Developing a Practicable Benchmark VAT

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Abstract

This thesis develops a practicable benchmark VAT that bridges the gap between theory and practice in VAT design and provides concrete guidance for countries to evaluate, assess, and, where appropriate, reform their VATs. The potential use of the practicable benchmark in devising a reform agenda is illustrated by means of a case study based on the Chinese VAT, a tax that is at odds with the theoretical model in many respects.

Experience has shown that real-world VATs most often deviate substantially from the theoretical VAT model, revealing the disconnect between the theoretical model based primarily on economic criteria and actual VAT designs that recognise the administrative, political and technical constraints encountered in the real world. A single rate and broad-based VAT is not readily achievable in many countries and VAT designers are further faced with issues that are not addressed directly in the model, including the application of VAT to small businesses, non-resident businesses, financial supplies, low value imports, and cross-border services as well as the challenges of devising workable arrangements for VAT systems in a federal or economic community setting.

The thesis applies a tax expenditure analysis to evaluate the effectiveness, efficiency implications and revenue impact of VAT concessions. The negative consequences of concessions could be reduced with better targeting if the removal of concessions is politically unattainable. Registration threshold should be set at a level where the revenue costs are offset by the administrative savings from excluding small businesses from the VAT. Small business regimes often do not achieve the intended objectives and moreover yield efficiency and revenue costs. The best option to bring the financial and insurance sectors into full taxation is to use a separate (reduced) rate approach to tax intermediary loan services, a cash-flow model to tax insurance services and to categorise the issue and transfer of financial securities as zero-rated supplies.

Effective collection of VAT on cross-border B2C imports of low value goods and services and removal of VAT from business acquisitions by non-resident businesses

could be achieved with a higher level of international cooperation through bilateral treaties and a clearing house mechanism. No single benchmark is possible in terms of the design of VAT sharing in federations or economic communities because appropriate design relies heavily on the political and structural factors in federations. The clearing house model appears to be the best option to distribute VAT revenue in most circumstances where sub-central jurisdictions have their own VATs.

The benchmark needs to be modified to accommodate local factors when applied to any particular country. It nevertheless provides a starting point for countries to evaluate and reform their VATs. The case study of China shows the process of applying the benchmark to an ill-designed real-world VAT. VAT design often reflects features of predecessor taxes and in this respect China may have an advantage notwithstanding the significant deviation of its current VAT from the benchmark. Some features inherited from the predecessor tax may make reform, particularly in respect of financial supplies, easier than in counterparts that evolved from European turnover taxes.

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List of Abbreviations

B2B	business-to-business
B2C	business-to-consumer
BT	Business Tax
CGST	Central GST
CICT	Consolidated Industrial and Commercial Tax
CVAT	Compensating VAT
ECR	Exempt, Credit, Refund
ER	Exempt and Refund
EU	European Union
FITR	fixed input tax recovery
FRS	flat rate scheme
GAARs	general anti-avoidance rules
GDP	Gross Domestic Product
GST	Goods and Services Tax
HFE	horizontal fiscal equalisation
HMRC	HM Revenue & Customs
HST	Harmonised Sales Tax
ICT	Industrial and Commercial Tax
IGST	Integrated GST
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
QST	Québec Sales Tax
RITC	reduced input tax credits
SAAR	specific anti-avoidance rule
SAT	State Administration of Taxation
SGST	State GST
SMEs	small and medium-sized enterprises
SOEs	state-owned enterprises
TCA	tax calculation accounts

UK	United Kingdom
US	United States
VAT	Value Added Tax
VRR	VAT revenue ratio
VTER	VAT tax expenditures ratio

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INTRODUCTION

1. Statement of the problem

Since its introduction in Europe over half a century ago, VAT or Goods and Services Tax (GST), as it is labelled in some Anglo jurisdictions, has become the world's primary tax on consumption in the developed world (all members of the Organisation for Economic Co-operation and Development (OECD) except the United States (US) have adopted the tax) and in a large cross-section of developing and transitional nations.[1] The remarkable success of VAT in terms of geographical coverage is commonly attributed to the theoretical merits of the tax. These derive from three established norms of a model VAT, namely, a single rate and broad base; the destination principle; and self-assessment through an invoice-credit mechanism.[2] The three norms are based on an overarching principle that the VAT is intended as a tax on final consumption.

The first two norms are design norms that concern with structural design features of the VAT, the subject of this thesis. A single rate and broad base ensure that all domestic consumption is taxed in the same manner, yielding a neutral tax that does not distort production or consumption decisions. The destination principle deals with cross-border aspects of the VAT. By removing the tax from exports and imposing the tax on imports, the destination principle ensures that the VAT is only imposed on final consumption in cross-border transactions, and that the VAT revenue accrues to the country of consumption. The VAT is therefore neutral between domestic sales and imports as they are taxed on the same basis.[3]

The third norm is an administrative norm that mainly addresses administrative aspects of the tax. While the economic burden should only be borne by final consumers, VAT in almost all countries is collected piecemeal throughout the production and distribution

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[1] The OECD statistics show that more than 166 countries have a VAT. See, OECD, *Consumption Tax Trends 2016: VAT/GST and Excise Rates, Trends and Policy Issues* (OECD Publishing 2016).
[2] K. James, *The Rise of the Value-Added Tax* (Cambridge University Press 2015); OECD, *International VAT/GST Guidelines* (OECD Publishing 2017).
[3] OECD, (n 1) 24.

chains via an invoice-credit mechanism.[4] The VAT is imposed on the output sales of suppliers and a credit is given to business purchasers for the tax they paid on input purchases. In the case that a taxable person's input tax credits exceed output tax in a taxing period, the excess input tax credits should be refunded to the taxable person immediately.[5] It has been claimed that the VAT is "self-enforcing", at least in respect of business-to-business (B2B) supplies, because the invoice-credit method creates conflicting incentives between the suppliers and the purchasers.[6] A supplier's incentive to understate the tax on output is matched by the customer's incentive to overstate the tax on input (to maximise input tax claim). The thesis does not address issues surrounding the third norm of the theoretical model.

Ironically, the design of almost all real-world VATs fail to incorporate one or both of the design norms of the model responsible for the claimed benefits. Depending on the extent of deviations from the theoretical model, the world's VAT systems are divided into two broad camps: the "traditional VAT" based on those in the European Union (EU) and the "modern VAT" found in New Zealand, Australia and many other jurisdictions with more recent VAT systems.[7] The division between the two models in practice is mostly centred on the use of reduced rates and exemptions, with the traditional VAT systems relying more heavily on concessions.[8] Modern VAT systems, seeking to avoid the complexity and economic distortions of multiple rates and exemptions in the traditional VATs, generally feature a single rate (apart from a zero-rate) and few exemptions.

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[4] An exception to this general rule can be found in Japan where VAT is determined using a subtraction method, under which the VAT is calculated by multiplying the tax rate by the difference between a firm's taxable sales and inputs. A comparison between the subtraction method and the invoice-credit method is set out in The U.S. Chamber of Commerce, 'An Introduction to the Value Added Tax (VAT)' (2010) <https://www.uschamber.com/sites/default/files/legacy/issues/econtax/files/vat_paper_4_25_2010.pdf> accessed 9 July 2018.

[5] In many developing countries, however, net VAT collected after input tax credits have been allowed is recorded as revenue with refunds of excess input tax credits treated as a government expenditure outside the administration of the VAT. VAT refunds thus require expenditure appropriations by the legislature and must compete with all other spending programmes. As a result, taxable persons entitled to refunds in developing countries may face long or indefinite waits and often law or administrative practice provides no option for refunds, with registered persons required to carry forward excess credits indefinitely. See, G. Harrison and R. Krelove, 'VAT Refunds: A Review of Country Experience' (IMF Working Paper WP/05/218, 2005).

[6] R. Bird and P-P. Gendron, *The VAT in Developing and Transitional Countries* (Cambridge University Press 2007).

[7] R. Krever, 'Designing and Drafting VAT Laws for Africa' in R. Krever (ed), *VAT in Africa* (Pretoria University Law Press 2008)

[8] *Ibid.*

Among the countries where VAT is poorly designed relative to the model, developing countries are of particular concern. China is one of the notable examples that the VAT is at odds with the design norms in many respects, although its VAT has been in place for over three decades and subject to several reforms in this period that has achieved substantial progress along the path towards modernising the tax. Reform of an ill-designed VAT has proved to be extremely difficult.

The gap between VAT in theory and in practice suggests that the model developed mainly on the basis of economic criteria has limited practicability in the real world. In practice, tax design is often frustrated by political, technical and administrative constraints. The theoretical model that disregards these factors thus does not provide solutions to many real-world problems, in particular in the modern era where new commercial patterns, technological development and globalisation present new challenges. Experience shows that a single rate, broad-based VAT is not readily achievable in most jurisdictions due to political constraints. Technical difficulties remain as to how to apply the VAT fully to financial supplies and insurance services. VAT designers are confronted with administrative difficulties in applying the VAT to small businesses, non-resident businesses, low value imported goods and cross-border supply of services, and devising workable arrangements for VAT systems in a federal or economic community setting, which are not addressed directly in the theoretical model. A more realistic benchmark is therefore needed to guide VAT design in practice.

It is against the backdrop of the foregoing that this thesis has been conceptualised. The intention, in this context, is to bridge the gap between theory and practice in VAT design.

2. Research questions, aims and objectives

Research questions

The key questions that are investigated in this thesis are as follows:

i. Why is there a gap between VAT in theory and in practice?
ii. Based on the established theoretical VAT model, what would be a more realistic benchmark that could be used by countries to assess and reform their VATs?

iii. How could the benchmark developed in this thesis be applied to evaluate, and adjusted to reform, an ill-designed VAT in practice?

Aims

The aims of the thesis are to develop a benchmark VAT that bridges the gap between theory and practice and to provide practicable guidance to VAT jurisdictions to assess and move their VATs closer to the established theoretical criteria of a good VAT; and to provide a case study of the application of the benchmark in a specific political, economic and administrative context.

Objectives

In order to address the research questions and fulfil the aims of the study, the following objectives are pursued in this thesis:

i. To identify the gap between VAT in theory and in practice; and to explore the reasons contribute to the gap;
ii. To develop a practicable benchmark within the framework of the established design norms, with a focus on the areas where the theoretical design norms are frustrated by political, administrative and technical difficulties;
iii. To provide a case study of China's VAT as an example of the application of the benchmark to evaluate and reform an ill-designed VAT in terms of aspects discussed in the practicable benchmark.

3. Methodology

The thesis starts with a theoretical framework of the established design norms of a good VAT. Real-world VAT models are evaluated against the design norms to identify the gap between VAT in theory and in practice. The thesis then develops a practicable benchmark, drawing on both theory and experience of real-world VATs. The practicable benchmark builds on the existing theoretical model and factors in three commonly confronted real-world constraints: political, administrative and technical difficulties. Five areas of VAT investigated in this thesis are those where the gap between theory and practice is mainly attributable to at least one of the three difficulties. The five areas are VAT concessions, threshold and small business regimes, financial supplies, VAT in federations and international cross-border issues.

The process of developing the benchmark is guided by the four canons of taxation set out by Adam Smith in *The Wealth of Nations*[9]: canon of equality or ability, canon of certainty, canon of convenience and canon of economy. In the context of consumption tax, these can be read as neutrality (economic efficiency), legal certainty, compliance costs and administrative costs. Table 1 illustrates Adam Smith's four canons in the context of VAT. A system designed to pursue one criterion of an ideal tax may full the tax away from another. The benchmark reflects a balance between the objectives, falling short of the ideal for each only to the extent needed to protect features crucial to the others.

Table 1 Adam Smith's Four Canons of Taxation in the Context of VAT

Adam Smith's four canons	**Criteria in the context of VAT**
Canon of equality or ability	Neutrality (economic efficiency)
Canon of certainty	Legal certainty
Canon of convenience	Low compliance costs
Canon of economy	Low administration costs

The second part of the thesis applies the benchmark to Chinese VAT in respect of the five areas to show how it can be used to evaluate, and be modified to reform, an ill-designed VAT. China's VAT is used as a case study because it deviates from the theoretical model in many aspects and is subject to ongoing reforms.

Table 2 Framework of the Thesis

<table>
<tr><th rowspan="2">Design norms</th><th colspan="3">Practicable Benchmark</th><th>Case Study of China</th></tr>
<tr><th>Areas of VAT</th><th>Real-world constraints</th><th>Design criteria</th><th>Areas of VAT</th></tr>
<tr><td rowspan="2">Norm 1: single rate and broad</td><td>Chapter 1. VAT Concessions</td><td>Political</td><td rowspan="2">• Neutrality/ economic</td><td>Section 7.1 VAT concessions</td></tr>
<tr><td>Chapter 2. VAT</td><td>Administrative</td><td>Section 7.2 VAT</td></tr>
</table>

[9] A. Smith, *The Wealth of Nations* (W. Strahan and T. Cadell 1776).

base	Threshold and Small Business Regimes		efficiency • Legal certainty • Low compliance costs • Low administrative costs	thresholds and the small business regime
	Chapter 3. Financial Supplies and Insurance Services	Technical & Administrative		Section 7.3 Financial supplies and insurance services
Norm 2: the destination principle	Chapter 4. International Cross-Border Issues	Administrative		Section 8.2 International cross-border issues
	Chapter 5. VAT in Federations	Technical & Administrative		Section 8.1 Inter-governmental VAT sharing

This thesis is based on a combination of economic analysis, socio-legal, comparative and historical approaches. Each of these methodological approaches takes on a particular role in the development of the thesis. Specifically, a comparative approach is employed throughout the thesis in the process of evaluating real-world VAT models against the theoretical model and evaluating China's VAT against the practicable benchmark developed in the thesis. A historical approach is used to provide insights into deviations from the benchmark and the factors that shaped the current policy in China. A socio-legal approach is used to analyse reasons that attribute to the gap between VAT in theory and in practice and apply the practicable benchmark in the Chinese context. Both economic analysis and socio-legal approach are used in developing a practicable benchmark that balances the four main criteria within the political, technical and administrative constraints.

4. Contribution to the literature

Two broad themes emerged in the literature on VAT over the last few decades: merits of a theoretical VAT model and actual experience of real-world VAT jurisdictions. Comparisons between the theoretical model and the real-world VATs reveal that the modern VATs more closely resemble the theoretical model than traditional VAT systems. The success of modern VATs has been variously explained by lessons learned from the experience of traditional VAT systems and specific political, economic and administrative conditions. With lessons learned from over half a century's experience and real-world models provided by modern VATs, however, traditional jurisdictions still have difficulties reforming their VATs to align more closely with the theoretical model. The difficulties are especially pronounced in developing countries.

While there has been substantial consideration of what constitutes optimal VAT practice based on economic criteria, there is a dearth of literature on how the VATs can be improved where real-world constraints rule out the first best reform option. For example, there has been almost no discussion on how VAT rate structure and exemptions should be designed to reduce the negative consequences in the case that a single rate and broad base is politically unattainable.[10] Similarly, the choice of registration threshold and design of small business regimes have received little attention in the literature. Although there has been extensive discussion on the VAT treatment of financial supplies, an administratively feasible solution that allows the VAT to be fully applied to financial supplies has yet to be found. A number of governments have adopted unilateral approaches to confront the challenges of foreign VAT refund, low value imported goods and imported services, and the OECD has developed guidelines for reform but both unilateral and proposed reforms fall short of comprehensive solutions. The operation of VAT in federations has mostly been discussed in a specific jurisdictional context, with little discussion on wider implications for other countries.

In addition, much less attention has been given to VAT design in developing countries. Bird and Gendron have argued that experts developing proposals for VAT in developing and transitioning economies might be biased and thus fail to appreciate why policy adopted in developed countries often cannot be directly transferred to a developing country.[11] VAT design in developing countries is certainly more challenging because design flaws in one area of VAT may block optimal reform options in other areas.

The literature on China's VAT is considerably under-developed. Although some serious

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[10] An exception is a proposal for reforming the rate structure in the EU within the political constraints. See, R. de la Feria, 'Blueprint for Reform of VAT Rates in Europe' (2015) 43 Intertax 155.
[11] Bird and Gendron, (n 6) 221-222.

design flaws of the current system have been identified, the policy reasons for these are insufficiently explored, and sometimes, wrongly explained. There have been very few published analyses of reform options that could be used to guide policy makers.

This thesis aims to contribute to the literature through the development of a more realistic benchmark, as compared to the theoretical model, that can be used by countries to evaluate and reform five central areas in their VATs. The benchmark cannot be fully implemented in any jurisdiction because of local factors and thus needs to be adjusted and modified to adapt to any specific context. It nevertheless provides a starting point for countries to identify the deviations and evaluate them fully in terms of the costs of distortions and offsetting economic benefits and to develop their context-specific solutions. The case study of China is an example of the application of the practicable benchmark to an immature VAT system. The case study not only shows how to modify the benchmark to adapt to a specific context, but also provides a set of reform suggestions for China that could guide the ongoing VAT reforms.

5. Overview of the thesis

This thesis is structured in line with the key questions that it investigates, as stated earlier in Section 2. The thesis contains two parts. Part I establishes a practicable benchmark in terms of five aspects of the VAT: concessions, threshold and small businesses, financial supplies and insurance services, VAT design in federations and international cross-border issues. Part II examines these areas of VAT in the Chinese context to show how the benchmark developed in Part I can be applied to a real-world VAT. The subsequent chapters of the thesis will proceed as follows:

Part I. Developing a practicable benchmark VAT

Chapter 1 engages in a critical analysis of VAT concessions under an overarching conceptual framework. It applies tax expenditure analysis to VAT concessions, recognising that concessions are the equivalent of, and a substitute for, direct spending programmes. The chapter first evaluates concessions by reference to three budgetary criteria: fairness, targeting efficiency and budget control. Next, it examines the consequences of using concessions in the VAT system in terms of economic distortions, legal difficulties and administrative and compliance costs. The chapter then shows how the measurement of the cost of concessions as a proportion of potential VAT revenue can better reveal their budget impact. Finally, the chapter explores how concessions can be removed from the VAT and, where their removal is politically unattainable, how they can be targeted more effectively with improved policy and legislative design techniques.

Chapter 2 critically evaluates the key considerations and challenges in setting a VAT registration threshold and the consequences of adopting that boundary, as well as the benefits and costs of small business regimes. The chapter starts with a review of the rationale for adopting a registration threshold, which is to balance revenue needs against administrative and compliance cost savings. It then examines the distortions and inefficiencies caused by a threshold, including the distortion of competition between small businesses above and below the threshold and businesses' behavioural responses to a threshold. The chapter critically analyses the implications of these distortions on the optimal level of the threshold. The second part of the chapter evaluates the costs and benefits of three types of commonly used small business regimes: transitioning regimes for small businesses shifting into the VAT; simplification regimes for small businesses in the VAT system and alternative turnover-type regimes.

Chapter 3 critically investigates the VAT treatment of loan intermediary services, financial securities and insurance services (general insurance and life insurance). With each of the three types of supplies, the chapter first identifies the theoretical correct result in terms of the VAT base. It then evaluates current country practices and proposals against the theoretical outcome. The chapter concludes with suggestions on the best available options to achieve the theoretical outcome in practice.

Chapter 4 critically assesses three international cross-border issues that raise difficulties: place of taxation rules, foreign VAT refund and collection mechanism for imports of low value goods and imported services. The chapter first reviews countries' approaches to place of taxation rules for goods and services. It then evaluates two main mechanisms that are used by countries to refund VAT incurred on business expenditure by non-resident businesses. Next, the chapter analyses the challenges of taxing imported low value goods and services and recent country practices in these areas. Finally, a new model is suggested for foreign VAT recovery and VAT collection on the imports of low value goods and imported services.

Chapter 5 critically examines existing and proposed models for allocating VAT revenue among sub-central jurisdictions in a federation or economic community context. The chapter first reviews allocation models based on the place of consumption, including the international zero-rating model, clearing house, VIVAT, CVAT and consumption statistics. It then looks at allocation on the basis of origin before analysing the fiscal equalisation formula model. The chapter finally evaluates the various models in terms of whether there is an overarching fiscal authority and whether the local governments have substantial fiscal autonomy and suggests the best option for different contexts.

Part II. Applying the benchmark: a case study of China

Chapter 6 provides a comprehensive assessment of the evolution of VAT in China, with the aim of identifying the historical and political factors that shaped some of the design features of the Chinese VAT that will be discussed in the subsequent chapters in this Part. The chapter reviews four main stages of the evolution of VAT in the context of the evolution of intergovernmental fiscal relationship: centralisation in 1950-1978, decentralisation in 1978-1993, recentralisation in 1994-2011, and further centralisation from 2012 onwards.

Chapter 7 critically evaluates three key base design issues in China: concessions, registration thresholds and the small business regime, and financial supplies and insurance services. Each of these issues is approached in the same manner. The chapter evaluates the current policy design of these issues against the benchmark established in Part I of the thesis to identify deviations. It then explores the reasons for, and the consequences of, the deviations. Finally, this chapter suggests possible ways to improve the VAT design in these areas within the identified political and revenue limitations.

Chapter 8 critically analyses two cross-border issues in China, inter-provincial supplies within China and international cross-border supplies into and out of China. The chapter starts by reviewing the problems with the origin-based system currently used in China to allocate VAT revenue among provinces in the wider context of revenue sharing and transfer systems. It proposes a new model for China to distribute the VAT revenue consistent with the destination principle. The second half of the chapter examines international cross-border rules for exports and imports. A focus of this section is the reasons why China's current export rules deviate from the destination principle.

The final chapter concludes the thesis with a summary of the practicable benchmark and its merits and limitations in application as illustrated by the case study of China. The chapter also sets out suggestions for future research directions.

PART I. DEVELOPING A PRACTICABLE BENCHMARK VAT

CHAPTER 1. VAT CONCESSIONS

1 Introduction

A benchmark VAT applies the same tax burden to all types of supplies, so that the tax is neutral in its application to all consumption. With no impact on consumption or production in the absence of tax biases, economic outcomes are shaped by market forces. Many real-world VATs, however, only reach just more than half of the theoretical model VAT base. Two factors may explain the disconnect between a good VAT in theory and the real VATs in practice: poor administration of the tax and deliberately adopted concessions that explicitly reduce or eliminate the VAT payable on designated types of consumption.[12] In developed economies with advanced administrative regimes in place, the gap is primarily explained by the adoption of tax concessions.

Concessions in a VAT system can take three forms: full taxation but at a reduced rate; input taxation, treating the supply as an exempt supply but denying the supplier any credits for tax included in the price of business inputs; or a full removal of tax by zero-rating the supply and allowing full input tax credits. The traditional VAT, represented by the EU, uses the first two methods to provide concessions. Some modern VAT systems such as those in Australia and Canada use the second and third methods.

Concessions are adopted for a variety of reasons. The goal of some is to reduce the regressivity of the VAT that is born disproportionally by lower income persons who apply far greater shares of their income to consumption than their higher income counterparts. A second aim is to subsidise (and hence encourage) the consumption of what the legislature perceives as merit supplies such as education or health supplies that it believes generate positive externalities which might not be recognised by consumers faced with a fully taxed supply, or to subsidise particular types of suppliers. A third objective is to facilitate efficient VAT administration through what might be labelled "technical concessions" that reduces VAT liabilities associated with abnormally high administrative and compliance costs or where there is uncertainty as to how particular

[12] M. Keen, 'The Anatomy of the VAT' (2013) 66 National Tax Journal 424.

types of transactions can be subject to tax.[13] Sometimes concessions arise merely because of accidents or inadvertence or practice based on administrative rulings or judicial precedents that misconstrued the purpose of provisions.

Concessions in a VAT have been shown to be inefficient subsidy tools, providing misguided benefits, distorting consumption, production and investment decisions, and giving rise to substantial administrative and compliance costs. Experience to date, however, suggests that they may be an unavoidable feature of the VAT as time and again politicians opt for VAT concessions as the preferred delivery vehicle to achieve all the rationales for reduced taxation. The ideal from a tax policy perspective would be a two pronged approach based first on the adoption of a simple and efficient comprehensive VAT allied with direct programmes to promote the consumption of merit goods or services and reduce the regressivity of consumption taxation and secondly the use of alternative tax law approaches to address the costs of imposing the tax in technically challenging areas. But the reality is that concessions are more likely than not to remain as a central feature of many countries' VAT systems. The challenge, therefore, is to design concessions that mitigate their undesirable consequences.

The negative ramifications of VAT concessions have long been recognised and tax reform literature almost uniformly advocates their removal as the optimal way to address these problems.[14] Little attention has been paid to how the negative aspects can be addressed or at least mitigated if they are to remain and there is almost no analysis of the issue in terms of an overarching conceptual framework. From a tax policy viewpoint, concessions that reduce the VAT payable under a neutral benchmark VAT are now treated for national budget purposes as indirect outlays or, as they are labelled in budget documents, "tax expenditures". The revenue forgone from incompletely taxed consumption is equivalent to direct budget expenditures. These could be substituted to subsidise directly the preferred consumption were the VAT to apply uniformly to all

[13] For an explanation of "technical tax expenditures", see C. Heady, 'Tax Expenditures: Definitional and Policy Issues' in L. Phillips, N. Brooks and J. Li (eds), *Tax Expenditures: States of the Art* (Canadian Tax Foundation 2011).
[14] See, e.g., J. Mirrlees and others, *Tax by Design: The Mirrlees Review* (Oxford University Press 2011), 216-230; A. Tait, *Value Added Tax: International Practice and Problems* (International Monetary Fund 1988), 44; I. Crawford, M. Keen and S. Smith, 'Value Added Tax and Excises' in S. Adam and others, *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press 2010); cf. qualified views for developing countries: S. Cnossen, 'Global Trends and Issues in Value Added Tax' (1998) 5 International Tax and Public Finance 399; Bird and Gendron, (n 6).

consumption, or applied to offset the costs of applying the VAT fully to consumption of services or supplies made by selected enterprises that would give rise to significant and costly administrative problems. Recognition of VAT concessions as tax expenditures opens the door for a conceptually sound analysis of their design and operation. As spending measures, they must be evaluated by using the same (budgetary) criteria that are used in evaluating direct spending programmes.[15]

This chapter examines concessions from a tax expenditure perspective, with the aim of developing a better process for reform. It focuses only on concessions adopted for non-technical reasons, that is, to reduce regressivity or to promote the consumption of supplies that are perceived to be socially desirable.

Tax expenditure analysis normally involves a three-stage inquiry. The first step is to ask whether a tax expenditure serves a valid government objective. If the answer to the first question is yes, the second question to be answered is whether a tax expenditure or a direct spending programme is a better instrument to achieve the government's objective. Finally, if the government decides to deliver subsidies through the tax system, the third question to be resolved is how should a tax expenditure be designed to achieve most effectively its intended objective.

This chapter uses this approach to analyse concessions in VAT laws. It takes as a given in respect of the first stage of analysis that governments have concluded the goals explaining tax expenditures are desirable policy objectives and turns to the second and third stages, treating tax concessions as the equivalent of explicit government outlays and considering whether the implicit expenditures are distributed in a fair and efficient manner, with minimal collateral distortions or whether alternative direct expenditure programmes or better designs for tax expenditures are desirable. To the extent that current VAT concessions are demonstrated to be a poor instrument for delivering subsidies, the chapter proposes suggestions for policy and legislative reform. The most significant constraint on reform is political perceptions of the unacceptability of alternatives to current concessions. A possible catalyst for overcoming this inertia might

[15] N. Brooks, 'The Under-Appreciated Implications of the Tax Expenditure Concept' in C. Evans and R. Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters 2009).

be the adoption of a new tool to measure the revenue impact of concessions (the VAT tax expenditures ratio or the VTER) that is better suited to tax expenditure analysis than presently used measurements.

1.1 Identifying and classifying VAT tax expenditures

The phrase "tax expenditures" was first coined by Stanley Surrey, then Assistant Secretary of the US Treasury, in 1967.[16] Surrey's seminal paper on the subject in 1970, followed by his 1973 book, laid the foundation for future work on tax expenditure analysis.[17] In 1974, the US adopted an annual tax expenditure,[18] prompting the development by British academics of a United Kingdom (UK) tax expenditure account in 1978,[19] with the first UK government account appearing soon afterwards.[20]

Tax expenditures are generally defined as reductions in tax liabilities relative to a benchmark tax that are implemented by way of tax provisions.[21] The concept is based on an identification of two distinct types of provisions in a tax act.[22] The first is normative tax provisions that define the basic elements necessary for the operation of the tax system.[23] The second type comprises concessional deductions, exemptions, preferential rates, credits or tax deferrals that provide relief from the tax otherwise determined applying the normative tax measures.[24] The relief of tax is conceptually equivalent to the collection of tax under the normative tax system and payment of an amount equal to the tax concession benefit as a direct subsidy. As a consequence, for budget purposes these tax reliefs were referred to as tax *expenditures*.

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[16] S.S. Surrey, 'The United States Income Tax System- The Need for Full Accounting' in W.F. Hellmuth and O. Oldman (eds), *Tax Policy and Tax Reform: 1961-1969. Selected Speeches and Testimony of Stanley S. Surrey* (Commerce Clearing House 1973).
[17] S.S. Surrey, 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures' (1970) 83 Harvard Law Review 705; S.S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditure* (Harvard University Press 1973).
[18] Congressional Budget and Impoundment Act of 1974.
[19] J.R.M. Willis and P.J.W. Hardwick, *Tax Expenditures in the United Kingdom* (Heinemann Educational Publishers 1978).
[20] HM Treasury, *Public Expenditure White Paper* (Cmnd 7746, 1979).
[21] See Heady, (n 13); OECD, *Tax Expenditures in OECD Countries* (OECD Publishing 2010).
[22] S.S. Surrey and P.R. McDaniel, 'The Tax Expenditure Concept: Current Developments and Emerging Issues' (1979) 20 Boston College Law Review 225.
[23] *Ibid.*
[24] *Ibid.*

In the late 1960s, Surrey advocated a cautious and conservative approach to the identification of tax expenditures in pursuit of his immediate goal of the adoption of a tax expenditure budget. He very deliberately did not use a theoretically ideal tax base as the benchmark for identifying tax expenditures, instead accepting almost all structural features of the US income tax as it then stood in his benchmark so only explicit and deliberate tax preferences were recognised as indirect budget outlays.[25]

By the time tax expenditure statements had become accepted budget tools, and the first tax expenditure budgets incorporating VAT were prepared, many countries had moved from the cautious and pragmatic approach to defining the benchmark base initially advocated by Surrey to a more conceptual approach. The benchmark adopted for VAT was closer to a neutral tax applied to economic concept of consumption, recognising that both structural and compromise design features of the tax law had the same economic and fiscal consequences as deliberate concessions.[26]

There are, to be sure, country differences between benchmark VAT models at the margins, leading to differences in the identification of some tax expenditures, and consequently making cross-country comparisons problematic.[27] However, all countries with tax expenditure accounts broadly agree the benchmark VAT is one that is imposed uniformly across all consumption, yielding no biases or distortions in the marketplace. An alternative benchmark in theoretical literature based on optimal tax theory developed by Ramsay suggests that it is possible to maximise revenue without impinging on economic efficiency by adjusting the tax rates to the demand elasticities of different types of goods and services.[28] This implies that higher VAT rates should be applied to price inelastic types of consumption goods, since the demand of these goods will not change in the face of slight price rises.[29] Before Ramsay optimal tax theory could be put into practice, however, the price elasticity of every product and service in the market would have to be determined, subject to regular recalculations as price elasticity is influenced by changes in consumer preference, technological development

[25] S.S. Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses' (1979) 1 *Canadian Taxation* 3.
[26] See OECD, *Choosing a Broad Base- Low Rate Approach to Taxation* (OECD Publishing 2010).
[27] *Ibid*.
[28] F.P. Ramsay, 'A Contribution to the Theory of Taxation' (1927) 37 The Economic Journal 47.
[29] W.M. Gentry, 'Optimal Taxation' in J.J. Cordes, R.D. Ebel and J.G. Gravelle (eds), *The Encyclopedia of Taxation & Tax Policy* (2nd edn, The Urban Institute Press 2005).

and the launch of new products.[30] The administrative complexity of such activities means that the optimal tax theory has little practical relevance to the setting of VAT rates. A single rate and broad base remain one of the key design norms of a good VAT.

While in theory any deviation from the benchmark is conceptually the equivalent of full taxation and a compensatory direct subsidy for the particular type of consumption, it is clearly far easier to hypothesise a rationale for deviations deliberately adopted to offset the regressivity of the VAT or to provide subsidies or incentives. Reduced rates or a zero rate applied to essentials such as food and energy that account for higher proportions of the income of lower income persons than of the wealthy are intended to counter regressivity.[31] Reduced rates and exemptions are used to encourage consumption of goods or services that have perceived social value or positive externalities and which would be under-consumed in a neutral market, particularly by lower income persons.[32] Subsidised goods and services with perceived broad social benefits may include books, education, medical care, cultural and religious activities, as well as products with environmental benefits. In some other cases, exemptions are used as tax incentives to achieve specific economic objectives[33] or support particular types of enterprises.

Although this chapter focuses on these VAT measures deliberately adopted as subsidy measures, other features in VAT laws that deviate from a benchmark equally amount to implicit tax expenditures. Examples include exemptions used to overcome technical challenges in applying the VAT to some types of supplies and relative excessive costs incurred by some enterprises. The application of VAT to financial supplies, for instance, raises a host of technical issues that can be overcome in theory but the administration and compliance costs that solutions would entail are thought to be excessive relative to the additional revenue that would be raised. The solution adopted in most VAT jurisdictions is to exempt the supplies. Similarly, small enterprises can be taxed in the

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[30] Copenhagen Economics, 'Study on Reduced VAT Applied to Goods and Services in the Member States of the European Union: Final Report' (2007) < https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/vat/how_vat_works/rates/study_reduced_vat.pdf> accessed 17 July 2018.
[31] S. Cnossen, 'What Rate Structure for a Value-Added Tax?' (1982) 35 National Tax Journal 205.
[32] A. Seely, 'VAT: European Law on VAT Rates' (House of Commons Briefing Paper Number 2683, 25 November 2015).
[33] See Bird and Gendron, (n 6), 127-130.

same manner as all other businesses but relative compliance costs faced by these persons as a percentage of turnover could be many multiples that of larger businesses. To avoid this outcome, most VAT regimes use a registration threshold and treat small businesses with turnovers below the threshold as out-of-scope enterprises, the equivalent of classifying all their supplies as exempt supplies. While neither feature is explicitly adopted as a concession, both result in revenue forgone and amount to implicit subsidies. The threshold and financial supplies issues will be examined in detail in Chapters 2 and 3 respectively.

1.2 VAT tax expenditures as spending programmes

Viewed objectively, the preference of legislatures for tax expenditures over direct expenditures is odd and the rationales commonly offered for following the tax expenditure path often seem weak when subject to critical scrutiny. It is claimed, for example, that tax expenditures reduce the administrative costs that would have been incurred by spending ministries if direct subsidies had been used.[34] Provision of subsidies by way of reduced taxes does not eliminate the need to identify qualifying recipients and arrange for the distribution of benefits, however. Delivering a subsidy via the tax system simply shifts responsibilities for these activities from a spending ministry to tax administrators.

Evaluated as the spending programmes to which they amount, tax concessions raise serious concerns in terms of fairness, targeting efficiency and budget control. The alleged administrative advantage of tax expenditures, even if it were to materialise, must be considered in light of these concerns.

1.2.1 Fairness

Tax expenditures in the form of exemptions, allowances, rate reliefs and deferrals provide benefits in proportion to the recipient's tax liability. In the case of a progressive income tax with increasing rates of tax applying to higher slices of income, the benefit of tax concessions rises with income in both absolute terms and relative terms. A

[34] D-J. Kraan, 'Off-budgeting and Tax Expenditures' (2004) 4 OECD Journal of Budgeting 121; J. Tyson, 'Reforming Tax Expenditures in Italy: What, Why, and How?' (IMF Working Paper WP/14/7, 2014).

concessional £1 deduction for a personal expense yields a 30 pence subsidy for a person in the 30% bracket, a 25 pence subsidy for a person in the 25% bracket, and a 10 pence subsidy for a person in the 10% bracket. This redistributive element is absent from the benchmark VAT, which imposes a single rate of tax on all consumption with the aim of achieving economic neutrality, leaving redistribution goals to other taxes and to spending programmes. The upside-down character of concessional income tax deductions does therefore not apply to the VAT. A £1 supply of zero-rated food saves 20 pence tax for the rich and 20 pence tax for the poor. However, whatever the type of supply receiving concessional treatment, higher income persons are likely to acquire more in absolute terms than low income persons.[35] While the value of the subsidy does not rise with income for each pound spent, it does rise in absolute terms. The concession thus provides a larger proportional benefit to the poor, but a larger absolute benefit to the rich.[36] The tax expenditure is both unfair in terms of who receives the largest subsidy and illogical from a social welfare perspective. Subjecting concessional supplies to full VAT could yield sufficient revenue to reimburse low income persons for the cost of tax on their concessional consumption and yield additional resources for further social welfare programmes.

1.2.2 Targeting efficiency

Targeting efficiency – ensuring expenditures reach the intended beneficiaries in the least costly manner with minimum spillover to other persons – is a prime design objective for any government spending programme. Implicit in the social contract that includes a compulsory transfer of income and expenditure from individuals to the state is an understanding that the funds will be used efficiently. The logic applies equally to appropriations for direct expenditure programmes and amounts disbursed by way of tax expenditures.

Targeting efficiency for subsidies, be they delivered as tax expenditures or direct spending programmes, has two elements. The first, which might be labelled object

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[35] L. Ebrill and others, *The Modern VAT* (International Monetary Fund 2001), 75.

[36] A 1994 South African report shows that only little more than one-third of the benefits of zero-rated basic foodstuffs went to households in the lower five income deciles: Davis Tax Committee, 'First Interim Report on Value-Added Tax for the Minister of Finance' (December 2014) < http://www.taxcom.org.za/docs/20150707%20DTC%20VAT%20First%20Interim%20Report%20-%20website.pdf> accessed 18 July 2018.

efficiency, seeks to ensure that subsidies are not wasted where they are not needed and do not detract from desired distributional outcomes. The second, which could be described as class efficiency, is a two-step process, determining whether the subsidy is intended to subsidise suppliers or their customers and then ensuring the benefit reaches the intended class of recipients.

Different, but parallel, considerations apply to object efficiency where specific types of consumption are targeted to address regressivity and where they are targeted to promote the consumption of merit goods or services. Tax expenditures that are used to address regressivity should not reduce the VAT paid by high income consumers significantly more than it reduces the VAT paid by low income persons. Tax expenditures adopted to subsidise merit goods or services should not deliver windfalls to beneficiaries who would have consumed the same amount of these supplies without a subsidy.[37]

To the extent that concessions are intended to address the regressivity of the VAT and reduce the proportion of expenditure by lower income persons that is subject to tax, the efficiency goal coincides completely with the fairness criterion for evaluating tax expenditures. As noted earlier, however, tax expenditures to reduce regressivity deliver larger absolute benefits to higher income persons than to lower income consumers. The spillover of benefits in this case is significant.

Fairness and efficiency concerns may also appear to overlap with tax expenditures designed to subsidise the consumption of merit goods. Subsidised goods or services are consumed by both high income and low income persons, possibly creating the impression that the benefit is poorly targeted – higher income persons are less in need of a subsidy than lower income persons.[38] This view misconstrues the goal of merit supply subsidies, however. The aim is not to subsidise the consumption absolutely, but rather to influence consumption choices. By reducing the cost of subsidised supplies relative to fully taxed supplies, the concessions will, it is hoped or anticipated, alter consumption choices and increase consumption of merit supplies by persons of all

[37] The problem is set out in J. Harris, 'Tax Expenditure Control' in J. Rabin (ed), *Handbook of Public Budgeting* (CRC Press 1992).
[38] For the view that reduced rates can be used to make merit goods more accessible for low income households, see Copenhagen Economics, (n 30), 5.

income brackets. If education, for example, is a worthy expenditure, it should be encouraged by way of price bias for persons of all income groups. At the same time, it could be argued that price has relatively little impact on higher income persons. If all alternatives are affordable – education at 100 and movies at 50, a subsidy to reduce the cost of education to 50 may not affect consumption decisions and would act as a genuine windfall for consumption that is chosen without regard to cost.

Subsidies delivered by way of direct spending programmes are most commonly provided directly to the intended beneficiaries. Tax expenditure subsidies in the form of zero rate or reduced rate supplies are normally applied to designated supplies. The intention, presumably, is to benefit final consumers by way of price reductions. Tax expenditure subsidies in the form of exemptions sometimes apply to specified supplies and sometimes apply to specified suppliers[39] and the concession may be intended to subsidise either consumers or suppliers.[40] The designation of healthcare and medical services or nursing home services as exempt supplies, for example, is presumably intended to subsidise consumers of those services. The designation of services provided by the disabled as exempt supplies, on the other hand, might be intended to provide benefits to the suppliers.

From a targeting perspective, subsidies adopted for the benefit of final consumers will only be efficient if they are passed on to the intended beneficiaries. Subsidies adopted to benefit particular types of suppliers may be efficient if the supplier is able to absorb a significant portion of the subsidy or if the supplier is able to pass on the benefit and increase volume at the expense of suppliers not entitled to the benefit. Where the benefit of the concession is actually enjoyed will depend entirely on the elasticity of the supply or whether the concession applies across an entire sector. If easily substitutable supplies are available, the benefit is more likely to be passed on to final consumers. If, however, there are no obvious substitutes, the concession may be appropriated by the supplier (or higher up the production chain). That is, the subsidy may provide a higher profit margin for businesses rather than lower prices for consumers. There is evidence, for example, that a concession for children's shoes, for which there is no substitute, may not reach

[39] See Bird and Gendron, (n 6), 125.
[40] J. Englisch, 'The EU Perspective on VAT Exemptions' in R. de la Feria (ed), *VAT Exemptions: Consequences and Design Alternatives* (Wolters Kluwer 2013).

consumers at all.[41] Similarly, a concession across a full sector such as labour-intensive industries may have little impact on final prices or consumption across the sector, with the benefit of the subsidy apparently absorbed elsewhere.[42]

Targeting efficiency is further threatened in the case of exempt supplies that might be made to both final consumers and registered businesses. With no corresponding recovery of input tax, an "exempt" supply is actually, as at least one jurisdiction has explicitly labelled it, an input taxed supply.[43] The paradox of VAT in conventional Anglo terminology, thus, is that for registered businesses, an acquisition of a taxable supply is tax free while an acquisition of an exempt supply is actually taxable.[44] As the tax cannot be recovered by business customers, the input tax component becomes another element of the cost of acquisitions to be factored into the final selling price. If exempt supplies or supplies by exempt suppliers are made directly to final consumers, the reduced tax burden of an exempt supply may be enjoyed by the intended beneficiaries. However, if input taxed supplies are acquired by other businesses, what was intended to be a subsidy becomes an additional cost for the customer and will likely actually increases prices for supplies further down the production chain. The outcome is grossly inefficient from a targeting perspective – a subsidy intended for final consumers has imposed a burden on registered business customers that can be expected to be passed on to customers of other goods and services. As tax is imposed on tax, an apparent tax expenditure becomes a negative tax expenditure yielding VAT revenue higher than would be collected on a taxable supply subject to the standard rate.[45]

1.2.3 Budget control

The problem of inefficient outlays by way of tax expenditures is exacerbated by the difficulty of controlling the quantum of expenditures, the limited ongoing evaluation and scrutiny they receive and their proclivity for expanding. Unlike direct expenditures,

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[41] Commission, 'Reduced rates of VAT: frequently asked questions' (2003) MEMO/03/149.

[42] See Copenhagen Economics, (n 30), 10; Commission, 'Report from the Commission to the Council and the European Parliament, Experimental application of reduced rate of VAT to certain labour-intensive services' COM (2003) 309 final; de la Feria, (n 10).

[43] Australia uses the term "input taxed supply".

[44] R. de la Feria and R. Krever, 'Ending VAT Exemptions: Towards a Post-Modern VAT' in R. de la Feria (ed), (n 40).

[45] A. Schenk, V. Thuronyi and W. Cui, *Value Added Tax: A Comparative Approach* (2nd edn, Cambridge University Press 2015), 269.

which are appropriated by the legislature prior to the release of funds and which can be subject to strict annual limits, tax expenditures are an "open-ended government spending" programme, the value of which is discovered by the government only after the fact.[46] It is not until the tax expenditure budget for a year is completed that the government learns how much subsidised consumption has taken place and how much revenue has been applied to this consumption as a result.

Nor does the Parliament know the extent of its subsidy at a micro level, even if it is assumed that 100 per cent of the subsidy is passed on to consumers. A zero rate means there is no tax whatsoever on the supply. A reduced rate means the only tax included in the final sale price is the lower rate of tax. However, as noted earlier in the case of exempt supplies, the impact of the subsidy is inherently inconsistent, dependent entirely on the nature of the supply and supplier. Although there may be no tax imposed on the final sale, all input tax previously collected remains in the sale price. It is impossible for the legislature to know the value of the subsidy it is providing where it exempts final supplies but leaves an unknown amount of input tax embedded in the price. The subsidy may be small or effectively non-existent if there has been one or more exempt supplies along the supply chain to the final sale.

At the same time, from a budget control perspective, the overall impact of exemptions is substantial. The tax expenditure for education in the UK, for example, climbed from £2.5 billion in 2012-13 to £3.85 billion in 2015-16 with no Parliamentary approval, while the tax expenditure for financial and insurance supplies almost trebled over the same period, rising from £2.65 billion to £7.15 billion.[47]

Tax expenditures are also more prone to 'exemption creep',[48] a consequence of the propensity of concessions to 'feed on one another'.[49] Reduced and zero rates and exemptions incentivise taxpayers to lobby for further concessions or call for the extension of favourable tax treatment to similar or related supplies to level the playing

[46] Z. L. Swift, H. P. Brixi and C. M. A. Valenduc, 'Tax Expenditures: General Concept, Measurement, and Overview of Country Practices' in H. P. Brixi, C. M. A. Valenduc and Z. L. Swift (eds), *Tax Expenditures – Shedding Light on Government Spending through the Tax System: Lessons from Developed and Transition Economies* (The World Bank 2004).
[47] HM Revenue & Customs (HMRC), 'Estimated Costs of Principal Tax Reliefs' (2016).
[48] See Ebrill and others, (n 35) 89.
[49] See Bird and Gendron, (n 6), 128.

field. For example, for many years there was a vigorous debate in the EU on whether there was a plausible rationale for applying a reduced rate or zero rate to printed books and standard rate to e-books.[50] The European Commission has recently proposed to extend current VAT concessions to e-publications.[51] Tax expenditures are almost certainly more vulnerable to lobbying and uncontrolled expansion than direct spending programmes that are subject to strict scrutiny.[52]

1.3 Operational consequences of VAT tax expenditures

Apart from their troublesome outcomes as spending measures, VAT concessions are problematic in terms of their economic, legal and administrative impacts. Each effect presents further compelling rationales for reform.

1.3.1 Economic distortions

If VAT is imposed on a broad base and at a single rate, all consumption is subject to the same level of tax and other than constraining the total amount of consumption, the tax has no impact on market decisions. The extensive use of VAT concessions undermines the neutrality and equality in actual VAT systems, distorts consumption decisions, and impacts on production and investment decisions as well as business structure choices.

