limited to the local buying and selling of goods. This has affected the smooth implementation of a comprehensive VAT.

Another major issue has arisen as a result of invoicing requirements. The law has stipulated two distinct invoices. One to the VAT registered persons and the other to the normal consumers. Many registered persons have expressed their inability to comply with these requirements. Even if they comply with these requirements huge additional costs have to be incurred to change the operating system.

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Exemptions under VAT

	Previous Position	Vat
1. Green Tea Leaves	No Tax	No Tax
2. Semi-processed rubber	NSL 6.5%	No Tax
3. Latex	No Tax	No Tax
4. Coconuts	No Tax	No Tax
5. Desiccated Coconut	NSL 6.5%	No Tax
6 Vegetable (other than potatoes, onions and chilies)	NSL 6.5%	No Tax
7. Fruits	NSL 6.5%	No Tax
8. Flowers	NSL 6.5%	No Tax
9. Cinnamon & spices	NSL 6.5%	No Tax
10. Live animals (other than poultry)	No Tax	No Tax
11. Unprocessed fish	No Tax	No Tax
12. Fire wood	NSL 6.5%	No Tax
13. Paddy and seed paddy	NSL 6.5%	No Tax
14. Rice & rice flour	NSL 6.5%	No Tax
15. Wheat & wheat flour	No Tax	No Tax
16. Eggs	NSL 6.5%	No Tax
17. Bread	No Tax	No Tax
18. Liquid milk	NSL 6.5%	No Tax
19. Infant Milk Powder	NSL 6.5%	No Tax
20. Books	NSL 6.5%	No Tax
21. Kerosene	No Tax	No Tax
22. Bunker Fuel & Aviation Fuel	NSL 6.5%	No Tax
23. Crude Petroleum Oil	NSL 6.5%	No Tax
24. Financial Services including Life Insurance, Agrahara Insurance and Crop & Livestock Insurance	NSL 6.5%	No Tax
25. Stamps	NSL 6.5%	No Tax
26. Burials & Cremations	NSL 6.5%	No Tax
27. Housing	NSL 6.5%	No Tax
28. Rent or Lease rent on houses	NSL 6.5%	No Tax
29. Pharmaceuticals & raw materials	NSL 6.5%	No Tax
30. Ayurvedic, Unani, Siddha, Homeopathic Products & raw materials	NSL 6.5%	No Tax
31. Recognised educational services	No Tax	No Tax
32. Library Services	NSL 6.5%	No Tax
33. Public Passenger Transport	No Tax	No Tax
34. Electricity up to 30 kwh. per month	No Tax	No Tax
35. Health care services	No Tax	No Tax
36. Medical machinery. Surgical instruments, medial and dental equipment and ambulance	NSL 6.5%	No Tax
37. Artificial limbs, crutches, hearing aids, wheel chairs, surgical glows, contact lenses, x-ray tubes, white canes for blind, Braille type writers and parts, prepared culture media and laboratory re-agents	NSL 6.5%	No Tax
38. Pearls, diamonds, precious stones, precious metals etc.	NSL 6.5%	No Tax
39. Aircraft, helicopters and temporary imports	NSL 6.5%	No Tax
40. Any personal imports with a value not exceeding Rs. 10,000/	[illegible]	No Tax
41. All small scale manufacturers and service providers who are not liable to register under VAT	[illegible]	No Tax
42. Agricultural tractors	NSL 6.5%	No Tax
43. Agricultural machinery etc.	NSL 6.5%	[illegible]