In addition to their macro effect on the economy, concessions create distortions and biases within individual firms. Competitive pressures for innovation and more efficient means of production are removed for suppliers of goods or services enjoying lower VAT rates. Producers not only shift production from higher taxed products to lower taxed ones but repackage and rebrand to shift products from one category of supply to another.[53]

[50] See e.g., Case C-479/13 *European Commission v France* [2015] STC 1706; Case C-502/13 *European Commission v Luxembourg* [2015] STC 1714; Case C-219/13 K Oy [2015] STC 433; Commission, 'Summary Report of the Outcome of the Public Consultation on the Green Paper on the Future of VAT Towards a Simpler, More Robust and Efficient VAT System' (2011), 36.
[51] Commission, 'Commission proposes new tax rules to support e-commerce and online businesses in the EU' (2016).
[52] See Tyson, (n 34).
[53] de la Feria, (n 10).

While all concessions raise economic efficiency concerns, the distortions caused by exempt supplies can be particularly pernicious. As noted earlier, when an exemption arises at intermediate stages and exempt supplies are used as inputs in the production of taxable supplies at the subsequent stages of the business chain, the 'logic of the VAT'[54] is violated and the B2B chain of tax and credit is broken. Non-recoverable input VAT forms part of the cost for business purchasers, leaving registered businesses that provide exempt supplies with embedded input tax and their competitors that provide fully taxable substitutes sit in starkly different competitive positions when selling to registered businesses. Businesses providing exempt supplies will be at a competitive disadvantage since their VAT exclusive prices to registered business customers will be higher than those of businesses that provide fully taxable supplies. Taxable persons who are entitled to input credits are likely to seek substitutes for exempt acquisitions with non-deductible embedded input VAT.

Once the B2B tax relief feature of the VAT is broken, the embedded VAT remains in the production chain forever. The tax component will thus be subject to VAT again and result in tax-on-tax cascades.[55] The longer the chain, the greater the level of cascading there will be. Confronted with disadvantage in terms of price competitiveness, some taxable persons may seek to absorb non-recoverable input VAT in their operating costs, yielding lower profit margins and further distortionary consequences.[56]

A further bias created by the use of exempt supplies as a subsidy is the incentive for self-supply. To avoid input tax on acquisitions, taxable persons making exempt supplies may seek greater vertical integration by bringing services that can be more efficiently outsourced into the business.[57] Exemptions thus potentially encourage in-house production, which inhibits specialisation and could lead to the growth of far less efficient businesses.

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[54] See Crawford, Keen and Smith, (n 14), 351-352.
[55] Tait, (n 14) 50.
[56] PwC, 'Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services' (November 2006) < https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/financial_services_study_managementsummary_en.pdf> accessed 18 July 2018.
[57] H. Grubert and R. Krever, 'VAT and Financial Services: Competing Perspectives on What Should Be Taxed' (2012) 65 Tax Law Review 199.

Exemptions also create a preference for imports by persons making exempt supplies, taxable persons making taxable supplies, and final consumers.[58] Domestically-sourced exempt supplies are input taxed, meaning undeducted input tax is embedded in the price. Imported exempt supplies, in contrast, have no tax in the source jurisdictions, where they are treated as zero-rated exports and no tax on importation so are completely free of explicit or implicit (embedded) VAT. Firms using exempt supplies as inputs may thus prefer exempt imports to domestically produced supplies. The efficiency loss associated with all the economic distortions is difficult to measure, in particular insofar as the exact impact of exemptions on the integrity of the VAT is unclear. Nevertheless, it could be presumed that the inefficiencies are not trivial.[59]

1.3.2 Legal difficulties

The complexity of the VAT system attributable to concessions is reflected in the legislation itself. The legal definitions used to identify supplies subject to lower rates or different tax treatment (taxable vs exempt) are not replicated in economic or commercial reality. The flexibility of modern commerce and commercial relations provides almost infinite opportunities for the repackaging or recharacterisation of supplies. Any concession that carves out particular supplies for concessional treatment, be it exemption, lower rate or zero rate, creates a legal distinction that raises a host of definitional and interpretative problems including boundary issues between the various types of supplies and the problem of multi-element supplies comprising two or more separate types of supplies. In addition, exempt supplies that are accompanied by a denial of input tax credits invite creative business arrangements to bypass the blocked credits.

The first issue that arises where the VAT applies in a different manner to similar supplies is how taxpayers and tax authorities should categorise products that do not clearly fall in one camp or the other. The boundaries between comparable products are far from intuitive and the indistinct borders both invite confusion and tempt taxable persons to push the boundaries, sometimes aggressively. Enormous administrative and judicial resources are then needed to draw the lines on a case by case basis. No cases

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[58] See Ebrill and others, (n 35) 88.
[59] See Crawford, Keen and Smith, (n 14) 352.

better illustrate these phenomena than the UK "Jaffa cake" litigation[60] that commenced with a food manufacturer successfully arguing that its confectionary product should be characterised as a zero-rated cake rather than a standard-rated biscuit, a distinction that could not plausibly be defined on policy grounds in the first place.

In many cases, confusing borders are rendered even more indistinct with exceptions to exceptions. Food in the UK is zero-rated but cooked meals are not unless they are prepared as cold take-away food, leaving taxpayers, tax administrators and inevitably tax judges with the arduous task of determining how warm the food is when served or the manner in which the food is served.[61] The seemingly insignificant questions are however key factors in determining VAT liability within the meaning of the law. The boundary problems would make the tax system vulnerable to avoidance and fraud as the arbitrary distinctions (made in either statutes or case law) provide taxpayers with incentives to deliberately misclassify items to take advantage of the concessional treatment.

A second issue that arises where different supplies are treated differently for VAT purposes is how to deal with multi-element supplies. A single notional supply may include components that on their own constitute different categories of supplies in terms of rates or character as fully taxable or exempt or zero-rated supplies. Since a large number of supplies in the contemporary economy are bundled supplies with multiple components, ambiguities exist as to whether multi-element supplies are mixed supplies that are separable into differently taxed components or composite supplies that take on the tax character of the principal component. The general rule is that a multi-element supply is considered a composite supply if the elements are integral parts of an overall supply, and a mixed supply if the elements are separable and each of them serves for its own purpose. While the general rule seems to be straightforward, the leading cases on mixed and composite supplies show that the distinction between them is never clear cut

[60] *United Biscuits (UK) Ltd v CC&E* [1991] LON/91/160.
[61] See *Mucho Mas Limited t/a Chilango v HMRC* [2016] UKFTT 0302 (TC) (burritos, tacos and other Mexican food are standard-rated cooked hot meals and not zero-rated cold packed food); *HMRC v Compass Contract Services UK Ltd* [2006] EWCA Civ 730; [2006] STC 1999 (sandwiches, salads, snacks and drinks sold at outlets in the BBC Television Centre are zero-rated food supplies and not supplies made in the course of catering).

in practice.[62] They also open the door to tax minimisation arrangements. A decision that in-flight catering is zero-rated as an integral part of (zero-rated) supply of transport[63] was no doubt a factor that prompted a train operator to offer dinner trips comprising a short circular train trip with a haut cuisine meal of a value many times that of the train trip that ended up exactly where it started. In this case, the court agreed with the tax authority's view that the supply was a mixed supply and allowed the authority to allocate the cost of the ticket mostly to a standard rated meal, with a small remainder treated as consideration for zero-rated circular rail transport services.[64]

Over time, common law jurisdictions will develop tests to distinguish composite and mixed supplies and civil law judges with an understanding of tax principles will develop interpretation norms that establish some guidance for taxpayers and tax administrators. However, as ongoing litigation of mixed and composite supply cases demonstrates, the cases turn on the facts, making it impossible to develop precise boundaries from case law precedents or civil law principles.

The juxtaposition of exempt and taxable supplies in national VAT laws invites tax minimisation schemes by suppliers seeking entitlement to input tax credits for acquisitions that ultimately relate to exempt supplies. The legality of schemes that unambiguously build on the provisions in VAT laws adds a veneer of respectability and legitimacy that attracts both commercial and non-profit enterprises into tax minimisation arrangements. The *Newnham* case[65] provides an example where the foundations in national law made it almost impossible for tax authorities to use specific anti-avoidance rules to combat the scheme. Most likely, similar difficulties will be encountered with general anti-avoidance rules or doctrines.[66]

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[62] See e.g., *Card Protection Plan Limited v CC&E* [2001] UKHL 4; [2001] STC 174; Case C-349/96 *Card Protection Plan Limited v CC&E* [1999] STC (registration services for credit card insurer is part of a composite supply of insurance); Case C-572/07 *RLRE Tellmer Property sro v Financni Reditelstvi v Usti nad Labem* [2009] ECR I-4983; [2009] STC 2006 (supply of residential premises and cleaning service for building common areas is a divisible mixed supply); Case C-41/04 *Levob Verzekeringen BV v Staatssecretaris van Financien* [2005] ECR I-9433; [2006] STC 766 (supply of software and customisation and training services is a single composite supply).
[63] *British Airways v CC&E* [1990] STC 643.
[64] *Sea Containers Services Ltd v CC&E* [2000] STC 82.
[65] *Principal and Fellows of Newnham College in the University of Cambridge v HMRC* [2008] UKHL 23; [2008] STC 1225.
[66] G. Morse, 'HMRC v Principal and Fellows of Newnham College in the University of Cambridge: VAT Anti-avoidance—the End of an Era?' [2008] British Tax Review 542.

Additional complexity arises where complex intra-group arrangements including internal transfer pricing are used to maximise input tax entitlements as cases such as *Halifax*[67] and *BUPA*[68] illustrate. Once again, where the structure of the law provides strong economic incentives for avoidance, solutions that rely solely on anti-avoidance measures will have limited impact. Policy-oriented judicial doctrines can arrest the spread of schemes, but in the longer term the more logical solution is to reform the structural features that encourage and reward successful avoidance arrangements.

1.3.3 Administrative and compliance costs

The use of concessions inevitably leads to an increase in compliance burden for registered businesses and administrative burden for tax administrators. In the first place, resources are needed to distinguish fully taxable, reduced rate, zero rate and exempt versions of often similar supplies. Further efforts are needed to distinguish composite from mixed supplies and then to dissect the latter into component parts. Once these steps are completed, registered persons need to divert time and resources to carry out additional accounting activities, including separating records of sales and purchases of the different categories of supplies.[69]

A further step is required when businesses make both exempt and taxable supplies. In these cases, the businesses must apportion the use of inputs between the production of taxable and exempt supplies, with input tax credits available for the former group of inputs only. The apportionment, however, is not always straightforward, as many inputs are indistinguishably related to both taxable and exempt supplies. Many countries allow taxpayers to self-select apportionment methods appropriate to their business model, while providing safe-harbour rules to the risk-adverse. This increases compliance costs as taxpayers make calculations based on alternative formulae to achieve an optimal tax result. The legitimacy of their chosen methods is often tested through costly litigation.[70]

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[67] *Halifax plc and others v CC&E* (C-255/02) [2006] ECR I-1609; [2006] STC 919.
[68] *HMRC & BUPA Purchasing Limited & Ors* [2007] EWCA Civ 542; [2008] STC 101.
[69] See Ebrill and others, (n 35) 78.
[70] See e.g., *HMRC v Lok'nStore Group Plc* [2014] UKUT 0288 (TCC) (taxable person allowed to apportion inputs attributable to taxable sales on the basis of floor space); *The Hurlingham Club v HMRC* [2015] UKFTT 76 (TC) (taxable person not allowed to apportion on the basis of floor space).

All concession issues that increase compliance costs equally impact on administrative costs for tax authorities. Officials processing and auditing VAT assessments must evaluate taxpayers' distinctions between fully taxed, reduced rate, zero-rate and exempt supplies, taxpayers' characterisations of bundled supplies as mixed or composite supplies, their dissection of elements in the case of mixed supplies, and their apportionment of input tax credits where they make taxable and exempt supplies. Further and significant resources are needed to uncover avoidance schemes attributable to the interaction of fully taxed and concessional supplies.[71]

Exact measurements of the effect of concessions on compliance costs or consequent administrative costs have yet to emerge and comparative measurements of compliance costs have proven difficult.[72] However, a rough indication of relative compliance costs may be garnered from a comparison of compliance costs as a proportion of revenue, provided the standard rates are similar. A comparison of compliance costs in Denmark and Croatia, which share the same standard rate, offers an illustration. Compliance costs have been estimated to be 0.3 per cent of the total VAT collections in Denmark, the lowest in the EU, and between 16-25 per cent in Croatia, the highest in the EU.[73] The absence of any reduced rate in Denmark may well be one reason for the notably low compliance costs in that country.[74]

1.4 Reforming VAT concessions

Tax expenditure analysis of VAT concessions in the form of reduced rates, zero rate and exemptions suggests they are ill-suited tools to achieve social and economic objectives. But while the revenue cost of VAT concessions is now commonly recorded in tax expenditure accounts, tax expenditures as spending programmes continue to evade scrutiny equal to that of direct expenditures. New methodology is needed to bring these

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[71] US Government Accountability Office, 'Value-Added Tax: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition' (Report to Congressional Requesters GAO-08-566, 2008).
[72] C. Sandford, 'International Comparisons of Administrative and Compliance Costs' (1994) 11 Australian Tax Forum 291.
[73] Institute for Fiscal Studies and others, 'A Retrospective Evaluation of the EU VAT System' (European Commission, December 2011), 111-112 < https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/report_evaluation_vat.pdf> accessed 18 July 2018.
[74] *Ibid.*

into the budget process. Tax expenditures found wanting in terms of fairness, targeting, or economic impact can then be replaced with direct expenditure programmes or modified to achieve better their intended purposes.

1.4.1 Recognising equally indirect and direct spending programmes

The foundation of tax expenditure analysis as a tool to reform tax concessions is full recognition of tax expenditures as government spending programmes. Currently, cost analysis of tax expenditures characterises these measures in terms of lost revenue, not applied revenue. In one sense, this is not surprising. The ability of VAT to raise a significant amount of revenue is the key attribute of the tax that explains its attractiveness to governments. If concessions are not correctly recognised as indirect expenditures, their effect appears to be to seriously undermine the revenue potential of the VAT,[75] among other things necessitating higher standard rates to replace lost revenue.[76] If, on the other hand, concessions are treated as indirect expenditures, their abolition would not necessarily be seen as a prompt for lower standard VAT rates. In the alternative, they could be replaced with equally costly, albeit likely fairer and more efficient, direct spending programmes or their elimination could provide resources for other government initiatives.[77]

Cost analysis of tax expenditures as lost revenue has been driven to a large extent by the work of international agencies such as the International Monetary Fund (IMF) and the OECD. These agencies calculate the gap in VAT collections from a theoretically comprehensive consumption base using national accounts to estimate total consumption. The bases used by the IMF and the OECD to measure potential consumption differ slightly. The IMF's "C-efficiency" formula uses the value of VAT-exclusive national consumption and the OECD's VAT revenue ratio (VRR) formula uses the value of VAT-inclusive national consumption.[78]

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[75] P-P. Gendron, 'Canada's GST at 21: A Tax Expenditure View of Reform' (2012) 1 World Journal of VAT/GST Law 125.
[76] C. Ball, J. Creedy and M. Ryan, 'Food Expenditure and GST in New Zealand' (New Zealand Treasury Working Paper 14/07, 2014).
[77] See Brooks, (n 15) 242.
[78] OECD, (n 1).

Both the C-efficiency and VRR measurements suffer from three shortcomings when used as tools to measure the revenue cost of tax expenditures. The first is that the measurement of consumption in national accounts varies in some respects from the generally accepted notion of consumption for VAT purposes.[79] There may be differences, for example, in the treatment of public services, imputed rent for owner-occupied housing, sales of second-hand goods, and other values.[80]

Secondly, and more importantly, the C-efficiency and VRR calculations measure the difference between VAT collected and potential VAT on all consumption without distinguishing revenue forgone for concessions from revenue lost to evasion or avoidance. Attempts have been made to decompose the C-efficiency and VRR into policy gap (revenue forgone by way of concessions) and compliance gap components in order to assess the respective impacts of the two components on VAT revenue.[81] The approach that is commonly used is to estimate the total C-efficiency/VRR gap, subtract the compliance gap, and calculate the policy gap as a residual.[82] This measurement, however, remains one based solely on theory, with no connection to revenue budget accounts.

This distinction exposes the third shortcoming of C-efficiency and VRR measurements as basis for tax expenditure analysis. Even if measurements derived from national accounts were to disaggregate shortfalls into policy and compliance components, their starting points, total consumption based on national accounts, might differ significantly from the aggregate tax bases of benchmark VATs used in tax expenditure budgets. What is needed is a measurement of the policy gap using a base that the legislature recognises as a realistic tax base, not a theoretical base never within its contemplation. Equally importantly, the gap must be treated not as a loss of revenue but rather as revenue notionally collected and spent by way of indirect expenditures.

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[79] L. Barbone and others, 'Study to Quantify and Analyse the Gap in the EU-27 Member States: Final Report' (European Commission, 2013).
[80] See Keen, (n 12) 432-434; and OECD, (n 1) 109-116.
[81] B. Clements, V. Perry and J. Toro, *From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies* (International Monetary Fund 2010); See Keen, (n 12).
[82] See Clements, Perry and Toro, (n 81).

The most useful tool for budget purposes will be an account derived from actual budget data of revenue received and revenue forgone on consumption that national authorities have explicitly recognised as untaxed consumption. That is, national tax expenditure budgets implicitly recognise total VAT revenue as comprising two components – a portion that is collected and then expended through direct expenditures and a portion that is notionally collected and immediately remitted as tax expenditures. The challenge is to modify budget processes so both types of expenditure receive equal recognition. To date, the two components have been analysed in isolation. If they are combined, the actual cost of tax expenditures and direct expenditures can be evaluated in terms of true VAT revenue, which comprises both collected tax and tax forgone prior to collection. The proportion of potential revenue expended by way of tax expenditures can be expressed as a VAT tax expenditures ratio (VTER). In figures, the VTER would be:

$$\mathrm{VTER} = \frac{\text{VAT tax expenditures}}{\text{VAT tax expenditures} + \text{revenue collected}}$$

Tax expenditure accounts measure the value of tax expenditures on the assumption that if concessional taxed consumption were fully taxed, the forgone revenue would be recovered completely. It could thus be argued that using raw tax expenditure figures as revenue forgone exaggerates the impact of these concessions; were the supplies subject to tax, suppliers might resort to avoidance or evasion arrangements that provide no benefit so long as a concession applies. It is equally probable, however, that compliance could improve as concessions are removed and the foundation for current avoidance arrangements disappears. In any case, the impact of improved or reduced compliance is likely to be negligible in terms of the overall measurements.

Data drawn from national tax expenditure accounts shows the VTER for the UK (a jurisdiction using a traditional VAT standard and reduced rate model, as well as a zero rate for some domestic supplies) and Australia (a jurisdiction using a modern VAT single positive rate model and a further zero rate for some domestic supplies) to be

0.38[83] and 0.29[84] respectively in 2015-16. The result is consistent with a supposition that VAT concessions are used with greater caution in more recently adopted VAT systems. In VTER terms, UK legislators are distributing well over one-third of their VAT revenue through tax expenditures that likely have not been reviewed since inception. In contrast, every pound of the remaining revenue is subject to vigorous debate and review in two houses of Parliament before expenditure, not to mention rigorous analysis in the press, academia and external research bodies.

The VTERs for different countries are not directly comparable given the diversity in the views of a benchmark VAT (and consequently what constitutes VAT tax expenditures). On a country-by-country basis, however, the VTER can show the proportion of VAT revenue disbursed by means of tax expenditures utilising each government's own accounts. Legislators can be held accountable for tax expenditures in the same way they are for direct expenditures. Tax expenditure analysis can then be incorporated directly into the budget process. The application of VTER approach would, of course, prove difficult in countries with no tax expenditure account, as is the case in most developing countries. In these jurisdictions, commitment to the use of VTER could be a catalyst for adoption of a tax expenditure account, a policy that could prove beneficial to the improvement of budget process for these countries in the long term.

1.4.2 Removing VAT concessions

Reform of VAT concessions must be tailored to their objectives. One group of VAT concessions is intended to subsidise particular types of suppliers or to encourage consumption of particular goods or services (merit supplies). This type of subsidy can be delivered more efficiently and with greater transparency through direct spending programmes.

The second type of concession is designed to moderate the regressive impact of the VAT, reducing the tax burden for lower income persons in general, as opposed to

[83] Author's own calculation. Sources: HMRC, 'Value Added Tax (VAT) Factsheet 2015-16' (2016); HMRC, (n 47); HMRC, 'Estimated Cost of Minor Tax Reliefs' (2016).
[84] Author's own calculation. Sources: The Treasury, Australian Government, '2016 Tax Expenditures Statement' (2017); and Australian Taxation Office, Australian Government, 'Taxation Statistics 2014-15' (2017).

subsidies for particular suppliers or types of supplies. Once again, direct expenditures provide the optimal response. The most efficient way of offsetting the VAT burden for low income persons is to provide tapering compensatory entitlements based on income. These can be made directly as welfare payments or indirectly by means of a progressive and refundable tax credit incorporated in the income tax system. The latter may be more cost efficient from an administrative perspective as the same agency measures income and distributes benefits based on that measurement. The Canadian compensatory tapering and refundable tax credit system[85] provides a working example of this system.

Compensatory payments are not only more efficient in directly offsetting the regressivity of the VAT but also avoid the paternalism found in most systems using tax relief for specific types of supplies as a means of offsetting regressivity. They achieve neutrality and remove distortions while providing visible assistance for those who would otherwise benefit from specific tax expenditures in VAT systems intended to reduce regressivity. The visibility in turn enhances the political support for reform by establishing a direct nexus between the replacement of concessions with substituted direct or tax credit payments.[86]

1.4.3 Designing VAT concessions

However strong the case may be for replacing VAT concessions with more efficient alternative instruments, experience shows that it is difficult to remove tax expenditures once they have been adopted.[87] This is especially true if concessions were adopted for historical or political reasons such as the path dependency concessions transferred into the EU VAT system to replicate preferential treatment in the predecessor turnover tax systems.[88] Concessions for food are particularly resistant to change in jurisdictions where their adoption was required to win initial public or political acceptance for a

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[85] Known as the Goods and Sales Tax/ Harmonised Sales Tax (GST/HST) credit.
[86] See R. Bird and P-P. Gendron, 'Sales Taxes in Canada: The GST-HST-QST-RST "System"' (2010) 63 Tax Law Review 517 on Canada's experience when the nexus was not established.
[87] See Crawford, Keen and Smith, (n 14) 301.
[88] On path dependency concessions see S. Cnossen, 'The Technical Superiority of VAT over RST' in J.G. Head (ed), *Australian Tax Reform in Retrospect and Prospect* (Australian Tax Research Foundation 1989); Commission, 'Proposal for a sixth Council Directive on the harmonization of Member States concerning turnover taxes - Common system of value added tax: Uniform basis of assessment' COM (73) 950.

VAT that was perceived to be inherently regressive.[89] A "temporary" zero-rating of food adopted when the VAT was introduced in the UK remains in effect 44 years later.[90]

What options are available if it is conceded that complete removal of concessions is politically unattainable in many of the countries in which they are used extensively? The second-best reform option within these political constraints is better design of concessions that more effectively target intended beneficiaries, minimise distortions, and reduce administration and compliance costs. In the case of subsidies to offset the regressivity of the VAT, policy decisions may feed directly into the design of the VAT law. In the case of concessions that were adopted to subsidise the consumption of merit supplies, it may be possible to piggy-back the concessional measures in the VAT law on other legislation directly implementing policy decisions.

To address the regressivity inherent in VAT systems, most VAT laws include concessions for "necessities", in particular food.[91] Empirical evidence suggests concessions for items that account for a higher percentage of lower income consumers' budgets can be effective in delivering relatively greater benefits to low-income groups, increasing the progressivity of the VAT, at least in terms of consumption expenditure.[92] However, as noted earlier, reducing the regressivity of the VAT in this manner comes at significant fiscal cost as it subsidises all consumption of designated items, both by low income and high income persons, and delivers a greater absolute benefit to higher spending, higher income persons. At the same time, fuzzy borders to concessionally taxed items increase administrative and compliance costs.

While inefficiency and complexity cannot be eliminated entirely so long as concessions remain in the VAT system, a better targeted list of concessionally taxed necessities can substantially reduce collateral costs. The policy objective is all too often lost in the

[89] A concession for food was seen as crucial to the acceptance of GST in Canada, for example; see Bird and Gendron, (n 86).
[90] Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes- Common system of value-added tax: uniform basis of assessment [1977] OJ L145.
[91] New Zealand and Japan are notable exceptions where the VAT is imposed at a uniform rate, with no concessions for necessities.
[92] Studies show that the progressive effects of rate differentiation were found in EU countries. See Cnossen, (n 88) 346-347; Ebrill and others, (n 35) 109.

current approach in many countries based on broad categories of necessities such as "food" along with ambiguous or arbitrary borders not obviously tied to the objective. The logic of distinguishing biscuits from cake, noted earlier, or treating a supply of six donuts as zero-rated food and five donuts as fully taxed consumption (as is currently the law in Canada) to target tax relief for lower income persons is at best obscure. To achieve the intended policy and improve targeting efficiency, seemingly random designations that seek to second guess the needs of lower income persons should be replaced with narrowly targeted goods and services that comprise a large percentage of expenditure by lower income persons as identified by objective household expenditure survey data. Efficiency can be enhanced if the targets are reviewed regularly and adjusted as appropriate to changes in the consumption pattern of lower income persons. Better targeting in this way avoids excessive leakage of benefits to high income persons while reducing VAT administrative and compliance costs. Complex disputes over the characterisation of snack food as a cake or biscuit would not arise if a system similar to that used in South Africa were adopted, where the zero-rating of food is strictly confined to 19 items of basic foodstuffs.

Concessions used to subsidise various merit supplies are common in VAT systems. The logic of careful drafting to target tightly subsidies for merit goods applies equally to direct expenditures and tax expenditures. However, as a consequence of ambiguous drafting of tax expenditure provisions in VAT laws and consequent judicial rulings that often misconstrue the intended goals of concessions, the types of supplies that are subject to lower rates or exemptions often extend far beyond a rational target for merit goods or those that would likely qualify for subsidies under a direct expenditure programme implementing deliberate policy choices.[93] Loosely drafted legislation invites suppliers to characterise their services as preferentially taxed supplies. In the UK, for example, suppliers of Pilates lessons,[94] belly dancing lessons,[95] golf lessons,[96] and college meals served to the general public[97] have attempted to present their supplies

[93] See e.g., the goods considered in *Harrier LLC v HMRC* [2011] UKFTT 725 (TC) (photography books containing only photographs taken by customers characterised as zero-rated supplies).
[94] *Hocking v HMRC* [2014] UKFTT 1034 (TC).
[95] *Cheruvier (t/a Fleur Estelle Belly Dance School) v HMRC* [2014] UKFTT 7 (TC).
[96] *Marcus Webb Golf Professional v HMRC* [2012] UKUT 378 (TCC); [2013] STC 574.
[97] *HMRC v Brockenhurst College* [2015] EWCA Civ 1196; [2016] STC 2145; *Brockenhurst College v HMRC* (C-699/15) [2017] STC 1112.

as exempt education supplies. It is almost inconceivable that suppliers would make similar arguments in the context of direct expenditure programme for education.

In contrast to the loose language and apparently unprincipled application of tax expenditures in many VAT laws, direct expenditures are tightly drafted to avoid ambiguous boundaries and inappropriate applications of public funds. One technique for targeting tax expenditures is therefore to tie the tax expenditures to relevant direct expenditure laws or to laws that tightly regulate a field. Health tax expenditures, for example, could be limited to services that qualify for direct payments under a national health insurance regime.[98] Similarly, education tax expenditures could be tied to services defined under education institution legislation. Rather than setting out ambiguous tests such as the currently UK concession for private tuition in "a subject ordinarily taught in a school or university",[99] education supplies eligible for concessional treatment could be tied directly to well-established and clearly focussed education (expenditure) laws as is done in Australia.[100] Tightly drafted tax expenditure provisions could free tax administrators and appeal adjudicators from the almost impossible task of determining how the man on the Clapham Omnibus would interpret "a subject ordinarily taught in a school" and the many other vague terms that establish the artificial boundaries in VAT laws.

1.5 Conclusion

VAT concessions often operate as unfair and inefficient subsidy programmes that give rise to significant legal and economic distortions and high administrative and compliance burdens. While often described as a cause of revenue loss, they are more appropriately viewed as indirect revenue appropriations. The ideal reform would see the replacement of VAT concessions with fairer and better targeted direct expenditure programmes. However, the political economy reality in most countries probably removes the first best option from the table for some, but perhaps not all, concessions. The question then becomes which current concessions can be removed and replaced and

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[98] E.g., (Australia) A New Tax System (Goods and Services Tax) Act 1999, 38-7, explicitly linking tax free medical services to those that qualify for direct subsidies under the national health insurance scheme.
[99] Value Added Tax Act 1994, Sch.9 Group 6 Item 2.
[100] A New Tax System (Goods and Services Tax) Act 1999, 38-85 and 195-1 defining tax free secondary and tertiary courses as those qualifying for financial assistance under the Student Assistance Act 1973.

which can be retained but improved and, in the case of the latter group, how they can be improved. The VTER approach outlined in this chapter to measure the cost of each concession and treat it as an expenditure made from total potential VAT revenue can provide a starting point for rigorous tax expenditure analysis of VAT concessions. The approach may, however, need to be coupled with the adoption of tax expenditure accounts in those countries, particularly developing countries that currently have no tax expenditure budget system.

Tax expenditure analysis suggests that concessions are not the best way to address the regressivity of a tax on consumption. The VAT is only one element in a larger tax and transfer system and its impact must be considered in the context of the overall progressivity of the entire tax system.[101] Subsidies to address the regressivity of the VAT are best provided as direct welfare transfers or tapering and refundable income tax credits. To the extent political considerations warrant retention of subsidies in the VAT to address regressivity, concessions could be better targeted by using household expenditure data to focus on a limited range of necessities that account for a larger percentage of lower income consumers' budgets. Subsidies for merit supplies are best delivered through direct spending programmes. If the concessions used to subsidise merit supplies must remain in the VAT system, targeting efficiency can be enhanced by linking the tax expenditure provisions in VAT laws to direct expenditure or regulatory laws that more tightly define qualifying supplies. There are, to be sure, significant geo-political hurdles to be overcome in the reform of VAT concessions. However, tax expenditure analysis can provide a useful conceptual framework for the process.

[101] See Adam, Philips and Smith, (n 73) 538.

CHAPTER 2. VAT THRESHOLD AND SMALL BUSINESS REGIMES

2 Introduction

Two features common to most VAT systems are the use of a registration threshold, usually based on annual turnover,[102] to determine when businesses are subject to the tax and one or more small business regimes that provide specific tax rules for small businesses that have crossed the registration threshold or which sit below the threshold. The common (but not universal) support for adoption of a registration threshold does not extend to the level at which it should be set. In the OECD, registration threshold levels range from £85,000 in the UK to zero in Spain, Turkey, Chile and Mexico.[103] Other countries are widely scattered between the two extremes, with most of them having a registration threshold far lower than that of the UK. As is the case with the registration threshold, there is no unanimity on the rules for small businesses.

The primary purpose of a registration threshold is to reduce administrative and compliance costs as study after study shows the administrative costs incurred by tax authorities to apply the VAT to, and the compliance costs incurred by, small businesses are disproportionate to the revenue these enterprises generate. The registration threshold has the effect of omitting small businesses from the formal VAT system. Generally, a bright line test is used to determine when an enterprise has reached the registration threshold, though in some cases, evidence of sustained turnover above the threshold is required.[104] Businesses with turnovers below the registration threshold are not fully outside the scope of the VAT, however. Although they are not required to register for or remit VAT, unregistered firms bear VAT on their inputs and this cost becomes incorporated into their selling prices.

Thresholds raise two concerns. The first is competitive distortion. A threshold that creates differences in terms of tax payments and compliance costs for businesses above

[102] There are in some instances alternative measurements of the threshold, however. For example, in the Netherlands, the thresholds are calculated by reference to net annual VAT due.
[103] See OECD, (n 1) 89.
[104] For example, an exemption threshold in the French VAT allows businesses that cross the threshold to retain the exemption for up to two years provided their turnover does not exceed €90,300 (for sales) or €34,900 (for services) for more than a year during this period.

and below it appears to affect the relative competitive positions of the firms.[105] Many countries allow businesses with turnovers below the threshold to voluntarily register for the VAT to mitigate this problem where unregistered businesses would be prejudiced by their exclusion from the VAT system.

A second and more significant concern is the possible economic and revenue cost of enterprise behaviour to remain deliberately below a registration threshold. The observed bunching of small businesses below the registration threshold may be the result of three types of business behaviour: dishonesty and failure to report some sales, artificial separation of business into multiple unregistered parts, or reduction of activity to reduce sales. Under-reporting of sales and business splitting lead to revenue losses while business restraint causes economic harm of particular concern to policy makers. One way of mitigating these problems is to reduce the double shock of compliance costs and higher tax faced by businesses entering the VAT. Some jurisdictions have adopted transitioning rules that provide subsidies to offset the costs and tax for businesses crossing the registration threshold.

While adoption of a threshold can mitigate the burden of comparatively high compliance costs faced by small businesses, it cannot eliminate the problem if some small businesses remain above the threshold. Simplified VAT procedural rules for small businesses to address the disproportionate compliance costs borne by these enterprises are not uncommon. Measures incorporated into simplified regimes include less frequent filing (and, often payments) and cash basis accounting. A variation allows eligible small businesses with turnovers exceeding the threshold to use a single presumptive input tax entitlement calculation in lieu of tracking all acquisitions to determine total entitlements.

Separately, instead of adopting a registration threshold that excludes small businesses entirely from the indirect tax system, some jurisdictions adopt a turnover border that distinguishes businesses subject to the full VAT and those subject to an alternative lower rate turnover tax.

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[105] Ebrill and others, (n 35) 119-121.

Registration thresholds and small business regimes work in tandem and the absence or presence of a simplified regime will have an impact on the full VAT registration point and vice versa. The interaction is complex, however. As explained further below, regimes that reduce compliance costs for small businesses in the formal VAT system may make lower thresholds feasible but the reduced threshold will lead to higher administrative costs with little offsetting revenue. Also affecting the threshold level is the choice of treatment of small businesses outside the formal VAT. As a general rule, higher income jurisdictions favour input taxation (that is, no recovery of input tax, leaving the businesses to bear the burden of the tax in the first instance) for smaller businesses below a registration threshold. The approach taken by medium and lower income jurisdictions is less consistent. Some subject small businesses with turnovers below the registration threshold to input taxation while others have substituted alternative tax borders for registration thresholds and impose a lower rate turnover tax on businesses below this boundary.

The lack of agreement on registration threshold levels does not reflect the absence of any theoretical framework for policy development in this area. Rather, it reflects the dearth of clear practical guidance in current theoretical analysis of the issue and the impact of exogenous factors on VAT design. Country-specific factors and domestic political considerations play crucial roles in tax design and there is thus no one size solution that can address all these issues. In the case of small business regimes, policy makers must address the design issues with almost no theoretical discussion to provide guidance or a conceptual framework on this subject.

It is nevertheless possible to identify the issues that should be taken into account when policy makers consider where the registration threshold should be set, whether simplified and phasing in regimes should be available for small businesses that have crossed the registration threshold, and whether alternative small business regimes should be adopted for businesses below the threshold at which they are required to register for the full VAT. An analysis of these issues can set the stage for the development of sorely needed practical guidance.

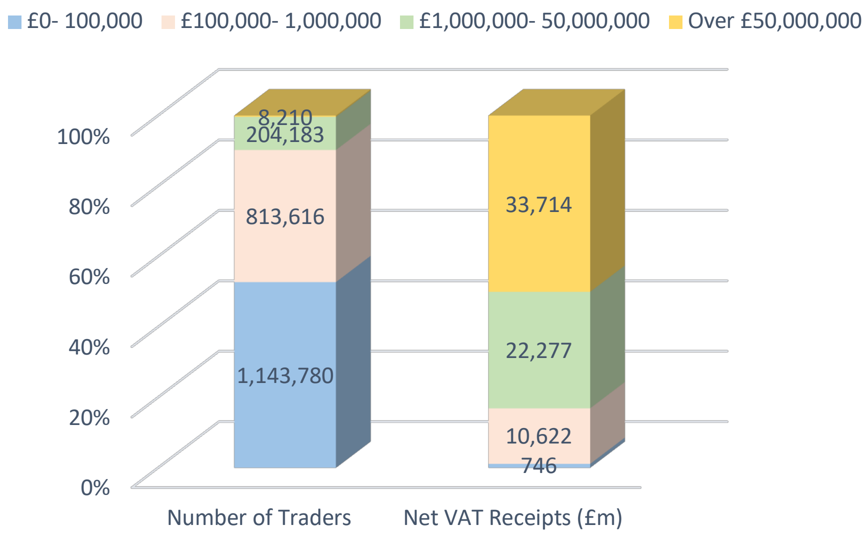
2.1 Balancing revenue needs against administrative and compliance costs

In principle, a neutral benchmark VAT will apply to all types of supplies made by all categories of suppliers. The general principle, however, neglects the uneven distribution of administration and compliance costs and tax revenue across different sizes of businesses. Small businesses constitute a large proportion of registered persons but contribute only a small proportion of VAT revenue. The sheer number of small enterprises in the VAT system means administrative resources devoted to the group are necessarily high even as the revenue collected from them is low. At the same time, compliance costs borne by the group are disproportionally high as a percentage of turnover compared to the relative cost of compliance for larger firms.

In most countries, a large share of VAT revenue is collected from an exceptionally small number of registrants with the highest turnovers. In the UK, for example, half of the total VAT revenue was paid by only 0.4 per cent of VAT-registered businesses, and 10 per cent of the VAT registrants contributed 83 per cent of the total VAT revenue in 2010-11.[106]

[106] HMRC, 'Value Added Tax Factsheet' (November 2011), Section 2.2.

Figure 1 Distribution of Net VAT Revenue by Turnover Groups in the UK, 2010-11



Source: HMRC, Value Added Tax Factsheet (2011)

Administrative efforts, however, are primarily devoted to the large group of small businesses that generate little net tax revenue. While overall VAT administration costs are sensitive to two main factors, the complexity of the tax (the use of reduced or zero rates and exemptions) and the number of VAT registrants,[107] those costs do not fall proportionately on small and large businesses. In the UK, more than half of the cost of administering the VAT can be attributed to administration of smallest businesses that account for the bulk of taxable persons and a tiny fraction of VAT revenue collected.[108] A US study considering the implications of adopting VAT in that country estimated that removal of smaller businesses from the VAT to reduce the number of registrants by

[107] S. Cnossen, 'Administrative and Compliance Costs of the VAT: A Review of the Evidence' (1994) 63 Tax Notes 1609.

[108] In a study looking at the 1977-78 fiscal year in the UK, Sandford estimated that 55% of administrative resources were allocated to 69 per cent of registered businesses (under £50,000 turnover) from which only less than 5 per cent of revenue was collected; see C. Sandford and others, *Costs and Benefits of VAT* (Heinemann Educational Books Ltd 1981); C. Sandford, 'The Administrative and Compliance Costs of Taxation: Lessons from the United Kingdom' (1985) 15 Victoria University of Wellington Law Review 199.

more than half could reduce administration costs by one-third while reducing revenue collections by only 3 per cent.[109]

Compliance costs borne by registered persons may be of even greater concern than administration costs borne by the tax authority as the former appears to be much higher.[110] There is, to be sure, a risk that measurements of compliance costs are vulnerable to overestimation and might be subject to a wider margin of error than estimates on administrative costs.[111] For example, it is difficult for businesses, in particular small businesses, to separate VAT compliance costs from the cost of basic recordkeeping and accounting activities that would be incurred in any case in the process of running the business or meeting the income tax obligations.[112] Also, empirical studies on compliance costs conducted in previous decades must now be read with caution, taking into account the impact technological advances in accounting and recordkeeping have had on compliance costs.[113]

Notwithstanding these caveats, it is clear that compliance costs fall disproportionately on small businesses.[114] Compliance costs as a percentage of turnover were estimated to be more than 30 times greater for small businesses than for large firms in one study.[115] These heavy and disproportionate compliance burdens on small businesses raise equity concerns,[116] in particular in countries where policies tend to favour small and medium-sized enterprises (SMEs).

In terms of both administration and compliance costs, small businesses thus present a special case in the VAT. From an efficient tax design perspective, even more important

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[109] The estimates were made with reference to a proposal for a VAT in the US; see US General Accounting Office, 'Value-Added Tax: Administrative Costs Vary with Complexity and Number of Businesses' (1993) < https://www.gao.gov/assets/160/153268.pdf> accessed 18 July 2018.
[110] Sandford, (n 108) 201.
[111] Cnossen, (n 107) 1610.
[112] Cnossen, (n 107) 1610; (UK) House of Commons Treasury Committee, 'The Administrative Costs of Tax Compliance: Seventh Report of Session 2003-04' (2004).
[113] Cnossen, (n 107) 1610. As early as 1993 a Canadian study showed that compliance costs of businesses that used computerised accounting systems were 20- 40 per cent lower than those of businesses that used manual accounting systems; see Plamondon and Associates Inc, 'GST Compliance Costs for Small Business in Canada' (1993).
[114] C. Sandford and others, *Administrative and Compliance Costs of Taxation* (Fiscal Publications 1989); C. Sandford and J. Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (Institute of Policy Studies, Victoria University of Wellington 1992); and Plamondon and Associates Inc, (n 113).
[115] The study looked at the 1977-78 fiscal year; see Sandford, (n 108) 201.
[116] Cnossen, (n 107) 1619.

than the absolute cost of small business administration and compliance is its magnitude relative to the revenue collected from these enterprises.[117] Revenue authorities devote significant resources to apply the VAT to small businesses and these businesses in turn incur relatively high costs to comply with the law, with little net tax revenue to show for all these outgoings. In fact, the total administrative costs incurred to collect tax from small businesses and compliance costs incurred by small businesses in respect of calculating and paying the tax may well outweigh the VAT revenue generated by this group of enterprises.[118]

The response in most countries to the high costs and limited revenue associated with the application of the VAT to small businesses has been the adoption of a registration threshold to exclude a portion of small businesses from the VAT system. This rule allows revenue authorities to concentrate scarce administrative resources on larger taxpayers and relieves small businesses outside the system from VAT compliance burdens. While the outcome seems not to be fully appreciated by jurisdictions with relatively low thresholds, the revenue loss resulting from even high thresholds is unlikely to be significant. With no entitlements to input tax credits, firms below the threshold are still input taxed; only their final value added escapes additional taxation.

Focusing on the trade-off between revenue and administrative and compliance costs, Keen and Mintz developed a simple theoretical rule that the optimal threshold should be set at the level where the marginal revenue gains from bringing more taxpayers into the VAT equals the additional administrative and compliance costs.[119] The application of the rule has proved to be more complex in practice with a host of other factors impacting on the choice of threshold, leading to thresholds above, and very often below, the optimal threshold to which the Keen and Mintz approach would point.[120]

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117 M. Salvail, 'The Goods and Services Tax: The Government's Administration Costs' (Background paper, Library of Parliament, Parliamentary Research Branch, Economics Division, February 1994) < http://www.res.parl.gc.ca/Content/LOP/ResearchPublicationsArchive/pdf/bp1000/bp377-e.pdf> accessed 19 July 2018.

118 Cedric and Hasseldine, (n 114) 120; Ebrill and others, (n 35) 117.

119 M. Keen and J. Mintz, 'The Optimal Threshold for a Value-Added Tax' (2004) 88 Journal of Public Economics 559.

120 For example, most of the EU member states have a threshold that is lower than the theoretically optimal threshold; see Institute for Fiscal Studies and others (n 73), 83.

A strict balance between revenue and collection costs also provides a case for a lower threshold for sectors with higher value-added-to-sales ratios.[121] A few countries (for example, Ireland and France) apply differentiated thresholds for goods and services.[122] They are, however, unlikely to be models for other countries due to the practical difficulties of distinguishing between goods and services, in particular for registered persons that provide mixed supplies.[123] Differentiated thresholds increase administrative and compliance costs, compromising some of the benefit of adopting thresholds in the first place.

An optimal threshold that balances revenue against administrative and compliance costs is inherently transitory. In theory, the threshold should shift downwards, for example, if administrative costs fall as capacity grows with experience and compliance costs decrease with advances in technology. At the same time, inflation will cause the nominal turnover of business to rise while their economic size and capacities remain constant, suggesting a rising threshold is appropriate. The UK and Canada represent examples of opposing practice. The VAT threshold in the UK has typically been increased annually in line with inflation, leaving the current threshold level in nominal terms 16.6 times that used when the VAT came into effect in 1973. In contrast, Canada has never changed its threshold since the GST was introduced in 1991. In between lie countries with *ad hoc* threshold lifts.[124]

A system of continual adjustments as is used in the UK appears to disregard the likelihood of reductions in administrative and compliance costs over time while the continual reduction of the threshold in real terms experienced in Canada brings ever smaller businesses facing relatively higher compliance burdens into the system. A more sensible approach would be to periodically review and adjust the threshold to balance changes in the real value of money and changes in administrative and compliance costs.

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[121] Ebrill and others, (n 35) 119; and Keen and Mintz, (n 119) 563.
[122] Keen and Mintz, (n 119) 563.
[123] A. Carter (ed), 'International Tax Dialogue: Key Issues and Debates in VAT, SME Taxation and the Tax Treatment of the Financial Sector' (2013) <https://www.oecd.org/tax/tax-global/ITD-publication-decade-sharing-experiences.pdf> accessed 19 July 2018.
[124] E.g., the registration threshold in New Zealand was increased by 50 per cent in 2009 in response to the global financial crisis.

2.2 Threshold-related distortions and inefficiencies

A registration threshold can mitigate the relatively high compliance costs that would be faced by small businesses and disproportionate collection costs that would be borne by revenue authorities if all enterprises were subject to the VAT. Provided the threshold is set at an appropriate level, these benefits can be achieved with a minimal cost to revenue. There might also be economic costs resulting from the adoption of a threshold, however. The omission of small businesses from the formal VAT system creates a break in the VAT chain if small unregistered businesses buy from or sell to registered businesses. This break may deny revenue authorities a source of information useful for assessment and audit purposes. In addition, the inability of small businesses to issue tax invoices could lead to a cascading problem as unrecovered VAT becomes another cost of acquisition for other businesses that buy from unregistered firms. Most importantly, the differential treatment for firms above and below the threshold in terms of tax payments and compliance burdens may give rise to costly distortions to the competitive positions of registered and unregistered businesses making otherwise comparable supplies and might induce inefficient changes in business behaviour that cause further economic harm or lead to revenue losses. Policy responses to these problems could in turn yield new problems and distortions.

2.2.1 Distortion of competition

A registration threshold drives a wedge between businesses in the VAT system and those excluded from the formal VAT system and instead subject to input taxation. It is a given that greatly different tax treatment of two groups of enterprises operating within the same market will result in competitive distortions but identifying the precise types and levels of distortions and devising responses to mitigate the negative impact of the distortions have proved difficult. Some firms left outside the VAT by a registration threshold enjoy benefits from exclusion while others are prejudiced by it.

On the apparent plus side of the advantage-disadvantage scale are small businesses that sell to final consumers.[125] Firms that have lower inputs relative to outputs and sell primarily to final consumers are likely to enjoy competitive advantages from being

[125] Ebrill and others, (n 35) 120.

input taxed only with their value added escaping tax. This competitive advantage will increase as the proportion of final price attributable to a firm's value added rises.

The claimed competitive advantages in this respect may not be a real-world problem for two reasons, however. First, although small firms below the threshold may enjoy tax advantages, their prices at the retail stage might still be higher than larger firms that are able to reduce costs by exploiting proprietary information and enjoying economies of scale.[126] Second, to the extent that the economic positions of firms just above and below the threshold are largely similar, the advantages and disadvantages are only a temporary phenomenon as business sizes are not static. On the one hand, some small businesses below the threshold may grow larger and cross the threshold. On the other hand, where firms just above the threshold are disadvantaged, their turnovers may fall below the threshold due to a reduction in sale volumes or profit margin.

While perceived benefits of escaping the full VAT may prove illusionary for some enterprises, two types of small firms below the threshold might be disadvantaged relative to firms subject to the VAT. The first type comprises businesses that seek to make supplies to registered businesses. Small firms below the threshold are unable to issue invoices that entitle registered purchasers to input tax credits. Registered businesses will thus be reluctant to purchase from unregistered firms. The second group consists of enterprises with high input costs relative to taxable output sales. Examples include new businesses that incur start-up costs which initially exceed turnover and businesses that make zero-rated export sales. These firms might be entitled to VAT refunds if they were within the VAT system.

To minimise the competitive disadvantage these firms might face, many countries, including the UK, New Zealand and Canada, allow voluntary registration by small firms with turnovers below the threshold. The option for voluntary registration, which removes the compliance and administration cost savings that flow from the registration threshold, has markedly different implications for enterprises choosing to enter the tax net and revenue agencies responsible for administering the tax. The former group is voluntarily incurring higher compliance costs and it must be assumed that these firms

[126] A similar argument was made in Ebrill and others, (n 35) 120.

believe they will enjoy an overall economic benefit from registration after incurring new compliance costs or they would not have elected to enter the VAT regime. From a tax collection perspective, in contrast, the result may be reduced income and disproportionately high administration costs.

Voluntary registrations may constitute a relatively high percentage of total registrations; in several OECD countries, well over one-third of total VAT registrants are voluntary registrants.[127] For example, in the UK, 46 per cent of the businesses registered for the VAT operated below the threshold in 2016-17.[128] Tax statistics in New Zealand show even higher percentages of voluntary registration in most years (ranging from a low of 45 per cent to a high of 52 per cent of total registrants) during the period 2009-2016.[129] As a consequence of the self-selection nature of voluntary registration, this group is likely to be disproportionately populated by persons claiming refunds from the revenue authority rather than those paying net tax to the government. In the UK and New Zealand, for example, a sizable proportion of voluntary registrants reported nil output sales (about 25 per cent and 37 per cent respectively) and in both jurisdictions VAT receipts from firms at the bottom of the turnover scale are negative.[130] In 2015-16, voluntary registrants in New Zealand collectively claimed a net VAT refund of NZD 656.5 million, a figure equal to 4 per cent of the net VAT revenue collected.

The self-selection character of voluntary registration also has significant implications for VAT administrative costs. Voluntary registration exacerbates considerably the disproportionate cost of administration relative to revenue that is a feature of the imposition of VAT on low turnover enterprises. Disproportionately high administration costs follow two aspects of voluntary registration. The first is the increased risk of refund-related avoidance schemes and outright fraudulent claims for refunds. Refund

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127 OECD, *Taxation of SMEs: Key Issues and Policy Considerations* (OECD Publishing 2009); In 2003-04, over 34 per cent of all GST/HST registrants in Canada had voluntarily registered. See, Canada Revenue Agency, 'Compendium of GST/HST Statistics: 2004 Edition', Table 6 < http://publications.gc.ca/collections/collection_2010/arc-cra/Rv44-1-2004.pdf> accessed 19 July 2017.

128 HMRC, 'Value Added Tax (VAT) Factsheet 2016-17' (2017), section 2.7.

129 'Number of GST Filers by Turnover Band 2007 to 2016' (New Zealand Inland Revenue, October 2017) < http://www.ird.govt.nz/aboutir/external-stats/revenue-refunds/gst-filers-by-turnover-band/gst-filers-turnover-band.html> 19 July 2018.

130 *Ibid*; HMRC, (n 128) Section 2.7.

requests must be vetted carefully, drawing costly additional administrative resources.[131] Secondly, voluntary registration opens the door to whipsaw behaviour by firms that register to claim input tax credits related to start-up costs and then deregister if ongoing business activities yield turnovers below the registration threshold.[132] It is not uncommon for jurisdictions to require voluntary registrants to remain registered for a minimum period of time (commonly between one to five years)[133] to discourage whipsaw behaviour. However, the limited VAT that might be collected from these firms in the compulsory registration period does little to offset the high administration costs incurred in respect of these persons responsible for negative VAT remittances for much of that period. An alternative such as that used in Canada and Australia to address the risk of whipsaw behaviour while avoiding ongoing administration costs is to reduce the minimum registration period but effectively recapture input tax credits on deregistration.[134]

As noted, in theory the optimal registration threshold would be set at the level where the marginal revenue gains from bringing more taxpayers into the VAT equal the increased administrative and compliance costs resulting from the additional registrations. However, the theoretical model disregards the impact on revenue and collection costs of voluntary registration. These costs must affect the choice of threshold level. The revenue yield from voluntary registrants below the threshold is likely to be less, and quite probably substantially less, than if the registration threshold were simply lowered to bring the same number of businesses into the VAT system. At the same time, the increased administration costs incurred in respect of voluntary registrants will increase revenue needs. The task of re-computing the trade-off between revenue and collection costs to take into account the potential impact of voluntary registration becomes a multi-layered undertaking.

[131] E. Brashares and others, 'Calculating the Optimal Small Business Exemption Threshold for a U.S. VAT' (2014) 67 National Tax Journal 283.
[132] OECD, (n 1) 75.
[133] E.g., the minimum registration period is one year in Canada and Australia, two years in Denmark and France, and five years in Austria and Germany. There is no minimum registration period requirement in the UK and New Zealand. See OECD, (n 1) 75 and 89.
[134] For the Canadian rule, see Excise Tax Act, RSC 1985, c. E-15, s 171 (3); for the Australian rule, see A New Tax System (Goods and Services Tax) Act 1999, s 138.5.

There is, however, little evidence of careful consideration of the impact of voluntary registration on the optimal threshold level. While small businesses may seek to register voluntarily for a number of reasons, including trade with registered businesses and market benefits from appearing larger than is actually the case,[135] there are few comprehensive studies of the relative weighting of different factors inducing voluntary registration.[136] It is also unclear how voluntary registration rates would change if registration thresholds were raised or lowered. Cross-country comparisons reveal no discernible relationship between threshold levels and the rate of voluntary registration.[137] Although the threshold in New Zealand (approximate £31,043) is significantly lower than in the UK, the voluntary registration rate in New Zealand appears to be higher than in the UK. At the same time, Japan, with a relatively high registration threshold (approximate £68,317), has a voluntary registration rate less than one-tenth that of the UK.[138] The comparisons must be read with extreme caution, however, given the fact that the nominal monetary value of thresholds may differ substantially from the actual purchasing power parity value.

In-country comparisons also yield inconsistent results. In the UK, for example, the voluntary registration rate has remained largely static in the past 10 years, although the UK has increased its threshold on an annual basis. At the same time, following invitations from the tax authority to deregister when registration thresholds were raised twice in each of 1977 and 1978, only one-fifth of the taxpayers who were newly eligible for deregistration opted to move outside the VAT system.[139] In contrast, with no changes in the threshold during the period, the voluntary registration rate in New Zealand declined by about 1% each year from 2009 to 2016.

Table 3 VAT Thresholds and Voluntary Registration in the UK (2007-2017)

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[135] Office of Tax Simplification, 'Value Added Tax: Routes for Simplification' (2017) 18.
[136] A recent UK study sought to rank factors using subjective data gathered from interviews of a limited sample of small businesses, but the findings are difficult to reconcile with HMRC data based on all taxable persons. See R. Klahr and others, 'Behaviours and Experiences in Relation to VAT Registration' (HM Revenue and Customs Research Report Number: 446, November 2017) < https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/659879/Behaviours_and_experiences_in_relation_to_VAT_registration.pdf> accessed 23 July 2018.
[137] Brashares and others, (n 131) 287.
[138] OECD, (n 127) 122.
[139] HM Customs and Excise, *Review of Value Added Tax* (Cmnd 7415, 1978), 12-13.

	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017
Threshold (GBP)	64,000	67,000	68,000	70,000	73,000	77,000	79,000	81,000	82,000	83,000
Voluntary registrants (as a percentage of total registrants)	43%	43%	44%	43%	42%	43%	44%	44%	44%	46%
Nil turnover registrants (as a percentage of total voluntary registrants)	30%	30%	30%	28%	24%	23%	25%	25%	25%	25%

Source: HMRC, Value Added Tax (VAT) Factsheet 2016-17

Table 4 VAT Threshold and Voluntary Registration in New Zealand (2009-2016)

	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016
Threshold (NZD)	60,000	60,000	60,000	60,000	60,000	60,000	60,000
Voluntary registrants (as a percentage of total registrants)	51.70%	51.00%	49.45%	48.80%	47.36%	46.12%	44.92%

Net payment by voluntary registrants (NZD 000,000)	-647.5	-450.5	-228.1	-347.3	-437.3	-518.7	-656.5
Nil turnover registrants (as a percentage of voluntary registrants)	38.54%	37.70%	38.65%	38.24%	37.63%	37.11%	36.39%

Sources: New Zealand Inland Revenue, Number of GST Filers by Turnover Band 2007-2016; Net GST by Turnover Band 2007-2016

Policy makers seeking to calibrate the registration threshold in light of the impact of voluntary registration on revenue and costs thus face a quandary. On the one hand, they may realise that voluntary registration will affect tax revenue and tax collection costs but they have no means of ascertaining the actual effects of voluntary registration. On the other hand, they may appreciate that changes to the registration threshold can influence the rate of voluntary registration without having any means of estimating the direction in which voluntary registrations may head or the degree to which the level might change.

These challenges may go some way towards explaining why VAT theorists most often ignore the question of voluntary registration when discussing an optimal registration threshold. Wherever the threshold is otherwise set, adoption of a voluntary registration option to assist businesses with turnovers below the threshold removes the downside of a registration threshold for enterprises that must be in the VAT system for commercial reasons. [140] However, as soon as voluntary registration is contemplated, its impact on revenue and administrative costs must be factored back into the equation used to identify the optimal threshold. While exact calculations may not be possible, an effective revenue service should be able to generate sufficient information for

[140] For those who do not believe the removal of commercial disadvantage should be a priority, the case for allowing voluntary registration may be overwhelmed by the disproportionate value of administration costs relative to tax revenues collected from small businesses; see W. J. Turnier, 'Designing an Efficient Value Added Tax' (1984) 39 Tax Law Review 435, 458-460.

authorities to take the probable effects of voluntary registration into account when setting the registration threshold.

2.2.2 Behavioural responses to a threshold

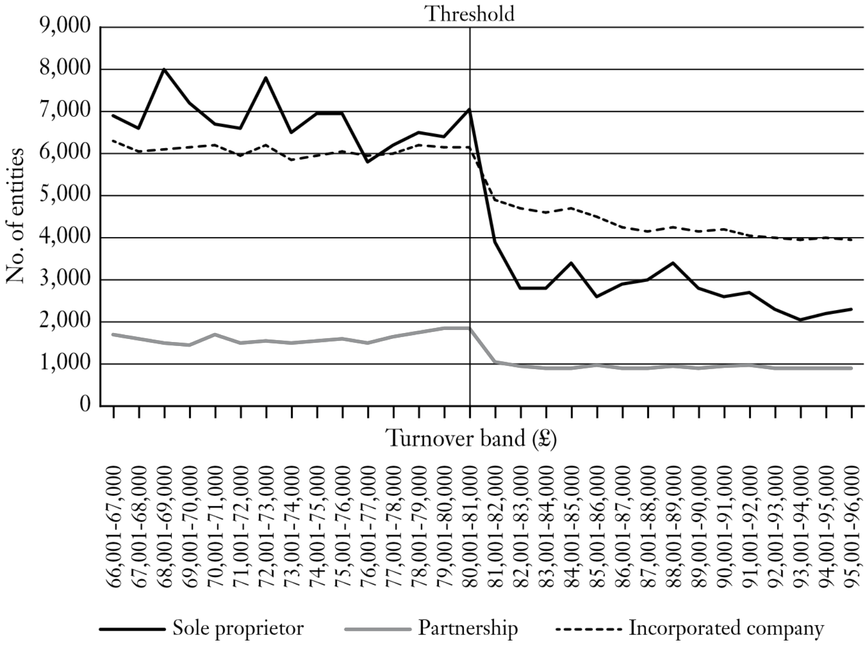
Not surprisingly, the sharp rise in tax liability and compliance costs for firms that cross the registration turnover threshold prompts behavioural responses by firms enjoying the advantages of sitting outside the formal VAT system. Co-existing with VAT registration threshold is the phenomenon of business bunching, with a large number of businesses reporting turnover just below the threshold level that would require VAT registration. A registration threshold thus creates a 'cliff-edge': a sharp increase in the number of businesses falling into the turnover band just below the threshold compared to the number in the band immediately below matched by a drop to a much smaller number of businesses in the turnover band immediately above the threshold.[141] Unlike the VAT, the income tax generally has no registration threshold and income tax data in some countries provides unambiguous evidence of small businesses bunching below the VAT registration threshold.[142] Businesses that are registered for VAT purposes but which qualify for particularly generous small business concessions or beneficial regimes within the VAT are equally likely to adopt behaviours to ensure turnover stays below the threshold at which the concessions are withdrawn.[143]

Figure 2 Number of Entities by Turnover Band in the UK, 2014-15

[141] Office of Tax Simplification, (n 135) 6.

[142] L. Liu and B. Lockwood, 'VAT Notches, Voluntary Registration and Bunching: Theory and UK Evidence' (Oxford University Centre for Business Taxation Working Paper WP 16/10, 2016); J. Harju, T. Matikka and T. Rauhanen, 'The Effects of Size-Based Regulation on Small Firms: Evidence from VAT Threshold' (VATT Working Papers 75, 2016).

[143] A clear example of behaviour related to concessions for registered small businesses can be found in Japan where concessions included generous tax credits. See K. Onji, 'The Response of Firms to Eligibility Thresholds: Evidence from the Japanese Value-Added Tax' (2009) 93 Journal of Public Economics 766; the Japanese concessional regime is described in J. Dabner, 'The Japanese Consumption Tax Experience: Lessons for Australia?' (2002) 5 Journal of Australian Taxation 185; and V. Beyer and K. Ishimura, 'The Progress of the Japanese National Consumption Tax' (1993) 3 Revenue Law Journal 115. More recently, the UK revenue authority uncovered a scheme to split a single enterprise into hundreds of mini-companies, each of which would be able to use a concessional presumptive input tax credit regime; See S. Goodley, 'Recruitment Advisers' Tax Scheme Liquidated after HMRC Asks Questions' (*The Guardian*, 10 July 2017) <https://amp.theguardian.com/business/2017/jul/10/tax-scheme-anderson-group> accessed 23 July 2018.



Source: Office of Tax Simplification, Value Added Tax: Routes to Simplification (2017)

Businesses seeking to remain below the registration threshold may adopt one or more of three tactics:

1) deliberately holding back expansion to remain input taxed suppliers;
2) splitting businesses with total turnover above the threshold into smaller separate entities, each of which has a turnover below the threshold; or
3) fraudulently under-reporting sales where actual turnover is above the threshold.

Each of these responses imposes economic costs on the community or leads to lost revenue, though their impact varies. While the empirical studies successfully document the existence of bunching,[144] findings are often ambiguous in terms of identifying the extent to which each tactic is used. A UK study attributes bunching largely to output restraint and under-reporting[145] while case law evidence in the UK points to splitting as a factor as well. A Finnish study suggests restraint is the main cause of bunching in that country,[146] but the methodology employed in the study to dismiss splitting as a tactic is problematic. A later UK study based on a telephone survey of a limited pool of businesses, not surprisingly, downplayed significantly the role of under-reporting and

[144] See, e.g., M. M. Gebresilasse and S. Sow, 'Firm Response to VAT Policy: Evidence from Ethiopia' (August 2016) <http://www.columbia.edu/~ss3721/EthiopiaVAT2016.pdf> accessed 23 July 2018.
[145] Liu and Lockwood, (n 142) 4.
[146] Harju, Matikka and Rauhanen, (n 142).

artificial splitting.[147] The limited and completely subjective dataset, however, makes reliance on the findings vulnerable to challenge.[148] In any case, uncertainty as to the prevalence of each tactic compounds the difficulty of devising effective responses.

Much of the emphasis in academic literature and policy discussion is on the first tactic, with concern that restrained production will result in 'significant efficiency losses'[149] from underutilisation of resources and reductions in potential outputs.[150] Businesses may decide to restrain outputs and stay below the registration threshold in two circumstances. First, they may wish to stay out of the formal VAT if they make supplies to final consumers and much of the sale price is attributable to their value added. As long as these firms are subject to input taxation only, their value added remains untaxed, providing an important competitive advantage relative to businesses in the full VAT system. These enterprises may conclude that higher sales will not yield greater profits if they have to reduce mark-up to maintain attractive pricing. Second, businesses may decide the higher compliance costs they would incur in the VAT system will outweigh the increase in net profits from additional sales. The Finnish study that found output restraint to be the primary tactic used by enterprises to stay below the threshold suggests that concern over compliance costs, as opposed to increased tax liability, was the driving factor for this behavioural response.[151] The conclusion is logical given the relatively low registration threshold (€8,500) in Finland,[152] as compliance costs relative to turnover fall disproportionately on small businesses.

Underlying the view that restraint is a primary cause of bunching is an assumption that small businesses have unlimited potential and desire for growth. The risk of economic harm may be exaggerated, however. Not all businesses that value the lower tax burden or reduced compliance costs associated with being outside the formal VAT will be tempted to reduce output to stay below the threshold. Businesses genuinely below the threshold fall into three groups. The first is those that are not capable of further growth. The second is those that are capable of a little growth, enough to cross the threshold but

[147] Klahr and others, (n 136).
[148] The UK government explained its reservations about the accuracy of data based on telephone surveys in HM Treasury, 'VAT Registration Threshold: Call for Evidence' (2018) 8.
[149] Harju, Matikka and Rauhanen, (n 142) 32.
[150] Office of Tax Simplification, (n 135).
[151] Harju, Matikka and Rauhanen, (n 142).
[152] The registration threshold was raised to €10,000 in 2015.

not much more. The third is those that are capable of ongoing growth. The threshold will be an inhibition only for the second group. Behaviour modification by the first group yields no benefits while the temporary setback of tax on value added and increase in compliance costs will not outweigh the additional profits from continuing expansion for firms in the third group. The focus, therefore, is on small firms with limited prospects for future growth in a no-threshold world that are likely to enjoy market advantages by holding back expansion to stay below the threshold. The efficiency losses caused by restrained production by these firms is unlikely to be great.

An alternative to restraint for an enterprise which is concerned that increased taxation or compliance costs will offset the benefits of higher sales to final consumers is to continue to pursue a total turnover above the registration threshold but artificially split the enterprise into smaller entities, each of which operates below the registration threshold. In some cases, the arrangements may extend to enterprises with turnovers well above the threshold. Concern over this tactic is not related to economic costs but rather lost revenue from final consumption that should be in the VAT system. Theoretical discussions of the optimal registration threshold and empirical studies of bunching tend to disregard splitting as a factor contributing to bunching.[153] An exception to this observation is the Finnish study on bunching noted earlier which explicitly considers artificial splitting as a possible explanation for bunching behaviour but finds no clear evidence that splitting is significant. The methodology it adopted to dismiss avoidance phenomenon appears to be problematic, however. It examined the average number of firms owned by individuals below and above the threshold on the assumption that split entities are owned by the same person,[154] an assumption that appears to discount the probability of multiple tier ownership structures or ownership structures between related individuals where enterprises are engaging in splitting arrangements.

The most convincing evidence of splitting is found in appeals documenting splitting behaviour uncovered by revenue authorities. UK cases reveal a number of techniques used by taxable persons who have attempted to split the output of service enterprises to

[153] R. Kanbur and M. Keen, 'Thresholds, Informality and Partitions of Compliance' (2014) 21 International Tax and Public Finance 536; and Liu and Lockwood, (n 142).
[154] Harju, Matikka and Rauhanen, (n 142) 30.

yield multiple turnovers below the registration threshold. One technique is to treat individual service providers within a single operation as separate contracted businesses (for example, characterising hairdressers in a hairdressing salon as independent contractors).[155] Another is to attribute different elements of a service to different businesses and business owners (for example, treating a pub meal as separate supplies of food and drink from different related persons).[156] A third is to seek to register separately different businesses operated by the same person (for example, attempting to register a real estate agent business separately from a land developer business).[157] Avoidance arrangements of these types prompted the UK government to insert specific anti-avoidance provision targeting the artificial separation of business activities to its VAT legislation.[158]

The concern with the third tactic used to remain below the threshold, under-reporting sales, is also lost revenue. This behaviour clearly constitutes illegal tax evasion and is most likely to take place in the case of small traders making cash sales to final consumers who do not request invoices.[159] False reporting is not limited to those seeking to avoid VAT registration. It may also be used by registered businesses (including voluntarily registered firms) seeking to mismatch full claims for inputs while reporting a fraction of outputs[160] and by both unregistered and registered firms seeking to evade both VAT on sales and income tax on profits.

The implications of each of the three types of behaviour for the setting of the threshold differ. One view holds that, to the extent that production restraint is a cause of bunching, a higher threshold might be desirable.[161] As the threshold increases, the firms that limited their output to less than the optimal level could produce a little more.[162] A contrary view holds that the preferable response to bunching attributable to restraint is a

[155] *Customs and Excise Commissioners v Jane Montgomery (Hair Stylists) Ltd* [1994] STC 256.
[156] *Commissioners of Customs and Excise v Marner and Marner* [1977] 1 BVC 1060.
[157] *Customs and Excise Commissioners v Glassborow and Another* [1974] QB 465.
[158] Value Added Tax Act 1994, sch 1 para 1A (amended by Finance Act 1997, c 16 s 31(1)). See also, A. Schenk, V. Thuronyi and W. Cui, *Value Added Tax: A Comparative Approach* (2nd edn, Cambridge University Press 2015) 69.
[159] D. Pomeranz, 'No Taxation Without Information: Deterrence and Self-Enforcement in Value Added Tax' (2015) 105 American Economic Review 2539.
[160] Liu and Lockwood, (n 142) 3.
[161] Kanbur and Keen, (n 153) 551.
[162] R. Kanbur and M. Keen, 'Reducing Informality' (2015) 52 Finance & Development 52.

substantial reduction in the registration threshold.[163] The second view assumes that businesses tempted to bunch below the current threshold would find it impractical to hold back production to operate at a significantly lower threshold.

The hypotheses underlying both views may fail to capture fully the implications of the proposed changes, particularly in respect of the group of businesses that find themselves just below the new threshold. A change of the threshold level does not remove the temptation to bunch; rather, it simply shifts it to a different group. If the threshold is raised to a level inhabited by fewer enterprises, there will be a much smaller pool of potential restrainers, prima facie translating to less bunching. Reinforcing this conclusion is the host of practical constraints that larger businesses contemplating restraint would face in terms of more substantial operating assets and a larger number of employees. Conversely, if the threshold is reduced substantially, the group of businesses that potentially might bunch grows exponentially, which may yield an absolute greater value of reduced output than that caused by restraint of far fewer firms at a much higher threshold. The sheer number of small firms and their dispersal through the economy may also mean the restraint could have a greater impact on the economy as a whole regardless of any output loss.

In respect of the restraint issue, in theory, the optimal choice of a new threshold will turn on a balance between the potentially increased production by firms with turnovers just below the previous threshold and newly suppressed production by firms with turnovers just below the new higher or lower threshold.[164] In practice, however, policy makers are unable to compare actual behaviour at both points. Moreover, as noted, the efficiency losses caused by restrained production may not be large enough to warrant a specific policy response in any case.

Finding an optimal threshold to discourage splitting behaviour is similarly challenging. One possibility is that a lower threshold would reduce avoidance by artificial splitting.[165] The lower the threshold, the more a business would have to split to remain below the threshold. A lower threshold would raise the cost of avoidance by limiting the

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[163] Office of Tax Simplification, (n 135) 23.
[164] Kanbur and Keen, (n 153) 549.
[165] Ebrill and others, (n 35) 121.

size of legitimate input taxed businesses.[166] However, whether it is more difficult and costly for businesses to split into multiple parts will also depend on a host of non-VAT considerations including the nature of the businesses, income tax consolidation rules, company and securities laws, and licensing rules. For example, large integrated firms with central financing and management functions would find it difficult to split finely to slip below a low threshold. Service providers that are able to characterise employees as independent contractors may be indifferent to the number of notional enterprises they create. It is questionable how effective a lower threshold would be in reducing avoidance by artificial splitting if such activities are strongly concentrated among small services providers, which might be the case in practice as the UK cases noted earlier illustrate.

A preferable response to splitting may be the use of a dedicated specific anti-avoidance measure to consolidate the output of associated or closely bound enterprises as has been done in Canada and the UK. There are limits to the effectiveness of such rules, however, as they operate within the definition of associated or closely bound persons. The Canadian rule,[167] for example, applies broadly to entities but unlike other anti-avoidance rules in Canadian tax legislation looking at associated persons, the output consolidation rule appears not to apply to related individuals. The UK rule may suffer from a similar shortcoming. Nor will the Canadian rule apply to unrelated persons working in the same enterprise but presenting themselves as independent contractors who have elected to operate out of the same premises. These arrangements are more likely to fall within the scope of the UK rule, though its application in these situations is not certain. A better anti-avoidance rule would explicitly overcome the doubts raised by existing models.

As is the case with bunching due to business splitting, bunching resulting from turnover under-reporting involves no constraints on business growth. Businesses expand or operate to capacity and simply fail to report some outputs. The concern, thus, with this tactic to remain below the threshold is lost revenue. It has been suggested that responses to under-reporting by those above the threshold can include raising the threshold so the

[166] Ebrill and others, (n 35) 121.
[167] Excise Tax Act, RSC 1985, c. E-15, ss 148 (1) and 127.

evaders become legitimate input taxed unregistered enterprises.[168] The argument assumes that the revenue lost to under-reporters is lost in any case so there is no revenue cost in terms of this group from raising the threshold to explicitly exclude these enterprises from the VAT. It must be recognised, however, that raising the threshold to change the status of under-reporters will have ancillary impacts on revenue and administrative costs. While no revenue is lost in terms of enterprises who stayed below the lower threshold by under-reporting, the higher threshold will have the effect of excluding a host of honest enterprises above the original lower threshold. Any revenue loss from excluding these persons from the VAT will be offset to some extent by the resulting administration and compliance cost savings. Contemporaneously, raising the threshold will encourage a new group of enterprises above the new threshold to become under-reporters. This observation may be tempered by the lower proclivity of larger enterprises to under-report.

An alternative view aimed at identifying and pursuing under-reporters calls for reducing the threshold so there will be a smaller number of businesses legitimately outside the VAT net, making it easier for authorities to detect those illegitimately below the threshold.[169] This view is problematic in respect of the impact a lower threshold might have on administrative costs, however. While the total number of businesses outside the net would be smaller, the lower threshold would apply to that pool of businesses selling primarily to final consumers and hence more likely to under-report. Administrators' workload in terms of the number of businesses to be investigated may increase as a result. Also, there is a possibility that those who evaded to remain below the old threshold might still be engaging in evasion after entering the VAT system. In that case, administration resources may remain equally stretched, with responsibility for finding evaders below and above the threshold. Administrative savings might be realised, however, if authorities conclude only limited resources should be allocated to chase the relatively small revenue lost to evasion by the larger group of low turnover enterprises. At the same time, the larger cohort of registered persons in the VAT will increase administration costs, although these will be offset to some extent by the increased revenue.

[168] Kanbur and Keen, (n 153) 551 and 556.
[169] Office of Tax Simplification, (n 135) 23.

The various revenue and administrative trade-offs encountered at different turnover levels are factors that should be considered as elements of the initial threshold setting exercise, not factors that lead to adjustments of the optimal threshold to address a problem of under-reporters. Wherever the threshold is set, there will be under-reporters with true turnovers above the threshold and consequent administrative costs incurred to protect the integrity of the VAT. Given the uncertainty over possible business responses to higher or lower thresholds, the best way to address under-reporting may be to accept this as an inevitable phenomenon whatever the VAT registration threshold, and direct resources to uncover under-reporters and bring those exceeding the threshold into the VAT. Persons under-reporting for VAT purposes are equally likely to under-report for income tax purposes. As thresholds for income tax purposes are uncommon, enhanced enforcement of the income tax for small businesses can be used to reveal under-reporters that should be registered for VAT. This route is admittedly more difficult in jurisdictions where VAT and income tax are administered by separate agencies as is the case in China.

A registration threshold balancing revenue objectives and administrative and compliance costs is a desirable feature of an efficient and fair VAT. The bunching problem it creates, and in particular the restraint, splitting and under-reporting tactics adopted by enterprises to fall below the threshold, yields economic harm for wider society and revenue losses for the state. A range of techniques are needed to combat these behavioural responses. Adjustment of the registration threshold has been suggested as one means of responding to the behaviour of businesses nearing the threshold. There are, however, competing views on how a registration threshold should be adjusted to address the different ways in which businesses might reduce actual or apparent turnover to avoid crossing the threshold. The contradictory conclusions along with the absence of empirical evidence on the extent of each type of behaviour make consideration of threshold responses to these issues problematic. A preferable approach is probably to look beyond threshold adjustment when considering these issues.

Policy makers in jurisdictions such as the UK that have identified a bunching phenomenon but not pinpointed the behaviour that has led to bunching need to investigate further the means adopted to remain below the threshold before they can develop appropriate responses. Policy makers in jurisdictions such as Canada where the phenomenon itself has yet to be studied need first to conduct this preliminary research to ascertain the extent to which bunching is present.

2.3 Transitioning regimes into the full VAT

In the absence of any special rules, the consequences for small businesses of crossing the registration threshold can be significant. Compliance costs jump and the burden of implicit tax built into the price of acquisitions is replaced by liability to remit a higher explicit tax. As noted, the increase in compliance costs and tax burden can lead to bunching behaviour by small businesses seeking to remain below, or appear to remain below, the registration threshold. To mitigate this problem, a small number of VAT jurisdictions have adopted "transitioning" regimes that subsidise the costs incurred by small businesses shifting into the full VAT.[170]

The measures are intended to remove the rationales for some of the behaviour that results in bunching. They will, of course, have no impact on unregistered firms nearing the turnover registration threshold with limited prospects for or interest in further growth.[171]

The transitioning subsidies commonly take the form of a disappearing credit provided to businesses with turnovers that climb over the registration threshold, with the credit phasing out as turnover rises.[172] Variations of the transitioning regime can be found in Finland and the Netherlands. Japan had a similar regime at the time its consumption tax, as the Japanese VAT is known, was introduced, but the regime was abolished after eight

[170] Institute for Fiscal Studies and others, (n 73) 91. Transitioning assistance is also found in some other sales tax regimes. For example, the retail sales tax (RST) in Manitoba includes a capped "commission" that businesses collecting the RST can retain. The cap has the effect of directing the commission primarily to small businesses. See, Manitoba Finance, 'Information for Vendors' (Bulletin No. 004, June 2017) <https://www.gov.mb.ca/finance/taxation/pubs/bulletins/004.pdf> accessed 14 August 2018.
[171] Institute for Fiscal Studies and others, (n 73) 91.
[172] Institute for Fiscal Studies and others, (n 73) 91. An alternative regime adopted in Mexico in 2014 provides generous offsets for compliance costs and increased tax burdens by way of a disappearing formula that allows newly registered businesses to retain a portion of VAT collected from customers sliding from 100 per cent of the tax collected in the first year of registration to 10 per cent in the tenth year. An even more generous concession allowing very small businesses to retain all VAT collected for a decade after entering the VAT has allowed Mexico to remove the threshold entirely, although it remains to be seen whether other concessional measures for small businesses will be enough to offset the compliance costs and increased tax burden that will be incurred when small businesses emerge from the full subsidy period.

years. The subsidies provided in the Japanese transitioning regime were particularly generous. When it commenced, the consumption tax featured a high registration threshold of 30 million Yen (approximately £204,706) and a vanishing credit for businesses with a turnover between 30 and 60 million Yen, starting with a full offset for consumption tax otherwise payable by enterprises with turnovers immediately above the threshold.[173] As a consequence of a high threshold and a generous offset, tax savings could be significant and not surprisingly there was a high take-up rate, with 93.3 per cent of eligible registrants signing up for the concession when the consumption tax was adopted.[174] While the concession may have had an impact on firms otherwise inclined to under-report sales,[175] its most obvious impact was a loss of 88 per cent of the total revenue that would have been gained if all taxpayers within this turnover range had been subject to the normal consumption tax.[176] To limit the windfall gains by businesses with relatively larger turnovers and capabilities to comply with the consumption tax, Japan lowered the upper limit of the scheme from 60 million Yen to 50 million Yen two years after the introduction of the regime and finally abolished the concessional regime in 1997.

A less generous regime was adopted in Finland in 2004. Under the Finnish system, still in effect, the VAT registration threshold remained unchanged at €8,500 but a disappearing transition tax credit in addition to the ordinary input tax credit entitlement was provided to firms with a turnover between €8,500 and €22,500.[177] For businesses with turnovers less than €8,500 that voluntarily register for the VAT, the transitioning regime tax credit equals the total VAT otherwise payable, which means that their taxable supplies are zero-rated. As the credit is calculated by reference to the net VAT payable, the transitional credit relief does not apply to businesses that have a negative VAT liability.

[173] The transition tax credit was calculated using this formula: $\text{Transition tax credit} = \text{VAT otherwise payable x } \frac{60\text{ million} - \text{annual sales}}{30\text{ million}}$.

[174] H. Ishi, *The Japanese Tax System* (3rd edn, Oxford University Press 2004).

[175] W. J. Turnier, 'Accommodating to the Small Business Problem under a VAT' (1994) 47 Tax Lawyer 963.

[176] Ishi, (n 174) 292.

[177] The tax credit is calculated using this formula: $\text{Transition tax credit} = \text{VAT paid} - \frac{(\text{turnover} - 8500) \times \text{VAT paid}}{22500 - 8500}$. The turnover range is now between €10,000 and €30,000.

The Finnish regime had very limited impact on bunching by businesses below the threshold.[178] It also attracted surprisingly little interest from registered firms that were eligible for the relief, with only 31 per cent of the eligible firms applying for the relief when the concessional regime was introduced.[179] The unremarkable impact of the transitioning regime in Finland may be explained by the very limited benefit the concession yields for eligible enterprises.[180] As a result of a relatively low registration threshold and the relatively low level at which transition relief disappears, the average relief for eligible businesses that did not apply would have been only €617 and 10 per cent of these businesses would have received less than €100 had they applied.[181] The value of incentives compared to the relatively high compliance costs faced by firms entering the VAT was insufficient to encourage very small unregistered businesses with limited sales to expand operations and lift turnover above the registration threshold.[182]

The Finnish and Japanese experiences illustrate the trade-offs encountered at the margins of transitional regimes. If the registration threshold is low, a transitional regime is unlikely to have a significant impact on bunching, with the value of tax relief low relative to the compliance cost burden faced by registered businesses. If the registration threshold is high, the corresponding higher value for tax relief may reduce bunching, but the high take-up rate by eligible registered businesses above the threshold may deliver windfall gains at a high cost to the revenue. The risk of windfall benefits is particularly acute in the case of voluntary registrants. By definition, these enterprises were willing to be part of the full VAT system but as a result of the transitioning regime, they will retain a portion of the output tax they collect.

It remains to be seen if transitioning regimes to reduce bunching incentives could yield better results in VAT systems with thresholds that lie between the two examples described. The challenge faced by policy makers is finding the level of relief and the withdrawal formula that achieves an optimal balance between providing incentives that are high enough to encourage transition to a normal VAT system and avoiding

[178] Institute for Fiscal Studies and others, (n 73) 88- 89.
[179] Institute for Fiscal Studies and others, (n 73) 90.
[180] Institute for Fiscal Studies and others, (n 73) 90.
[181] Institute for Fiscal Studies and others, (n 73) 90.
[182] Institute for Fiscal Studies and others, (n 73) 91.

excessively high windfall gains to businesses that would make no effort to remain deliberately below the registration threshold.

2.4 Simplification regimes for small businesses in the VAT system

Both small businesses facing VAT compliance costs and VAT designers recognise the unfairness of the disproportionate compliance costs faced by the sector compared to that borne by large businesses. The response has been the adoption of a number of “simplification” systems designed to reduce the cost of compliance for small businesses that have moved into the VAT system. These regimes can operate in conjunction with a VAT threshold, applying to businesses in a defined band above the threshold or, in the absence of a threshold, can apply to all businesses with turnovers below the level it is agreed the unfairness has largely dissipated. Simplified regimes may have an impact on the optimal registration level if they operate in conjunction with a registration threshold. The optimal threshold balances revenue against compliance and administrative costs. The reduction of compliance costs for businesses with turnovers at the lower end of the VAT system in theory makes it possible to use a lower threshold while still balancing compliance costs and revenue. Any possible reduction would be limited, however, and possibly negated by the increased administrative costs that would follow if more enterprises entered the VAT system. Even if the goal of reduced costs from simplified rules is not achieved, the professed outcome may provide a rationale for a lower threshold if policy makers seek to tip the balance in favour of increased revenue.

Simplified regimes or methods that are commonly used to reduce compliance costs borne by small businesses fall into three groups:

1) Less frequent filing and payments;
2) Optional cash or payment basis accounting (as opposed to accrual basis accounting);
3) Presumptive regimes for small businesses that approximate the VAT that would otherwise be paid under the normal VAT system.

Many countries use more than one of these regimes. For example, the UK uses all three regimes, while Canada uses two of the three, namely less frequent filling and payments and presumptive regime (known as quick method GST/HST accounting).

Table 5 VAT Simplification Measures for SMEs

		Calculation of VAT/GST liability		**Accounting, payment, filing**		
	Exemption thresholds	**Presumptive tax schemes**	**Simplified input tax credit calculation schemes**	**Cash accounting**	**Reduced frequency of filing**	**Other**
Argentina		Y				Y
Australia	Y		Y	Y	Y	Y
Austria	Y		Y	Y	Y	Y
Belgium	Y	Y			Y	Y
Brazil		Y		Y	Y	Y
Canada	Y	Y	Y		Y	Y
Chile		Y			Y	
China					Y	Y
Czech Republic	Y				Y	
Denmark	Y				Y	
Estonia	Y			Y		
Finland	Y				Y	
France	Y	Y			Y	Y
Germany	Y		Y	Y		
Greece	Y	Y		Y		Y
Hungary	Y			Y	Y	Y
Iceland	Y					
India						
Ireland	Y			Y	Y	
Italy	Y			Y	Y	Y
Japan	Y		Y			
Korea	Y	Y				Y
Luxembourg	Y			Y	Y	Y
Mexico		Y		Y	Y	Y
Netherlands	Y					Y
New Zealand	Y			Y	Y	
Norway	Y				Y	
Poland	Y			Y	Y	Y

Portugal	Y			Y	Y	Y
Slovak Republic	Y					
Slovenia	Y			Y		
South Africa	Y			Y	Y	Y
Spain		Y			Y	Y
Sweden	Y			Y	Y	
Switzerland	Y	Y			Y	Y
Turkey						Y
United Kingdom	Y	Y		Y	Y	Y
United States						

Source: Based on data extracted from OECD, *Taxation of SMEs in OECD and G20 Countries* (OECD Publishing 2015) and updated and corrected by the author.

2.4.1 Less frequent filing and payments

Many countries allow small businesses to file and remit less frequently than larger counterparts, often coupling the small business rules with more frequent filing for very large enterprises. The filing (and payment) periods available vary from jurisdiction to jurisdiction. The UK, Canada and Australia use monthly, quarterly and annual filing. The assumption that less frequent filing could significantly reduce compliance costs[183] may be exaggerated, however. Return filing often accounts for a small proportion of compliance costs. Study on compliance costs in Canada shows that the actual completion of the return accounts for only 4 per cent of the total labour effort on compliance, indicating that small businesses allocate very little time to return filing activities.[184] The costs of filing returns may have been largely reduced, moreover, with the availability of online filing services. The larger costs are incurred in the process of identifying inputs and outputs to be inserted into the return and this task requires a fixed amount of time and effort regardless of the frequency of return filing. It is likely that the total compliance costs remain relatively constant whether returns are filed once or four times a year.

In a worst case scenario, less frequent filing may actually be counterproductive in terms of its simplification goals. In the UK, for example, quarterly filing is the standard option

[183] OECD, (n 127) 124.
[184] Plamondon and Associates Inc, (n 113) 46-47.

for small and medium-sized businesses (defined by turnover ranges), while small businesses below an annual filing turnover level can elect to file annually. Evidence suggests that in some cases annual return filing raised compliance costs as the single filing prompted poorer record keeping, leaving businesses struggling to assemble records required to complete one return covering a full year of transactions.[185] As a result, many small businesses that joined the annual accounting scheme later moved back to standard quarterly returns.[186] In fact, although over 90 per cent of the total registrants had a turnover eligible for annual accounting, only less than 1 per cent of all registered taxpayers were in the scheme in 2016-17.[187]

An alternative rationale for using less frequent filing is to reduce administrative costs. With a view to reduce the total number of returns handled by the tax authority,[188] the Canadian law was amended to provide a default annual reporting period for small businesses below a specified turnover level from 1994, with the option to elect to use other reporting periods. The assignment of annual reporting as the default option may have contributed to the relatively high take-up rate of the option. By 2003-04, 36 per cent of small businesses below the annual filing threshold were annual filers.[189] The significant difference in terms of the take-up rate of the annual accounting option between the UK and Canada might be attributable to the way in which the option is made available (whether the default is standard filing period with an opt in to annual filing or the default is annual filing with an opt out to other filing periods). The UK approach could thus be used by countries that concern with compliance costs, whereas the Canadian approach could be followed by countries that concern with administrative costs. However, the overall benefits of less frequent filing option are uncertain given its potential to increase compliance costs and discourage good business management.

For small businesses that use less frequent filing, there may be a separate fiscal benefit if tax payments are tied to the filing of returns. Less frequent tax payments may provide a small cash-flow benefit to qualifying taxpayers that could be seen as compensation for

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[185] The Office of Tax Simplification, 'Review of Value Added Tax: Progress Report and Call for Evidence' (2017) 14.
[186] *Ibid.*
[187] HMRC, (n 128) Section 2.11.
[188] Salvail, (n 117).
[189] Canada Revenue Agency, (n 127) Table 2.

the relatively higher compliance costs faced by small businesses.[190] There has been concern, however, that small businesses tend to have difficulties in meeting deferred payment obligations associated with less frequent filing.[191] A compromise solution is to allow optional less frequent filling but require qualifying small businesses to make estimated advance payments on the same frequency as is required for other businesses.[192] The annual accounting scheme in the UK provides an example of this approach.[193]

2.4.2 Cash accounting

VAT systems are generally accrual based, meaning that the VAT is paid (or deducted) when invoices are issued (or received). In many countries, small businesses have the option to use a cash accounting method, accounting for VAT on the basis of payments received or made. While cash accounting is often advocated as a means of reducing compliance costs,[194] the overriding purpose is more likely to provide cash-flow benefits to eligible businesses. In particular, businesses that collect the payments from their customers long after the invoices are issued may benefit greatly as the output tax is not due until the payments are received. Cash accounting thus avoids VAT being paid on bad debts.

The common practice in most countries is to set a threshold based on turnover, up to which level businesses are eligible to use cash accounting. Those whose turnovers above that threshold should account for VAT on an accrual basis. Concurrent cash and accrual accounting, however, creates a timing mismatch between input tax deduction and output tax liability when a cash basis supplier makes a supply to an accrual basis purchaser.[195] The accrual basis purchaser claim immediate input credit while the cash basis seller may defer the payment for a significant period of time or even

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190 OECD, *Taxation of SMEs in OECD and G20 Countries* (OECD Publishing 2015) 112; C. Sandford, 'The Administrative and Compliance Costs of the United Kingdom's Value Added Tax' (1990) 38 Canadian Tax Journal 1.
191 Tait, (n 14) 138-139.
192 Turnier, (n 175) 984.
193 For details, see 'VAT Annual Accounting Scheme' (*UK Government*) <https://www.gov.uk/vat-annual-accounting-scheme/overview> accessed 31 July 2018.
194 OECD, (n 190) 110.
195 The New Zealand Inland Revenue and The New Zealand Treasury, 'Options for Strengthening GST Neutrality in Business-to-Business Transactions' (An officials' issues paper, June 2008) < http://taxpolicy.ird.govt.nz/publications/2008-ip-gst-b2b-neutrality/overview> accessed 23 July 2018.

indefinitely.[196] New Zealand and Australia had the experience that some related cash and accrual basis taxpayers aggressively exploited the timing mismatches to obtain interest-free loans from the governments.[197] The schemes were considered avoidance arrangements and were attacked by tax authorities using general anti-avoidance rules (GAARs). New Zealand also subsequently adopted a specific anti-avoidance rule (SAAR) to address the problem. In the UK, where the GAAR does not apply to the VAT, a SAAR was used to target these schemes.[198] New Zealand experience shows that inadequately designed SAARs may limit avoidance schemes but do not eliminate them.[199] It is quite possible that cases uncovered by Australian and New Zealand authorities represent only the tip of a cash-accrual mismatch abuse iceberg. The problem is avoided in the first place in countries such as Canada where the GST law does not provide the cash accounting option.

2.4.3 Presumptive input tax entitlement regimes

Presumptive input tax entitlement regimes seek to simplify the calculation of VAT liability by removing the need to record and total input tax on all acquisitions and instead allowing qualifying persons to substitute a single presumptive input tax entitlement. Under presumptive regimes, small businesses charge VAT at regular rates on all taxable supplies of goods and services. Then a single flat rate is applied to the total (VAT-inclusive) turnover to determine the amount of tax to be remitted to the tax authority. This amount is a proxy for the amount of net VAT the enterprise would have remitted after deducting actual input tax credits from output tax in the ordinary VAT system. Importantly, registered customers of persons using the presumptive input tax entitlement system are entitled to full input tax credits as they have been charged full VAT on their acquisitions. The presumptive input tax calculation regimes do not affect the amount of VAT imposed on supplies and charged to customers. Their only role is to

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196 *Ibid.*

197 See, e.g., *Ch'elle Properties (NZ) Limited v Commissioner of Inland Revenue* [2007] NZSC 73 (Supreme Court of New Zealand); *Education Administration Ltd v Commissioner of Inland Revenue* [2010] NZHC 663 (High Court of New Zealand); and *VCE and Commissioner of Taxation* [2006] AATA 821 (Administrative Appeals Tribunal, Australia).

198 Value Added Tax Regulations 1995, reg 58(e) and (f). For an analysis of the Australian, New Zealand and UK approaches, see Y. Zu and R. Krever, 'GST Cash and Accrual Mismatches: Avoiding the Avoidance' (2017) 46 Australian Tax Review 271.

199 In *Case X25* [2006] 22 NZTC 12, 303 (Taxation Review Authority of New Zealand), the parties avoided a SAAR by structuring the transaction to fall just below the trigger threshold for the SAAR. The tax authority ultimately prevailed applying the GAAR.

determine the amount of net VAT remitted by qualifying small businesses while obviating the requirements that the businesses track and then total the VAT included in the price of every acquisition.

The presumptive input tax entitlement may vary across industries or sectors, and may reflect both the average costs incurred by enterprises in a sector and the extent to which acquisitions within the sector are likely to be exempt, zero-rated or reduced-rated supplies.[200] In addition to the presumptive input tax credit entitlement provided through a retention of a proportion of output tax collected, the systems allow further explicit input tax credits for acquisitions of capital assets. Notable examples of such presumptive scheme include the flat rate scheme (FRS) in the UK and the quick method of GST/HST accounting in Canada. Both are optional for registered businesses below a specified turnover.

An inherent problem in any presumptive regime that determines net VAT to be remitted by use of a single flat rate applied to turnover is inaccuracy in specific cases. The input tax credits notionally incorporated in the flat rate are based on averages that are by definition not accurate for most individual traders. The finer the group used to determine an average, the more accurate the calculation will be in theory. However, the finer the group the more boundary problems that are created. For example, seeking to mitigate the presumed input tax inaccuracy problem, the UK has calculated different presumptive rates ranging from 4% to 14.5% for 54 categories of industries. The proliferation of categories creates a new level of complexity for businesses that must determine which type of business activity they conduct when registering[201] and a new set of policing problems for the tax authority.[202] Successful challenges to the UK tax authority's guidance and decisions illustrate the difficulty revenue officials have in applying the law.[203]

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[200] OECD, (n 190) 107.
[201] KPMG, 'Administrative Burdens- HMRC Measurement Project Report by Tax Area Part 27: Value Added Tax' (March 2006).
[202] J. Mirrlees and others, (n 14).
[203] See, for example, *Idess Ltd v The Commissioners for Her Majesty's Revenue & Customs* [2014] UKFTT 511 (TC); *SLL Subsea Engineering Ltd v The Commissioners for Her Majesty's Revenue & Customs* [2015] UKFTT 0043 (TC); and *JJK Engineering Ltd* [2016] UKFTT 615 (TC).

Enterprises with higher than average inputs that believe they will be unable to recover fully all input taxes under the industry-by-industry flat rate scheme can simply not opt to join the scheme. In 2016-17, only 25 per cent of the taxpayers eligible to join the scheme were actually in the scheme.[204] Deciding whether or not to opt in is not a cost-free exercise. Eligible businesses will regularly incur internal and external costs to estimate VAT liabilities under both the FRS and the normal VAT regime before making the decision.[205] At the same time, the flat rate will provide a tax advantage to businesses in each group with lower than average input purchases. The additional compliance costs incurred by businesses to determine if the "simplified" scheme prejudices or enhances their recovery of input tax clearly offset some of the simplification benefits that the FRS is expected to achieve.

The FRS therefore functions in practice as a concessional scheme for some businesses rather than a simplification scheme as is intended. The main purpose for many of these businesses to enter the scheme is actually to reduce their tax liabilities. Subsequent to the adoption of FRS, the UK government ascertained that about 30 per cent of the businesses that used the scheme enjoyed substantial cash advantages relative to the position they would have faced under the ordinary VAT regime.[206] It viewed this outcome as an abusive use of the FRS and consequently introduced a new remittance rate to remove the benefit from service providers with presumed limited input costs.[207] A new 16.5% rate then applies to "limited cost traders" whose expenditure on goods is less than 2 per cent of their turnover. The limited cost trader test adds further complexity for businesses that genuinely use the scheme to save compliance costs as it requires the businesses to separate records of purchases of goods and services, a distinction that does not readily exist in a modern economy. The test can be easily avoided by those that use the scheme 'abusively' to achieve tax savings.[208] For example, a firm primarily supplying services may be able to enjoy a fiscal benefit if it engages in

[204] HMRC, (n 128) section 2.10.
[205] KPMG, (n 201) 24.
[206] (UK) Explanatory Memorandum to the Value Added Tax (Amendment) Regulations 2017.
[207] 'Tackling Aggressive Abuse of the VAT Flat Rate Scheme- Technical Note' (*UK Government*, 5 December 2016) <https://www.gov.uk/government/publications/tackling-aggressive-abuse-of-the-vat-flat-rate-scheme-technical-note/tackling-aggressive-abuse-of-the-vat-flat-rate-scheme-technical-note> accessed 23 July 2018.
[208] The Office of Tax Simplification, (n 185) 11.

a subsidiary activity of buying goods and selling them at a loss.[209] The UK experience shows that specific anti-avoidance measures may have limited value in preventing businesses from benefiting from a system that is presumptive in essence. At worst, the measures may induce unproductive and inefficient business responses.

The initial design of the Canadian quick method may have avoided some of the problems experienced in the UK. Instead of calculating dozens of industry-specific rates, Canada has only two sets of rates, distinguishing between businesses that purchase goods for resale and businesses that provide services, with the former allowed a higher notional input tax credit by way of a greater retention of output tax.[210] The Canadian system thus avoids much of the complexity found in the UK system as a result of the need to identify each business' specific industry category. However, a sharp distinction between businesses that primarily sell goods and those that primarily provide services may induce inefficient behaviour by enterprises operating near the margin, a risk noted in the UK. While the Canadian system may prevent excessive windfall benefits for pure service providers, with its broad sweep approach across all industries, this system has much more scope for inaccuracy in respect of any given enterprise within each rate category.

The number of rates, to a degree, reflects a government's perception on the balance between neutrality and simplicity. The quest for greater accuracy in and lesser abuse of the presumptive regime in the UK, for example, has had an impact on its effectiveness as a simplification system. Cost savings from the UK FRS were initially estimated to average £750 per business,[211] but a later evaluation estimated average compliance cost savings to be only £45.[212] Potential savings are likely to fall even further with increased computerisation of cash registers and accounting systems, which, as noted earlier, have

[209] N. Warren, 'VAT: Limited Cost Trader Category for FRS Users' (*AccountingWEB*, 20 December 2016) <http://www.accountingweb.co.uk/tax/hmrc-policy/vat-limited-cost-trader-category-for-frs-users> accessed 27 July 2018.
[210] A further mandatory regime applies to charities which allows them to retain 40 per cent of the GST/HST they collect in lieu of input tax credits.
[211] HM Customs and Excise, 'Easing the Impact of VAT: Consultation on a Flat Rate Scheme for Small Firms: HM Customs and Excise Summary of the Responses to the Consultation Document Issued in June 2001' (Parliament Deposited Paper Dep 02/956, 2002).
[212] 'VAT Flat Rate Scheme (FRS): Impact Assessment of Changes to the Flat Rate Percentages in January 2010' (HMRC, 2009) < http://www.legislation.gov.uk/ukia/2009/327/pdfs/ukia_20090327_en.pdf> accessed 14 August 2018.

greatly reduced compliance costs.[213] These technological changes cannot obviate the need for simplification schemes entirely, however. They are useful where systems can automatically record tax attributes of sales or acquisitions – for example whether supplies are taxable or exempt and in the former case whether they are subject to standard, reduced or zero rates. They offer no savings where judgments are required such as the apportionment of input tax credits by businesses that make both taxable and exempt supplies. Simplified regimes will continue to play a cost reduction role in these cases.[214] From a tax policy perspective, the need for simplification regimes in these circumstances arguably reinforces the need to address the underlying complexity of a concession-ridden VAT.

Of the three techniques that have been used – less frequent filing and payments, cash basis accounting, and presumptive input tax calculations – the first appears to entail the least risk of abuse or inaccurate and inappropriate outcomes. The simplification benefits of all three techniques are uncertain, however. Leaving political considerations aside, it is difficult to pursue so-called simplification regimes as a reform priority. If measures are necessary, less frequent filing and payments would seem to be the best candidate of the trio for adoption.

2.5 Alternative regimes for small businesses

As noted, the primary rationale for a threshold is to reduce compliance and administrative costs. Firms with turnovers below the threshold are "input taxed", meaning they need not remit any tax on sales but at the same time are not entitled to claim input tax credits for their acquisitions. Subjecting small businesses to input taxation comes at a small revenue cost to the state but shields the firms almost entirely from compliance costs.

Highest income countries have universally concluded that a registration threshold with input taxation of enterprises below the threshold is the preferable response to

[213] See also, The Office of Tax Simplification, (n 185) 11. The adoption of a simplified regime has been seen as a direct outcome of the compliance challenges faced by small businesses in the pre-computer period; see L. Dana, 'Goods and Services Tax (GST) and the Small Business Sector: Some Canadian Reflections' (1993) 52 Australian Journal of Public Administration 457.
[214] The Office of Tax Simplification, (n 185) 11.

disproportionate compliance and administration costs associated with very small businesses in a full VAT system, although there is a wide variation in their conclusion on the level of the optimal threshold. Commonly, these jurisdictions also adopt simplified rules for small businesses above the registration threshold. A handful of middle income countries have instead opted to remove registration thresholds entirely in a bid to extend the revenue base. In some jurisdictions, particularly developing countries, another approach to simplification for small businesses is used, with the registration threshold replaced by a turnover border that distinguishes larger businesses subject to full VAT and smaller businesses subject to an alternative turnover tax system. The latter is commonly described as a "simplified" VAT system.[215]

There is no doubt that compared to full VAT, a turnover tax imposed solely on sales without regard to input tax credits is easier from a tax administration perspective and a taxpayer compliance viewpoint.[216] It is equally clear, however, that subjecting small businesses to a turnover tax is not as simple as the alternative of removing the businesses from the VAT system entirely and leaving them subject to input taxation. Not surprisingly, other rationales are offered for the application of so-called simplified regimes to these firms.

A common explanation for the alternative turnover tax is to bring informal businesses into the "formal" economy, but advocates of this view offer no example of formality apart from formally paying higher taxes.[217] In theory, tax authorities could pass details of known enterprises on to other authorities responsible for business licenses or other attributes of the formal economy; in practice, however, particularly in developing economies, channels for the automatic exchange of data between ministries are limited. It is possible, that if appropriate information channels were established, incorporation of small businesses into the formal (taxpaying) economy could provide the government with a better understanding of the overall economy, allowing it to make more informed macro-economic decisions. Somewhat ironically, many of the jurisdictions that have embraced an alternative turnover tax as a means of reducing informality have a

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215 Examples of jurisdictions with a turnover tax for small businesses that is notionally incorporated into a VAT include China, Ethiopia and West Bengal in India.
216 Bird and Gendron, (n 6) 29.
217 The weakness of this explanation was noted in Kanbur and Keen, (n 153) 52.

relatively lower administrative capacity than those jurisdictions that exclude enterprises with turnovers below the VAT threshold from tax with the goal of a smaller taxpayer base.

A second explanation for simplified turnover tax regimes for small businesses is to provide these businesses with basic fiscal skills as preparation for compliance should they grow sufficiently to cross the full VAT border.[218] The theory is that an introduction to simple turnover accounts can mature into more sophisticated record keeping skills at a later stage.

While small business turnover tax regimes appear to lack all the fundamental attributes of a VAT, particularly entitlement to input tax credits on acquisitions and the provision of tax invoices on sales, the description of the regimes as simplified quasi VAT alternatives is not wholly misleading. A single low tax rate imposed on total turnover is notionally similar to the full rate applied to sales reduced by input tax credits on acquisitions. The analogy between the turnover taxes and an actual VAT is limited, however. Without tax invoices in hand, registered taxpayers under the normal VAT system who purchase from suppliers in the turnover tax system cannot claim input tax credits and the turnover tax becomes a cascading non-recognisable cost of acquisition for enterprises in the VAT system. The cascading effect is noticeable higher than that encountered when small businesses are simply left outside the VAT but incur input taxation on acquisitions.

In some ways, the turnover tax applied to small businesses below the registration threshold resembles the presumptive input tax system designed for small businesses above the threshold. Under both regimes, the amount of tax remitted to the tax authority is determined by applying a reduced rate, lower than the standard VAT rate, to gross receipts. In the case of the presumptive input tax, the net remittance is presumed to reflect the application of full tax to sales and full recovery of input tax credits, so a registered customer will receive a tax invoice evidencing payment of the full VAT. The notional netting of input tax credits against output tax is manifested in a reduced remittance by the supplier to the tax authority, not in the tax paid by customers. In the

[218] Bird and Gendron, (n 6) 187.

case of the turnover tax, however, there is no presumption that the final price always includes a full VAT component and the vendor is not able to issue a tax invoice.

In a revenue neutral context, a lower rate turnover tax on small businesses allows a government to raise the threshold at which a higher rate VAT applies.[219] This is because the tax collected by way of a lower rate turnover tax applied to gross receipts with no recognition of input tax credits is likely to exceed the revenue that would be collected if these enterprises were excluded entirely from the VAT and consequently subject to input taxation. The trade-off comes with an economic cost, however. To begin with, the non-recoverable turnover tax provides an incentive for self-supply which may result in less specialised and less efficient businesses.[220] Concern over this outcome was one of the prompts for members of the predecessor to the EU to replace their turnover taxes with VAT systems.[221] Equally importantly, the non-creditable feature of the turnover tax and the tax cascading to which this leads put small suppliers subject to the tax at a significant competitive disadvantage to enterprises in the full VAT system when selling to registered businesses.

2.6 Conclusion

Registration thresholds and small business regimes are primarily designed to reduce administrative costs borne by tax authorities and compliance costs that fall on small businesses. Each of these features of VAT systems gives rise to concerns.

The registration threshold raises concerns because of the distinction it creates between small businesses bearing lower tax and compliance burdens and slightly larger firms with higher liabilities and compliance costs. Businesses left outside the full VAT that primarily sell to final consumers will generally enjoy a competitive advantage from the lower tax burden and compliance costs. Those selling to registered enterprises will be disadvantaged, a problem that can be addressed through voluntary registration, albeit with implications for both revenue and administration costs. These factors will impact

[219] Bird and Gendron, (n 6) 120.
[220] Krever, (n 7) 10.
[221] E.g., France, Italy, and the Netherlands, etc. See H. J. Aaron, *The Value-Added Tax: Lessons from Europe* (The Brookings Institution 1981).

on the optimal registration threshold, particularly in countries where the voluntary registration rate is high.

These reduced tax burden and compliance costs for unregistered enterprises create incentives for businesses selling primarily to final consumers to stay below the threshold through real output changes or avoidance or evasion activities. Empirical studies clearly reveal business behaviour to bunch below a registration threshold in the jurisdictions in which this research has been conducted. They do not reveal the extent to which the capped turnover that leads to business bunching is attributed to real output changes, avoidance or evasion, causes that may vary in impact across different jurisdictions depending on the nature of incentives given to small businesses above the threshold, relative compliance costs, and administrative and enforcement capacities.

Views on a possible role for the registration threshold level to address unwanted behavioural responses are ambiguous, with different observers proposing higher or lower thresholds to address the same type of behaviour in some cases. Each recommendation is based on assumptions regarding probable changes to business behaviour, a risky basis for policy development. Balancing the recommendations may thus be impossible, in particular where empirical studies do not provide evidence on the extent of each behaviour. At the same time, it seems that concern over restraint as a cause of bunching may be exaggerated. In the face of uncertainty coupled with the availability of alternative direct policies that can be used to address splitting and under-reporting, the best approach for policy makers appears to be to seek a threshold that balances revenue and compliance and administration costs without regard to bunching behaviour but taking into consideration the impacts of voluntary registration.

A few countries have sought to minimise inefficiencies and distortions caused by a sharp increase in tax liability and compliance costs at the threshold by adopting a graduated phasing-in regime. Experience nevertheless suggests that it is difficult to set the correct incentives to make the regime work effectively while not providing excessive windfall benefits.

Wherever the VAT registration threshold is set, just above the threshold are enterprises relatively smaller than those further up the turnover scale. These smaller businesses face disproportionate compliance costs, prompting the adoption of simplified regimes to reduce those costs. If the simplified regimes truly led to reduced compliance costs, the optimal threshold level balancing costs and revenue might shift, subject to the constraint of greater administration costs. Even if an actual reduction of costs does not materialise, as appears likely in many instances, the nominal outcome of a simplified system may provide political cover for adoption of a lower threshold.

Further considerations that may affect the decision to adopt a simplified regime include the risks entailed in simplified systems and questions about their fairness and behavioural consequences. Simplified regimes that allow concurrent cash and accrual basis accounting for VAT purposes are vulnerable to avoidance schemes involving cash basis sellers who may defer tax liability indefinitely while related accrual basis buyers claim immediate input tax credits. Presumptive regimes intended to remove the need for small businesses to track input tax will approximate the impact of a VAT in respect of only a tiny number of businesses that mimic exactly the characteristics of the models used to calculate the notional input tax entitlement built into the retention formula. For all others, they either provide windfalls or penalties. At the same time, separate presumptions for enterprises that provide different types of supplies may induce businesses to add particular types of supplies to or remove others from their business models.

While higher income jurisdictions have concluded that input taxation only of smaller businesses below the threshold is the optimal solution to the compliance cost and administrative cost problems, there are some jurisdictions with no registration threshold, extending the VAT to all enterprises. A different approach adopted in some medium and lower income jurisdictions sees the replacement of the registration threshold with an alternative tax border, with a lower rate turnover tax imposed on businesses below the full VAT threshold. The turnover tax leads to cascading and consequent competitive disadvantages for many businesses while encouraging others to adopt less efficient self-supply structures.

VAT thresholds and small business regimes remain one of the most difficult policy areas in a VAT, presumably because the evidence on the extent of problems associated with them and business responses to attempted solutions is so ambiguous. Subject to this caveat, however, a number of tentative conclusions can be reached. First, the adoption of a registration threshold is the most efficient measure to reduce administrative and compliance costs. A higher threshold with the option of voluntary registration is generally preferable to a lower threshold with concessional or simplified regimes for businesses above the threshold and input taxation rather than alternative turnover taxation is preferable for enterprises with turnovers below the registration threshold. Second, where simplified rules for small businesses with turnovers above the registration threshold are necessary (for political reasons), the option for less frequent filing, possibly coupled with less frequent payments, is the least harmful concession available. Third, incentive schemes designed to transition enterprises into the VAT appear not to be successful. Distortions and inefficiencies caused by a threshold might have to be seen as a necessary price to be paid for achieving administrative and compliance cost savings, at least before more evidence on the negative effects of a threshold is learnt.

CHAPTER 3. FINANCIAL SUPPLIES AND INSURANCE SERVICES

3 Introduction

The application of VAT to financial supplies and insurance services in the context of an invoice-credit VAT system is one of the most complex areas of VAT design. The theoretical benchmark as applied to financial and insurance supplies is simple – services related to loans, insurance and the transfer of financial securities should be fully taxed as are all other services to the extent they comprise final consumption, while there should be full recovery of any tax in the case of B2B supplies and the acquisition of savings. Translating this theory into practice has confounded tax designers for 60 years since the first adoption of the VAT in Europe in mid- to late- 1960s. Officials were uncertain as to how VAT should be applied to a wide range of services and intangible supplies and adopted a stop-gap solution that saw all financial supplies treated as exempt supplies to keep them out of VAT calculations. The most challenging practical issue is to identify the value added in the case of intermediary services that are normally charged in the form of interest spreads. The problem is further complicated by the conceptual difficulties as to the consumption elements in financial and insurance supplies and fundamental differences between different types of supplies.

The rationale for continuing incomplete taxation of financial supplies became weak as distortions and inefficiencies of the EU exemption approach were gradually learnt by legislators outside Europe. Although this approach has endured for selected financial supplies and some insurance services in more modern VATs, a variety of alternative approaches that depart from the exemption approach have been adopted for other financial supplies and insurance services. There are also more radical proposals that aim to bring the financial sector into full taxation.

While legislated definitions of financial supplies differ across jurisdictions, the two core types common to all are intermediary loan services and the issuance and transfer of financial instruments. Insurance services include general insurance services and life insurance services. This chapter identifies the theoretically optimal tax base for each of the four types of supplies and suggests specific tax regimes appropriate for the legal and economic nature of each type of supply based on a comparison of the existing and proposed models.

3.1 Financial supplies

3.1.1 Intermediary loan services

Intermediary loan services are the most common form of financial intermediation that link savers and borrowers to facilitate different timing preferences for consumption of both parties. The appropriate tax base of intermediary loan services is one of the main conceptual issues that attracts ongoing debate. This section takes traditional banking services of deposit-taking and loan-making as an example to illustrate the conceptual and practical problems.

3.1.1.1 Conceptual issues

One distinct feature of intermediary loan services is that they are not charged explicitly. Rather, the value of intermediary services is reflected in the spread between the higher interest rate charged to borrowers and the lower interest rate paid to depositors. Loan payments involve four components: repayment of loan principal, pure interest, an intermediary service charge and a risk premium. There is a general consensus for the view that the loan principal and the pure interest components should not be taxed under the VAT.[222] The loan principal only represents the transfer of funds via the bank from the depositor to the borrower, which involves no consumption and should not incur VAT.[223] The pure interest rate is the rate that the depositor would charge to the borrower if there were no intermediary services. The pure interest payments are compensation for deferring consumption for savers and cost of moving forward consumption for borrowers.[224] This component is merely a reflection of the time value of money, and so should not be part of the VAT base. The conceptual inconsistencies in the literature are surrounded by three issues concerning the interest spread, which is comprised of three components: an intermediary service charge for borrowers, an intermediary service charge for savers and a risk premium.

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[222] See Grubert and Krever, (n 57) 319-322.
[223] Grubert and Krever, (n 57), 319-320.
[224] S. Poddar and M. English, 'Taxation of Financial Services Under a Value-Added Tax: Applying the Cash-Flow Approach' (1997) 50 National Tax Journal 89, 91.

1) Should intermediary services be subject to VAT?

The key conceptual debate has focused on whether financial intermediary services should be subject to VAT like all other goods and services. Different perspectives on the character of financial intermediary services lead to conflicting VAT implications. One view is that financial intermediary services function in a similar way as pure interest rates that they only act to smooth the time preferences of consumption between borrowers and lenders, while yielding no consumer utility.[225] Under this view, financial intermediary services are not consumption goods and should be excluded from the VAT base.[226] This view has been challenged by Auerbach and Gordon on the basis that the production of financial services uses real resources, and 'all primary factors that enter into the production of final consumer goods' should be taxed under the VAT.[227] From the perspective of government's revenue constraints, Grubert and Krever[228] reached the conclusion that financial intermediary services provided to borrowers should be subject to VAT.[229] If the consumers were not acquiring the financial services, they would use the funds to acquire other goods or services that are subject to tax, and the capital and labour inputs used in the acquisition of financial services would be used to provide taxable non-financial goods or services.[230] Therefore, only if financial intermediary services acquired by the person who accelerates consumption are taxed can the government obtain the same amount of tax revenue from accelerated or deferred consumption.[231] Although the conclusions drawn by Grubert and Krever, on the one hand, and Auerbach and Gordon, on the other, would yield different results with respect to depositors or savers, both positions are opposed to the view that financial

[225] N.-C. Chia and J. Whalley, 'The Tax Treatment of Financial Intermediation' (1999) 31 Journal of Money, Credit and Banking 704; and H. Grubert and J. Mackie, 'Must Financial Services be Taxed Under a Consumption Tax?' (2000) 53 National Tax Journal 23.

[226] Through a different route, Jack reached a similar conclusion that financial intermediary services charged by means of margin should not be taxed under the VAT. The assumption is that the prices of all consumption goods should be increased by the same percentage in response to the VAT. Since the (net of tax) prices of margin-based financial services are increased in proportion to the nominal value of the underlying transaction, imposing a tax on them would mean that the prices increase proportionately in response to the tax, and so would distort relative prices of consumption goods. See W. Jack, 'The Treatment of Financial Services Under a Broad-Based Consumption Tax' (2000) 53 National Tax Journal 841.

[227] A. Auerbach and R. Gordon, 'Taxation of Financial Services under a VAT' (2002) 92 The American Economic Review 411.

[228] Grubert originally argued that financial intermediary services should not be taxed under the VAT. See Grubert and Mackie, (n 225). He later recanted his view in Grubert and Krever, (n 57).

[229] The correct treatment of intermediary services provided to savers will be discussed later.

[230] Grubert and Krever, (n 57) 324.

[231] *Ibid.* Grubert and Krever argued that the same does not hold true for savers.

intermediary services should be completely excluded from the VAT base. The extreme challenge to the taxation of financial intermediary services under the VAT does not gain any further support in the literature. The remaining question is that if the entire intermediary services, or only the part that provided to borrowers, should be subject to VAT.

2) Should intermediary services provided to savers be subject to VAT?

It is widely recognised that the costs of intermediary loan services are borne by both depositors and borrowers. Nevertheless, there has been a surprisingly silence in the literature as to whether the two parts of intermediary services, namely, those provided to savers and borrowers, should be taxed alike. If the view of Auerbach and Gordon were adopted, it would be equally logical to subject intermediary services provided to both savers and borrowers to VAT. Proposals for taxing financial intermediary services under the VAT explicitly take the view that VAT should be applied to intermediary services to both savers and borrowers.[232]

This view, however, neglects the different characters of financial intermediary services provided to the opposite sides of loan transactions. While intermediary services provided to both savers and borrowers use real resources, savers are not acquiring the inputs as an alternative to the consumption of other goods or services as is the case with borrowers.[233] Rather, the expenses incurred by savers in applying the resources are part of the costs of generating further savings for future consumption.[234] Under a benchmark VAT, therefore, intermediary services provided to borrowers would be taxed and those provided to savers should be removed from the VAT base.

3) Should the risk premium element of interest rate spreads be subject to VAT?

In addition to the charge for intermediary services, the interest margin includes an element of risk premium to cover the risk of default by the borrowers.[235] The risk

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[232] See e.g., Poddar and English, (n 224); and H. H. Zee, 'A New Approach to Taxing Financial Intermediation Services Under a Value- Added Tax' (2005) 58 National Tax Journal 77, 88-89.

[233] Grubert and Krever, (n 57) 324.

[234] Grubert and Krever, (n 57) 324.

[235] Auerbach and Gordon, (n 227) 416; Poddar and English, (n 224) 91; L. Hoffman, S. Poddar and J. Whalley, 'Taxation of Banking Services under a Consumption Type, Destination Basis VAT' (1987) 40 National Tax Journal 547; A. Schenk, 'Taxation of Financial Services Under a Value Added Tax: A Critique of the Treatment Abroad and the Proposals in the United States' (1994) 9 Tax Notes

premium is equivalent to insurance for lenders, covering the unpaid principal and interest of defaulters. If characterised as principal repayments and interest payments by other borrowers on behalf of defaulters, the amounts should be free from VAT just as direct repayments and interest would have been. This view, however, has been challenged on the ground that risk assessment requires the use of real resources, and is thus an element of financial intermediary services.[236] The conclusion may reflect a confused commingling of the risk premium, which functions as 'an element of insurance in intermediation between borrowers and lenders', and the intermediary's activities of assessing default risk that is an integral part of intermediary services.

In theory, therefore, among the three components of interest spreads, the charge for intermediary services provided to savers, the charge for intermediary services provided to borrowers and the risk premium element, only the value of intermediary services provided to borrowers should be taxed under the VAT.

3.1.1.2 Practical difficulties

Apart from conceptual issues, the unique features of loan intermediary services also present practical difficulties for the operation of the VAT. Under the invoice-credit mechanism, the tax object is transaction based upon which the tax liability is calculated. The invoice-credit mechanism thus effectively turns the VAT into a transaction-based tax. The proper function of the VAT relies on the identification of explicit prices of taxable sales and inputs so that the VAT liability can be determined.[237] The charges for intermediary loan services, however, are hidden in interest spreads and cannot be identified on a transaction-by-transaction basis. Even the margin could potentially be measured on an aggregate basis, there is no readily achievable measure to separate the risk premium element from the intermediary services component and allocate the value of intermediary services to the depositors and borrowers on any particular

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International 823; R. Carroll and A. Viard, 'Value Added Tax: Basic Concepts and Unresolved Issues' (2000) 126 Tax Notes 1117, 1125.

[236] H. H. Zee, 'VAT Treatment of Financial Services: A Primer on Conceptual Issues and Country Practices' (2006) 34 Intertax 458, 462.

[237] *Ibid*, 461.

transaction.[238] These difficulties have led to the assertion that the VAT is ill-suited for taxing financial services.[239]

3.1.1.3 Exemption approaches

The fallback approach incorporated into the traditional European VAT six decades ago, a wholesale exemption for all financial supplies and insurance services, remains the starting point for almost all VAT systems. But while exemption remains a central design feature of other VAT systems, many modifications and variations have appeared in later iterations of the tax. Exemption is not universal, however. Most notably, Israel uses an addition method to tax financial services, with value added being computed as a sum of profit and wages.[240] The addition method turns the VAT into an account-based tax in the financial sector, inconsistent with the invoice-credit method that applies to all other types of supplies.[241]

Full exemption: EU

The difficulties of applying the VAT to financial intermediary services were a key reason for exempting financial services in the EU,[242] although the initial choice of exempting financial services seems to be a matter of path dependency.[243] The EU exemption approach was then followed by most other countries adopting a VAT. However, as discussed earlier in Chapter 1, the use of exemption generates economic distortions, and administrative and legal difficulties.[244] While these problems are associated with any type of exempt supplies, it is believed that the problems are particularly acute with the financial sector.[245] The spillover effects of the distortions in

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[238] Poddar and English, (n 224) 92.

[239] See A. Tait, *Value Added Tax* (McGraw-Hill Book Company 1972) 20; Committee on Turnover Taxation, *Report of the Committee on Turnover Taxation* (Cmnd 2300, 1964) para 185.

[240] Y. Ruppin, 'VAT on Financial Services and Israel's Addition Method' (2017) 85 Tax Notes International 657.

[241] Hoffman, Poddar and Whalley, (n 235).

[242] See R. de la Feria and M. Walpole, 'Options for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared' (2009) 58 International & Comparative Law Quarterly 897.

[243] It was explained in the Commission's proposal for the Six Directive that 'the other exemptions, …, such as insurance, provision of credit and dealings in currency and on the stock exchange, where they are justified for reasons of general policy common to all the Member States'. See Commission, (n 88) 15.

[244] Economic distortions and legal difficulties caused by treating financial supplies as exempt supplies are discussed in the EU context in de la Feria and Walpole, (n 242).

[245] See S. Poddar, 'Consumption Taxes: The Role of the Value-Added Tax' in P. Honohan (ed), *Taxation of Financial Intermediation* (The World Bank and Oxford University Press 2003) 352; and Zee, (n 236) 463.

the financial sector may be strong given the significant role the sector plays in supporting the economy.[246]

Exemptions have mixed impacts on financial service providers and their (business and private) customers. Although exempt supplies do not attract a tax liability, no credit is provided for the tax paid on inputs related to these supplies. Financial institutions thus have an incentive to avoid paying the non-deductible input tax by vertical integrating businesses or self-supplying inputs. Exemptions thus discourage specialisation and reduce economic efficiency in the financial sector.[247]

Where the non-deductible input tax is not avoided, it becomes part of the business costs. The tax component will be embedded in the selling price to the extent that it is not reflected in a reduction of the profit margin of financial institutions. In this case, private costumers are under-taxed as they only bear the tax burden on the inputs acquired by financial institutions, while being freed from the tax on the value added by their suppliers. In contrast, registered businesses that acquire exempt financial supplies to make taxable supplies are over-taxed and the inclusion of unrecovered tax in their cost base leads to cascading in the VAT system.

The primary justification for treating loan intermediary services as exempt supplies is thus based on administrative considerations. Under the exemption approach financial intermediaries do not need to calculate the value of intermediary services and allocate it between depositors and borrowers. These compliance savings are offset to some extent, however, by the compliance and administrative costs related to the apportionment of inputs between those incurred to make taxable supplies and those incurred to make exempt supplies. Once these costs are considered, the administrative benefits of exemption appear to be outweighed by the economic distortions resulting from this treatment.

[246] *Ibid.*
[247] Poddar, (n 245) 353.

Exemption with partial input tax credits: Australia and Singapore

One way to ameliorate the problem of cascading or the self-supply bias is to allow financial institutions making exempt supplies to claim credits for a proportion of input costs. Australia and Singapore provide examples of two different partial recovery systems.

The Australia regime, referred to as the reduced input tax credits (RITC) system, was adopted primarily to remove self-supply bias created by the full exemption rule.[248] Under the RITC regime, financial services providers are entitled to recover a reduced credit for input tax paid on a list of specified acquisitions relating to exempt financial supplies. The reduced input credit is generally 75 per cent of the GST payable on a qualifying acquisition,[249] which provides a partial relief of the full input tax burden.

Concern over the cascading effects of the exemption approach promoted Singapore to adopt a different type of partial input tax credit regime.[250] The Singapore system, known as the fixed input tax recovery (FITR) method, allows banks to claim credits for fixed percentages of the total input taxes with the percentage depending on the character of the banks' customers. The proportion recoverable is the percentage of inputs used to make supplies to registered businesses and non-resident customers, with this figure determined using annually updated industry statistics for different categories of financial institutions based on the type of banking licence.[251] In theory, if the full recovery of input tax were passed through to registered customers and non-resident customers only, the result would approximate the effect of zero-rating supplies to these customers.

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[248] For detailed description of the RITC regime, see R. Krever and J. Teoh, 'Financial Loan Intermediary Services: Australia' in R. F. van Brederode and R. Krever (eds), *VAT and Financial Services: Comparative Law and Economic Perspectives* (Springer 2017).

[249] A 55 per cent recovery is provided for a small group of reduced credit acquisitions. See, A New Tax System (Goods and Services Tax) Regulations 1999 and A New Tax System (Goods and Services Tax) Amendment Regulation 2012 (No. 1), 70-5.03.

[250] Zee, (n 236) 463-464.

[251] See, Inland Revenue Authority of Singapore, 'IRAS E-Tax Guide: GST: Guide for the Banking Industry' (3rd edn, 2014) <https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/e-Tax_Guides/etaxguide_GST_Guide%20for%20the%20Banking%20Industry.pdf> accessed 19 December 2016.

Exemption with zero-rating of B2B financial services: New Zealand

An alternative approach to reduce the cascading problem with registered business customers that results from exemptions for financial supplies is found in New Zealand, which zero-rates B2B supplies of financial intermediation services. The effect is to replicate in a sense a retail sales tax.[252] Financial service providers are given the choice to opt for the zero-rating treatment for supplies made to registered businesses, provided that the business customers' taxable supplies account for at least 75 per cent of their total supplies in a given period.[253] The task of ascertaining whether business customers are entitled to the zero-rating treatment rests on the financial institutions. As B2B zero-rating is only allowed if supplies made by the recipient of financial supplies are predominately taxable supplies, the treatment is not available for financial supplies made to other financial service providers.[254] To overcome this limitation, the GST Act provides a special rule that allows financial services providers a pro-rated deduction of input tax for exempt financial supplies made to another financial services provider, to the extent that the recipient financial institution makes taxable supplies to registered business customers.[255] The deductible amount is determined by the ratio of taxable to non-taxable supplies made by the recipient financial services provider. The policy intent, in this context, was to reduce tax cascades when financial services are provided to businesses making taxable supplies.[256]

Exemption with VAT on financial supplies for explicit fees: South Africa

While the conceptual and practical difficulties are associated with margin activities, the value of financial services for which explicit fees and commissions are charged can be easily identified and subject to tax. This approach is adopted in South Africa, which only exempts financial services that are charged by way of margin, while imposing full

[252] For detailed description of the B2B zero-rating rules in New Zealand, see M. Pallot, 'GST and Financial Services- Rating Zero-Rating' in R. Krever and D. White (eds), *GST in Retrospect and Prospect* (Brookers Ltd 2007); and M. Pallot, 'GST and Financial Services in New Zealand' in C. Peacock (ed), *GST in Australia: Looking Forward from the First Decade* (Thomson Reuters 2011).
[253] (New Zealand) Goods and Services Tax Act 1985, Sections 11A (1) (q) and 20F.
[254] The New Zealand Inland Revenue, *GST Guidelines for Working with the New Zero-Rating Rules for Financial Services* (The Policy Advice Division of the Inland Revenue Department 2004) 24.
[255] (New Zealand) Goods and Services Tax Act 1985, Sections 20 (3) (h) and 20C.
[256] See, 'GST Incurred in Making Certain Supplies of Financial Services' (*New Zealand Inland Revenue*) < https://taxpolicy.ird.govt.nz/publications/2009-commentary-arttspkrm/gst-incurred-making-certain-supplies-financial-services> accessed 22 December 2016.

tax on fee- or commission-based services. The measure intends to limit the scope, and thus distortions, of exemptions.

Evaluation

The four alternative approaches have addressed or avoided the problems of the exemption approach to varying degrees. The explicit B2B zero-rating approach used in New Zealand, combined with a special rule that removes the tax cascading element where financial services are supplied to other financial institutions, is the only regime that fully addresses the cascading problem of exempt financial supplies. This approach nevertheless leaves the problem of under-taxation of private customers unresolved. It also results in higher compliance costs as financial institutions need to identify the registration status of customers and ascertain whether registered customers primarily make taxable or exempt supplies.

The implicit "zero-rating approach" in Singapore based on an average rate applied to the total input tax to approximate the effect of removing the tax on supplies made to registered customers and non-residents was also designed to remove the cascading effects. The decision to use an indirect approach was mainly driven by the desire to avoid the administrative and compliance costs that would have incurred were the creditable input tax directly linked to the exempt supplies made to registered businesses, in which case financial institutions have to identify the status of the customers.[257] However, while the fixed rate (reduced) input tax is creditable against all (taxable and exempt) supplies, there may be a leakage of benefit to non-business consumers.[258] The FITR method could thus effectively reduce the over-taxation of business customers, rather than achieving an equivalent of zero-rating B2B supplies that completely eliminates cascading.[259] Meanwhile, given that private consumers may obtain part of the benefit of the input tax recovery, the FITR method tends to aggravate the under-taxation of final consumers.[260] In addition, the FITR method relies heavily on administrative efficiency and discretion in terms of the allocation of input costs of financial institutions

[257] See also, G. Jenkins and R. Khadka, 'Value Added Tax Policy and Implementation in Singapore' (1998) 9 VAT Monitor 35, 40-41.
[258] Zee, (n 236) 464.
[259] Zee, (n 236) 464; S. Poddar, 'VAT on Financial Services – Searching for a Workable Compromise' in Krever and White (eds), (n 252)188.
[260] Zee, (n 236) 464.

between their taxable and exempt supplies.[261] It is unlikely that the approach will have wider application,[262] in particular in developing countries that are equipped with poor administration.

The partial relief of input tax burden provided in the Australian RITC regime may be effective in neutralising the bias against outsourcing and reducing tax cascades. It nevertheless does not eliminate the cascading problem. As is the case with Singapore's FITR, the RITCs could be passed through to final consumers in Australia, aggravating the problem of under-taxation of final consumers.

The extent to which the imposition of VAT only on fee-based services can limit the distortions of a general exemption system may depend on the mix of margin and fee-based services in the financial sector[263] and the ability of financial institutions to shift costs out from margins to fees for business customers and roll the cost of services into margins for final consumers.[264] The risk of shifting may not be high where the financial markets are highly competitive and market forces restrict institutions' ability to vary too far from prevailing interest rates.[265]

Since the first adoption of a VAT more than half a century ago, the default rule for taxation of financial supplies has been exemption treatment. Pure exemption has been modified in some jurisdictions, however, usually at a revenue cost, as countries sought to remove or mitigate the cascading consequence of exempt B2B transactions. In each case, they have been responses to local pressures and designed in the context of local financial environments and it is not clear if they have potential as models for wider application.

[261] Poddar, (n 259) 188; T. Edgar, 'The Search for Alternatives to the Exempt Treatment of Financial Services under a Value Added Tax' in Krever and White (eds), (n 252) 149.
[262] Poddar, (n 259) 188. The Singapore FITR regime was followed by Malaysia when its GST commenced operation in 2015. However, its new government has recently placed bills to abolish the GST and re-introduce the sales and services tax.
[263] Poddar, (n 259) 188.
[264] Poddar noted that attempts to tax fees and commissions on foreign exchange transactions in Russia promoted a shift from explicit fees to margins. See, Poddar, (n 245) 377.
[265] Poddar, (n 245) 368; A. Kerrigan, 'The Elusiveness of Neutrality – Why Is It So Difficult to Apply VAT to Financial Services?' (2010) 21 International VAT Monitor 105.

3.1.1.4 Alternative proposals

While the recent measures adopted by a few modern jurisdictions discussed above are all modifications of the exemption approach, alternative proposals seek more radical changes to bring intermediary loan services into full taxation. Proposals that attract most attention from academics and policy makers include the cash-flow method, modified reverse-charging method, separate tax rates approach and subtraction method. As is the case with the addition method, the subtraction method does not fit into an invoice-credit VAT and therefore will not be considered.[266]

Cash-flow method

The cash-flow method brings margin-based services into an invoice-credit VAT by treating a financial institution's cash inflows as consideration for its taxable sales, and cash outflows as consideration for its purchases of taxable inputs. Therefore, tax would be imposed on deposits, loan interest and loan repayments, and banks can claim credits on loans, deposit withdrawals and interest payments. The net tax payment would equal the tax on the interest margin, which is the value added by the financial institution (if the risk premium element is not taken into consideration). While registered depositors and borrowers could claim an input tax credit for the tax they paid on intermediary services, individual savers may be over-taxed as the intermediary services provided to them are also subject to tax.

In addition, a few operational problems of the method have been identified.[267] First, borrowers would face a cash flow burden as the tax is imposed on loan principal at the time they make a loan. Second, the implementation of the system and any change in the tax rate would pose transition problems; the tax payment and input tax credit on the same principal would no longer match. Third, the system would require financial institutions and their registered customers to maintain their own cash-flow accounts, incurring high compliance burden. Some of the problems were addressed in a modified mechanism, known as tax calculation accounts (TCA), that built on the basic cash-flow approach described above.[268] Experiment with the TCA system in the EU, however,

[266] See note 4 for an explanation of the subtraction method.
[267] Poddar, (n 245) 363-364.
[268] Poddar and English, (n 224).

indicates that the system would still entail significant compliance (and administrative) costs.[269]

Modified reverse-charging method

The modified reverse-charging method would treat loans as a bank's output sales and deposits as its input purchases.[270] A deemed VAT would then be applied to the loan and deposit interest, which are the bank's output tax and input tax respectively. The excess of the output tax over the input tax that remitted to the government is the tax on intermediary services provided by the bank. This tax would be borne by the borrower through a franking mechanism. The method would over-tax unregistered borrowers as they bear the tax on the whole intermediary services. In addition, although the method is untested in practice, its operation is likely to give rise to great complexity.[271]

Separate tax rate

The separate tax rate approach applies a reduced rate to the gross interest on loans to approximate the tax consequence of applying the standard rate to the proportion of interest that represents the service charge.[272] Registered borrowers would be entitled to input tax credits as normal. A similar method is used in Argentina that imposes the VAT, at a rate half of the full VAT rate, on the gross interest on loans. The Argentina approach, however, was not viewed as consistent with fundamental VAT policy principles as its objective was to reduce inflation by curtailing consumer demand.[273]

The method requires an estimate of the portion of interest represents the service charge to borrowers based on industry average so that the reduced VAT rate imposed on gross interest could roughly equate to a full-rate on the intermediary service charge. Although the outcome does not achieve a conceptually accurate result for particular institutions or loans, even if the applicable VAT rate is subject to regular reviews and adjustments, the approach has several advantages over alternatives. First, it is fully integrated into the

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[269] H. Huizinga, 'A European VAT on Financial Services?' (2002) 35 Economic Policy 499, 522-523.

[270] The method was proposed by Zee. See, H. H. Zee, (n 232).

[271] Kerrigan, (n 265).

[272] The method was proposed by Bakker and Chronican. See, C. Bakker and P. Chronican, *Financial Services and the GST- A Discussion Paper* (Victoria University Press for the Institute of Policy Studies 1985).

[273] C. E. Alba, 'Taxation of Financial Services Under the Value Added Tax: A Survey of Alternatives and an Analysis of the Argentine Approach' (1995) 6 International VAT Monitor 335.

invoice-credit VAT without the need for special mechanisms. Once the reduced rate is determined, the implementation of the separate rate method does not incur additional administrative and compliance costs relative to those arising in the cash-flow method or the modified reverse-charging method. Second, to the extent that particular B2B transactions are over-taxed or under-taxed, the inaccuracy does not have an impact on business borrowers because they can claim an offsetting input tax credit. The degree of inaccuracy for unregistered borrowers is likely to be much smaller than the under-taxation of unregistered borrowers found in New Zealand, Singapore and Australian alternatives.

The various approaches and proposals vary in terms of the balance between efficiency and simplicity. None of them could achieve the conceptually perfect outcome given the lack of consensus on the conceptual issues. The cash-flow and modified reverse-charging methods are devised to identify and segregate the service charge from the interest margin. They are closer to the conceptually optimal result than existing approaches at the cost of unreasonable complexity. In contrast, the separate tax rate approach that relies on an estimation of the service charge compromises the purity of the VAT as a consistent tax on the value of all types of supplies. It could nevertheless provide greater simplicity than existing approaches for removing the tax element in B2B transactions. The approach could achieve a better balance between the efficiency and simplicity objectives. The separate tax rate approach might be the best available choice for developing countries to tax fully loan intermediary services. The problem with estimation efficiency may be less pronounced in countries in which the financial sector is small or highly concentrated or regulated.

3.1.2 Financial securities

The trading and issuance of financial securities present a different conceptual issue that has seldom been discussed in the literature. Three types of supply may be acquired in the process of trading financial instruments: the direct acquisition of investments, intermediary services (provided by brokers), and ancillary services such as investment advice and financial analysis. All these supplies could be acquired by both registered businesses and unregistered individuals. The direct acquisition of investments is simply an investment activity with no personal consumption element, and therefore should not be included in the VAT base. In the case of financial instruments that are traded through a broker, the purchaser and the seller acquire intermediary services from the broker, with the commission fee for brokerage service payable as a fixed amount or a percentage of the sale or acquisition price. As is the case with intermediary loan services provided to savers, charges for intermediary services in securities trading are costs of investment that do not involve personal consumption. Similarly, in theory, payments for supplies ancillary to the acquisition of investments should not be subject to unrecoverable VAT.[274] All three types of services thus fall outside the benchmark VAT base.

In practice, however, most countries exempt the issuance and transfer of financial instruments and related services from the VAT. The exempt treatment gives rise to over-taxation of both registered and unregistered investors. In countries where other types of financial services are brought into the tax base, the over-taxation of securities trading may distort investment decisions and the ways in which businesses and individuals seek funding. Alternative approaches include full taxation and zero-rating of investment services. The imposition of full taxation on investment services, however, can only remove cascading for B2B supplies. Unregistered individual investors would continue to bear imbedded VAT in their acquisitions and disposals of financial instrument. Removal of tax from their acquisitions would require them to register for the VAT to be entitled to input tax credits, which is arguably not administratively feasible.[275]

The best way to achieve this result is therefore to zero-rate these supplies. There might be two difficulties with the zero-rating option, however. First, separating investment activities and services from other (financial) supplies may give rise to classification and borderline difficulties, in particular with respect to ancillary services related to the transfer of financial instruments. The transfer of financial securities and brokerage activities are relatively easy to identify as is the direct issuance of securities by a company where there is no intermediary stock exchange or broker involved. The boundary of investment-related services, however, is less clear-cut in practice. For

[274] R. Krever, 'VAT and Financial Investments' in van Brederode and Krever (eds), (n 248).
[275] *Ibid.*

example, a subscription to financial journals or newspapers may provide information valuable for investment decisions, while at the same time delivering personal consumption benefits.[276] Investment-related services should be clearly defined in the VAT law to include only services directly and unavoidably incurred in the acquisition of investments. Broadly defined “investment-related services” may cause confusions and invite taxpayers to misclassify supplies to take advantage of the zero-rating treatment. Subjecting ancillary services to full taxation appears to achieve better policy outcomes if the risk of abuse by investors avoiding tax on personal consumption of mixed element inputs is compared to the small over-taxation of unregistered persons that might follow if ancillary services yielding mixed benefits were taxed.

The second difficulty with the zero-rating option is the fiscal cost of reform. Replacement of exemption with zero-rating will remove the tax embedded in the price of financial instruments, but lead to reduced VAT revenue for the government. The revenue impact may be the greatest impediment, among other factors, to the shift to zero-rating approach. Reform in this area is more likely to be achieved as a part of a wider reform agenda, with offsetting revenue gains yielded in other areas of VAT.

3.2 Insurance services

Insurance services are pooling services offered by insurers that collect premiums from a group of policy holders and use the funds to satisfy indemnity claims by insured persons who suffer property or profit losses (in the case of general insurance, or casualty insurance, as it is sometimes called) or who pass away (in the case of life insurance). In the case of both general and ordinary term life insurance, premiums pay for coverage over a fixed coverage period and the policy has no cash value at the end of the coverage period. A variety of life insurance known as whole life insurance or whole of life insurance includes a saving component on top of the premium for the initial years of the policy, with the savings allowing the insurer to apply constant premiums even when the true cost of insurance rises above the premium level in later years and leaving a cash value if the insured person wishes to cash out the policy prior to death. The different types of insurance carry different VAT implications.

[276] Krever, (n 274).

3.2.1 General insurance

Policy holders of general insurance consist of both registered businesses and unregistered individuals. Insurance premiums paid to the insurer include two components: the proportion that will be paid as a benefit to the policy holders who suffer losses and the charge for the pooling services offered by the insurer. The two components should both be subject to VAT. As is the case with loan intermediary services, the intermediation services, that is the pooling services, utilise real resources and should be taxed under the VAT. Where policy holders are registered businesses, they should be entitled to input tax credits. The indemnity payments paid by the insurer to the claimants include the VAT that will be later paid by claimants on the repair or replacement of assets. This VAT component should be collected from all the policy holders. If the insured is a final consumer or a registered business making exempt supplies, the VAT will be remitted to the tax authority when the replacement goods or services are purchased. If the insured is a registered business making taxable supplies, the VAT should be remitted to the tax authority as the repair or replacement will be free of VAT; the registered business, therefore, does not bear any VAT burden.

Experience of a few modern VAT jurisdictions, for example, New Zealand and Australia, has shown that the correct results in term of the service charge and the indemnity payments can be achieved in an invoice-credit VAT.[277] The New Zealand VAT provides an example of the full cash-flow tax model of applying VAT to insurance services. VAT is imposed on all insurance premiums, with registered businesses making taxable supplies entitled to offsetting input tax credits. The insurer makes a tax payment to the tax authority in respect of premiums received, while issuing invoices to registered business policy holders. VAT on premiums paid by registered businesses are recovered by the insured enterprises through the ordinary input tax credit system and VAT paid by unregistered policy holders is effectively used to gross up benefits to cover the VAT-inclusive cost of repairs and replacements. The indemnity payment is treated as an acquisition by the insurer, giving rise to an input tax credit for the insurer and a notional taxable supply if the claimant is registered. The tax authority

[277] R. Krever and J. Teoh, 'GST and Insurance: Australia' in van Brederode and Krever (eds), (n 248).

then collects the tax on repair or replacement (the VAT included in the indemnity payment) when the final consumer uses the proceeds of the indemnity payment to purchase goods or services. In this scenario, the net tax remitted by the insurer is the VAT on the service charges. In addition, the tax authority collects VAT on the consumption of repair or replacement, although this will of course be recovered by registered claimants through the ordinary input tax credit system.

An alternative approach, used in Australia, is based on the same logic but simplifies the process by requiring the insurer to pay a registered claimant the VAT-exclusive amount as settlement payment. This system avoids the circular flow of funds found in the New Zealand approach from the insurer to the tax authority and back to the insured that would follow characterisation of the settlement as consideration for a taxable supply. It nevertheless adds a separate step to the process as the insurer needs to distinguish between registered and unregistered claimants. With both approaches, the tax authority does not collect any revenue from a series of B2B transactions.

The Australian and New Zealand model may pose some problems where the settlement is made in cash to unregistered claimant in countries that use reduced rates and exemptions. In the case that the VAT rate applies to insurance premiums is different from the rate applies to the repair or replacement of assets and that the repair or replacement of assets is an exempt supply, there will be a notional mismatch between the VAT collected from the policy holders on the repair or replacement and the VAT element paid to the claimant by the insurance company. In a sense, however, the tax on premiums reflect the nature of the items of being insured because the indemnity of the items depends on the VAT included in the cost. The tax on the premiums therefore automatically, but very indirectly, mirrors the tax rate on the insured and replacement items. There may be mismatches, however, if the insured person receives a payout and purchases a different item subject to a different tax rate instead of the replacement item. The small inaccuracy for unregistered claimants is nevertheless negligible and does not undermine the overall merit of the model.

3.2.2 Life insurance

In one sense, taxing the intermediary pooling services of a life insurer should be simpler than taxing similar services by a casualty insurer as almost all holders of life insurance policies are final consumers, although in some cases registered businesses could also be the policy holders. This conclusion holds true for pure term life insurance where annual premiums provide coverage only for a year. It is not correct for whole life insurance coverage, however, where premiums comprise four elements: a savings component, a pure insurance component, an intermediary service charge for risk pooling, and an intermediary service charge for savings management.

Whole life insurance provides lifelong protection and the policy has cash value that grows at a pre-determined rate. The savings component (premiums exceeding the cost of pure insurance) in early years of the policy can be used to help fund the benefit payable in later years. This enables the insurer to charge level premiums over the life of the policy for a guaranteed benefit. Each year, the proportion of the guaranteed benefit that would be paid from the pooled insurance fund reduces and the amount that is paid from the insured person's accumulated savings increases. At some point, the savings equal the benefit value of the policy, at which time there is no longer any benefit from paying premiums and the policy will be cashed out.

Among the four elements of whole life insurance, only intermediary services attributable to risk pooling should be subject to VAT. However, due to the practical difficulties of separating that service charge from the savings element in the premium, the universal practice, even in countries that impose VAT on intermediary pooling services for casualty insurance, is simply to exempt life insurance from the VAT. Since the majority of the policy holders are final consumers, the exemption approach does not lead to a cascading problem in the VAT system. In addition, although final consumers are under-taxed for the acquisition of insurance services, they may still bear a portion of the tax as the insurers are likely to pass on the tax on the input costs incurred in providing the services. The exemption approach is therefore considered an acceptable compromise in the case of life insurance.[278]

[278] *Ibid.*

There are two proposals for bringing life insurance into the tax base. The first is the additive method,[279] imposing the tax on the sum of wages and profit at the institutional level. While the tax is calculated on an account basis, rather than a transaction basis, the additive method could be integrated into the invoice-credit VAT by allowing insurance companies to deduct input tax on the costs incurred in providing life insurance services. As is the case with the exemption approach, the additive method is feasible for taxing life insurance because the policy holders are mostly final consumers, removing any need to allocate VAT between the policy holders.[280] It remains problematic for whole life policies, however, since services related to savings would be subject to full VAT.

The second proposal largely replicates the approach used for general insurance.[281] Under this approach, VAT would be imposed on the full premium and the insurer's payout to the policy holder (either death benefits or savings) is treated as a purchase, entitling the insurer to a deemed input tax credit for the payout. While the savings element in the premium is subject to tax, the tax is the present value of the tax that should be paid in later years when the savings is applied to the actual cost of protection, leaving the government with the same economic outcome as if tax were imposed on the actual cost of protection each year the policy is in force.[282]

A similar logic can be applied to pure term life policies with level premium options. Under these policies, premiums are set at a level rate for a period of years rather than rising each year as mortality risk increases. Premiums exceed the cost of protection coverage in the earlier years and fall short of the cost in later years. In effect, policy holders are pre-paying a portion of premiums in later years, with the tax paid on the excess portion of the premium applied to coverage in later years equal to the present value of the tax that would have been paid had premiums increased annually, leaving the government in the same position it would have been with a rising annual premium policy. The only difference from the whole life policy is the absence of any savings

[279] S. Cnossen, 'A Proposal to Apply the Kiwi-VAT to Insurance Services in the European Union' (2013) 20 International Tax and Public Finance 867, 880; Bakker and Chronican, (n 272) 50.
[280] Bakker and Chronican, (n 272) 50.
[281] V. Barham, S. N. Poddar and J. Whalley, 'The Tax Treatment of Insurance Under a Consumption Type, Destination Basis VAT' (1987) 40 National Tax Journal 171.
[282] *Ibid*, 177.

component, meaning there will not be a cash value of the policy if the insured survives past the insurance period.

The second proposal suffer from the same flaw as the additive system, subjecting the cost of intermediary services related to savings built into the premium to tax. Both proposals may nevertheless more closely resemble the theoretically correct treatment than the exemption approach. The second proposal will be a better choice than the additive method as it is fully compatible with the “invoice-credit” feature of the VAT. Given its similarity to the approach used for general insurance in jurisdictions that subject general insurance pooling services to VAT, it may not create additional compliance costs in countries that already tax general insurance where the same insurer has life and general insurance arms. Aligning the tax treatment for life insurance with that for general insurance would also achieve the neutrality of the tax in the insurance industry. The exemption approach, however, remains an attractive option for countries that do not include general insurance in the tax base or have poor administrative capacities.

3.3 Conclusion

Under a benchmark VAT that only taxes final consumption, intermediary services unrelated to savings or investment should be subject to tax. In the case of intermediary loan services, only services provided to borrowers should be taxed. In the case of insurance, only risk pooling services should be taxed. Financial investment services should not be subject to VAT. The nature of services and the structure of these transactions make achievement of these conceptually optimal results with an invoice-credit VAT challenging. Special arrangements are therefore needed in these cases.

Existing VAT approaches and alternative proposals to tax intermediary loan services, financial investments and insurance services have different efficiency and simplicity implications. The best achievable option to balance between these objectives appears to be the adoption of the separate tax rate method to tax intermediary loan services, application of a cash-flow model to tax insurance services, and the characterisation of original issuance and subsequent transfer of financial instruments and direct investment services as zero-rate supplies.

Ultimately, the choice of VAT regime for loan intermediary services, insurance pooling services and the issuance and transfer of financial instruments depends on how a government balances against different objectives, taking into consideration the specific characteristics of the financial sector and the economy as a whole. For developed countries with advanced tax administration, the pursuit of simplicity may not be the top priority. For developing countries with poor administrative capacities, simplicity and revenue collection could outweigh the objective of achieving a conceptually pure result. A further consideration in developing economies may be the level of financial services provided by small entities operated in the unregulated informal economy.[283] In this environment, increased tax may promote a further shift of unregistered users' consumption of financial and insurance services from the formal economy to the informal sector.

[283] Poddar, (n 245) 376.

CHAPTER 4. INTERNATIONAL CROSS-BORDER ISSUES

4 Introduction

A fundamental principle of VAT as a tax on final consumption is that the VAT should operate as a destination-based tax that applies where consumption takes place. In the case of cross-border sales, this is achieved through two separate transactions; first, exports are zero-rated in the exporting country and, second, imports are subject to taxation in the receiving country. The destination basis regime based on the final consumption principle is often compared to the "origin basis" system in which the tax paid on a supply is the sum of the taxes that apply at the local rates on value added created in every country along the supply chain. While it is possible to construct a hypothetical model including resultant changes in foreign exchange rates between the trading countries or other consequent macro and micro adjustments that can lead to an equivalence between an origin basis and destination basis VAT, the prevailing view is that given the many assumptions needed for an origin basis VAT to achieve economic efficiency, the preference for destination basis taxation is 'well founded'.[284]

Three VAT issues arise in the context of international cross-border sales. The first is how to determine when intangible supplies have been exported from one jurisdiction and when they are imported into another (tangible items can be traced relatively easily). This question is commonly answered by means of place of taxation rules. Place of taxation rules for goods generally raise no difficulties but the drafting of rules for services is far more challenging. Two legislative approaches to services are found in practice, the schedular approach used in the EU and the principle approach used in New Zealand and Australia.

[284] Ebrill and others, (n 35) 183. There remains some question, however, whether the theoretical superiority of the system stands in a real-world international trade environment. In this respect, competing views can be found in M. Keen and S. Lahiri, 'The Comparison between Destination and Origin Principles under Imperfect Competition' (1998) 45 Journal of International Economics 323; A. HaufLer, G. Schjelderup and F. Stähler, 'Barriers to Trade and Imperfect Competition: The Choice for Commodity Tax Base' (2005) 12 International Tax and Public Finance 281 and B. Lockwood, D. de Meza and G. Myles, 'On the European Union VAT Proposals: The Superiority of Origin over Destination Taxation' (1995) 16 Fiscal Studies 1.

The second issue is how to remove the VAT on business expenses incurred by non-resident businesses. Country practices vary but they fall into two broad groups. The first, represented by the EU, has a special mechanism that allows non-resident businesses to claim a refund for a limited range of expenses. The second, represented by Australia, allows foreign businesses to register to claim a refund. There are also many countries that deny VAT recovery to non-resident businesses.

The third issue is who should bear liability to pay the tax on imports. Although the invoice-credit mechanism normally places the tax liability on the supplier, it is challenging to collect the tax on imports from overseas suppliers. In the case of B2B imports, therefore, the VAT is normally paid by the importer. The VAT on imported goods is paid by the importer at the border with effective border controls. The common approach to taxing imported B2B services is to use a reverse charge rule to shift the liability from the supplier to the importer. Challenges remain, however, with the collection of tax on B2C sales of low value goods and imported services and intangible supplies. Tax on low value goods can be collected from customers but the administrative costs far outweigh the tax collected. There is no simple way to collect tax on imported services and intangible supplies from unregistered final consumers, however, without a customs border or a post office to act as a collection point or a delivery service to act as a collection agent, as is the case with tangible goods. New collection models are being developed and tried to address both these problems.

This chapter reviews place of taxation rules for goods and services, country practices on refunds to foreign businesses and recent initiatives to bring imports of low value goods and cross-border sales of services and intangible supplies into the VAT system. It suggests an alternative approach to taxing cross-border sales of low value goods and digital supplies and refunding the VAT incurred by non-resident businesses.

4.1 Place of taxation rules

While the design requirements are simple, there is a remarkable diversity in the legislative approaches used to implement the destination principle subjecting supplies to tax in the jurisdiction in which consumption takes place, in particular in terms of services. A common feature is that the legislative approaches do not attempt to identify the location where the consumption actually occurs.[285] Rather, they rely on a set of jurisdictional rules to predict the place of consumption. The destination principle is implemented through place of taxation rules which are intended to act as proxies for the place of consumption.

4.1.1 Goods

Place of taxation rules for goods normally include three components: place of supply rules that create a liability to domestic VAT if the supply takes place in the jurisdiction or from the jurisdiction, zero-rating rules that remove the tax on exports, and import rules that impose a VAT liability on supplies from abroad received in the jurisdiction.[286] There are exceptions to the general rule. For example, Australia defines taxable supplies in terms of a connection between the supply and the jurisdiction, which effectively functions as place of supply rules.[287]

Since the movement of goods can be easily tracked, the proxy used for the prediction of the place of consumption is normally the location of goods. With effective border controls, goods are zero-rated when they leave a country and are taxed as taxable imports when they enter a country. In the case of large goods arriving by rail, air or sea, the importers are required to pay the VAT. In the case of small goods sent by post or courier, collection from the importer (mostly final consumers) at the customs may be costly. As a result, small imported goods are exempt from the VAT in many countries. An alternative approach developed recently is to tax small imported goods by extending the scope of place of supply rules to make certain supplies made outside the country deemed supplies made in the country, consequently requiring foreign suppliers to register and collect the VAT on behalf of importers. The recent development will be discussed in further detail in Section 4.3.2.

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[285] M. Keen and W. Hellerstein, 'Interjurisdictional Issues in the Design of a VAT' (2010) 63 Tax Law Review 359, 367.
[286] R. Millar, 'Echoes of Source and Residence in VAT Jurisdictional Rules' in M. Lang, P. Melz and E. Kristoffersson (eds), *Value Added Tax and Direct Taxation: Similarities and Differences* (IBFD 2009) 286.
[287] A New Tax System (Goods and Services Tax) Act 1999, s 9.25 (5).

4.1.2 Services

The logic of identifying the place of taxation for services is essentially the same as goods. The rules, however, are more complicated because unlike goods, cross-border supplies of services do not move through customs borders and cannot be physically tracked. Where the consumption takes place is thus far more difficult to ascertain than is the case with goods. Place of taxation rules for services rely on a larger set of proxies, including the location of immovable property or goods to which services relate, the place of physical performance, the location or residence of the supplier, the location or residence of the recipient and the location of effective use or enjoyment. The hierarchy given to the different proxies varies among countries but generally where services are attached to tangible proxies (for example, the locations of immovable property and goods), these proxies prevail over other proxies. The location or residence of the supplier or recipient are the least reliable proxies because they are more easily shifted than other proxies.

The span of the drafting approaches used to identify the place of taxation is great and it is difficult to segregate practices into different models. It can be seen, however, that the alternatives fall into two very broad camps, schedular approach and principle approach.[288]

Legislation using the schedular approach enumerates different types of supplies and sets out a place of taxation for each one based on the proxy chosen. VAT laws adopting a principle approach 'systematically applies a series of proxies'[289] to set out broad circumstances when consumption is assumed to take place within or outside the jurisdiction. The principle approach takes two steps to determine the place of taxation; the first step looks at whether the supply is made in the jurisdiction and the second looks at whether the supply is an imported service (in the case that the supply is made outside the jurisdiction) or an exported service (in the case that the supply is made in the jurisdiction). The main difference between the two approaches in terms of the use of proxies is that the principle approach explicitly provides a hierarchy of proxies, while the schedular approach implicitly sets out a hierarchy in specific circumstances.

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[288] R. Millar, 'VAT Treatment of Cross-Border Trade in B2C Services' (Second Meeting of the OECD Global Forum on VAT, Tokyo, April 2014).
[289] *Ibid.*

In practice, most countries use a hybrid approach that heavily relies on one of the two approaches but contains elements from both. For example, the EU uses the schedular approach, specifying the place of taxation for services connected with immovable property, restaurant and catering services, transport, hiring of means of transport, etc.[290] The specific rules are nevertheless backed up by the general rules that the place of taxation of services to a taxable person is the customer's location and the place of taxation of services to a non-taxable person is the supplier's location. Australia and New Zealand, in contrast, generally use principle-based rules to determine the place of taxation. However, the GST laws also contain specific rules that apply to particular types of supplies, including transport and telecommunications services.

The two drafting approaches both raise interpretation difficulties. The uncertainty associated with the schedular approach arises because legislators cannot envisage every possibility and include a comprehensive list of supplies in the law. This uncertainty has generated a great deal of litigation with courts in the EU regularly hearing appeals from assessments in which taxable persons and tax authorities dispute how particular supplies may fit into the enumerated lists,[291] particularly services related to immovable property,[292] entertainment services[293] and transfers of rights[294] etc. The principle-based approach is not immune from uncertainty and litigation, however, with broad principles sometimes too general for the myriad of different configurations possible in ordinary commercial transactions.[295] In some instances both systems generate uncertainty. The

[290] Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services.
[291] See also, R. de la Feria, 'Place Where the Supply/Activity is Effectively Carried Out as an Allocation Rule: VAT v. Direct Taxation' in Lang, Melz and Kristoffersson (eds), (n 286).
[292] Case C-166/05 *Rudi Heger GmbH v Finanzamt Graz-Stadt* [2008] S.T.C. 2679; [2006] E.C.R. I-7749 (whether the transfer, for value, of fishing permits for a river constituted a supply of services connected with immovable property).
[293] Case C-327/94 *Jürgen Dudda v Finanzamt Bergisch Gladbach* [1996] 3.C.M.L.R. C1063 (whether setting up equipment needed for concerts and similar events was artistic or entertainment services or ancillary services); Case C-452/03 *RAL (Channel Islands) Ltd v Customs and Excise Commissioners* [2005] E.C.R.I-3947; [2005] S.T.C. 1025 (whether installation and operation of gaming machines were a supply of entertainment services)
[294] *Tanjoukian v Revenue and Customs Commissioners* [2012] UKUT 361 (TCC); [2013] S.T.C. 825 (whether the supply of vehicle registration marks was a transfer or an assignment of copyright, patents, licences, trademarks and similar rights).
[295] See, e.g., *ATS Pacific Pty Ltd v Commissioner of Taxation* [2014] FCAFC 33 (whether tourist services, e.g., accommodation, provided by a non-resident intermediary to a foreign travel agent that re-sold the services to its customers were supplies connected with Australia); *Levy v Bergseng* [2008] NSWSC 294 (whether a supply of legal services by a barrister paid for by a resident solicitor for its non-

supply of foreign currency for use outside the jurisdiction, for example, has triggered litigation in jurisdictions using principle-based proxies (Australia- the place of use and enjoyment of rights)[296] and those using schedular proxies (the UK- the place of residence of the customer).[297] It thus cannot be said with confidence that either of the two approaches is superior. The principle approach, however, may be more adaptable in terms of unanticipated continual changes in evolution of delivery of services as it will be more and more difficult for legislators to divide modern services into strict categories.

4.2 Foreign VAT recovery

Under the destination principle, VAT is only collected on final consumption in the jurisdiction in which consumption takes place. There are nevertheless circumstances where businesses incur significant amount of VAT on business expenditure in countries in which they are not established or VAT-registered, including expenses on conferences, travel, accommodation and meals. An OECD survey shows that of the 308 businesses responded to the questionnaire, over 80 per cent incurred more than USD 10,000 per annum and over 25 per cent incurred more than USD 1 million per annum on foreign business expenditure.[298]

In theory, foreign VAT should be refunded so that no tax is imposed on business activities. In practice, however, the entitlement to refund for VAT incurred by non-resident businesses does not exist in many VAT systems, leading to double taxation in both the country where the VAT is charged and the home country in which the business is registered. In the countries where this entitlement exists, the systems in place are largely inconsistent in terms of the mechanism used, the scope of VAT recovery and restrictions to refunds.

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resident client was a supply connected with Australia); *Fiduciary Ltd and Ors v Morningstar Research Pty Ltd and Ors* [2004] NSWSC 381 (whether legal services made to a non-resident company with two directors and an employee present in Australia at the time the thing was done were supplies connected with Australia).

[296] *Travelex Ltd v Commissioner of Taxation* [2010] HCA 33.

[297] *1st Contact Ltd v Revenue and Customs Commissioners* [2012] UKFTT 84 (TC).

[298] OECD, 'VAT/GST Relief for Foreign Businesses: The State of Play – A Business and Government Survey' (February 2010) < https://www.oecd.org/tax/consumption/44560750.pdf> accessed 9 August 2018.

Two main mechanisms are found to provide refunds to non-resident businesses:

1) Direct refund mechanism: Countries provide direct refunds for non-resident businesses to claim back VAT charged on business expenses incurred in their jurisdictions.
2) Registration mechanism: Countries have registration procedures in place that allow foreign businesses that do not make taxable supplies in the country to register nevertheless and claim back VAT incurred in their jurisdictions.

While countries largely provide refunds on a unilateral basis, those using direct refund mechanism tend to make the refunds conditional upon the grant of reciprocal refund rights by claimants' countries to their resident businesses. The reciprocity condition may be of greater value for countries where the VAT rates are considerably lower than other countries. The EU provides an example of the direct refund mechanism, under which non-EU businesses seek refunds by completing a separate application form.[299] The EU allows member states to apply the reciprocity condition. Most member states do not apply this rule but where it is applied, reciprocity treatment in a non-EU country is not recognised in the same way.[300] Australia[301] and New Zealand[302] are examples of jurisdictions that require non-resident businesses to register if they wish to claim back GST.

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[299] Council Directive 2008/9/EC of 12 February 2008 laying down detailed rules for the refund of value added tax, provided for in Directive 2006/112/EC, to taxable persons not established in the Member State of refund but established in another Member State. Rules and procedures to obtain a VAT refund in European countries are summarised in Deloitte, 'European VAT Refund Guide 2018' < https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-european-vat-refund-guide.pdf> accessed 10 August 2018.

[300] Ernst & Young, 'EU VAT Refunds for Non-EU Businesses Require Action by 30 June 2018' (Indirect Tax Alert, 31 May 2018) < https://www.ey.com/Publication/vwLUAssets/EU_VAT_refunds_for_non-EU_businesses_require_action_by_30_June_2018/$FILE/2018G_02911-181Gbl_Indirect_EU%20VAT%20refunds%20for%20non-EU%20businesses%20require%20action.pdf> accessed 10 August 2018.

[301] The Board of Taxation, Australian Government, *Review of the Application of GST to Cross-Border Transactions* (Commonwealth of Australia 2009).

[302] The New Zealand rule came effective from 1 April 2014. Refunds to non-residents that do not make taxable supplies in New Zealand were not allowed before 2014. See, 'Non-Resident Businesses Claiming GST' (*New Zealand Inland Revenue,* 24 July 2017) <https://www.ird.govt.nz/industry-guidelines/non-res-bus-gst/intro/non-res-bus-gst.html> accessed 10 August 2018.

Both two mechanisms have weaknesses and advantages.[303] The registration system imposes higher compliance costs as non-resident businesses are required to register for VAT and fill periodic returns.[304] These costs may deter non-resident businesses from seeking a refund. The direct refund system may be more susceptible to fraudulent refund claims than systems that require non-resident businesses to register.[305] Since one system's weakness is in effect the other's advantage, there is no general conclusion as to which system is superior to the other. The ultimate choice by a government may be based on context-specific factors.[306]

The use of two different mechanisms by the country in which consumption takes place and the country in which a non-resident business is registered causes a potential conflict that the registration system may not be recognised by the country using a direct refund scheme as providing similar benefits to its resident businesses. For example, a number of EU countries, including Germany, Italy, Spain and Switzerland, do not recognise that Australia provides refund entitlements to their registered businesses via a registration system.[307]

In addition to the recognition problem, experience shows that in countries where there are mechanisms for foreign VAT recovery on paper, it might be difficult for non-resident businesses to fulfil the requirements in practice, in particular in terms of both of procedures and dealing in local languages.[308] Compounding the problems in some cases are restrictions that limit refunds to particular types of expenditure. These difficulties multiply where a business incurs VAT in multiple jurisdictions.[309]

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[303] The weaknesses and advantages of the systems were compared in P. Dunne, *GST: Business-to-Business Neutrality Across Borders- A Government Discussion Document about GST on Cross-Border Supplies between Businesses* (Policy Advice Division of Inland Revenue 2011).
[304] *Ibid.*
[305] *Ibid.*
[306] E.g., the New Zealand government considered the direct refund system would incur higher administration costs for Inland Revenue as it would require new forms, staff and IT systems. See, *Ibid.*
[307] PwC, 'Submission to Board of Taxation – Direct GST Refund to Non-Residents' (8 September 2009) <https://cdn.tspace.gov.au/uploads/sites/70/2015/07/VATit__PWC.pdf> accessed 8 August 2018.
[308] Ernst & Young, (n 300).
[309] OECD, (n 298) 4.

4.3 Imports

Generally, import of goods by registered businesses can be taxed at the border without difficulties. Services, however, cannot be taxed in the same manner because they do not physically move across borders. The technique commonly used to collect VAT on cross-border services provided to registered customers is a reverse charge mechanism that shifts the VAT liability from foreign sellers to domestic purchasers.[310] The importer accounts for the VAT on the import and deducts it from the output VAT in the same periodic return. The VAT on the import is thus effectively self-assessed by the importer. The reverse charge mechanism has proved to be an effective measure to tax cross-border B2B services. It may not be necessary where the importer uses the imported services to make taxable supplies, in which case there is a wash between the input tax that is deductible and the output tax due.

The story is not the same with imports of low value goods and imported services by private consumers. When the VAT systems were adopted between the 1950s and the 1990s in most countries, the volume of cross-border sales of goods and services was relatively small. Cross-border business-to-consumer (B2C) sales of services and goods of a value below a specified threshold were typically exempt from the VAT in the importing country on the ground that the collection costs would outweigh the revenue if these sales were brought into the tax net. However, the advent of internet and globalisation has led to a remarkable surge in online purchase by private consumers of goods and services from suppliers located in other jurisdictions in the last two decades. The increasing volume of cross-border digital supplies and imports of low value goods gives rise to significant revenue loss.[311] Non-collection of VAT on these sales has also promoted consumers to shift their consumption from taxable domestic sales to un-taxed equivalents supplied by foreign sellers, which further erodes a country's tax base.

[310] A country survey of the use of reverse charge mechanism can be found in KPMG, 'VAT/GST Treatment of Cross-Border Services: 2017 Survey' (November 2017) < https://assets.kpmg.com//content/dam/kpmg/xx/pdf/2017/10/ess-survey.pdf> accessed 15 September 2018.

[311] The VAT foregone as a result of low value imported goods exemption was estimated to have risen from €118 million in 1999 to €640 million in 2011. See, Ernst & Young, *Assessment of the Application and Impact of the VAT Exemption for Importation of Small Consignments* (European Commission 2015).

In addition to revenue implications, the tax relief causes a number of distortions. It is a source of competitive distortions between domestic suppliers and foreign suppliers if domestic suppliers are obliged to charge VAT on their sales.[312] Domestic suppliers thus have the incentives to restructure their affairs to make supplies from an offshore location. The exemption threshold for imported goods induces offshore suppliers to avoid or evade paying the tax. They may split the order and ship items separately so that each of the parcels falls below the threshold. The European Commission reported that the exemption, known as low value consignment relief, is vulnerable to fraud and abuse as imported high-value goods are 'consistently undervalued or wrongly described' to benefit from the exemption.[313]

Exemption was a simplification measure to address the difficulty of taxing imported services and low value imported goods. The problems are no doubt exacerbated with the growth of the digital economy and new solutions are needed. The challenge of bringing these supplies into taxation is to devise an effective collection mechanism. In 2015, the OECD took the lead to address the issues in the Action 1 of the Base Erosion and Profit Shifting Action Plan, focusing on the challenges in the context of the digital economy.[314] The OECD work promoted a few countries to take actions in this area.

4.3.1 Imported services

The common approach to taxing digital B2C services is to require non-resident suppliers to register and account for VAT in the jurisdiction in which private consumers reside if the value of supplies exceeds the registration threshold or a higher specified amount. The customer's location can be determined by reference to a list of indicators, including their billing address, bank account details, credit card details, internet protocol address and mobile country code.

[312] Retailers in some jurisdictions have requested the government to remove the exemption for low value imports to level the playing field. See, Commission, 'Modernising VAT for E-Commerce: Question and Answer' MEMO/16/3746; and Productivity Commission, Australian Government, *Collection Models for GST on Low Value Imported Goods: Productivity Commission Inquiry Report* (Commonwealth of Australia 2017).
[313] Commission, (n 312); See also, R. Allen, 'How a Mechanism to Aid Free Circulation Distorted EU Market' (*International Tax Review*, July/August 2012) <http://www.ravas.org.uk/wp-content/uploads/2012/07/ITR-LVCR-Article-EU-Distortion.pdf> accessed 7 August 2018.
[314] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1- 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project* (OECD Publishing 2015).

The approach was adopted in the EU as early as 2003. Non-EU based suppliers supplying electronic services to EU customers are required to register and collect the VAT in the member state in which the customer resides. A one-stop-shop scheme has been in place to simplify non-EU suppliers' obligations by allowing them to register and collect the VAT in a single member state on their EU-wide sales (at the rate applicable in the customer's country). The revenue is then allocated through a clearing house mechanism to the customers' countries. In more recent years, a few countries also adopted rules that require foreign suppliers to register, including South Africa, Korea, Japan, New Zealand, Russia and Australia. The requirement for registration is normally accompanied by rules providing simplified registration and collection to ease the compliance obligations of non-resident suppliers. In some cases (for example, in Australia and New Zealand), electronic marketplaces, instead of the underlying suppliers, are made liable for GST.

The major concern with this approach is that compliance is voluntary as the customer's jurisdiction has little enforcement capacity to audit, or sanction in the case of non-compliance, offshore suppliers. Experience in countries that adopted the approach suggests that high-profile suppliers that take up a considerable market share tend to be more tax-compliant for reputational reasons.[315] There may still be revenue loss, however, if many small non-resident suppliers fail to register in the customer's jurisdiction.[316] This could be less of a problem if online marketplaces are made liable for tax, which catches a large number of small suppliers.

4.3.2 Low value goods

Developments in taxing low value imports followed the OECD initiative in 2015. The OECD identified four collection models that are distinguished by the party liable to account for VAT: the traditional customs collection mechanism, the purchaser collection model, the vendor collection model and the intermediary collection model.[317]

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[315] *Ibid*, 122.
[316] *Ibid*, 122.
[317] *Ibid*, 123-126.

The traditional customs collection mechanism, under which customs authorities assess the value of the goods and hold the imports until the recipient makes VAT payment, is considered inefficient given the administrative burden imposed on customs authorities.[318] An Australian study shows that abolishing the threshold would yield over AUD 550 million GST revenue at the cost of raising the administrative and compliance costs borne by businesses, consumers and government by AUD 2 billion.[319]

The second model, the purchaser collection model, requires domestic purchasers to self-assess and remit the VAT. While the model does not impose compliance burden on offshore suppliers, it is expected that the level of compliance by domestic purchasers could be low.[320]

The third model, the vendor collection model, places the burden of collecting and remitting the VAT on the non-resident vendor by requiring the vendor to register in the customer's jurisdiction. As mentioned, compliance with the rules by non-resident vendors could be difficult to be enforced as they are not within the legal reach of the importing country.[321]

The last model is the intermediary collection model, which requires intermediaries to collect and remit the VAT on behalf of non-resident vendors. Intermediaries could include financial intermediaries, online marketplace, couriers or postal operators. The intermediary collection model has advantage over the vendor collection model in terms of administration and enforcement if the intermediary has a physical presence in the importing jurisdiction.[322] The main problem with this model is that it would create additional compliance costs for intermediaries.

All four models have limitations. The drawbacks of individual models could be limited to some extent with a combination of the models. While the traditional customs collection model, the purchaser collection model and the intermediary collection model

[318] *Ibid*, 123-124.
[319] Productivity Commission, Australian Government*, Economic Structure and Performance of the Australian Retail Industry: Productivity Commission Inquiry Report* (Commonwealth of Australia 2011).
[320] OECD, (n 314) 124.
[321] Productivity Commission, Australian Government, (n 312) 6.
[322] OECD, (n 314) 125.

are widely used by countries for collecting tax on higher value imports, it is generally considered that these models are not feasible for the collection of VAT on a rapidly increasing number of low value imported goods.[323] A few countries have adopted, or proposed to adopt, the vendor collection model to remove exemption for low value imports.

Australia was the first to implement a hybrid vendor/intermediary model which took effect in July 2018.[324] Overseas suppliers, online marketplaces and redeliverers[325] that meet the Australian GST registration threshold are liable for GST on imported goods of a value of AUD 1,000 (approximately £565) or less, which were exempt from the GST before the change. Online marketplaces and redeliverers are treated as suppliers of low value goods and required to register for and collect the GST if their turnover, including the value of sales made through their platforms or redelivered by them, is above the threshold.

With no international experience to learn from, Australia largely aligned the design of the collection mechanism with that is used for imported services and digital products. The vendor/intermediary model was strongly opposed by electronic marketplaces (for example, Amazon and eBay) because of the additional compliance burden placed on these businesses.[326] Placing the liability on intermediaries, however, could significantly reduce the number of new registrants that the tax authority has to administer. Large intermediaries are also more tax compliant than small retailers. The government is nevertheless aware that the adopted model 'has limitations and carries significant uncertainty about levels of compliance'. While it was estimated that the reform will

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[323] Productivity Commission, Australian Government, (n 312).
[324] (Australia) Treasury Laws Amendment (GST Low Value Goods) Act 2017.
[325] Redeliverers are businesses that cater to the needs of Australian customers who wish to purchase from foreign suppliers that do not ship to Australia. These businesses create local delivery addresses and then ship the goods to Australia.
[326] See, 'Collection Models for GST on Low Value Imported Goods: Submissions' (*Productivity Commission, Australian Government*) <https://www.pc.gov.au/inquiries/completed/collection-models/submissions#initial>; Amazon has stopped shipping overseas goods to Australian customers in response to the new GST rule. See, N. Zhou, 'Amazon to Block Australians from Using US Store after New GST Rules' (*The Guardian*, 31 May 2018) <https://www.theguardian.com/australia-news/2018/may/31/amazon-to-block-australians-from-using-us-store-after-new-gst-rules> accessed 7 July 2018.

capture only half of all eligible sales,[327] the government considered the model to be the 'best available collection model' at the current stage.[328] The reform will be subject to reviews in two years, with the government expecting to learn from any international developments.[329]

Following the Australian initiative, the EU adopted rule to remove the exemption for goods of low value below €22. The new rule, along with rules adopting a hybrid vendor/ intermediary model to collect VAT on imported goods of a value under €150, will take effect by 2021.[330] The New Zealand government has also proposed to adopt a vendor/ intermediary model in October 2019. The compliance levels and costs are difficult to predict at this stage.

4.4 A new approach

Recent developments in the area show a growing trend for countries to adopt unilateral measures to tax cross-border supplies of services and low value goods and refund the VAT on foreign business expenses. In the cases of imported services and low value goods, the vendor/ intermediary collection model appears to be the preferred collection mechanism. It is nevertheless recognised that the model is not a perfect solution. From the perspective of suppliers, the concern is that the compliance burden of registering and filing returns in every country to which the supplier sells could be very high.[331] From the perspective of the importing jurisdiction, the concern is that compliance is essentially voluntary. Most countries that use the vendor collection model also adopted a simplified registration procedure, such as the one-stop-shop system used in the EU that allows a single registration in an economic block.[332] The simplified registration systems are considered important in facilitating compliance by non-resident

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327 K. James, 'Levying GST on All Packages is Complicated and Risky for Everyone Involved' (*The Conversation*, 28 June 2018) <https://theconversation.com/levying-gst-on-all-packages-is-complicated-and-risky-for-everyone-involved-98763> accessed 8 August 2018.
328 Productivity Commission, Australian Government, (n 312).
329 *Budget Paper No. 2 2016-17* (Commonwealth of Australia 2016).
330 The new EU rules extend the use of one-stop-shop to B2C supplies of a value not exceeding €150 by non-EU suppliers. A taxable person not established in the EU will be obliged to designate an intermediary that acts as a deemed supplier in order to use the one-stop-shop scheme.
331 M. Lamensch, 'Is There Any Future for the Vendor Collection Model in the 21st Century Economy?' (2016) 27 International VAT Monitor 182.
332 *Ibid.*

suppliers.[333] The OECD and G20 also recommended that collection by importing jurisdiction could be enhanced through international cooperation in tax administration, such as exchange of information.[334]

Both the two mechanisms that are commonly used to allow non-resident businesses to recover VAT incurred in a foreign country have limitations and the inconsistent approaches used in different countries create further problems. The registration system shares similar problems with the vendor collection model discussed above in terms of administrative and compliance costs as both require foreign businesses to register. The compliance costs may be high relative to the benefits of registration for the purpose of recovering foreign VAT, particularly if this entails ongoing filing requirements. Enterprises are unlikely to avoid sales in a foreign jurisdiction if that requires them to register in the jurisdiction notwithstanding difficulties such as working in another language but this additional complication may deter some businesses that do not make sales in the foreign jurisdiction from registering to recover VAT incurred on acquisitions in the jurisdiction. These problems require a more consistent approach based on a higher level of international cooperation.

An alternative solution to all these problems might be replacement of unilateral collection and refund arrangements with a cooperative system established by way of a multilateral or bilateral treaty.[335] The treaty or treaties would place the obligations of collecting the VAT on B2C sales of digital supplies and low value goods to the importing country on the exporting country, and refunding the VAT incurred on foreign business expenses on the resident jurisdiction. The VAT would be collected at the rate applicable in the customer's jurisdiction and the exporting country would transfer the revenue to the importing country via a clearing house. In the case of VAT recovery, the country in which the foreign business incurs VAT would transfer the amount to be recovered to the resident country, again through the clearing house. The system would therefore be fully consistent with both the destination principle and the principle that all

[333] OECD, (n 2).
[334] OECD, (n 314).
[335] Multilateral treaties in the field of VAT were proposed by Ecker to address the problems of double (non-)taxation. See, T. Ecker, *A VAT/GST Model Convention* (IBFD 2013).

VAT incurred on B2B transactions should be recoverable by the business that initially pays the tax.

The system would ideally be put in place via a multilateral tax treaty so that the same regimes on B2C sales of remote services and low value imported goods and foreign VAT recovery are applied internationally. In respect of any particular bilateral relationship, there might be a significant imbalance in flows from one jurisdiction to another. While administrative burden would be higher on the jurisdiction that has higher exported B2C sales than imported B2C sales, the losses and gains could be largely washed out in a multilateral relationship. The difficulty with a multilateral treaty as outlined is that it requires a central clearing house that works efficiently if it is administered by an overarching authority, as explained further in Section 5.4.2. In the international context, a multilateral treaty could work with reasonable efficiency with an international tax authority such as the World Tax Organisation proposed in the literature,[336] which is not on the horizon. In addition, it can be expected the negotiation process in signing a multilateral tax treaty would not be easy.

A more efficient and practical option would be the adoption of bilateral tax treaties. If outflow and inflow between the two countries are roughly balanced, the two treaty parties would have equal incentive to collect the tax and administer foreign VAT recovery. Any significant imbalance in flows between the two parties could lead to uneven administrative burden. The solution to this problem could be to allow the supplier's country to retain an administration fee on commission basis (for example, a proportion of tax collection). This would also provide an incentive to the exporting country to act as a collection agent for the importing country, and to the resident country to act as a refund agent for the country in which the foreign VAT is incurred.

The origin-based collection model is superior to the vendor collection model that has been adopted or proposed in some countries as it could address the concerns with both compliance costs and compliance levels. The tax authority in the exporting country is more reliable than intermediaries and its collection efficiency would be much higher than any self-assessment system. The origin-based refund system also addresses the

[336] See, A. Sawyer, *Developing a World Tax Organization: The Way Forward* (Fiscal Publications 2009).

difficulties with the registration system and the direct refund scheme. Additional compliance burden and language difficulties do not exist as businesses claim refunds from their resident countries. Fraudulent refund claims could be more easily traced by the jurisdictions that actually refund the VAT with the assistance of the claimants' local tax administration. The OECD could take the lead to develop a model treaty as it has rich experience in the field of income tax and has led the way to impose VAT on imported services and low value goods. The model treaty, however, may need to be modified in the case that one party has regional VATs to accommodate differences in rates in federations with respect to collection.

One potential concern with the proposed model would be that the origin-based collection mechanism would only catch suppliers who are registered for the VAT in the exporting country. This may not be a problem because exporters tend to register to claim input tax credits. One possibility to collect VAT from more unregistered small suppliers is to require electronic distribution platforms to collect the tax on behalf of suppliers. Although experience shows that the requirement might face opposition from online marketplaces, the approach is actually more effective and could be justified because consideration is made directly to the platform operator. The platform is responsible for refunds and there is no direct contact between the buyer and the actual supplier. The platform therefore in effect serves as an agent for the actual supplier in terms of the sales. The commerce pattern makes it reasonable for the platform to also serve as an agent for the supplier for VAT collection. The UK has gone some way towards the idea to combat VAT fraud by making online marketplaces to be jointly or severally liable for VAT unpaid by overseas businesses operating on the platform.[337]

4.5 Conclusion

While there is a wide agreement across countries that cross-border sales should be taxed in line with the destination principle under the VAT. The implementation of the destination principle is not straightforward and country practices vary in three main aspects. The first is the use of place of taxation rules to predict the place of consumption of services. The two legal drafting approaches, the schedular approach and the principle

[337] 'VAT: Online Marketplace Seller Checks' (*UK Government*) <https://www.gov.uk/guidance/vat-online-marketplace-seller-checks> accessed 14 July 2018.

approach, both raise interpretative difficulties, which makes it difficult to compare the relative merits of the two. The principle approach, however, may have an advantage over the schedular approach. The schedular system may cover many services but it cannot cover all and it is not clear if the fall-back position for supplies outside the enumerated list yields the right result in all cases. This is less of a concern in principle-based systems.

The second issue is the refund of VAT incurred on business expenses by non-resident businesses. While many countries do not provide refunds to foreign businesses, two main mechanisms are used in countries where refunds are available, the direct refund system and the registration system. Both systems are inefficient in preventing double taxation in practice and the inconsistent use of the two systems across countries create further difficulties.

The third issue is the collection mechanism for B2C imports of low value goods and services. Final consumers are generally not relied on for effective collection of the tax. A few countries consider a hybrid collection model that makes foreign suppliers and intermediaries to be liable for remitting the VAT is the best available option to bring imported low value goods and services into taxation. This model is not without its limitations, however, particularly in terms of compliance by foreign suppliers.

This chapter suggests that a preferable solution is an origin-based collection and refund mechanism that combines the use of a clearing house and a bilateral treaty to distribute the revenue and refunds between two countries. The proposed model is fully consistent with the destination principle and addresses the concerns with the vendor collection model and the two refund mechanisms that are currently in use.

CHAPTER 5. VAT IN FEDERATIONS

5 Introduction

Two issues arise in federal countries, economic communities, or large countries with sub-national governments faced with expenditure responsibilities. The first is whether there should be a vertical allocation of taxing rights in a jurisdiction with multiple tiers of government, that is, should sub-central jurisdictions have the fiscal autonomy to levy VAT (determine the base and rate) in addition to or without a national VAT. The EU provides an example of a jurisdiction with separate subordinate jurisdictions and no central (EU) tax. Canada and India provide examples of a jurisdiction in which national and subordinate jurisdictions levy parallel VATs. Australia is an example of jurisdictions with a national VAT only.

Inevitably, the legal basis for a vertical allocation of taxing rights rests on constitutional authority, a subject clearly outside the scope of the current study. However, distinct from the question of whether sub-central governments can levy separate VATs, in jurisdictions in which the central government holds exclusive power to levy a VAT, the central government may agree to share this revenue with subordinate jurisdictions. Whether this happens and the extent to which it happens is a question of domestic politics, another subject clearly outside the scope of this study. China and Ethiopia are examples of a national VAT shared with sub-national governments. Sitting at the far end of the sharing spectrum is Australia, where the central government holds exclusive legal power to levy a VAT but distributes all the tax collected to sub-national governments.

Whether sub-national governments levy their own VATs or the central government has exclusive taxing rights but agrees to share some or all of its revenue with lower tier governments, the question arises how VAT should be distributed between sub-national jurisdictions. While there are a range of systems in operation and a greater number of theoretical models advocated, they fall into three broad groupings. Allocation regimes in the first group, with many variations, allocate VAT revenue to subordinate jurisdictions on a destination basis (the place of consumption). These systems must address many of the conceptual and practical issues raised in the chapter on international cross-border sales (Chapter 4). Systems in the second group allocate VAT revenue on an origin basis, that is, to the place from which a supply is made. Systems in the third group disregards both the origin of supplies and their destination, allocating VAT revenue on the basis of a fiscal equalisation formula. The formula may look at other revenue sources available to subordinate jurisdictions or allocate on a per capita basis or use some combination of these factors. The chapter reviews models that are currently in use or have been proposed to allocate VAT revenue among sub-central jurisdictions.

5.1 Allocation on the basis of consumption

As noted, in theory the VAT revenue should accrue to the jurisdiction where consumption takes place. A destination-based VAT achieves this by imposition of tax as supplies enter the jurisdiction coupled with a zero rate and full input tax credits for supplies exported from the jurisdiction. Border points at which import tax can be collected and exports confirmed for zero-rating purposes are typically absent from a country with multiple levels of governments or a single economic community that is comprised of different countries. The challenge, therefore, is to devise feasible alternative measures to allocate the revenue to the "destination" jurisdiction without incurring significant administrative costs. Five models currently in use attract most attention: the international zero-rating model, clearing house, VIVAT, CVAT and consumption statistics.

5.1.1 The international zero-rating model

The model for avoiding double taxation in an international setting has the jurisdiction from which supplies are made zero-rating exports and the importing jurisdiction imposing tax on imported goods upon entry to the country and on imported services via a reverse charge rule. The international rule has been modified in the EU for sales between enterprises in different member states with B2B goods and services zero-rated in the state of supply and subject to tax in the place of receipt imposed via a reverse charge mechanism. The reverse charge rule for imported goods is sometimes referred to as the "deferred payment" system because payment by the importer is deferred until the importer's first periodic return in the importing jurisdiction, with tax levied at the rate applicable to domestic sales in the jurisdiction. In practice, unless the purchaser is using the supply to make exempt supplies, the reverse charge amount will be immediately offset by an input tax credit. The deferred payment method works on a self-assessment basis and can only be used for taxing B2B supplies, necessitating alternative schemes or arrangements for inter-jurisdictional B2C sales.

The deferred payment system has proven to be susceptible to a type of infamous cross-border fraud, known as “missing trader intra-Community” fraud or “carousel” fraud.[338] While exports are zero-rated in the exporting country, a fraudulent importer purchases VAT-free goods and then charges VAT on them when re-selling them in its own country. The importer then disappears before remitting the reverse charge VAT on its imports and the output VAT included in the sale price to its customers. Evasion schemes of this type give rise to significant revenue loss, and have prompted the EU to seek other measures to tax intra-Community supplies under the VAT.[339]

An alternative to the EU system of zero-rating exports and subjecting imports to a reverse charge rule is to simply ignore B2B supplies in the importing jurisdiction, provided they are zero-rated in the exporting jurisdiction. This can be done if there is no rule treating the importation by a registered business as a taxable import, subject to exceptions for imports for which input tax credits are not available (for example, imports to be used to make exempt supplies or imports to be diverted to personal use by the registered importer). Treating B2B imports as out of scope supplies offers a simple way to reduce compliance and administrative costs.

This approach is used in Canada in a “dual VAT” system.[340] The federal government and the province of Québec impose separate VATs, the former a GST and the latter the Québec Sales Tax (QST). Both the GST and QST are administered by the province, which hands over the federal share to the federal government. Although the province

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[338] See, ‘Stopping the Carousel: Missing Trader Fraud in the EU’ (House of Lords European Union Committee 20th Report of Session 2006-07, HL Paper 101, May 2007) <https://publications.parliament.uk/pa/ld200607/ldselect/ldeucom/101/101.pdf> accessed 21 May 2018.

[339] See, ‘Value Added Tax: EU Proposals for Reform and the Implications of Brexit’ (House of Commons European Scrutiny Committee Twenty-third Report of Session 2017-19, HC 301-xxii, 2018) 50-52 <https://publications.parliament.uk/pa/cm201719/cmselect/cmeuleg/301-xxii/30108.htm> accessed 21 May 2018.

[340] For a description of the system, see, R. Bird and P-P. Gendron, ‘Dual VATs and Cross-Border Trade: Two Problems, One Solutions?’ (1998) 5 International Tax and Public Finance 429.

has the power to set the rate and determine its base independently, the GST and QST bases are largely harmonised. In terms of inter-jurisdictional sales, exports from Québec are zero-rated and B2B imports from another province to Québec are out-of-scope supplies, not subject to import VAT unless the importer is a registered business and no input tax credit could be claimed if the tax were paid on imports. Notionally, final consumers are liable for QST on inter-provincial imports they receive but as final consumers are not registered, there is no effective way to enforce this liability. It is suggested that the evasion problem in the EU is mitigated in Québec because the federal GST audit can serve as a cross-checking mechanism for inter-jurisdictional sales.[341] In theory, similar cross-border administrative cooperation is possible in the EU but to date seems not to have been achieved.

5.1.2 Clearing house

The simplest response to the elimination or absence of border controls within a common market entailing the lowest administration and compliance costs would be the adoption of an origin-based VAT, with tax imposed on the seller at the time of sale without regard to the location of the customer. A traditional destination basis VAT, in contrast, would require suppliers to register in every subordinate jurisdiction in the federation or common market, calculate VAT separately for customers in each jurisdiction, and remit tax to the appropriate jurisdiction.

While the origin basis VAT offers the advantage of simplicity and low compliance costs, it does so by violating the fundamental destination principle of the VAT as a tax on final consumption rather than a tax paid to the sellers' jurisdictions. A solution to the conundrum is the use of a clearing house mechanism that would allow sellers to impose tax on an origin basis with the clearing house transferring the VAT collected on intra-state sales to the tax authority in the customer's state.[342] This system allows local collection of tax with local audit and enforcement for all sales, be they domestic or intra-state, with little consequent administrative costs if systems are put in place to provide VAT data on intra-state sales directly to the clearing house. Before collecting

[341] *Ibid*, 434.
[342] The clearing house mechanism was first documented in S. Cnossen, 'Harmonization of Indirect Taxes in the EEC' in C. E. McLure (ed), *Tax Assignment in Federal Countries* (Australian National University Press 1983).

any VAT revenue for redistribution between participating members, the clearing house calculates the net amount to be transferred between each pair of countries, collecting and redistributing the net revenues.

A clearing house system for B2B sales was proposed by the European Commission for the European Economic Community, the forerunner to the EU, in 1985 as a solution to VAT allocation following the proposed elimination of internal customs borders but had not been adopted when customs border controls were removed eight years later.[343] The growth of internet over the following decades has nevertheless led to the adoption in 2003 of a limited clearing mechanism, known as the one-stop-shop, to distribute the VAT paid by non-EU suppliers making B2C supplies of electronic services.[344] The system was augmented in 2015 to apply to intra-EU B2C digital supplies (telecommunication, television and radio broadcasting and electronically supplied services).

The clearing house system is not a panacea to the problem of distributing VAT revenues in a federation in which each jurisdiction levies its own VAT. A key issue is the difficulty of imposing different rates in each jurisdiction. The fundamental feature of an origin basis tax is the simple application of origin base rules to both local and cross-border intra-federation sales. The EU's response to this problem was to adopt a hybrid destination basis clearing house regime. Under the EU system, registered businesses impose VAT at the rate applicable in the country where the customer is located (importing country) and remit the VAT to the country in which they are registered (exporting country). Accounts are filed with the clearing house which calculates the net difference between flows between each pair of countries and transfers the net amount from the country with more export sales to the other country.

The result is consistent with the destination principle – the VAT is charged at the rate in the jurisdiction where the consumption takes place and the revenue is accrued to that country – but comes at the cost of losing many of the benefits of origin basis taxation.

[343] Commission, 'Completing the Internal Market' (White Paper) COM (85) 310 final.
[344] Under the system, the non-EU supplier only needs to register in one single member state and is then allowed to treat that state as the origin state for supplies made from outside the EU. An evaluation of the scheme can be found in M. Lamensch, 'Are "Reverse Charging" and the "One-Stop-Scheme" Efficient Ways to Collect VAT on Digital Supplies?' (2012) 1 World Journal of VAT/GST Law 1.

While suppliers may not have to register in each country to which they sell, they must track every sale and identify the location of their customers and keep track of the current rate in that country applicable to every type of supply they make.[345] Compliance costs remain high.[346] Administrative costs for the clearing house are also high. These would be greatly reduced if the sub-national VATs were harmonised so that the clearance is based on aggregate exports and imports of each rate category.[347] If different rates prevail, each sale must be considered separately to determine the net amount.

Three methods can be used by a central clearing house to allocate VAT revenues from cross-border trade within a federation. Two methods rely on information gathered from tax invoices, the first relying on information provided by the sellers' country, based on the tax invoices reported by sellers, and the second, available only for B2B sales, relying on information provided by the customers' country, based on tax invoices reported by purchasers for input tax credit purposes. Both entail risks. If sellers' country data is used, there is little incentive for tax authority in the sellers' jurisdiction to look for all unreported or underreported sales as any missing revenue uncovered will flow to the buyers' country. If the customers' country data is used, relying on B2B input tax claims, the importing jurisdictions have little incentive to verify the acquisitions claimed so long as they are able to recover the costs from the clearing house.[348] The third method relies on aggregate consumption statistics from national accounts, with revenue allocated proportional to the share of total consumption that takes place in each subordinate jurisdiction. If VAT is collected first by subordinate governments, as is the case in the EU, for example, and then distributed on the basis of consumption patterns, a disconnect is created between collection and the reward from collection. The incentives that national tax administrators have to administer and enforce the tax might be weak if the revenue they collect through strengthened administration is to be shared with other member states.[349]

[345] For a review of the problems with the current EU system, see I. Lejeune and S. Claessens, 'The VAT One Stop Shop System: An Efficient Way to Collect VAT on Digital Supplies into the EU Consumer Market?' in M. Lamensch, E. Traversa and S. van Thiel (eds), *Value Added Tax and the Digital Economy: The 2015 EU Rules and Broder Issues* (Kluwer Law International 2016).
[346] *Ibid*; a similar argument was made by Lamensch in the context of the one-stop-shop scheme for non-EU suppliers making B2C supplies in the EU, see Lamensch, (n 344).
[347] H. H. Zee, 'Inter-jurisdictional Sharing of the VAT' in Krever (ed), (n 7) 172.
[348] M. Keen and S. Smith, 'The Future of Value Added Tax in the European Union' (1996) 11 Economic Policy 373.
[349] Ebrill and others, (n 35) 190-191.

5.1.3 VIVAT

A variation of the clearing house system, known as VIVAT ("viable integrated VAT"), was proposed by Keen and Smith for the EU in 1996.[350] The system was intended to address the cross-border evasion problem that has plagued the EU since it adopted its current system of zero-rating by exporters and deferred reverse charge recognition by importers by requiring exporting states to collect tax on domestic and cross-border sales, removing the possibility of a missing trader. The proposal would see a harmonised rate used across the community for inter-jurisdictional and intra-jurisdictional B2B sales while allowing cross-jurisdiction diversity in rates for sales to final consumers, which would be taxed at the rate applicable in the jurisdiction in which the final consumer is located. Tax collected on inter-jurisdictional sales would be reallocated through a clearing mechanism to ensure that the revenue is accrued to the destination jurisdiction. The clearing process might be marginally simpler than clearance based on invoices discussed above. Because a single rate applies to inter-jurisdictional B2B sales, allocations can be made on the basis of computations of B2B sales extracted from aggregate trade figures rather than tracking each cross-border sale.[351] For this to work, however, bases would have to be harmonised across all jurisdictions and trade figures would have to accurately record trade in services as well as goods.

Under the VIVAT, registered suppliers do not need to distinguish between inter-jurisdictional and intra-jurisdictional sales when they sell to other registered businesses. Registered customers must alert the seller of their status prior to the supply, however, and suppliers must distinguish between B2B and B2C sales due to the difference in rates. In the case of B2C sales, they must identify the destination of the supply so as to charge the applicable rate. The administrative and compliance burden could be very high. The proposal is untested in any country and while strongly advocated by its designers,[352] it has not attracted support from other experts in the field.[353]

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[350] Keen and Smith, (n 348).
[351] Zee, (n 347) 174.
[352] Keen and Smith, (n 348); M. Keen, 'VIVAT, CVAT and All That: New Forms of Value-Added Tax for Federal Systems' (IMF Working Paper WP/00/83, 2000).
[353] C. E. McLure, 'Implementing Subnational Value Added Taxes on Internal Trade: The Compensating VAT (CVAT)' (2000) 7 International Tax and Public Finance 723; R. Bird and P-P. Gendron, 'CVAT,

5.1.4 CVAT

A model that is designed for a country that has a central government on top of local governments is the "Compensating VAT" (CVAT) that zero-rates inter-jurisdictional sales in the local VATs but subjects them to a supplemental VAT administered by the central government.[354] This approach would require a uniform tax base for the federal VAT and the state VATs, to some extent compromising the fiscal autonomy of state governments.

Under the CVAT approach, all inter-state exports are zero-rated for state VAT purposes. Registered traders account for CVAT on inter-state sales under a reverse charge system. The CVAT is applied to inter-state sales to both registered and unregistered customers. To avoid excess CVAT credits and refunds, the CVAT could be made creditable against both the federal VAT and the state VAT. This would incur transfers of tax credits and liabilities between federal and state governments. The net results are that registered purchasers are entitled to credits for the CVAT they paid on inter-state sales, and unregistered purchasers bear the costs of the CVAT on their final consumption.

The CVAT has a clear advantage over the deferred payment method as it applies to sales to both registered and unregistered customers. The CVAT operated at the federal level could help to reduce the risk of revenue loss from B2B and B2C sales. It is therefore considered a better choice for countries with poor administrative capacities.[355] The structure of the system is nevertheless complex and registered sellers must distinguish between three types of sales: intra-state sales; inter-state sales and exports to other countries.[356]

The approach was adopted in India when its GST came into effect in 2017. The Integrated GST (IGST) is imposed on inter-state supplies of goods and services in

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VIVAT, and Dual VAT: Vertical "Sharing" and Interstate Trade' (2000) 7 International Tax and Public Finance 753.

[354] The CVAT approach was originally proposed by Varsano in 1995 and was modified by McLure in 2000 in C. E. McLure, *ibid*.

[355] Bird and Gendron, (n 353).

[356] Bird and Gendron, (n 353) 755; McLure, (n 353) 730.

addition to the Central GST (CGST) levied by the central government on domestic inter-state and intra-state supplies and the State GST (SGST) levied by the state governments on intra-state supplies. The IGST is administered by the central government. The revenue is transferred to the importing state after adjusted with the CGST and SGST credits. It is too early to tell whether the regime is effective and administrative and compliance costs are reasonable.

5.1.5 Consumption statistics

As noted, the VAT collected on inter-jurisdictional sales can also be distributed on the basis of consumption takes place in each jurisdiction as revealed by national account data. Compared to other approaches discussed above, allocation of revenue on the basis of consumption statistics achieves administrative and compliance cost savings as it avoids the need to track individual transactions.

The Harmonised Sales Tax (HST) in Canada provides an example of this approach. The HST is applied in five provinces, along with the federal GST. The rates and bases are largely harmonised with the federal GST into a single joint central-provincial VAT,[357] which is administered solely by the federal government. The HST revenues are shared among the participating provinces by the federal government through a complex formula based on estimated national revenues and provincial tax bases.[358]

Allocation based on consumption statistics could be used either in countries with a central VAT only or in countries where there are sub-national VATs. In the case of sub-national VATs, administrative costs incurred in the allocation process will be lower if there is a single rate and common base used in all sub-national jurisdictions. A level of complexity is added to the allocation formula if different rates are used in different jurisdictions and considerable further complexity added if bases differ or different rates apply to different types of supplies. The Canadian HST avoids most of these complexities because bases and rates in the participating provinces are largely, though not entirely, harmonised. In the case of a central VAT only, consumption statistics may

[357] Four of the five provinces imposing HST have a 10% tax; one province imposes an 8% HST.
[358] For details of the allocation of HST revenues, see R. Bird and P-P. Gendron, 'Sales Taxes in Canada: The GST-HST-QST-RST "System"' (2010) 63 Tax Law Review 517.

not be a good option for VAT systems that are ridden with reduced rates and exemptions, in which case the consumption statistics for each type of supply, rather than the aggregate statistics, are needed to allocate the VAT revenue. The success of Canadian experience with the consumption statistics method has to be read with caution when transferred to another context. The model may not be an option for most developing countries where consumption statistics are less likely to be available.

5.2 Allocation on the basis of origin

An origin basis allocation of VAT revenue across subordinate jurisdictions would leave suppliers' jurisdictions with all VAT revenue collected on sales made from the jurisdiction. Suppliers do not need to distinguish between domestic and inter-jurisdictional sales and, if the base or rates are different across subordinate jurisdictions, customers face the rates and base of the supplier's jurisdiction, not their own. With no need for border adjustments, the application of VAT on the basis of origin does not generate administrative difficulties in the federal context and imposes no additional compliance burden on suppliers. Jurisdictions in which a portion of revenue is allocated between subnational governments on an origin-basis include countries with a central VAT only and countries where subnational VATs co-exist with a central VAT. China and Ethiopia provide examples of the former, with part of the revenue collected under the national VAT law divided between provinces and states respectively on an origin basis. In Brazil, the state VAT, known as the ICMS, is applied to a range of goods and services on an origin basis, while the federal VAT is applied to a different base.

Under these systems, the tax is collected by, and the revenue is accrued to, the jurisdiction of production (as is the case in Brazil), the place where the supplier is registered (as is the case in China), or the place where the supplier's identification number is issued (as is the case in Ethiopia). The tax paid in the exporting state will be recovered by the business purchaser in the importing state. In effect, the seller's jurisdiction retains revenue that is forgone by the buyer's state, amounting to a subsidy from the state of consumption to the state of supply.

The use of origin-based VAT in federations has a few drawbacks. First, an origin-based VAT is inconsistent with a consumption tax that applies only to final consumption.

Second, to the extent that local governments have autonomy in terms of rate and base setting and administration, collection at origin gives rise to horizontal tax competition as local governments adjust rates or bases to attract investment to their jurisdictions. The tax competition among the states in Brazil, which is referred to as 'tax war', appears to be a serious problem.[359]

A third problem is that an origin-based VAT creates regional inequality. Since the tax on inter-jurisdictional supplies collected by the exporting jurisdiction is matched by input tax credits allowed in the importing jurisdiction, net importing jurisdictions are disadvantaged to net exporting jurisdictions. In most cases, net exporting jurisdictions are wealthier states while net importing jurisdictions are poorer states. To reduce the inequality between rich and poor states caused by the origin-based VAT, Brazil applies two different rates on interstate supplies. Sales from wealthier states to poor states are taxed at 7%, while sales from poorer states to wealthier states are taxed at 12%. A related issue is that since exports to another country are zero-rated, states with export industries may end up providing input tax credits or even paying refunds for input taxes retained by other states.

5.3 Fiscal equalisation formula

A common feature of federations is that payments are transferred between sub-central jurisdictions to balance differences in revenue raising capacities and expenditure needs. While horizontal fiscal equalisation (HFE) elements are unrelated to the VAT, they could be incorporated into formulas that distribute the VAT revenue among sub-national jurisdictions. For example, Australian GST revenue is fully distributed among the states based on the HFE formula. While German GST revenue is vertically allocated among three levels of government, the Länder (federal states) share of the revenue is distributed among the Länder on the basis of fiscal equalisation.

The aim of the Australian HFE is to give states the same fiscal capacity to provide services and infrastructure at the same standard. The formula first distributes the GST revenue unequally to raise all of the states to the fiscal capacity of the strongest state.

[359] L. de Mello, 'The Brazilian "Tax War": The Case of Value-Added Tax Competition among the States' (OECD Economics Department Working Papers No. 544, 2007).

The remaining of the revenue pool is then distributed to all the states on an equal per capita basis. Since poor states are effectively subsidised by rich states, the HFE system provides disincentives for the state governments to develop their own economy to generate own source revenues.[360] For this reason, it is argued that the HFE impedes the country's economic growth.[361]

In Germany, 43 per cent of the revenue is allocated to the Länder, at which level two steps of the horizontal sharing occurs. First, for the purposes of HFE, up to 25 per cent of the Länder share of the VAT revenue is used to raise up the fiscal capacity of the Länder under average. Second, the reminder (a minimum of 75 per cent) is distributed on the basis of the number of inhabitants of the Länder. The German system shares a similar problem with the Australian system. Contributing Länder lose incentives to keep the above average fiscal capacity, while receiving Länder tend to rely strongly on fiscal equalisation transfers.[362] It has also been suggested that the system weakens the incentives for receiving Länder to make effective spending decisions.[363] In addition, although the VAT is a "shared tax", it is administered by the Länder. The fiscal equalisation system provides little incentive for the Länder to improve tax collection.

5.4 Evaluation

VAT revenue could be allocated among sub-national jurisdictions on the basis of the place of consumption, the place of origin or fiscal equalisation needs. Of the three, the origin principle is the least optimal design option not only because it contradicts the logic of consumption tax, but also because of the undesirable incentives and the unbalanced revenue allocation to which it leads. The feasibility of an allocation based either on the place of consumption or fiscal equalisation formula will depend on whether there is an overarching fiscal authority and whether the local governments have substantial fiscal autonomy.

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360 Australian Government Productivity Commission, 'Horizontal Fiscal Equalisation: Productivity Commission Draft Report' (2017) <https://www.pc.gov.au/inquiries/completed/horizontal-fiscal-equalisation/draft/horizontal-fiscal-equalisation-draft.pdf> accessed 1 August 2018.
361 *Ibid*, 37.
362 J. Werner, 'Fiscal Equalisation Among the States in Germany' (Institute of Local Public Finance Working Paper 02-2008, 2008).
363 S. J. Stehn and A. Fedelino, 'Fiscal Incentive Effects of the German Equalization System' (IMF Working Paper WP/09/124, 2009).

5.4.1 Central VAT only

As Bird and Gendron pointed out, particularly in a developing economy context but it is equally true in developed countries as illustrated by Germany and Australia, the simplest and administratively most efficient system is a single national tax with the central government distributing revenues between subordinate jurisdictions.[364] Allocation on the basis of fiscal equalisation is an option for countries where local governments do not have fiscal autonomy and the power to levy separate VATs with different rates and bases. It does, however, reduce the incentive for sub-national governments to raise further revenue from local tax sources. This problem can be mitigated if allocation is made wholly or partly on a per capita basis rather than a fiscal equalisation formula.

5.4.2 Sub-central VATs only

The options for exclusive sub-central VATs include the international zero-rating model, VIVAT and clearing house mechanism. The international zero-rating model does not provide full solution to the problem as enforcement can be difficult in terms of the collection of VAT on B2C sales that relies on private consumers' self-compliance. This could be more of a problem in developing countries that cannot risk losing revenue on domestic B2C sales. The more serious problem is that it is vulnerable to fraud. The VIVAT is essentially a variation of the clearing house model. It does not reduce the administrative and compliance burden that would be incurred in the clearing house model in the case of B2C sales. It nevertheless adds an extra layer of complexity by requiring the supplier to identify whether the buyer is a business or private customer. While the VIVAT does not provide simplicity as compared to clearing house, it would limit local fiscal autonomy in respect of rate for B2B sales.

The clearing house system also raises administrative difficulty. If the VAT revenue is allocated on the basis of invoices, either the importing jurisdiction or the exporting jurisdiction may have limited incentive to enforce the tax on inter-jurisdictional sales. This difficulty could be overcome with an overarching fiscal authority administering a separate VAT while operating the clearing house for sub-central VATs. The federal VAT could be a source for cross-checking of sub-central VATs on inter-jurisdictional

[364] Bird and Gendron, (n 6) 149.

sales. The clearing house, therefore, could be a better option for federations in which local governments have substantial taxing powers.

5.4.3 Central VAT co-exists with sub-central VATs

If constitutional or political constraints preclude a single national tax and co-existing subordinate taxes or exclusive subordinate taxes are necessary, origin collection and clearing house redistribution appears to be the best system. The key design issue, in this case, is to allocate the revenue to the jurisdiction where consumption takes place while allowing local governments to retain autonomy with rates, base and administration.

One feature of an effective clearing house, however, is technological and communication capacity that ensures immediate and accurate communication between all participating revenue offices and the clearing house. Additionally, if the tax is administered by sub-national jurisdictions, full communication and cooperation between the revenue agencies themselves is important to ensure consistency and accuracy in the information provided by exporting and importing jurisdictions. The technological and communication capacity required for effective operation of a clearing house system may be absent from some developing countries. For these countries, the CVAT model may be the best option. The effectiveness of the CVAT will be revealed over time with Indian experience.

Table 6 Comparison of Destination-Based Models

	Fiscal autonomy	**Complexity (additional administrative and compliance burden)**	**Central VAT**	**Effectiveness**
Zero-rating	Complete	No additional administrative and compliance burden	Could work with or without a central VAT	Not effective in terms of B2C sales
Clearing house	Complete	Suppliers have to identify customers' location and the	Could work with or without a central VAT but works better with	Effective based on the EU experience

		applicable rate in that jurisdiction	a central tax administration	
CVAT	Requires harmonised base	Suppliers have to distinguish between intra-jurisdictional sales, inter-jurisdictional sales and exports to other countries	Requires a central VAT	Effective based on the Indian experience
VIVAT	Requires harmonised rate on B2B supplies	Suppliers have to distinguish between B2B and B2C sales; in the case of B2C sales, suppliers have to identify customers' location and the applicable rate	Could work with or without a central VAT but works better with a central tax administration	Effective in theory; untested in practice

5.5 Conclusion

The distribution of VAT within a federal jurisdiction is an area where no single model is possible as the decision turns on both political and structural factors including in some cases constitutional constraints. However, a comparison of existing and proposed models can provide guidance on the merits of and problems with different options that may be considered within the political and structural parameters.

A review of the models reveals that none of the solutions is fully satisfactory. Exclusive sub-national VATs appear to be the most difficult situation since with most models the existence of a central VAT, or at least central tax administration, would improve administration and enforcement. In the case of sub-national VATs, whether or not there is a central VAT, the clearing house may be the best available model for most developed jurisdictions. It may not be an option for countries with weak technological and communication capacity. These countries may consider the CVAT as a better option.

PART II. APPLYING THE BENCHMARK: A CASE STUDY OF CHINA

CHAPTER 6. EVOLUTION OF VAT IN CHINA

The history of VAT is crucial to an understanding of how current policy is shaped. The main VAT reforms in China were part of broader fiscal reforms. The development of VAT is therefore consistent with the development of intergovernmental fiscal relationship. This chapter sets out the political and historical background in which the Chinese VAT system developed. It reviews four main stages of the evolution of VAT in the context of the evolution of intergovernmental fiscal relationship: centralisation in 1950-1978, decentralisation in 1979-1993, recentralisation in 1994-2011, and further centralisation from 2012 onwards.

6.1 1950- 1978

The history of VAT in China commenced with the first public finance initiatives of modern China. Following the fight to Taiwan of the Nationalist government and the establishment of the People's Republic of China in 1949, China formally established (and unified) its tax system in 1950. The initial tax system was dominated by two types of turnover tax, the Commodity Tax and the Business Tax (BT), as well as an income tax on industrial and commercial entities. The tax system had two main features. First, multiple taxes could apply to a single stage in the production and supply chain of a product. Second, a single tax (for example, BT) could apply to multiple stages in the production and supply chain of a product. The complicated tax system was designed to accommodate the economic diversity with the existence of capitalist industry and commerce so as to ensure that economic activities yield the maximum revenue for the government in times of economic recovery.

Under the influence of Soviet socialism, China started to establish its highly centrally planned economy by transforming its private sector into public ownership in the 1950s. By the end of 1956, most private commercial enterprises were turned into state-owned enterprises (SOEs). The SOEs were not "enterprises" in a commercial sense. Rather, been attached to ministries and government bodies, they were *de facto* production units for the state that performed both economic production and social welfare functions. These enterprises normally built their own communities; they did not only operate the factories, but also housed their own employees, ran stores, hospitals, schools, and canteens for the employees. The high degree of vertical integration promoted a tax simplification reform in 1958 and a further reform in 1973, reducing the types of taxes that were in use. The 1958 reform integrated four types of taxes, including BT and Commodity Tax, into a single Consolidated Industrial and Commercial Tax (CICT).[365]

The role of taxation as a source of revenue was largely weakened during the period of 1958-1978. While the function of taxation is to transfer funds from the private sector to the state, the private-public relationship ceased with the nationalisation of private commercial enterprises. Following this shift, the government increasingly relied on profits of SOEs as its main source of budgetary revenue, with the income tax on SOEs being replaced with profit remittance in 1959. The 1973 tax simplification reform thus distinguished SOEs and non-SOEs for tax purposes— SOEs were subject to only a single Industrial and Commercial Tax (ICT), while collectively-owned enterprises were subject to the CICT and an income tax.

The fiscal system in 1950-1978 was characterised with a high level of centralisation. Budgetary revenue and expenditures of local governments were planned at the central level. Although local governments collected the taxes, they remitted the collected revenue to the central government which then transferred the budget to local governments based on centrally approved expenditure priorities. Local revenue in excess of expenses accrued to, and any shortfalls were covered by, the central government.

The inefficiency of the centrally planned system was recognised in late 1970s, with national economy close to collapse after 10 years of the Cultural Revolution. Since the fiscal power and revenue largely remained with the central government, SOEs lacked incentives to improve production efficiency and make profits and local governments lacked incentives to administer the taxes and collect the revenue.

6.2 1979- 1993

The reform and opening up policies initiated by Deng Xiaoping in late 1978 that aimed to transit the centralised planned economy to a socialist market economy required a

[365] Elements of the CICT were described in R. D. Pomp and S. S. Surrey, 'The Tax Structure of the People's Republic of China' (1979) 20 Virginia Journal of International Law 1.

fundamental reform of not only the relationship between the central government, local governments and SOEs, but also the over-simplified and cascaded tax system.[366] The initial attempt to introduce a "VAT" was the first move of reforming the tax system at the beginning of the economic reform. In 1979, a VAT experiment was carried out in a small number of cities in southern China to reduce the cascading effect in the tax system. The VAT was applied to only five items of goods, including machineries and agricultural equipment, by allowing the enterprises to deduct the costs of designated input items from their turnovers to calculate the tax liability.

The 1979 experiment was an earlier example of what became an enduring feature of VAT reforms in China. While the tax is a national tax, the experiment was limited to a small number of supplies within a small geographical area. The ability of authorities to restrict the changes in this way illustrates the very fragmented and local application of what should be a national law. The fragmented implementation also had significant implications on the design of the tax. Given that upstream supplies may have been subject to the cascading Product Tax at different rates, it was not administratively feasible to calculate the exact amount of input tax imbedded in each supply. The simple solution of allowing the deduction of only a fraction of the tax on a selective basis, however, does not reflect an effort by the government to approximate the effects of a proper VAT. Rather, the deduction was seen as a concession to relieve the excessive tax burden caused by cascading. The logic behind the measure, viewing a departure from traditional turnover tax logic as concessional in nature, was to prove influential in almost all subsequent reforms and retains an enduring impact on current VAT design.

The primary objective of tax reforms in the opening up stage was to notionally separate enterprises owned directly by Ministries from the government budget for those Ministries and provide enterprises incentives to improve efficiency and compete in the market.[367] Domestic tax system undergone two phases of reform in 1983-84. In the first phase, corporate income tax was introduced to replace profit remittances, with SOEs being able to retain a proportion of their after-tax profits. The focus of the second phase was on the structure of turnover taxes. The ICT was divided into three turnover taxes,

[366] L. Jin and R. Krever, 'Globalization and Modernization as Drivers for Tax Reform in the Socialist Market Economy' (2010) 11 Theoretical Inquiries in Law 687.
[367] The World Bank, *China: Revenue Mobilization and Tax Policy* (The World Bank 1990).

namely, Product Tax, VAT and a revival of the former BT, and Resource Tax, each of which applied to a different category of supplies. The Regulations of the People's Republic of China on the VAT (Draft) issued by the State Council (the executive branch of government) in 1984 marked the formal establishment of the VAT system in China. The tax was applied nationwide to 12 items of goods that were produced domestically or imported. There were six levels of rate ranging from 6% to 16%. 270 items of other goods were taxed under the Product Tax, with 21 different rates ranging from 3% to 60%. Supplies subject to the Product Tax were mostly shifted to the VAT during 1986-88. Only 96 items remained to be taxed under the Product Tax in mid-1988. Under the BT, four different rates ranging from 3% to 15% were applied to 11 categories of industries, most of which were services industries. Importantly, the VAT and Product Tax only applied at the production and import stages. The retail and wholesale stages were taxed under the BT.

In 1984 when goods and services were subject to separate taxes for the first time, China was still in the earliest stages of the shift towards a market economy. The leadership retained some scepticism over the ability of the market to allocate resources optimally and many retained an inclination to oversee economic management. The 1984 reforms offered a perfect vehicle for ongoing economic intervention in production and consumption decisions by the Communist Party through multiple taxes imposed at multiple rates. The apparent purpose of the extensive range of rates was to balance after-tax profits for firms subject to and those outside the scope of price controls.[368]

The highly centralised fiscal system in the planned economy was incompatible with the objective of market-oriented reforms. A revenue sharing system that granted provincial governments greater fiscal autonomy was introduced in 1980, with an aim to provide them incentives to collect the revenue.[369] The system had been subsequently modified twice, first in1985 and then in 1988, to adjust the revenue sharing mix between the central and provincial governments. The various attempts on fiscal arrangements during

[368] P. B. Prime, 'Taxation Reform in China's Public Finance' in U.S. Joint Economic Committee (ed), *China's Economic Dilemmas in the 1990s*, vol 1 (U.S. Government Printing Office 1991).
[369] M. Oksenberg and J. Tong, 'The Evolution of Central-Provincial Fiscal Relations in China, 1971-1984: The Formal System' (1991) 125 The China Quarterly 1.

1979-1993 were unsuccessful, with fiscal deficits consistently incurred by the central government in the period.

The revenue decline was attributable to two main factors. First, while the central government only collected taxes from state-owned enterprises, the growth in market forces and the rise of non-state-owned enterprises have quickly eroded the central government's tax base.[370] Second, the revenue sharing agreements were largely based on negotiable and flexible contracts. That enabled the central government to adopt *ad hoc* measures to absorb excessive revenue from rich provinces and subsidise poorer areas. The redistribution policy however weakened the incentives of provincial governments to collect revenue. In response to the central government's various measures to take away extra revenue from localities, governments of rich provinces devised ways to collude with enterprises in their own jurisdictions to hide profits from taxation. Although the central government was the exclusive authority in setting tax rates and determining tax bases, provincial governments gained actual control over taxation through tax administration.[371] They were able to either take advantage of vaguely drafted rules to, or illegally, adjust the effective rates and bases by granting deductions or exemptions. Budgetary revenue was consequently diverted to extra-budgetary funds. Accompanied the continuing decline of the central budgetary revenue to Gross Domestic Product (GDP) ratio in the period of 1979-1993 was the growth of extra-budgetary funds that were largely controlled at the provincial level.[372]

6.3 1994- 2011

With the increasing growth in the budget deficits, the fiscal system was on the verge of crash in early 1990s. Decentralisation and the decline in central revenue had largely weakened Beijing's control over macroeconomic policy. A radical fiscal reform, the launch of the Tax Sharing System, was carried out in this context in 1994. The main goal of the reform was to increase the "two ratios" (central revenue to GDP and central

[370] T. Shu-ki and C. Yuk-shing, 'China's Tax Reforms of 1994: Breakthrough or Compromise?' (1994) 34 Asian Survey 769
[371] E. Ahmad and others, 'Recentralization in China?' (IMF Working Paper WP/02/168, 2002).
[372] C. Shen, J. Jin and H. Zou, 'Fiscal Decentralization in China: History, Impact, Challenges and Next Steps' (2012) 13 Annals of Economics and Finance 1.

to local revenue) by replacing the negotiated contact system with rule-based tax assignments.

In the 1994 reform, the Product Tax was completely shifted to the VAT, with the issue of Provisional Regulations of the People's Republic of China on the VAT by the State Council. The VAT was applied to supplies of goods and imports, as well as a few items of services that were closely related to goods. The rate structure was largely simplified. There were only two levels of rates, a standard rate at 17% and a reduced rate at 13%. Exports were generally zero-rated.

The efficiency of the VAT as initially adopted was undermined by three features: continued cascading caused by limited entitlement to input tax credits, a narrow base and retention of a turnover tax for small businesses. The end of zero-rating for exports a year after the tax was adopted, which is reviewed in detail in Section 8.2.1, further undermined the efficiency of the tax.

The 1994 VAT was a "production-type VAT", as is labelled by the Chinese government, because input tax on fix assets was not allowed to be deducted from output tax. The VAT on capital goods thus became part of the business cost. The denial of input tax contradicts with the fundamental feature of VAT that it is intended to be a tax on consumption. The flawed design must be explained in the specific economic context. In 1992, Deng Xiaoping's visit to Southern China started an investment boom in construction projects that eventually led to an unprecedented inflation in 1993-94.[373] As input tax credits are seen as tax concessions, entitlement to input tax credits for fixed assets was considered an encouragement to further investment. Most importantly, the choice of a production-type VAT was also a result of the government's revenue constraint.[374] The VAT rates were calculated to ensure that the overall revenue collection would remain unchanged as compared to the total revenue raised from the previous Product Tax and VAT. Had deduction of input tax on fixed assets been allowed, the standard rate would have been set at 23%, which is 6% higher than 17%, to

[373] G. Chang and J. Hou, 'Structural Inflation and the 1994 "Monetary" Crisis in China' (1997) 15 Contemporary Economic Policy 73.
[374] M. Yu, 'Tax Authority Designates Trial Points for New VAT Regime' (2004) 33 Tax Notes International 135.

raise the same amount of revenue.[375] A standard rate of 23% was considered too high even for European countries at the time.[376]

The second major flaw of the VAT was the narrow base it applied to. Although the government was advised prior to the reform that the VAT should be extended to all goods and services, services remained to be taxed under the BT after 1993.[377] The economic superiority of the VAT over the BT was well understood by the policy makers. The reason for applying separate taxes to goods and services was almost entirely political.

The 1994 reform divided all taxes into three categories: central taxes, provincial taxes and shared taxes. Revenue raised from central taxes and provincial taxes is accrued to the central government and provincial governments respectively, with the revenue collected from the shared taxes allocated between the central and local governments based on fixed ratios. In addition, tax administration was split into central administration and local administration. While there is only a national office, namely, the State Administration of Taxation (SAT) established in 1950 at the central level, tax offices at each of the three local levels (provinces, municipals and counties) were divided into SAT offices and local tax bureaus in 1994.[378] The SAT was mainly responsible for the collection of central and shared taxes, whilst provincial tax bureaus were mainly responsible for the BT, with the revenue retained by the provinces. The responsibility of tax administration was thus allocated in line with revenue sharing.

The VAT was a shared tax, with 75 per cent of the revenue assigned to the centre and 25 per cent assigned to the provincial governments. Since the income tax revenue was low relative to turnover taxes, the VAT and BT would be the main revenue generators for both central and local governments. The imbalanced shares would lead to a significant revenue loss, if all goods and services were to be subject to the VAT, for rich

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[375] S. Xu, 'History of Tax Reforms since 1994 and the Current BT-to-VAT Reform' (Speech at a training meeting of the China International Capital Corporation, 12 July 2012) (in Chinese) <http://blog.sina.com.cn/s/blog_5e1ec63e01019mms.html> accessed 20 June 2018.
[376] *Ibid.*
[377] *Ibid.*
[378] For a discussion of the division of tax administration and the tensions between the central and local tax administrations, see W. Cui, 'Chapter 17: China (People's Rep.)' in G. Bizioli and C. Sacchetto (eds), *Tax Aspects of Fiscal Federalism: A Comparative Analysis* (IBFD 2011).

provinces, who were reluctant to accept the reform package.[379] The BT was thus allocated to provinces as a provincial tax that generated the largest share of the provincial revenue. The tax base was split into goods and services to balance the interest between the central and provincial governments, which was necessary at the time for the launch of the entire reform package.[380]

While the two major design flaws were compromised solutions adopted in the particular historical context, these problems were gradually solved over more than two decades of implementation of the VAT. The transition to a consumption-type VAT, with input tax credits granted for capital goods, was proposed at the Third Plenary Session of the 16th Central Committee of the Communist Party in 2003.[381] Although the production-type VAT was considered a hindrance to technological development, the transition to a consumption-type VAT was not an easy move due to the government's fear for revenue loss.

The reform was carried out gradually in the form of pilot programme to minimise the impact on revenue. The input tax credits for capital goods in the pilot programme were again used as tax subsidies to achieve economic priorities. In 2004, input tax credits for certain capital goods were allowed in eight industries in three north-eastern provinces as one of the tax preferences adopted to facilitate the government's strategic economic objective, namely, rejuvenating its rust belt in north east China. The pilot programme was extended to areas in Sichuan Province that were most seriously damaged in the Wenchuan earthquake in 2008 to facilitate rebuilding. The transition to a consumption-type VAT was finally implemented across the whole country in response to the financial global crisis in 2009.[382] The availability of input tax credits, which is a built-in feature

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[379] *Ibid.*

[380] Y. Xu, 'China's Turnover Taxation in the Pre-VAT Period: 1949-93' (2012) 1 World Journal of VAT/GST Law 149.

[381] Central Committee of the Communist Party of China, 'Decision of the Central Committee of the Communist Party of China on Some Issues concerning the Improvement of the Socialist Market Economy' (Third Plenary Session of the 16th CPC Central Committee, 14 October 2003) (in Chinese).

[382] W. Cui, 'China's Tax Policy Response to the Global Financial Crisis' in J-P. Cabestan, J-F. Meglio and X. Richet (eds), *China and the Global Financial Crisis: A Comparison with Europe* (Routledge 2012).

of VAT mechanism, was explicitly characterised as a significant tax reduction measure by the government.[383]

6.4 2012-2016

The remaining major flaw of the VAT— the narrow base as it only applied to goods— was the theme of the most radical VAT reform in China that was carried out in 2012-16. The reform merged the BT on services into the VAT. The government took its conventional incremental approach to tax reform that the reform rolled out geographically, starting from the pilot programme in Shanghai in 2012, and on a sector-by-sector sequence. The reform was completed in a four-year period, with all services formerly taxed under the BT shifted to the VAT by May 2016. The main aspects of the reform are examined in Chapters 7 and 8.

While contemporary official documents and commentators usually ascribe the BT-to-VAT shift as a reform to remove the cascading effects in the tax system, an examination of the changing fiscal positions of the central and provincial governments may reveal another trigger for the change. The revenue figures reveal a fundamental shift in the Chinese economy particularly evident from 2010. The maturation of the economy saw a significant shift of economic activity from final consumption of manufacturing and industrial outputs to the consumption of services and a continual decline in the rate of growth of VAT revenue on the sale of goods was matched by a steady increase in the growth of BT revenue on the supply of service. In the absence of change, the indirect tax base would continue to shift from the central government to the provinces.

Table 7 Annual Tax Revenue Increases (2009-2016)

	National		**Central Government**		**Provincial Governments**	
	Tax Revenue (billion yuan)	**Percentage of Revenue Increase**	**Tax Revenue (billion yuan)**	**Percentage of Revenue Increase**	**Tax Revenue (billion yuan)**	**Percentage of Revenue Increase**
2009	5,952.16	9.8	3,336.42	7.7	2,615.74	12.5

[383] 'The Ministry of Finance and the SAT Answered Questions from Journalists regarding the Nationwide Transition to a Consumption-Type VAT' (*The Central People's Government of the People's Republic of China*, 11 November 2008) (in Chinese) <http://www.gov.cn/zwhd/2008-11/11/content_1146048.htm> accessed 14 July 2017.

2010	7,321.08	23	4,050.93	21.4	3,270.15	25
2011	8,973.84	22.6	4,863.17	20.1	4,110.67	25.7
2012	10,061.43	12.1	5,329.52	9.6	4,731.91	15.1
2013	11,053.07	9.9	5,663.98	6.3	5,389.09	13.9
2014	11,917.53	7.8	6,003.54	6	5,913.99	9.7
2015	12,492.22	4.8	6,226.03	3.7	6,266.19	6
2016	13,035.4	4.3	—	—	—	—
Source: *China Statistical Yearbook 2016.*						

Table 8 VAT and BT Revenue (2009-2016)

	VAT						**BT**	
	National		**Central Government**		**Provincial Governments**		**Provincial Governments**	
	Revenue (billion yuan)	**Percentage of Revenue Increase**	**Revenue (billion yuan)**	**Percentage of Revenue Increase/ Decrease**	**Revenue (billion yuan)**	**Percentage of Revenue Increase**	**Revenue (billion yuan)**	**Percentage of Revenue Increase/ Decrease**
2009	1,848.12	2.7	1,391.6	2.7	456.53	2.7	884.69	19.6
2010	2,109.35	14.1	1,589.72	14.1	519.63	14.1	1,100.46	24.4
2011	2,426.66	15	1,827.74	15	598.93	15	1,350.44	22.7
2012	2,641.55	8.9	1,967.84	7.7	673.72	12.5	1,554.29	15.1
2013	2,881.01	9	2,053.38	4.3	827.63	22.8	1,715.46	10.4
2014	3,085.54	7.1	2,110.3	2.8	975.23	17.8	1,771.28	3.3
2015	3,110.95	0.8	2,099.7	- 0.5	1,011.25	3.7	1,916.21	8.2
2016	4,071.2	30.9	—	—	—	—	1,150.2	- 40.4
Source: *China Statistical Yearbooks 2010-2016.*								

Since the responsibilities of the central and provincial tax administrations were divided by reference to the types of taxes, the merger of VAT and BT raised questions about the future of provincial tax administrations. The completion of the BT-to-VAT reform proved to be the trigger for the merger of provincial tax offices into central administration, which was proposed by the State Council, with no foreshadowing, at the first meeting of the13th National People's Congress in 2018.[384] The proposal for

[384] The history of tax administration and the problems with the separation of tax administrations were reviewed in N. Li and R. Krever, '24 Years Later- China Finally Centralizes Its Tax Administration' (2018) 90 Tax Notes International 539.

bringing the administration powers back at the central level further strengthens the view that recentralisation was an important motivation behind the scenes for the post-2012 reforms.

6.5 Conclusion

The VAT was introduced to enhance the role of taxation in government budget in the context of an initial wave of fiscal reforms following the opening of the Chinese economy and early growth of the private sector. The primary objective of subsequent reforms in China was arguably not to improve the tax system per se but rather to strengthen the fiscal position of the central government. This partly explains why the completion of the reforms was considered a priority over the integrity of the VAT system and apparent design flaws remained in each reform. Many design problems are also a result of path dependency, with features of the earlier VAT reforms and the 1984 VAT system appearing as enduring features in later reforms. These include fragmented implementation of a reform, denial of input tax credits that are seen as concessions and the use of rate differentiation to adjust after-tax profit across industries. Notwithstanding the "impure" objectives behind reforms and the continuing impact of path dependency, however, China has made significant progress in terms of moving the VAT closer to the theoretical benchmark and modern VAT counterparts.

CHAPTER 7. VAT BASE DESIGN ISSUES

7 Introduction

The recent BT-to-VAT reform that shifted services into the VAT represents a significant improvement towards a modern VAT in terms of base broadening. It is, however, not clear that a neutral and efficient VAT was the ultimate goal. The outcome of the reform and a few post-reform changes suggest a split agenda. On the one hand, the direction of shifting the BT into the VAT indicates that there was a desire to move to a modern and efficient indirect tax for final consumption- a genuine VAT. On the other hand, a large share of consumption was excluded from the tax base by use of reduced rates and exemptions. At the same time, the greatly enlarged threshold that captures far more businesses in the "simplified VAT", which is really a cascading turnover tax, represents a backstep from the reform efforts.

In addition, with almost no international experience to learn from, China applies the VAT to financial supplies and insurance services broadly. It was expected that other countries will follow the Chinese initiative to seek ways to bring the sector into full taxation.[385] The Chinese approach, however, was not intended to achieve the correct outcomes under a consumption tax and cannot be used as a model for other countries as it now stands.

This chapter evaluates three key base design issues, namely, concessions, threshold and the small business regime and VAT treatment of financial supplies and insurance services, in China against the benchmark developed in Part I of the thesis. It explores the reasons for, and the consequences of, deviations and suggests possible ways to reform the system in these areas.

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[385] L. Wolfers and others, 'Post VAT Reform in China- What's Next?' (*International Tax Review*, 05 December 2016).

7.1 VAT concessions

7.1.1 Rationales for VAT concessions

China uses two types of concessions: reduced rates and exemptions. Different motives explain the adoption of different types of concessions. As explained further below, some were adopted with vertical equity or social objectives, to reduce the tax burden on perceived necessities or to subsidise goods or services with perceived positive externalities; and some to aid particular groups or indirectly subsidise government employment. In addition to the rationales that are common in VAT systems discussed in Chapter 1, certain concessions in China undertake unique roles as economic management or political tools.

The VAT concessions originally incorporated in the 1994 system was largely modelled on the EU VAT system. A reduced rate and exemptions were used mainly to achieve vertical equity objectives and promote the consumption of perceived social goods. For example, milk, tap water, household heating and hot water can be viewed as necessities that account for a higher proportion of the income of poorer households. Subjecting them to the reduced rate could reduce the regressivity of the VAT. In addition, books, newspapers and magazines may be perceived to have positive social values and applying reduced rate to them could be a measure to maximise the social benefits of these products.

These explanations extend to exemptions used in the BT system that were later transferred to the VAT. In some cases, the exemptions apply to specific supplies, and in some other cases they apply to supplies made by specific suppliers. As noted, where exemptions apply to supplies in general, the intended beneficiaries are presumably final consumers. Examples of concessions intended to help particular groups include exemptions for services provided by the disabled and for services provided by retired military personnel.

A third group of tax concessions are the economic management concessions used to promote sectors favoured by state economic planners.[386] Concessions serve for this

[386] Bird and Gendron, (n 6) 129-130.

purpose take the form of exemptions in China. Use of concessions in this way has greatly diminished in recent years as the government has relied on more direct subsidies or non-commercial lines of credit to support particular sectors.

An example of politically-motivated concessions is the use of reduced rates for services. Prior to the BT-to-VAT reform, only the supplies of goods and a few items of services were subject to VAT, whilst the supplies of other services were subject to BT. The degree of rate differentiation was moderate in the pre-reform VAT system. A standard rate at 17% applied to the supplies of goods, imports, and repair, processing and replacement services and a reduced rate at 13% applied primarily to necessities and goods that are essential for agricultural production.[387] In the BT system, the supplies of services were classified into nine different sectors, among which services in eight sectors were taxed at either 3% or 5%, with no input tax credits allowed for suppliers.

The BT-to-VAT reform significantly increased the complexity of the VAT rate structure, which was a result of political compromise for the completion of the reform. In addition to a standard rate and a reduced rate in the pre-reform VAT system, two new levels of reduced rates (at 11% and 6%) were introduced. Of the services that were subject to the reform, the leasing of tangible and movable property is the only item that is taxed at the standard rate. The scale of concessions introduced in the reform makes political motive the dominant rationale for concessions in China. The political motive will be explored in the next section.

Some efforts were made to simplify the rate structure after the reform. In 2017, a small step towards simplification was taken that removed the 13% reduced rate and merged all goods that were taxed at 13% into the 11% band. In 2018, the government lowered the 17% standard rate and the 11% reduced rate to 16% and 10% respectively. The rate adjustments in 2018 were claimed to be a transitionary measure towards further simplification of the rate structure.[388]

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387 Provisional Regulation of the People's Republic of China on Value-Added Tax (2008), art 2 (in Chinese).

388 K. Li, 'Report on the Work of the Government' (The First Session of the 13th National People's Congress, 2018) (in Chinese) < http://www.gov.cn/zhuanti/2018lh/2018zfgzbg/zfgzbg.htm> accessed 17 June 2018.

7.1.2 Politically-motivated concessions

The most recent round of concessions was, to a large extent, driven by the political concern that the impact of the former turnover tax has to remain unchanged in the new VAT system. One of the basic principles guiding the reform was that the overall tax burden on the sectors that have been taken into the reform shall not increase or shall slightly decrease.[389]

The government investigated the general patterns of input and output of the sectors, with particular attention paid to the potential amount of input tax credits that businesses were able to claim.[390] It then considered that businesses' tax liabilities would be much higher in the sectors shifted from the BT to the VAT, most of which are classified as services sectors, than in the goods sectors that were subject to VAT before the reform if the same rates were to apply. Due to a larger proportion of labour input, the value added at each stage of the supply chain is likely to be higher in services industries. Applying high VAT rate to high "value added" would correspondingly result in high tax liability for businesses.

Moreover, concerns were raised about transitional impact, that is, the potential short-term increase in tax burden, on firms. Given that services were shifted into the reform on a sector-by-sector sequence over a relatively long period of time, businesses providing VAT taxable services might purchase input services that were still taxable under the BT and were thus not entitled to input tax credits.

Taking these factors into consideration, the government calculated the applicable VAT rates to ensure that the statutory tax burden on businesses, which is the net VAT that businesses remit to the government, remains roughly unchanged or even reduces under the new VAT system. Since the standard rate (17%) and the reduced rate (13%) in the pre-reform VAT system are much higher than the BT rates (either 3% or 5%), the introduction of two levels of reduced rates (6% and 11%) was considered necessary for ensuring that the tax burden on businesses does not increase after the transition.

389 Ministry of Finance and SAT, Notice regarding the Pilot Programme for Replacing BT with VAT, Circular Caishui [2011] 110 (in Chinese).

390 W. Cui, 'China's Business-Tax-to-VAT Reform: An Interim Assessment' [2014] British Tax Review 617, 627.

The approach is nevertheless misleading from the policy perspective. The VAT is a tax on final consumption, with final consumers bearing the economic burden of the tax. In theory, the tax remitted by registered businesses will be passed on to final consumers. The switch to a VAT seemed entirely beneficial for businesses. China's approach to concessions in the reform was based on political considerations. In contrast with economic incidence which might be difficult to observe and predict, the statutory burden often becomes the focus of attention of the business communities as it could be more obvious. Business lobbying may have also played a role in the setting of preferential rates, in particular in the sectors in which the market is highly concentrated.[391] While the discussion had been focused on the impact on registered businesses, the government seems to have avoided potential opposition from the general public.

In addition, exemptions under the BT system were directly shifted into the VAT so that the reform would not negatively impact on businesses that were benefited from the concessions in the BT system. As a result, 40 exempt supplies were brought into the VAT in the reform. The newly added exemptions were labelled as transitional concessions. However, there has been no indication from the government on a possible timetable for their removal.

7.1.3 Difficulties and distortions

The extensive use of concessions inevitably creates legal, administrative and compliance difficulties, as well as economic distortions. The concessional treatment of telecommunications services shifted into the VAT provides a useful case study of the targeting difficulties encountered in VAT concessions as enterprises bundle other services into concessionally taxed services. The transfer rule provided two reduced VAT rates for telecommunications services, namely, 11% for basic telecommunications

[391] E.g., it was reported that the expansion of the reform to the telecommunications sector was subject to continuous delay during the second half of 2013 and the first half of 2014 due to dissatisfaction from the three largest telecommunications enterprises. The focus of negotiation between the telecommunications enterprises and the Ministry of Finance was the estimated increase in tax burden on enterprises. The choice of applying two different rates of 11% and 6% to basic and value-added telecommunications services respectively was likely a compromise made by the government.

services and 6% for value-added telecommunications services.[392] The transition instruction provided that basic telecommunications services refer to the provision of voice communications services, the lease and sale of bandwidth and wavelength and other network services; and value-added telecommunications services refer to the provision of text messages, multimedia messages, electronic data and information transmission and internet access.[393] The reasoning behind the differentiated application of two reduced rates is that basic telecommunications services rely more heavily on infrastructure as compared with value-added telecommunications service.[394] It was believed that the providers of basic telecommunications services could benefit more from input VAT credits than the providers of value-added telecommunications services.[395] This is therefore a reflection of the misleading approach which confuses the "economic incidence" and "statutory tax burden" on businesses.

The artificial distinction between basic and value-added telecommunications services becomes highly problematic when fixed packages services come into consideration. The three largest telecommunications enterprises in China, namely, China Mobile, China Telecom and China Unicom all provide various fixed packages that incorporate some call usage allowances, text usage allowances and data usage allowances. The new VAT rule creates a problem for both tax authorities and the telecommunications enterprises as to how to separate the value of call usage allowances from that of text and data usage allowances in a fixed package. Due to the large number of different packages provided by each provincial branch of telecommunications enterprises, their compliance burden of setting a price for every component of packages on a case-by-case basis could be very high. The differential VAT treatment of basic and value-added telecommunications services also provides room for tax planning. For example, the prices for call usage allowances could be set higher and the prices for data and text usage allowances could be set lower without changing the customer prices for the packages. Since tax authorities cannot design a uniform criterion that could be applicable to various

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[392] Ministry of Finance and SAT, Notice regarding the Expansion of VAT Pilot Programme to the Telecommunications Industry, Circular Caishui [2014] 43 (in Chinese).
[393] *Ibid*, art 2.
[394] KPMG, 'China Tax Alert: VAT Reforms for the Telecommunications Sector' (May 2014) <https://assets.kpmg.com/content/dam/kpmg/pdf/2014/05/China-tax-alert-1405-10-VAT-Reforms-for-the-Telecommunications-Sector.pdf?_ga=2.98292895.1251242621.1532546808-53002623.1530476003> accessed 25 July 2018.
[395] *Ibid*, 3.

packages, they have to investigate whether the prices set by the enterprises are unreasonable for tax purposes, which results in higher administrative costs.

In addition to its effect on fixed packages, rate differentiation raises difficulties in terms of bundled sales in the telecommunications industry. As a market strategy, telecommunications enterprises frequently provide bundled sales to customers, such as the sale of mobile phone handsets being bundled with telecommunications services, or the sale of services being bundled with handsets. Given that the applicable VAT rate for the sale of handsets is 16%, which is different from the rates applicable to telecommunications services, the Circular Caishui [2014] 43 provides a specific rule that treats bundled sales as mixed supplies. When taxpayers sell telecommunications services being bundled with free SIM card, devices or other telecommunications services, each component should correspondingly be subject to the VAT rate of its category. This rule, however, is difficult to execute in practice as a fair and reasonable allocation of the value of a handset and the value of telecommunications services in a bundled sale would be hard to achieve. In response to the problem, some provincial offices of the SAT temporarily equalled the price of a handset in a bundled sale with its input cost, and the remainder of the bundling price was treated as the price of telecommunications services.[396] However, in an internal guidance document issued to the Tax Investigation Department[397], the Department of Goods and Services Taxes of the SAT explained that allocating the value of different components in a bundled sale is the enterprises' price-setting practice, and the prices should be determined by the enterprises themselves.[398] It further claimed that for VAT purposes, the enterprises should be allowed to set the sale price of a handset lower than the input cost, but the tax authorities have the power to adjust the prices in the case that the prices set by the enterprises lead to an unreasonable revenue loss for the government.[399] This explanation is far from clear as to the extent to which the enterprises are allowed to set the prices of handsets lower than their input costs for VAT purposes. Importantly, the guidance documents from the SAT have no legal effect. Legal and interpretative uncertainties

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[396] See, e.g., 'Zhejiang Provincial Office of SAT's Response to 26 Hot Issues on the VAT Reform in the Telecommunications Sector' (*Tax Services*, 25 February 2015) (in Chinese) <http://www.cnnsr.com.cn/cssw/swhtml/20150225103706176028.html> accessed 25 July 2018.
[397] The Tax Investigation Department is a functional department of the SAT.
[398] Department of Goods and Services Taxes of the SAT, 'Advice on VAT Treatment for the Telecommunications Sector' (2 December 2015) (in Chinese).
[399] *Ibid*, 5.

remain. While the legislators intend to draw distinct lines between different types of goods and services, the use of rate differentiation often requires more specific, detailed and lengthy rules or soft law guidance to clarify where the borderline is, which further complicates the VAT system.

The practical difficulty of distinguishing services subject to different rates in mixed supplies is also experienced in the logistics industry as transportation services are taxed at 10% whilst logistics and ancillary services are subject to 6% VAT.[400] The Qingdao Sifang Provincial Office of SAT recognised the high likelihood of VAT fraud and revenue loss in cases in which input VAT rate is much higher than output VAT rate.[401] It presented a case that concerns with a logistics company in Qingdao City.[402] The company mainly provided transportation, warehousing and material handling services, etc. Due to a limited ability to provide transportation services, the logistics company subcontracted transportation services to a transportation company. The customers of the logistics company made full payment to the logistics company, which categorised its services as freight forwarding services that attract 6% VAT liability. The logistics company then makes the payment for transportation to the transportation company, whose output sales were subject to 11% VAT.

The Qingdao Sifang SAT Office found that the logistics company had never made any net VAT payment since the BT-to-VAT reform expanded to the transportation sector in August 2013. Because excess input tax credits are not refunded in China, the company accumulated a large amount of excess input credits to be carried forward to future tax periods. The Office considered this situation might give rise to unintended revenue loss when the lower-rated supplies are made to final consumers.[403] It was also aware of the risk that enterprises might engage in fraudulent or avoidance activities by way of sham supplies or actual transactions at non-arm's length prices between related parties to shift the excess credits to an enterprise that is able to make use of the credits against output

[400] 'Public Opinions on VAT Rates Setting after the Transition from BT to VAT' (*The State Information Centre of China*, 24 July 2014) (in Chinese) <http://www.sic.gov.cn/News/455/3132.htm> accessed 25 July 2018.
[401] B. Wu, 'Discussion on the Circumstances where Input VAT Rate is Higher than Output VAT Rate after the BT- to- VAT Reform' (13 November 2015) (in Chinese) <http://www.ctax.org.cn/hyzq/ywyj/201511/t20151113_1023893.shtml> accessed 02 February 2016.
[402] *Ibid.*
[403] *Ibid.*

tax on taxable supplies.[404] While the approach that taxpayers might use to obtain *de facto* refunds would be considered illegal or treated as avoidance in China, the outcome would not be inappropriate from a VAT theory perspective since absence of any refunds of excess input tax credits is inconsistent with VAT principles.

In addition to practical difficulties and potential risk of avoidance and fraud, the artificial distinctions inevitably result in unfair tax treatment, and possibly, distorted production and consumption decisions. For example, beers sold in a bar incur one-third of the VAT payable on the same bottles sold in a supermarket. Take-away food is taxed at 16%, while eat-in restaurant meals, as well as take-away containers filled with left-over food, are taxed at 6%. Pick-up services provided by a hotel with explicit fees are classified as transportation services, subjecting to 10% VAT. However, the same services are treated as hotel services that attract 6% VAT if the hotelier provides "free" pick-up services and implicitly charge the fee as part of the room rate. In these circumstances, the supplies that are essentially the same in terms of economic substance give rise to different tax burdens under the Chinese VAT. The possible responses of consumers and businesses to the tax biases might be that consumers shift their consumption from take-away food to eat-in meals, and hotel owners repackage their separate services into bundled supplies that are subject to 6% VAT. The distortions and biases in the tax system will lead to a loss of economic efficiency, negatively impacting on the nation's long-term economic growth.

Distortions caused by exempt supplies may be less significant than those resulting from rate differentiation, despite the fact that the range of exempt supplies in China is much wider than in many traditional VAT systems. This is because in China most exempt supplies are services provided directly to final consumers, including medical services, education and funeral services. Treating supplies as exempt supplies is less economically harmful if exemption falls mostly at the retail stage where it cannot give rise to cascading. Cascading remains, however, in the financial sector where a range of B2B services are treated as exempt supplies, an issue that is discussed in detail in Section 7.3.

[404] *Ibid.*

7.1.4 Reforming VAT concessions

The changes in the BT-to-VAT reform are far from reform in terms of the use of concessions. The proliferation of VAT rates explicitly moves China backwards, away from modern VAT principles, escalating compliance and administrative costs and dampening economic efficiency.

While the extensive use of concessions is largely a consequence of political compromise, the concessions are tax expenditures and should be subject to tax expenditure analysis. The absence of publicly available tax expenditure budget in China, however, increases the challenge of analysing the effectiveness, and assessing the revenue impact, of the concessions.

The government nevertheless clearly understands the costs of concessions and has taken a few steps to simplify the rate structure after the reform. In 2017 the 13% reduced rate was removed and the items that were taxed at 13% were moved to 11%. The measure shows that any positive move faces political constraints. Removing the 13% reduced rate was indeed the easiest start for simplifying the rate structure for two reasons. First, there were fewer items subject to 13% than 11% and so less businesses were affected by the change. Second, the shift of supplies from a higher rate to a lower rate would be more acceptable to businesses and consumers than the other way round.

In 2018, the government lowered the standard rate, for the first time since 1994, by 1%. The 11% reduced rate was lowered to 10% in the meantime. The rate adjustments were made with the clearly stated purpose of reducing the tax burden on enterprises. This reason is, again, inconsistent with the VAT theory that businesses should not bear any tax burden under the VAT. The more convincing explanation is that the measure was taken as an intermediary step towards a dual rate structure, although at this stage the government did not indicate how this can be achieved. One possibility that could be considered is to merge the 10% and 6% rates into a new 8%.

The post-reform developments show that China is on the right path towards simplification of rate structure. The simplification, however, is achieved at the cost of giving up a further slice of tax base because the shift of lower taxed supplies into a higher rate band would be politically challenging. While the slogan of reducing the tax burden on enterprises was likely to be a strategy to minimise the potential resistance to reforms from businesses, future reforms must be founded on the sound understanding by both the government and businesses that in theory businesses do not bear tax burden no matter what the VAT rate is.

It is therefore the economic effects of VAT rate changes on consumer prices that should be the focus. The question is how much prices would rise if the ordinary VAT rate were applied to services shifted from the BT to the VAT so that the reduced rates could be removed. There are a wide range of interacting factors that determine the final price of goods and services in the marketplace, making it difficult to estimate precisely the impact of VAT rate changes on the final tax-inclusive price to consumers. What is clear is that in a competitive marketplace the final price will not reflect the notional change in rates if the structure of the tax changes as well. In other words, the increase in tax for final consumers would not be as great as the notional difference between the BT and VAT rates suggests since new VAT registered businesses could claim input tax credits for the tax on their purchases.

Three factors will have an impact on possible price changes as a result of an increase in the tax rate. The first is the extent to which the price of supplies at the former rate included embedded unrecoverable tax that could now be recovered and the extent to which the final price reflects in-house labour inputs.

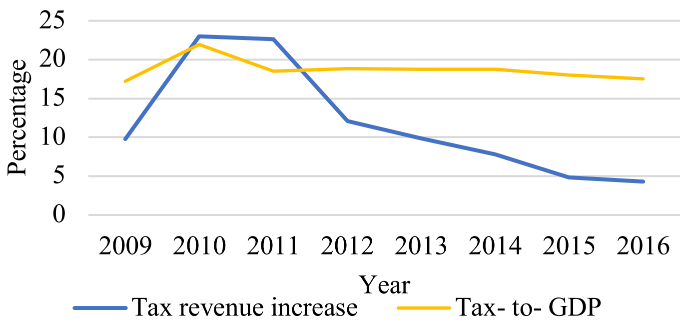
The second is the extent to which any tax benefit of the lower rate was capitalised into the final selling price of the supply. Experience has shown that enterprises along the supply chain may well convert tax savings to additional profits rather than pass them along to customers. If any tax differential between lower taxed supplies and higher taxed substitutions has been capitalised into the price of the lower taxed supplies and the price is relatively inelastic as the result of substitutable supplies, the vendors' response to a higher tax rate might be, as the market theory predicts, to reduce profit margins or retain margins by increasing productivity (a response not previously required when the lower tax rate acted as a subsidy for profits). Alternatively, absolute profits could be maintained through price reductions and increases in volume.

A third, albeit unlikely, possibility is that there are almost no taxable inputs into the supply and the benefit of a lower tax was not capitalised into the final retail price, meaning the tax rate change would lead to higher prices. To the extent customers of the supply are businesses able to claim input tax credits, the price rise due to tax is irrelevant; the increased cost can be fully recovered through input tax credits. To the extent customers are final consumers, a price rise occurs and demand for the output is elastic, sales may fall. There is a fear that a decrease in demand may subsequently give rise to wage cut and even unemployment. Nevertheless, if individuals do not alter the proportions of income saved and used for final consumption following a price rise in respect of a particular type of supply, the impact of the price rise on employment will depend entirely on where the diverted consumption funds flow. If the substituted consumption has a higher labour employment than the sector subject to the tax and price rise, employment may climb following the rate change. If the original and substituted consumption both have the same labour inputs, there might be no effect on employment.

It is possible that total tax consumption falls following the tax increase as more consumption dollars are diverted to the government as it takes higher taxes. Whether this leads to lower employment will depend on how the government uses its higher tax revenue. If it is used to increase wages or employment, the net VAT yield may remain constant as new or higher paid employees consume more or welfare recipients have greater disposable resources.

Removing reduced rates thus would not have a significant impact on the economy in any conceivable situation. The best outcome in the short term, however, would probably be a dual rate structure, given that the starting point after the reform was four levels of rates. In the long term, subjecting almost all services to reduced rates may have an increasingly evident impact on revenue as the economy is shifting from manufacturing industries to services industries. Figure 3 shows a downward trend of the tax-to-GDP ratio during the BT-to-VAT reform (2012-16). The fiscal pressure caused by rate reductions may inhibit positive move towards a modern VAT in other areas. In addition, although exemptions do not appear to be as problematic as reduced rates in China, narrowing the scope of exemptions should be on the reform agenda.

Figure 3 Annual Tax Revenue Increase and Tax-to-GDP Ratio 2009-2016



7.2 VAT thresholds and the small business regime

7.2.1 Overview

The rules for VAT thresholds in China are complex and misleading to foreign observers, which is largely due to the co-existing of the VAT with a turnover tax system for small businesses that is mislabelled as the "simplified VAT". Small businesses below a specified turnover border are subject to a 3% turnover tax; their output sales are taxed at 3% but they are denied input tax credits. The small business regime is essentially the same as the replaced BT. It is nevertheless seen as part of the VAT system in China.

In the official language, the "VAT registration threshold" refers to the threshold for registering for the small business turnover tax regime. Businesses paying tax under this regime are known as "small-scale taxpayers", which are distinguished from "general taxpayers" who are registered for the full VAT system. The actual VAT registration threshold is described in the VAT rules as a turnover border below which small businesses are qualified for registering as small-scale taxpayers.

The threshold for registering for the full VAT is measured by annual turnover. Prior to the BT-to-VAT reform, the thresholds were RMB 500,000 (approximately £55,908) for enterprises that are solely or mainly engaged in the production of goods or the provision of processing or repair services; and RMB 800,000 (approximately £89,454) for enterprises providing personal labour services. A new threshold, at RMB 5 million (approximately £5.6 billion), was introduced in the reform for enterprises providing services that were transferred to the VAT from the BT. At the end of the reform, three different thresholds applied to different types of enterprises, with the threshold for services providers ten times as high as that for enterprises engaged in production activities. In May 2018, the thresholds for enterprises mainly engaged in production activities and enterprises providing personal labour services were raised to the same level as that for services providers, which was publicised as a measure to reduce the tax burden on small businesses. Businesses in all sectors are now subject to a single threshold of RMB 5 million.

The registration threshold for the turnover tax regime only applies to sole traders and other individuals. The threshold is set considerably low, between a gross turnover of RMB 5,000 to 20,000 per month or RMB 300 to 500 per transaction in the cases where the tax is paid by transaction. The applicable threshold is set within these ranges by the provincial SAT and Finance Bureau in line with regional specifics. Businesses subject to the turnover tax are not allowed to issue "special VAT invoices", a term referring to standardised invoices used in the VAT system that entitle VAT-registered purchasers to input tax credits. They are subject to less stringent invoice requirements as they can only issue "regular VAT invoices" that cannot be used by purchasers for deduction purposes. Businesses in the turnover tax system are required to file returns less frequently than in the VAT system. They are allowed to voluntarily register for the VAT if they are equipped with sound accounting system and able to provide accurate tax information. Once they opt in the VAT, however, they are not allowed to opt out and re-enter the small business regime. This basically means that deregistration for VAT is not permitted in China.

7.2.2 Evaluation of recent reforms

The misclassification of the small business turnover tax system as a concessional VAT regime creates confusions on the nature of the regime. In particular, failure to understand that the simplified VAT is the equivalent of BT by another name has led to an exaggeration of the achievements of the BT-to-VAT reform, with the government and commentators claiming that the reform completely removed the BT from the Chinese tax system.[405]

While the BT-to-VAT reform significantly expanded the VAT base by including sales by large services providers, it had little impact on those with turnovers below RMB 5 million, who merely shifted from one turnover tax system to another. The reform had no direct impact on the small businesses providing services that were taxed at 3% in the BT, including transportation, telecommunications, postal, sports, cultural and construction services. It may reduce the tax burden on small businesses providing services that were taxed at 5% in the BT system, such as insurance and financial services, the transfer of intangible assets and the sale of real estate and lifestyle services. This might explain the adoption of a significantly higher threshold for services providers in the reform. The government may have intended to minimise the impact on small businesses so that the reform could be acceptable to the sector.

The reform, however, left the VAT with three different thresholds, which had not only created unfair treatment for small businesses in different business sectors, but also significantly increased the complexity of the VAT. Small businesses operating close to the border had to distinguish between sales of goods and services.

The later changes to the thresholds in 2018 that unified the thresholds for businesses in all sectors were a positive move that corrected these distortions. The direction of change is also consistent with the theoretical recommendation that a higher threshold is desirable from both administrative and compliance perspectives.

The move, however, was not all positive because the base of the small business turnover tax was expanded. Businesses engaged in production activities with turnover between RMB 500,000 and 5 million, and those providing personal labour services with turnover between RMB 800,000 and 5 million, are excluded from the VAT and instead subject to the turnover tax. With the turnover tax sitting below the VAT, changing the VAT

[405] See, e.g., J. Liu, 'The Business Tax has completed its Historical Mission' (*Ministry of Finance of the People's Republic of China*, 1 December 2017) (in Chinese) < http://tfs.mof.gov.cn/zhengwuxinxi/caizhengfazhidongtai/201712/t20171201_2763967.html> accessed 18 August 2018.

registration threshold was simply changing the relative proportions of the two tax bases. The increase of threshold levels in 2018 in fact went against the efforts in the BT-to-VAT reform.

The rationale for raising the thresholds is also questionable. The intention was to shift small businesses from the full VAT to the concessional regime to reduce their tax burden. While the tax rate on output sales was reduced from 16% to 3%, small businesses are not entitled to input tax credits in the turnover tax system. However, for small businesses engaged in the production or sales of goods, input costs are likely to be the biggest cost component.

7.2.3 Further reforms

Threshold and the small business regime are areas that require further reform in China. The illogically labelled simplified VAT is actually a classic turnover tax, similar in operation to the turnover taxes of last century that have been largely abandoned elsewhere in the world because of the economic inefficiency they engender. The combination of a turnover tax and a VAT in China extends the distortions, in particular the cascading, of a turnover tax into the VAT system.

To reduce cascading and the possible disadvantage faced by small businesses when they sell to VAT registered businesses, small businesses subject to the turnover tax are entitled to request the tax bureaus to issue special VAT invoices on their behalf to their registered customers that will allow the customers to claim input tax credits (the 3% turnover tax). In practice, this rule may not be used very often because of the additional compliance burden on small businesses.[406]

The primary reason for adoption of the turnover tax in China was to collect revenue.[407] The large number of small businesses subject to the turnover tax, however, only contributed 2.69 per cent of the total revenue of the VAT and the turnover tax in

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406 The compliance burden involved in the process of requesting a special invoice was also noted in A. Schenk, V. Thuronyi and W. Cui, ‘An Anatomy of the Chinese VAT’ in Schenk, Thuronyi and Cui, *Value Added Tax: A Comparative Approach* (2nd edn, Cambridge University Press 2015).
407 *Ibid.*

2011.[408] The net cost of abolishing the small business regime may not be great. While the IMF estimated that the VAT compliance ratio had increased from about 39 per cent of potential VAT revenue in 1997 to 56 per cent in 2005,[409] VAT compliance remains low in China. Concentrating administrative resources on large taxpayers to reduce non-compliance could yield more revenue than taxing a large number of small businesses under the turnover tax.

There is evidence that evasion by small businesses in the turnover tax regime is not insignificant.[410] Abolition of the turnover tax and subjecting them to input taxation can provide a cost-effective solution to the evasion problem.

Although there is a strong case for abolishing the small business regime, the government may be cautious about the idea because of the potential revenue impact, in particular after giving up part of the base by lowering VAT rates. A compromise solution is to abolish the small business regime while lowering the VAT registration threshold at the same time. While a higher threshold is desirable before the SAT improves its administrative capacity to a level that it is capable of administering a large number of taxpayers effectively, at the current stage, a VAT with a low threshold is still superior to a combination of a VAT and a turnover tax. An important reason that reform of the area has not attracted much attention in China is the lack of conceptual understanding of the true nature of the "simplified regime" as a turnover tax rather than a VAT.

There has been no empirical study on business bunching below the VAT registration threshold in China. But the rule that disallows deregistration may encourage bunching behaviour by small businesses, in particular those that are not expecting sustained growth. It may also be argued that abolishing the 3% turnover tax will increase small

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[408] *Ibid.*

[409] J. Brondolo and Z. Zhang, 'Tax Administration Reform in China: Achievements, Challenges, and Reform Priorities' (IMF Working Paper WP/16/68, 2016).

[410] E.g., the Shanghai SAT office found that a beauty salon registered as a small-scale taxpayer provided discounts to customers if they do not request invoices. The small-scale taxpayer under-reported sales by only reporting the proportion made to customers that requested invoices. See, 'The Seller Under-Reported Sales when the Purchasers do not Require Invoices' (*Shanghai Municipal Tax Service, SAT*, 29 September 2015) (in Chinese) <http://www.tax.sh.gov.cn/pub/ssxc/xxgkdxal/201509/t20150929_419379.html> accessed 23 June 2018.

businesses' incentives to stay below the threshold.[411] Finding a solution to the bunching problem that troubles some other countries, in particular the UK, should not be a priority for China before it addresses more worrying structural flaws in the VAT. The option for deregistration, however, should be allowed to avoid punishing low-turnover small businesses with compliance burden and level the playing field for small businesses of similar size that are currently on either side of the threshold.

7.3 Financial supplies and insurance services

7.3.1 Overview

As noted in Chapter 3, the application of VAT to financial supplies is one of the most technically difficult challenges in the VAT. While traditional VAT countries have broadly exempt financial and insurance services from the tax and a few modern VAT jurisdictions devised ways to address some of the shortcomings of the exemption approach, China was one of the first countries that started from a full taxation position and applied the VAT to financial and insurance services broadly.

Financial and insurance sectors were among the last sectors that shifted to the VAT in the BT- to-VAT reform in 2016 due to the significance of the sectors in the economy and the technical difficulties of taxing them under the VAT. The broad application of VAT to these sectors was not surprising, however. Prior to the BT-to-VAT reform, gross interest on loans, gross insurance premiums and net gains from trading of financial securities were taxed at 5% in the BT system. The sectors contributed a significant share of the BT revenue, accounting for about one fifth of the total BT revenue in 2012.[412] The government could not afford losing the revenue by following the EU approach of exempting the entire sectors. The transfer to full taxation under the VAT was also politically achievable. Political difficulties that might be experienced in other countries if they were to shift from exemption to full taxation was not a problem in China since the sectors have been subjecting to tax for over two decades. Business resistance that was expected or actually experienced in other sectors during the reform

[411] A similar point was made in Schenk, Thuronyi and Cui, (n 406) that a lower turnover tax rate may increase small businesses' incentives to keep their production below the VAT threshold.
[412] 'Government Revenue and Expenses in 2012' (*Ministry of Finance of the People's Republic of China*) (in Chinese) <http://gks.mof.gov.cn/zhengfuxinxi/tongjishuju/201301/t20130122_729462.html> accessed 25 June 2018.

was far less a concern in the financial and insurance sectors, given that the sectors are strongly dominated by the state-owned enterprises.[413] The challenges were thus almost entirely concerned with technical issues.

The government, however, did not take the opportunity to seek solutions that are consistent with the correct VAT outcomes. It took an (politically and technically) easy route that replicated the previous BT rules in the VAT system. This was likely driven by the pressure to complete the reform in a relatively short period of time. The result is that the cascading effects remain in these sectors and are brought into the real economy. The reform was nevertheless considered positive in the sense that China took the initiative to apply the VAT to the financial and insurance services generally.[414]

The new VAT rules divided financial services into four categories: loan services, fee-based financial services, trading of financial products and insurance services. Consistent with the previous BT approach, the VAT rules prescribe three methods different from the invoice-credit mechanism to calculate VAT liability for different types of supplies:

1) the ***gross method*** which applies VAT to gross payments received by the supplier;
2) the ***margin method*** which applies VAT to the net margin between the purchase and sale prices; and
3) the ***net method*** which applies VAT to the net margin between purchase and sale prices reduced further by the amount of related ancillary costs incurred by the supplier (for example, interest expenses incurred by a finance lease supplier).

Table 9 provides a summary of the VAT rules apply to financial and insurance services.

Table 9 VAT in the Financial and Insurance Sectors

Categories of Taxable Supplies	Scope	Calculation Method & Tax Base	Special Rules	Main Exemptions

[413] S. Shen and R. Krever, 'China's VAT Reform: Experiences and Lessons Learned' [2017] International VAT Monitor 147.
[414] Wolfers and others, (n 385).

Loan Services	Loans	Gross method: VAT applies to gross loan interest	Registered borrowers are not entitled to input VAT credits for loan interest as well as fees or charges paid to the lenders for services directly related to loans.	Interbank lending; Lending from the People's Bank of China to other financial institutions; Government bonds; etc.
	Sale-and-leaseback services	Net method: The taxable sale is determined by deducting the interest that the lessor paid on loans and debentures from the total income and charges received from the lessee, excluding the loan principal	-	-
Fee-based Financial Services	Financial services provided with explicit fees or commissions	General VAT rules apply to the amount of fees	-	-
Trading of Financial Products	Transfer of foreign currencies, securities, non-commodity futures and other financial products	Margin method: VAT applies to the balance of the sales price less the purchase price	Positive and negative balances can be offset within the same tax period. Any remaining negative balance after offsetting can be carried forward to the subsequent tax periods. However, if there is still negative balance at the end of the tax year, it cannot be carried forward to the next tax year.	Transfer of financial products by unincorporated enterprises or individuals; Purchase and sale of shares and/or bonds with investment funds by funds managers; etc.

			No special VAT invoices can be issued for the transfer of financial products.	
Insurance Services	Life and health insurance and casualty insurance	Gross method: VAT applies to gross insurance premiums	-	Life and health insurance with a term of one year or greater

7.3.2 Loans

The Chinese VAT rules distinguish between two types of loans services: lending services and sale-and-leaseback services.

In terms of lending, a 6% VAT is imposed on the gross interest on loans. This rule applies to both direct loans where no intermediary services are involved and loans through financial intermediaries. The VAT on loan interest cannot be claimed as input tax credits by business borrowers. The non-deductibility of input tax also applies to loan-related services rendered by lenders to borrowers, such as financial consultancy services and services involving handling fees. Interest on bank deposits is treated as an out-of-scope supply. Another exception to the general rule that VAT is charged on gross interest is that interest on interbank lending and loans made by the People’s Bank of China to financial institutions are exempt from the VAT.

These rules raise a number of concerns. Tax on gross interest leads to over-taxation of loan services.[415] As discussed in Chapter 3, to achieve the theoretically correct outcome, the VAT should only be imposed on intermediary services provided to borrowers. While intermediary services provided to depositors are not subject to VAT in China, borrowers are taxed heavier than the theoretical outcome. In particular, borrowers who borrow directly from lenders (for example, a public company borrows by issuing bonds) are taxed more heavily than those borrow through intermediaries (for example, banks). The over-taxation would not be a problem in normal B2B transactions because business inputs are free of tax under the VAT.[416] However, the denial of input tax credits for loan interest and ancillary services, which retains the BT treatment, raises the cost of business financing and brings tax cascading into the real economy.

Exemptions of interest on interbank loans and loans from the People's Bank of China are concessions directly transferred from the BT. Under the VAT, however, exemption of B2B transactions increases the tax burden because banks are not entitled to input tax credits for the costs incurred in making exempt supplies. The input costs incurred in making taxable and exempt supplies are not readily distinguishable and exact tracing of inputs through to outputs is not possible. A proxy is needed to attribute inputs and generally this is done by reference to the proportion of exempt supplies to total supplies. Interbank loans, however, often involve large cash flow. Interest on interbank loans may therefore constitute a large share of a bank's outlays or receipts. Exempt treatment could significantly impact banks' ability to claim input tax credits.

Sale-and-leaseback services were initially brought into the scope of BT-to-VAT reform along with finance lease and operating lease of tangible movable property in 2013 with gross lease payments taxed at the standard rate of 17%. In the course of the final push of the reform in 2016, a distinction was made between finance leases where the asset is acquired from third parties and sale-and-leaseback arrangements, with the former continuing to be treated as an operating lease and the latter recharacterised as a loan service. The two types of finance leases are identical in terms of economic substance

[415] Y. Xu and R. Krever, 'Applying VAT to Financial Services in China: Opportunities for China and Lessons for the World?' (2016) 45 Australian Tax Review 38.
[416] Applying the VAT on gross interest but allowing full input tax credits by business borrowers is considered an improvement to the EU exemption approach. See, *ibid.*

and accounting standards and are treated as loans under Chinese accounting standards. The VAT on finance lease and sale-and-leaseback is levied on a “net basis”. The taxable value of finance lease services is the total income and charges received by the lessor less interest and, in the case of motor vehicle leases, any vehicle tax it paid. The lessor is entitled to input tax credits on the purchase of the property. The taxable value of a sale-and-leaseback arrangement is essentially calculated in the same way. The sale of property by the lessee to the lessor is, however, treated as an out-of-scope supply. Because the transaction is treated as a loan arrangement rather than an operating lease, the lower financial supplies rate applies to the payments.

In addition to the different rates applying to lease payments under simple finance leases and sale-and-leaseback arrangements, different rules apply to input tax under the change made in 2016. The lessee in a simple finance lease arrangement is entitled to input tax credits on the full lease payments since they are treated as ordinary operating lease payments. The lessee in a sale-and-leaseback arrangement was formerly entitled to input tax credits on the same basis. With the recharacterisation of the transaction as a loan, the “lease” payments are treated as interest and principal repayment amounts. While VAT is payable on the interest component, no input tax credits are available to registered borrowers bearing VAT on interest expenses. Although the rate applies to finance lease (now 16%) is much higher than the rate for sale-and-leaseback services (6%), businesses may prefer the former as the entire VAT payable on the lease payments can be recovered as input tax credits. The non-deductibility of input tax credits for loan interest can be circumvented by business borrowers that are able to restructure loans as finance leases.[417] A Ministry of Commerce report on the development of finance lease industry shows that in 2014, 61.7 per cent of financing was made through sale-and-leaseback services and 22.4 per cent though finance lease.[418] It remains to be seen how different VAT treatment will impact on the business pattern in the industry.

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[417] N. Li and R. Krever, ‘Loan Intermediary Services: China’ in R. F. Brederode and R. Krever (eds), *VAT and Financial Services: Comparative Law and Economic Perspectives* (Springer 2017).
[418] Department of Circulation Industry Development of the Ministry of Commerce, ‘Report on the Development of Finance Leasing Industry in China’ (August 2015) (in Chinese) <http://leasing.mofcom.gov.cn/newsupload/developreport2015.pdf> accessed 30 June 2018.

Although the Chinese approach to loan intermediary services appears problematic from a policy perspective, it would not be difficult to reform it to produce a better policy outcome. The government did not wish to lose the revenue from the financial sector by broadly zero-rating or exempting the sector. It nevertheless applied the lowest level of reduced rates (6%) to taxable supplies to ensure that the tax burden on the sector did not increase. This was considered important not only because the financial sector plays a key role in boosting the growth of the real economy, but also because heavy tax burden would dampen the sector's international competitiveness. Unintentionally, the approach of applying a lower rate to gross loan interest resembles the separate tax rate approach discussed in Chapter 3, which aims to approximate the effect of applying the standard rate on intermediary services provided to borrowers. To illustrate, consider the interest paid to depositors is 1.5% and interest charged to borrowers is 4.5%, and the deposit and loan principals are 10,000. When the standard rate of 16% applies, the correct tax on intermediary services should be 48. If the intermediary services are provided to the depositor and the borrower in the ratio of 50 per cent and 50 per cent respectively, the correct tax that should be collected from the borrower is 24. In order to collect 24 from the borrower, the government can apply the VAT at 6% to gross loan interest paid by the borrower.

In practice, what the spread will be for particular loans is difficult to ascertain. The approximation of the spread may, however, be relatively easier to determine in the Chinese context, given the high degree of market concentration, state monopoly in the banking industry as well as interest rate regulation. Business borrowers should be entitled to full input tax credit to remove the tax element from the cost of doing business. The move would also align the VAT treatment of sale-and-leaseback with finance lease services, removing distortions of business decisions. The denial of input tax credits for business borrowers was presumably due to revenue concerns.[419] A change to allow input tax credits would thus entail a revenue cost.

[419] The BT revenue collected from the financial sector increased by 32.7 per cent in 2012 compared to the previous year, which was mainly the result of increased interest income from basic loan services in the sector. See, 'Revenues and Expenditures in 2012' (*Ministry of Finance of the People's Republic of China*) (in Chinese) <http://gks.mof.gov.cn/zhengfuxinxi/tongjishuju/201301/t20130122_729462.html> accessed 03 August 2018.

7.3.3 Financial securities

The trading of financial instruments is taxed on a margin basis under the VAT by calculating the value of the taxable supply as the difference between the selling and purchase prices. Supplies between financial institutions, and supplies made by individuals, are exempt from the VAT. Traders of financial instruments are not allowed to issue special VAT invoices. Input tax credits are thus not available for persons acquiring financial instruments.

The rules on financial securities were directly transferred from the BT. Under a benchmark VAT, however, supplies of financial securities would be free of tax because there is no personal consumption involved in such transactions. The cascading and distortion effects in the BT system therefore remain in the VAT.

Ideally, trading of financial instruments should be zero-rated in the VAT. The most significant impediment to the zero-rating approach might be the potential revenue impact. This may not be large, however, given the fact that such supplies are already treated as exempt supplies.[420] One possibility is to take an incremental approach to reform, starting with zero-rating of supplies between financial institutions. Transfers between unregistered individuals or from unregistered individuals to registered businesses remain out of scope supplies, equivalent to exempt supplies. Interestingly, current law specifies these are exempt supplies even though the result would be identical without this measure.

7.3.4 Insurance services

As is the case in many modern VAT jurisdictions, the Chinese VAT rules distinguish between two categories of insurance services, general insurance and life insurance, due to their distinct characteristics. Life and health insurance with a term of one year or greater are exempt from the VAT. In the case of general insurance, a 6% VAT is imposed on the gross premium. The indemnity payment made by the insured to the claimant is out of the scope of the VAT.

[420] Xu and Krever, (n 415).

While the VAT rules on insurance services were directly transferred from the BT, they coincidentally provide the correct policy outcome where the indemnity is made in-kind. The insurer charges the VAT on both intermediary services and the repair or replacement of assets. It will then claim back the VAT on the repair or replacement as an input tax credit when it purchases repair services or replacement goods from the services or goods providers. The net result is that the insurer only remits the VAT on the intermediary services it provides.

The rule that denies insurers input tax credits for cash settlements of general insurance claims nevertheless causes over-taxation. Insurers may either pass the irrecoverable tax to unregistered policy holders in the form of higher premium charges or avoid the irrecoverable tax by shifting cash settlements to in-kind settlements.[421] The distortion could be removed if China follows the Australian model by requiring insurers to pay registered claimants VAT-exclusive amount in the case of cash settlements. The Australian model might be easier than the New Zealand model to implement given the current out-of-scope treatment of cash settlements in China.

7.4 Conclusion

The Chinese VAT deviates from the benchmark in terms of all three base issues. Reduced rates and exemptions are used extensively. The VAT system sits on top of a small business regime which is actually a cascading turnover tax. The treatment of financial supplies and insurance services was directly transferred from the BT system, which certainly does not lead to correct outcomes from a VAT policy perspective. A closer examination of the VAT design reveals a heavy footprint of the BT which questions the claimed success of the BT-to-VAT reform. The deviations in China are primarily the result of political difficulties and revenue needs. Future reforms would ideally see the removal of a reduced rate and exemptions and the small business regime, zero-rating of financial securities, as well as application of the separate rate approach to intermediary loan services and the Australian simplified cash-flow model to general insurance. Any positive move, however, may still be subject to revenue constraints.

[421] Wolfers and others, (n 385).

Removal of some concessions may yield the revenue needed for abolishing the small business regime and reducing the over-taxation in the financial and insurance sectors.

CHAPTER 8. CROSS-BORDER ISSUES

8 Introduction

As a large country with sub-central governments undertaking major expenditure roles, China must resolve VAT issues in respect of both inter-provincial supplies and international cross-border sales. Current rules applying to both types of transactions fall short of international best practice, particularly the fundamental destination principle of the VAT which suggests tax should be borne only in the jurisdiction in which final consumption takes place.

The inter-provincial aspect of China's VAT raises fundamental questions about inter-provincial and provincial-central government fiscal relations. Inconsistent with the destination principle, China distributes the VAT revenue among provinces on an origin basis. The system gives rise to a number of problems including cross-subsidisation between jurisdictions and local tax competition. The chapter assesses the problems with the current system and proposes a new model to address the problems.

Several issues flow from China's international cross-border VAT regime. The first, and most significant is China's rule for exported goods. In contrast to the VAT norm which sees all exports zero-rated, China's VAT rules only provides selective relief from tax on exports. The rules, regarded as an economic management tool by the government, lead to double taxation of some exports. The optimal solution to this problem would be simply to following common international practice and zero-rate exports. The question is thus not how to address the issue but rather why has China deviated from the norm. The chapter suggests the root cause is a legacy of socialism and explores the impact of this legacy on prospects for future reform. The second issue is its treatment of B2B imported services, with China using a withholding mechanism rather than the conventional reverse-charge rule to collect tax on these imports. The third is the special regime set up for B2C imports of low value goods.

8.1 Intergovernmental VAT Sharing

8.1.1 The fiscal system and fiscal imbalances

Although China is a politically unitary country, it encounters fiscal federalism issues common to all federations because a high level of expenditure responsibilities is assigned to provincial and lower level governments.[422] Provincial and local governments, as agents of the central government, provide a wide range of public services, such as education, health and social welfare.[423] Measured in terms of the share of local government expenditure to total government expenditure, China has one of the most decentralised fiscal systems in the world.[424]

The expenditures are primarily funded through tax sharing and intergovernmental transfer systems that have been in place since 1994. Under the tax sharing system, different types of taxes are divided into three groups: central taxes, sub-national taxes and shared taxes. Revenue raised from the central taxes accrues to the central government and revenue raised from the sub-national taxes accrues to the provincial governments. Revenue raised from the shared taxes are allocated between the central and the provincial governments in different ratios, depending on the types of taxes.[425] The legislative power in the field of taxation remains exclusively with the central government.

In the 1994 reform, the intergovernmental transfer system was redesigned to move away from *ad hoc* and negotiated transfers to a more transparent and rule-based system.[426] The transfer system has two main components: a supplementary amount equal to 30 per cent of the annual increases in the central government's share of VAT and excise tax revenue and two types of central government grants. The supplementary amounts are

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422 Cui, (n 378).
423 Expenditure responsibilities of the central and sub-national governments are summarised in Z. Zhang and J. Martinez-Vazquez, 'The System of Equalization Transfers in China' (Georgia State University Andrew Young School of Policy Studies International Studies Program Working Paper 03-12, July 2003).
424 Asian Development Bank, *Money Matters: Local Government Finance in the People's Republic of China* (Asian Development Bank 2014)
425 Ratios of tax assignments are summarised in X. Wang and R. Herd, 'The System of Revenue Sharing and Fiscal Transfers in China' (OECD Economics Department Working Papers No. 1030, OECD Publishing 2013). Following the merge of the BT into the VAT, the VAT sharing ratio was changed to 50: 50 between the central and the provincial governments in 2016.
426 E. Ahmad, R. Singh and M. Fortuna, 'Toward More Effective Redistribution: Reform Options for Intergovernmental Transfers in China' (IMF Working Paper WP/04/98, 2004).

transferred to provinces on an origin basis, with revenue collected in each province transferred to that province. The system was intended to compensate the provincial governments for their losses in the reform of tax sharing.[427]

Central government grants are divided into two categories, general purpose grants and specific purpose grants, depending on their different functions. General purpose grants mainly include equalisation transfers and transfers to minority regions, which were adopted to raise the fiscal capacities of poorer provinces and regions to the average level and narrow regional disparities.[428] Specific purpose grants target a wide range of spending projects on an *ad hoc* basis, including education, employment, health care and medical services, etc. They are mainly used by the government as a macroeconomic tool for strategic development objectives.[429]

The efficiency of the 1994 system has frequently been criticised on the basis of a mismatch between local governments' resources and responsibilities. While revenue was centralised after the 1994 reform, expenditures have been increasingly decentralised.[430] In 2014, the provincial governments undertook 85 per cent of the expenditure responsibilities with only half of the total tax revenue.[431] The transfer system has been insufficient in offsetting the vertical fiscal imbalances that result from the centralisation of tax revenue and decentralisation of expenditures.[432] As a result, local governments have been increasingly relying on off-budget sources of revenue (including illegal fees and charges) to meet their expenditure responsibilities.[433]

Regional fiscal disparities are a further concern. The provinces' revenue-generating capacities vary greatly. While the revenue transfers are regressive as richer provinces are refunded with a larger share of the revenue, the scope of equalisation transfers was

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[427] 'The Tax Refunds and the Transfer Payments Systems' (*Ministry of Finance of the People's Republic of China*) <http://www.mof.gov.cn/zhuantihuigu/czjbqk2010/2cztz/201110/t20111031_603357.html> (in Chinese) accessed 15 July 2018.
[428] *Ibid.*
[429] *Ibid.*
[430] Ahmad, Singh and Fortuna, (n 426) 5.
[431] Asian Development Bank, (n 424) 75.
[432] J. Martinez-Vazquez and B. Qiao, 'Expenditure Assignments in China' (Georgia State University Andrew Young School of Policy Studies International Studies Program Working Paper 10-28, September 2010).
[433] Ahmad, Singh and Fortuna, (n 426).

significantly limited by revenue returns and specific purpose transfers.[434] The proportion of total transfers distributed as equalisation payments has nevertheless been increasing over years, raising from about 2 per cent in 2000 to 19 per cent in 2011.[435]

8.1.2 Horizontal VAT sharing

China has a single national VAT, which has been administered by the provincial offices of the SAT. The VAT-sharing system allocates the provinces' shares of revenue based on where the suppler is registered, not where the customer is located. A portion, now 50 per cent, of the revenue collected in each province is transferred to the provincial government after collection. As noted in Chapter 5, an origin-based system is problematic in the context of a federation. In China, the combination of allocating and returning revenue on a derivation basis and the vertical and horizontal fiscal imbalances in the wider fiscal system has no doubt aggravated the problems.

The current system which allocates half the VAT revenue collected in a province to the provincial government gives rise to two issues. The first is the mismatch in tax entitlements between the province of sale and the province of consumption in the case of inter-provincial supplies. The second is the opportunity for tax competition between provinces.

The fiscal consequence of the first problem is widening revenue disparities among provinces. The output tax collected by the exporting province on an interjurisdictional cross-border B2B supply is matched by an input tax credit paid by the importing province. In the case of B2C sales, the supplier's jurisdiction, rather than the consumer's jurisdiction, collects the VAT on the sale. The exporting jurisdictions are, however, strongly concentrated in east China, the wealthier area of the country, whilst the importing jurisdictions are mostly poorer western provinces. The system thus creates a cross-subsidisation problem, with the poorer provinces effectively subsidising the richer provinces.

[434] Ahmad, Singh and Fortuna, (n 426).
[435] Wang and Herd, (n 425); Ahmad, Singh and Fortuna, (n 426).

The problem is well illustrated with a national business that has branches across the country. If a business with its head office in province one sells to customers through its store in province two, in a legal sense the sale is made by the entity in province one and the VAT is remitted by the head office in that province. The store in province two is simply a branch of the single entity. But, not surprisingly, officials in province two will want to see the sale treated as a sale made in province two and a share of the VAT revenue flowing to the province two government. To accomplish this, they will likely require the branch to register for VAT as if it were a separate entity and then account for VAT on all its sales to customers. If this happens, the government of province one may require the head office to treat shipments to its branch as taxable sales that attract VAT. They may or may not allow the head office to issue VAT invoices to the branch. At the same time, the government in province two will understandably be reluctant to give the branch input tax credits for the VAT on a notional purchase from the head office – the government of province two would not want to give credits for tax paid to the government of province one.

All these problems disappear if the tax is administered as a truly national tax and businesses operating across jurisdictions are treated as single firms, with intra-branch activities ignored for VAT purposes or, as happens in many VAT jurisdictions, intra-group activities ignored (that is, between separate legal entities that are all subject to common ownership).

The second problem can be traced to the origin-based system for allocation of VAT revenue. Provincial governments have an interest in seeing the tax operates as if it were a set of regional VATs and perhaps unsurprisingly, sub-national governments have devised various approaches to attract tax revenue. The result has been a proliferation of tax competition among sub-national governments and tax biases that may greatly undermine economic performance by distorting business behaviour.

While sub-national governments have no legal power to alter tax rates or the VAT base, they can indirectly grant tax preferences to attract enterprises to register in their jurisdictions, either illegally or by circumventing central government rules. The common approach has been to grant "tax refunds" for the local share of the corporate income tax or VAT or both to enterprises newly registered in the jurisdiction for the initial three to five years. The concessions are seen by the local governments as a short-term loss for long-term economic growth, sustainable tax revenue and employment opportunities.[436] The local governments' practice undermines the validity of central tax policy.

The informal tax competition among local governments has also significantly distorted business decisions, with businesses choosing where to register on the basis of the availability of tax preferences.[437] However, where the local governments offer preferential tax treatment illegally, taxpayers' rights to receive the concessions are not protected under the law. A recent case concerns the non-performance of a municipal government's promise, in the form of administrative documents, to offer tax preferences to enterprises.[438] The taxpayer's claim for unpaid tax refunds was dismissed by the court on the ground that the "administrative promise" by the municipal government was against the probative provisions in the law.

8.1.3 A new approach

It was hoped that the consolidation of BT that was paid entirely to the provinces into the VAT that was shared between the national and provincial governments would trigger a wholesale revision of the tax sharing arrangements to address the existing problems and, in particular, remove the incentives of local governments to compete for the tax base. In addition to the vertical allocation problem, BT-to-VAT reform may have exacerbated the regional inequality because under the BT, the importing jurisdiction does not provide input tax credits, whilst the tax revenue of the importing province is reduced by the amount collected in the exporting province in the VAT. Such hopes probably failed to recognise the enormous challenges in any central-provincial revenue sharing negotiations. Securing the agreement of 23 provinces, four municipalities and five autonomous regions is a task that may take years to accomplish. The challenges for tax

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[436] B. Wu, X. Xu and Z. Feng, 'Investment Promotion, Fiscal Competition and Economic Growth Sustainability' (2018) 10 Sustainability 45. It has also been found that the career interests of local political leaders are an important factor in explaining informal tax competition; See, E. K. Choi, 'Informal Tax Competition among Local Governments in China since the 1994 Tax Reforms' (2009) 45 Issues & Studies 159.
[437] Choi, (n 436).
[438] Administrative Ruling of the Intermediate People's Court of Leshan City, Sichuan Province (2016) Chuan 11 Xingzhong No. 56 (in Chinese).

sharing created by the reform was responded with a temporary rule that changed the VAT sharing ratio between the central and provincial governments from 75: 25 to 50:50, leaving the problems with the horizontal allocation of VAT revenue unaddressed. While a long-term solution is on the reform agenda, it is unclear what will be the future direction.

At the root of the problems with the allocation of VAT revenue among provinces is the derivation-based system. International experience, as discussed in Chapter 5, shows that allocation on the basis of either consumption or equalisation formulas is superior to an origin-based system. Since VAT raises the biggest share of the revenue after the BT-to-VAT reform,[439] allocating the entire local share based on equalisation transfers would not be acceptable to richer provinces.

The realistic option for China is therefore to change the origin-based system to a consumption-based system. Among the existing models, clearing house appears to be the best to allocate revenue between sub-national jurisdictions with no authority to set rates and determine base. While the extensive use of reduced rates and exemptions will rule out the option to allocate on the basis of consumption statistics, the VAT revenue will have to be allocated via a clearing house on the basis of invoices for each transaction.

This will necessitate adoption of a set of proxies for determining the place of taxation for domestic cross-border sales. The place of taxation for B2B taxable supplies is less important because the revenue collected on a supply will be later paid out from the central clearing house as an input credit for the purchaser. It is nevertheless important for B2C supplies and exempt supplies for the purpose of correctly allocating the revenue among provinces.

The place of taxation rules will need to be drafted in a way that they have to specify which jurisdiction is the place of taxation (as is the case in the EU), rather than just

[439] VAT accounted for 39 per cent of the total tax revenue in 2017. See, The Press Office of the Ministry of Finance, 'Report on the Press Conference of the Ministry of Finance on Revenues and Expenditures in 2017' (*Ministry of Finance of the People's Republic of China*, 25 January 2018) (in Chinese) < http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/201801/t20180125_2800163.htm> accessed 2 August 2018.

determining whether the place of taxation is in or outside the jurisdiction (as is the case in almost all other countries). The EU approach is different from all others because the EU uses a single set of place of taxation rules for both intra-Community and international cross-border sales. For the purpose of intra-Community sales, place of taxation rules need to predict the place of consumption. The place of taxation rules in other countries are used only for international cross-border sales. As a result, countries are not concerned where the place of taxation is as long as they know a supply is an export from their own jurisdiction so that they can apply zero-rating to the supply.

The EU approach is the preferable model for China to follow. Use of a single one set of rules for both domestic and international cross-border supplies will simplify both enforcement and compliance. If China were to shift to the EU approach, the place of taxation rules for international cross-border sales will need to be amended as currently they only determine whether the place of taxation is in or outside the country.

The proposed clearing house system may increase the compliance burden for some taxpayers as suppliers will be required to provide the information on place of consumption in their returns. The additional burden should not be a concern, however, because the place of consumption can be easily identified for most types of supplies. Inaccuracy and mistakes in the course of enforcement and compliance can be tolerated for B2B supplies. Tax officials will need to spend more auditing efforts on B2C supplies in terms of the place of consumption.

Although the clearing house system was first adopted in the EU, it could be applied with greater ease and efficiency in China. First, there is no diversity in terms of rates and base among sub-national jurisdictions. Taxpayers' compliance burden could be lower compared to that under the EU's hybrid destination basis clearing house system because taxpayers in China do not need to deal with different rate systems depending on where the customers are. Second, the VAT is administered by the national tax administration in China. Incentive asymmetry between sub-national governments observed in the absence of an overarching tax administration as discussed in Chapter 5 would therefore not to be a problem in China.

8.2 International cross-border issues

8.2.1 Exports

The world's VAT systems have settled on a standard for cross-border sales, providing full relief from taxation in the source country to leave room for full taxation in the destination jurisdiction. China's VAT treatment of exports is like no other. Some exports are fully taxed, others are taxed but at lower than standard rates, and a third group bears no output tax. Different types of exporters may be entitled to input tax credits for all input tax incurred to make some exported supplies, partial input tax credits for other supplies, and no input tax credits for others still. Firms that make both export and domestic sales may be entitled to refunds of a portion of excess input tax credits and required to carry forward the remainder. The complicated landscape is further confused by misleading terminology and complex calculations embedded in the rules that govern the jumbled export regime.

The significant departures from a conventional VAT system are attributable to two principal legacies. The first is the legacy of path dependency. As noted in Chapter 6, the immediate predecessor version of the current tax was to a large extent a VAT in name only, more closely resembling the earlier turnover taxes from which it evolved than a modern VAT. In the view of the designers of the present VAT, however, that tax and its forerunners were sound prototypes for the current law and many norms established in those taxes can be found in today's rules. The second is the legacy of socialism. Prior to the gradual shift to a market economy commencing in 1979, Chinese socialist leaders were convinced that central planners could allocate capital more effectively than an unconstrained market. More than traces of that view remain today. Tax is not regarded merely as a vehicle for raising revenue but rather as a tool for manipulating the economy and directing investment to sectors those following in the footsteps of former central planners intend to promote.

As with almost all VAT laws, the Chinese VAT legislation designates a zero rate for exports to remove tax from export sales. The law was only implemented as drafted for one year, however, as immediate revenue needs trumped policy soon after the law was adopted. The operational assumption since then, following the precedent of the predecessor turnover tax locked into the mind-set of VAT designers, has been that any entitlement to input taxes and any rate for export sales less than the ordinary domestic rate are concessions. Consistent with the enduring heavy hand approach to economic management, authorities often modified entitlement to input tax credits and rates of VAT imposed on exported goods, with differential adjustments across different sectors of the economy, as they shifted economic objective priorities.

The policy of favoring particular industries with lower export tax rates or higher input tax recoveries regularly runs into revenue constraints attributable to China's unique central-provincial governments tax allocation system. Selective relief from the export tax burden for some industries can therefore only be accomplished if higher tax obligations are retained for exporters in others. Both sides of the coin interfere with the market by putting some exporters at a competitive disadvantage to others. In all cases, since exports enter the global market with a tax element included in the price, exporters face a competitive disadvantage when compared to international competitors that export tax-free supplies. A review of the evolution of export VAT policy explains China's deviation from the destination principle.

8.2.1.1 Evolution of export VAT policy

1984-1993

When the VAT was introduced in 1984, it provided no universal exemption for exports but both the VAT and Product Tax laws authorised the State Council to exempt from tax products "encouraged for exports".[440] In all other cases, export sales were treated similarly to domestic sales with full tax on sales and an entitlement to input tax credits on selected acquisitions. Where input tax credits exceeded output tax liability for domestic and export sales, the excess input tax credits could be carried forward but no refunds were allowed.

Following the adoption in 1985 of the "export refund" policy, intended to boost exports and increase foreign currency reserves, exporters were entitled to refunds of tax on inputs attributable to export sales. In the case of the Product Tax, only the tax on immediate acquisitions was refunded. In the case of the VAT, taxes at previous stages

[440] Regulations of the People's Republic of China on VAT (Draft) (1984), art. 11 (1); Regulations of the People's Republic of China on Product Tax (Draft) (1984), art. 7 (1).

of production had been recovered through the ordinary VAT mechanisms. The policy shift created a sharp divide between exporting companies entitled to refunds of excess input tax credits and domestic sellers required to carry forward any excess input tax credits. The refunds to centrally- and provincially-owned enterprises were paid with the budget revenue of central and provincial governments respectively.

The gradual merger of the Product Tax into the VAT over the next few years brought full relief for taxes levied at previous stages for transferred goods. From 1988, exporters subject to the Product Tax were provided with equivalent treatment by means of a deduction for estimated unrecovered tax embedded in the price of acquisitions. At the same time, the financial responsibility of paying refunds was shifted entirely to the central government.

1994-1996

In the 1994 reform, the Product Tax disappeared completely when all remaining subjects of that tax were transferred to the VAT which extended to all production, wholesale, retail and import stages. The VAT law explicitly “zero-rated” exports but reserved a power to the State Council to revoke the application of the zero rate on a case-by-case basis.[441]

The concept of zero-rating exports in China was considerably different from international practice. As in other countries, zero-rated supplies were taxable supplies (although no tax was actually collected as a result of the zero rate) and exporters were entitled to claim input tax credits on acquisitions used to make the supplies. However, the VAT law did not provide any input tax credits for VAT included in the cost of acquisitions of capital assets or for BT included in the cost of acquisitions of services. These restrictions applied to all enterprises making taxable supplies, whether the supplies were sold into the domestic or export markets.[442]

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[441] Provisional Regulations of the People’s Republic of China on VAT (1993).
[442] Entitlement to input tax credits for tax on acquisitions of capital assets was allowed in some regions in 2004 with coverage widened to further selected regions in several steps over the next five years. In 2009 the government extended entitlement nation-wide.

While the refund of input tax no doubt was an important factor behind the growth of exporting industries, the rapid increase in exports imposed a significant fiscal burden on the central government. It was to be expected that tax collections would fall as a proportion of GDP as exports grew as a proportion of the national economy. However, the relative decline in VAT collections and more importantly the rate of VAT refunds outpaced the relative growth of exports.[443]

Three reasons have been suggested for the fiscal shortfall. The first is proliferation of refund-related fraud,[444] which is a risk in all VAT systems but was a particular acute problem in China due to the weak administrative capacity. The second is a discontinuity between refunds claimed based on the nominal tax rate that applied to inputs and the actual tax paid as a consequence of concessions granted by lower-tier governments.[445]

The third, and it appears the most profound, reason is a mismatch between the central and provincial governments in terms of tax collection and tax refunds.[446] When the VAT was redesigned in the course of the 1994 tax reform programme, the central government agreed it would retain only 75 per cent of the VAT revenue from domestic sales and allocate the remaining 25 per cent to provincial governments. VAT revenue collected from imports is retained fully by the central government while the cost of input tax credits claimed by importers in respect of that import VAT is borne partially by the provinces as the net VAT they share is reduced by the credits. This mismatch on the import side was countered by a mismatch on the export side when the central government was solely responsible for the payment of VAT refunds to exporters. The tax being refunded were retained by the provinces to the extent that revenues from the earlier supplies had been shared. The countervailing cross subsidies should largely have resulted in a wash if imports were of a similar value to exports but when exports grew rapidly, the cost to the central government rose quickly.

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443 See, The State Council, Notice of the State Council concerning Lowering Export Refund Rates and Enhancing Administration of Export Refund, Guo Fa Ming Dian [1995] No. 3.
444 Z. Cui, 'China's Export Tax Rebate Policy' (2003) 1 China: An International Journal 339.
445 *Ibid.*
446 'The Ministry of Finance, the Ministry of Commerce and the State Administration of Taxation Answered Questions from Journalists regarding Reform of the Central- Provincial Governments Export Refunds Sharing Mechanism' (2006) (in Chinese).

The zero-rating of exports consequently became a very short lived phenomenon and was replaced the following year by a dual track regime that increased the tax burden on exports for all exporters, with separate rules for production companies that exported their wares directly and trading companies buying and exporting goods produced by enterprises that lacked export licenses to sell directly. Trading companies were entitled to a zero rate for exports but were subject to limitations on their entitlements to input tax recovery. Production companies continued to be entitled to ordinary input tax credits but sales were subject to VAT at reduced rates. The reduced entitlement to input tax credits available to trading companies and the reduced rates imposed on exports by production companies were calculated by reference to an export adjustment factor.[447] A single factor was used to calculate both the discount from the standard rate available to production companies and portion of input tax that can be claimed by trading companies. Thus, as the export adjustment factor reduced, the VAT rate imposed on production companies increased and the portion of input tax that could be claimed as credits by trading companies fell.

The starting point for export adjustment calculations was full taxation for exports by production companies and no recovery of input tax credits by trading companies. The initial export adjustment factor system adopted in 1995 was generous. The factor was 14% for goods to which the standard rate applies and 10% for goods to which the lower concessional rate applies. Subject to some small adjustments in the calculation formulas, the effect was to reduce the standard rate and the concessional rate to 3% for production companies and increase the input tax recovery rate for trading companies to 14% and 10% for both standard rate and concessional rate supplies.[448] The fiscal burden of exports on the central government remained high, as a consequence, and in January 1996 the export adjustment factor for exports of goods subject to the 17% standard VAT rate was reduced from 14% to 9% (yielding approximately an 8% output rate for production companies and a 9% input tax recovery for trading companies) while the

[447] While the system is understood in China, the unusual terminology adopted for the regime causes considerable confusion for foreign observers as virtually all foreign translations adopt the peculiar label "export refund rate" for the factor used to adjust the output tax levied on exports and input tax credits allowed to exporters. This section uses the term "adjustment factor", although official documents cited in it inevitably speak of the "export refund rate".

[448] The base to which the tax is applied for producers is not the tax-exclusive FOB (free on board) value of the export but rather a hybrid value that takes into account the value of exempt inputs. These are only rarely used by producers and are therefore of little consequence for most of these exporters.

factor for goods subject to the 13% concessional VAT rate was lowered to 6% (yielding approximately a 7% output rate for production companies and a 6% input tax recovery for trading companies).

1997-2011

Although the initial departure from the zero-rating rule was due to budgetary conditions, the government quickly moved to make VAT rules on exports an explicit tool of economic management. Starting with a principle that exports by producers should be fully taxed at ordinary rates and trading companies should not be entitled to any input tax credits on export sales, any export adjustment factor that reduced the rate of VAT on sales or increased entitlements to credits was regarded as an effective subsidy tool to direct investment and production in preferred sectors of the economy. Reflecting the State Council's view that deliberate biases and distortions could and should be used to support sectors favored by state economic planners, the across-the-board export adjustment factor applied to all standard rate or concessionally taxed goods was replaced by a host of differentiated adjustment factors varying from zero to the full VAT rate applicable to the products, at which point the tax was effectively reduced to zero. Goods falling into each adjustment factor were identified by reference to their customs commodity codes.

The 1997 Asian financial crisis significantly affected the performance of China's export sector. Responding to the external trade shock, the Ministry of Finance and the SAT, with the approval of the State Council, in 1998 increased the export adjustment factors for selected products.[449] The boost of export adjustment factors was extended to most types of goods in 1999.

The rapid increase in export volumes after the financial crisis had again led to fiscal shortfalls for the central government. One consequence of the budget difficulties was a continual delay in the payment of refunds to companies with excess input tax credits. At the heart of the problem once again was the unbalanced allocation of responsibility for paying refunds with the central government responsible for refunding almost the entire amount of tax that had previously been allocated in part to provincial governments. Two

[449] E.g., textiles and electromechanical and light industrial products.

important changes were made to the export tax regime in 2004 to relieve the fiscal burden faced by the central government. First, the adjustment factors were generally lowered for most products, in particular resources related and environmentally unfriendly products, to reduce the potential amount of total refunds. The adjustment factors for products favored by the government for export purpose remained unchanged, however. Second, a sharing mechanism was established to allocate the fiscal responsibility for paying refunds between the central and provincial governments. In 2004, the central government was responsible for 75 per cent of the total refunds that exceeded the actual refunded tax in 2003, while the provincial governments were responsible for the remaining 25 per cent. The division of liability for refunds of VAT on exports thus matched the ratio of entitlements of the central and provincial governments to the original collection of VAT later being refunded.

The 2004 changes enabled the central government to pay the backlog of refunds within a year but gave rise to another problem. The refund sharing mechanism exacerbated the cross-subsidisation problem across provincial governments. The VAT sharing system allocated the provinces' shares of revenue on the basis of where the supplier was registered, not where the customer was located. As a result, the province where the exporter was located often refunded VAT that had been paid to other provinces where the exporter's suppliers were located. Since exporters were mostly gathered in a few eastern coastal cities, the imbalance between input tax collections and refund payments was significant. Seeking to avoid making net tax repayments, some provinces resorted to administrative measures that restricted exports which contained inputs sourced from other provinces and the establishment of new export-oriented projects by foreign investors.[450] To address the economic distortions caused by tax-induced responses of provincial governments, the State Council adjusted the central-provincial refund responsibility ratio a year after it had been adopted with the central government responsible for 92.5 per cent of the refund amounts exceeding the amount of refunds in 2003.

[450] The State Council, Notice of the State Council on Improving the Central and Provincial Export Tax Refund Sharing Mechanism, Guo Fa [2005] No. 25 (Repealed by The State Council, Decision of the State Council on Repealing a List of State Council Documents, Guo Fa [2016] No. 38).

In 2006, the government expanded the use of export tax policy as a tool of economic intervention to achieve environmental and resource allocation goals, lowering the export adjustment factors (and hence increasing the tax burden) for products whose manufacture requires high energy consumption and products whose manufacture causes heavy pollution. In some cases the factors were reduced to zero and the products entered the global market subject to full taxation. At the same time, the factors were increased for high-technology products that were favored in line with state industrial policy.

Despite the changes, exports remained strong and an unprecedented trade surplus surge led to trade friction tensions with China's trading partners and increased international pressure for the country to cease pegging its currency and allow appreciation of the Yuan. VAT changes were included in the strategy adopted in 2007 to dampen the trade surplus and deflect calls for a floating currency.[451] The export adjustment factors were reduced to zero, removing any entitlement to input tax credits, for a further 553 items whose manufacture was associated with high energy consumption or environmental degradation and the adjustment factors were lowered for 2268 products considered vulnerable to trade frictions.

The policy of increasing taxation to slow the flow of exports was largely reversed with the onset of the 2008 global financial crisis. The government's response to the crisis was an unprecedented increase over a number of occasions of export adjustment factors applying to thousands of items.

2012-2017

Unlike the VAT applicable to goods, the BT applicable to services was a pure turnover tax with no special rules for exports and no provision for input tax credits for acquisitions. Exported services thus bore the full burden of BT in the same manner as domestic sales of services.

[451] 'The Ministry of Finance Answered Questions from Journalists regarding Changes to the Export Refund Policy: The Aim is to Reduce Trade Surplus' (*Sina*, 19 July 2007) (in Chinese) <http://finance.sina.com.cn/guonei/hgjj/20070619/16073704777.shtml> accessed 5 August 2018.

The reform that merged the BT into the VAT provided an opportunity for China to move closer to the benchmark and remove discrimination against exported services. The opportunity was lost, however, when the new rules characterised most exported services as "exempt" supplies rather than zero-rated supplies. Both exempt and zero-rated supplies are exempt from tax on sales but only enterprises making zero-rated exports are entitled to input tax credits to recover the tax paid on acquisitions. In some circumstances, therefore, enterprises making exempt supplies of services could bear higher tax burdens than producers making taxable exports but entitled to full input tax credits and in almost all cases they would bear higher tax burdens than trading companies selling goods free of output tax and recovering a portion of their input tax.

An option was provided for exporters of zero-rated services that had been transferred from the BT to elect to have the services treated as exempt supplies, an election commonly made as a consequence of the often overwhelming compliance costs required to complete the complex procedures mandated in China to recover input tax on zero-rated supplies. More often than not, potential refunds were small relative to compliance costs, particularly in the case of service providers with high labor inputs and fewer taxed inputs.

The restricted application of zero-rating to exported services might be a result of revenue constraints faced by both the central and provincial governments as services shifted from the BT to the VAT. The constraints derived from three sources. First, the reform was carried out in the context of an economic downturn, with the GDP growth rate dropping from 10.6 per cent in 2010 to 6.7 per cent in 2016.[452] The economic slowdown was matched by a decline in the rate of growth of tax revenues, inhibiting further revenue reductions by way of zero-rating.

Secondly, the government wanted the tax reform to be largely invisible to the general public in terms of impact on consumer prices while business support was cultivated with promises that the tax burden would remain the same or be reduced. These goals

[452] 'GDP Growth (Annual %)' (*The World Bank*) <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=CN> accessed 5 August 2018.

were accomplished by means of generous concessions for commonly used services that left little room for further revenue losses.

Third, the central and provincial governments have not yet been able to agree on a final revenue sharing arrangement following the shift of services from the BT to the VAT. The BT was the main source of revenue for provincial governments, with close to 100 per cent of the tax revenue retained by provincial governments under the tax sharing system adopted in 1994. Shifting the tax into the VAT, which was divided between provinces and the central government on a 25:75 basis in favor of the central government, involved delicate political compromises. Had the formula remained the same, provinces would have seen their total share of revenues drop significantly. The temporary solution adopted during the reform allocated all VAT revenue collected from the tax base that was shifted from the BT to provincial governments for the duration of the transfer process. In 2016, when the last services were shifted to the VAT, another temporary solution was adopted, providing for a 50:50 split of all VAT revenue between the central and provincial governments. That agreement is set to be reviewed in “two to three” years. Until a long-term agreement is reached and future revenue entitlements become more certain, both the provincial and central governments are likely to be wary of any extension of the scope of zero-rated supplies.

Revenue constraints alone may not explain the decision to characterise the bulk of exported services transferred from the BT to the VAT as exempt supplies, with a much smaller group treated as zero-rated supplies. To offset the decline in the manufacturing sector in recent years, the government is pursuing policies to increase the size of the service sector and the selective application of zero-rating quite likely reflects the government’s view that the designated services merit preferential tax treatment. The emphasis in the designated services list is on high technology and similar services.

The sharing of refund payments between the central and provincial governments was further adjusted in 2015. The actual amount of refunds paid by provincial governments in 2014 became an upper cap of provincial governments’ responsibility for paying refunds. Any refunds in excess of the cap are financed exclusively by the central government. The change appears to be aimed at providing incentives for provincial governments to encourage export growth. It remains to be seen if the new sharing structure is a sustainable solution given past experiences that a higher burden for the central government can cause fiscal difficulties in times of significant trade surplus. The doubling of provincial governments' share of VAT revenues no doubt exacerbates the risk.

8.2.1.2 The export refund myth

The VAT treatment of exports in China is both complicated and, as a consequence of imprecise terminology, confusing. The complexity is largely attributable to the use of four separate regimes that apply in parallel to exports. The rules for producers exporting wares directly, as noted, impose tax ranging from zero to the full tax rate on sales and provide input tax credits for all tax incurred on acquisitions. The rules for trading companies exporting goods acquired from others stipulate a zero rate of tax on their exports coupled with a restricted entitlement to input tax credits. Exported services are designated either as exempt supplies, bearing no tax on sale but providing no entitlement to input tax credits to the supplier, or as zero-rated supplies, bearing no tax on sale but granting the supplier full entitlement to input tax credits.

While the exemption rule for service exporters cannot give rise to a refund entitlement, the rules for producers exporting directly, trading companies exporting goods bought locally for export, and service providers making zero-rated exports can lead to a refund claim where input tax credits exceed output tax. In all cases, the right to refunds of excess input tax credits is capped if the exporter also makes domestic sales.

Two methods are used to determine refund entitlements, the "Exempt and Refund" (ER) method, also referred to as the "Levy First, Refund Later" method, and the "Exempt, Credit, Refund" (ECR) method. The ECR method used by production companies and service providers making zero-rated supplies is complex, taking into account exempt acquisitions and domestic and export sales. The ER method applicable to trading companies is the simpler of the two, mainly because it is assumed that normally trading companies do not make domestic sales.

Under the ER system, no tax is payable on export sales by a trading company but limits are imposed on the entitlement of these exporters to input tax credits for VAT on purchases. The extent to which input tax credits can be claimed will be determined by the export adjustment factor (the so-called "export refund rate") for each category of goods sold. The input tax credit is calculated by multiplying the adjustment factor by the VAT-exclusive purchase price. The trading company cannot recover any difference between the input tax credit after application of the adjustment factor rate and the actual VAT imposed on acquisitions. However, the full credit to which it is entitled will be refunded as the formula assumes trading companies have no domestic sales.

Prior to 2002, the ER method was also used for production companies that did not have their own import and export licenses and which consequently exported their products through "agents" such as trading companies or other production companies that held export licenses. The "agents" did not take the ownership of the products to be exported, but charged a commission for the export channel. The ER treatment for these producers were removed in 2002 when they were brought into the ECR regime.

In a sense, the ECR – exempt, credit, refund – title appears ill-suited to describe the full VAT system applied to producers exporting goods as the initial consequence of an export sale is a liability to pay VAT on the export. Only if the adjustment factor reduces the output tax rate to zero will there be no tax on the sale. The title is accurate in terms of its purpose, however, which is to calculate an exporter's refund entitlement where input tax credits from acquisitions exceed output tax payable on sales and the enterprise makes both export and domestic sales. While tax may be payable on exports, the ECR formula starts with the tax-exclusive price which is the value of the export had it notionally be exempt from output tax; hence the "exempt" in the formula. The difference between the ordinary rate and the adjustment factor is applied to the tax-exclusive export price and the resulting liability is added to the enterprise's liability to VAT on domestic sales. This figure is fed into the ECR formula which first segregates input tax related to exempt supplies and then allocate all remaining input tax between exported and domestic sales to determine which input tax can be refunded and which input tax must be carried forward.

One element of the formula excludes from the tax base the value of inputs used by the exporter that were exempt supplies to the exporter. The effect is an unusual policy outcome of extending the exempt nature of a supply through to a subsequent taxable supply. Generally, to the extent input tax credits exceed output tax, the portion of input tax related to exports can be refunded and the portion attributable to domestic sales must be carried forward to future tax periods. However, the formula brings a proportion of input tax attributable to domestic sales into the refundable portion of excess input tax credits, giving enterprises that make both export and domestic sales an advantage over enterprises that sell into the domestic market only. The latter group, as noted, must carry forward all excess input tax credits.

The adjustment factors used to determine the rates imposed on some export sales and restrictions on input tax credits available for others are essential elements of both the ER and ECR calculations. Describing the adjustment factors as “export refund rates”, their official title, causes some confusion for external observers. While both the ER and ECR methods include steps in which the adjustment factors affect calculations, in neither method do the so-called “export refund rates” directly determine the amount of refunds. Only for trading companies is the refunded amount usually equal to the input tax allowed by the “export refund rate”.

8.2.1.3 The future: a destination-based VAT?

China’s deviation from the destination principle applied in almost all other VAT regimes reflects the government’s policy of using the tax system as a lever of economic management. Differential rates for different types of supplies seek to encourage investment in preferred sectors of the economy and achieve a range of social, economic and environmental goals. At the same time, tax burdens are adjusted in response to domestic political and budget constraints and international trade pressures, increasing when the government faces budgetary pressures and decreasing in times of external economic shock.

The impact of the Chinese government’s export tax policy on export performance has been examined by both international trade scholars and economists. Investigations of the relationship between output tax rate and input tax entitlement adjustments, on the one hand, and export volumes, on the other, have yielded inconsistent results, with some scholars finding a positive impact of reduced export taxes and increased input tax entitlements on export growth generally[453] and others suggesting impacts are limited to particular sectors.[454] Studies discounting the impact of tax suggest other exogenous factors, particularly exchange rates, demand and other input factors have a greater effect on export volumes.[455] At the end of the day, rising labor costs may prove to be the most important factor. The wisdom of using export tax policy to achieve the government's economic goals is unclear.

The important question, perhaps, is not whether selective reductions in tax burdens for some goods have promoted exports of these goods but rather whether over-taxation of almost all exports, some to a greater extent than others, has had a negative economic impact compared to what might have been the outcome if the international norm had prevailed and all exports been free of VAT. China's significant trade surpluses with its largest trading partners suggest the tax burden on exports has had little direct effect on the competitive position of Chinese exporters. The apparent limited impact of over-taxation may mask the true cost of the policy, however. The overall economic benefits may have been far greater if the alternative to limited concessions were not full taxation but rather no taxation on exports and investment capital allocation and production decisions had been made in the absence of tax biases.[456]

In the short term, any benefit from the pursuit of neutrality in the tax system might be outweighed by the impact of the many other tools the Chinese government uses to manipulate the market such as exchange rates and monetary and trade policies.[457] In the longer term, however, as the economy moves further towards a market economy and industries lose access to less expensive funds from state-owned banks while facing increased labor costs and infrastructure charges, it must be asked whether China can still afford the risk of tax-induced misallocation of resources and any over-taxation of

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453 See P. Chandra and C. Long, 'VAT Rebates and Export Performance in China: Firm Level Evidence' (2013) 102 Journal of Public Economics 13; J. Gourdon and others, 'Incomplete VAT Rebates to Exporters: How Do They Affect China's Export Performance?' (CEPII Working Paper, 2014).
454 C. Bai and others, 'Empirical Analysis of the Impact of Adjustments of Export Tax Policy on Export Performance in China' (2011) 10 China Economic Quarterly 799 (in Chinese).
455 See, e.g., Z. Wang and Y. Chen, 'Empirical Investigation on the Impact of Adjustments of Export Tax Policy on Export Performance in China' (2009) International Taxation in China (in Chinese).
456 See, e.g., Chandra and Long, (n 453) 22.
457 W. Cui, 'Indirect Taxation of Cross-Border Services in China: (Partial) Switch to Destination-Based Taxation' in Lang, Melz and Kristoffersson (eds) (n 286); J. Whalley and L. Wang, 'Evaluating the Impure Chinese VAT Relative to a Pure Form in a Simple Monetary Trade Model with an Endogenous Trade Surplus' (NBER Working Paper 13581, 2007).

the export sector. Alignment of China's VAT with the internationally prevailing destination principle can protect the competitiveness of Chinese exporters.

With the adoption of zero rating for a limited range of exported services following their shift from the BT to the VAT, the government has signaled its recognition of the importance of following international practice and operating the tax on a destination basis. As market principles advance, the most significant impediment to further reform may not be ideological but rather fiscal, in particular the constraints posed by China's unique revenue sharing arrangements. The cycle of reforms followed by staged returns to past practices demonstrates well the problems. If the central government undertakes the entire responsibility for paying refunds, the mismatch between its share of revenue and its refund obligation will lead to budgetary problems in times of trade surplus. If the responsibility for paying refunds is shared between the central and provincial governments, the cross-subsidisation problem among provincial governments will be revived, inducing exporting provinces to discourage export activities. Central to the problem is the origin basis system used to allocate revenue between provincial governments. Any move towards a destination-based VAT will require a fundamental change to this system, shifting the place of taxation from the location where a business is registered to the place of consumption. Reform of China's export tax regime must truly begin at home.

8.2.2 Imports

Chinese VAT rules for imports generally align with international practice. Import of goods other than low value goods is taxed in the same manner in China as in many other countries. VAT is collected at the customs border, in conjunction with the customs duty, by the customs authority.

8.2.2.1 B2B

Tax on imported services by registered businesses was first imposed under the VAT following the BT-to-VAT reform, when the services were shifted from the BT to the VAT. Since the BT did not apply to imports, no tax was imposed on imported services until the recent reform. Services imported by registered businesses are taxed under a withholding mechanism, as opposed to the reverse charge system used in many countries. In theory, under the withholding tax system, the service provider rather than the importer bears the tax which is unrecoverable for the service provider. To avoid this outcome, suppliers must negotiate gross-up clauses in contacts when they sell to Chinese purchasers to ensure the payment they actually receive net of the withholding is the pre-tax amount expected for the supply. A recent survey of VAT/GST treatments of cross-border services found China to be one of the three countries (the other two are Russia and Vietnam) that uses a withholding system.[458] The international survey concluded that withholding systems tend to be more commonly used among communist or socialist countries with currency controls. In China, the withholding of taxes is a precondition for currency clearance.[459]

8.2.2.2 B2C

There has been a rapid growth of cross-border shopping by consumers in China in recent years. The strong demand for imported goods in China, however, cannot be explained in the same manner as in other countries. China's demand for foreign products has been centred on two main categories: first, daily supplies including beauty and personal care products and food and healthcare supplements and second, luxury goods. Demand for daily products is primarily driven by consumers' concerns over food safety and counterfeit products in the domestic market.[460] Chinese consumers' desire for purchasing luxury goods from abroad is mainly due to the large price differences, with prices of luxury goods in mainland China marked up to prices 40 per cent higher than those found in overseas markets.[461]

Chinese shoppers purchase foreign products via four channels:

1) overseas websites;
2) "daigou" shoppers, mostly Chinese students and immigrants in foreign countries purchasing commodities and selling them to customers in mainland China for a profit;

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[458] KPMG, (n 310) 20.
[459] KPMG, (n 310) 20.
[460] Fung Business Intelligence, 'Cross-Border E-Commerce (Import)' (Spotlight on China Retail- Issue 7, March 2017) <https://www.fbicgroup.com/sites/default/files/SCR2017_Issue7.pdf> accessed 24 July 2018.
[461] S. Shannon, 'On the Floor with the Daigou, China's Overseas Shoppers' (*Financial Times*, 26 September 2016) <https://www.ft.com/content/0e0c6a36-330c-11e6-bda0-04585c31b153> accessed 24 July 2018.

3) dedicated domestic online import platforms;
4) other domestic online retailers or bricks and mortar retailers selling imported goods.

The first, Chinese customers venturing into international purchases sought to purchase products directly from overseas suppliers via their websites. There were, however, only a limited number of overseas suppliers that shipped products to China. Unfulfilled consumer demand led to the rise of the daigou industry (the second channel), with overseas Chinese entrepreneurs in effect acting as agents for Chinese customers, buying goods online or in shops and forwarding the items by post or courier to customers in China. While the industry accounts for a remarkable share of B2C imports, the unregulated market has exposed problems with tax evasion and consumer fraud.[462] The daigou shipments are associated with tax evasion based on false descriptions or valuations on parcels forwarded to China. The third channel, known as cross-border e-commerce in China, emerged as a new import channel with the government support. Technically, the commercial arrangements with the third channel are not different from the fourth channel. The domestic platforms, approved by the government, import products and on-sell them via their platforms, making domestic sales to customers. However, authorities allow these retailers to act in effect as agents, treating sales as imports by customers. The online platforms become the mainstream channel for Chinese customers to purchase daily supplies, whilst luxury products are mainly bought through daigou shoppers in the hope of avoiding high customs and excise taxes in addition to VAT.

As is the case in most other countries, China applies an exemption threshold to B2C imported goods of low value. The VAT, excise tax and customs duty are not collected on goods where the total of the three taxes is less than RMB 50 (approximately £5.7). Since the exemption offers an unfair advantage to overseas suppliers, it was considered as an important factor that leads to the rapid growth of cross-border online shopping from China in recent years.[463] It was also found that the exemption has been abusively

[462] Fung Business Intelligence, (n 460) 7.
[463] 'New Tax Regime Launched for Imports through Domestic Online Platforms' (*Ministry of Finance of the People's Republic of China*, 25 March 2016) (in Chinese) <http://www.mof.gov.cn/zhengwuxinxi/caijingshidian/jjrb/201603/t20160325_1923548.html> accessed 10 August 2018.

used by domestic online platforms, whose sales are treated as B2C imports.[464] Evidence emerged of platforms splitting orders into lower value ones to take advantage of the low value goods exemption and in 2016 the government removed the exemption for purchases made via domestic online platforms. The platforms continued to be treated as agents rather than importers and resellers but a concession equal to 30 per cent of the VAT and excise tax payable and 100 per cent of the customs duty was adopted for goods with a value of less than RMB 2,000. Platforms are required to report purchases by customers and are informed when the value of total annual purchases of imported goods via these platforms by each customer reaches RMB 20,000, at which point the concession ceases.

The new rule adopted in 2016 removed the incentive for domestic online import platforms to split parcels so each part fell within the exemption. At the same time, however, in effect it reinforced the advantage of domestic online import platforms over other domestic retail and wholesale importers. In the absence of any cost-benefit analysis, the measure is difficult to rationalise apart from a programme to favour this form of retailing over all others or, assuming the concession is passed on wholly or in part to consumers, to subsidise the select group of customers who bypass local retailers and purchase imports online. This later explanation has been endorsed by the government which has labelled the measures a concession given to individual purchasers for a reasonable quantity of imported goods for personal use.[465] It may be the case that the government wished to avoid a possible consumer backlash by retaining a lower cost avenue for customers seeking imported products in lieu of local products that have generated safety and quality concerns.

Language and payment constraints have limited direct purchases from foreign websites and no special measures have been introduced to ensure VAT is paid on low value imports sourced in this way. The government has responded to the daigou phenomenon with enhanced customs inspections, although it remains uncertain how effective this has

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[464] *Ibid*.

[465] 'Customs' (*The State Council, The People's Republic of China*, 5 August 2014) <http://english.gov.cn/services/visit_china/2014/08/23/content_281474982975950.htm> accessed 24 July 2018.

been and no cost-benefit analysis has emerged to make it possible for observers to evaluate the response.

Digital services provided to final consumers in China by overseas suppliers are implicitly out of the scope of the VAT and no measures have been adopted to extend the VAT to this type of supplies. Under the current VAT rules, overseas suppliers are not allowed to register for the VAT in China.

The significance of these issues prompting legislative changes and debates may be exaggerated in China. For non-tax reasons authorities have developed effective means of screening incoming post and courier parcels. For the present, China is primarily the sender of low value goods, rather than receiver. Any measures to target the import of low value goods, however, should balance the revenue and collection costs.

Imported B2C services can be brought into the tax net by requiring foreign suppliers to register and remit tax in China, as has been done in, or is being considered by, a number of jurisdictions. The concern over compliance under the vendor model in other countries may be less of a problem in China. In other contexts, Chinese authorities have been shown to be very effective at controlling gateways to and from sources abroad and are thus probably in a better position than other jurisdictions to decide on and enforce the appropriate tax rules for enterprises that are allowed to provide intangible supplies into China.

8.3 Conclusion

China's VAT deviates from the destination principle in terms of both inter-provincial and international cross-border aspects. Domestically, the VAT operates on an origin basis to allocate revenue among provinces. The origin-based system creates a cross-subsidisation problem that augments regional inequality and provides incentives for provincial governments to engage in tax competition. These problems could be addressed if the revenue were allocated on the basis of place of consumption. An evaluation of existing models for allocating VAT revenue on inter-provincial supplies described in Chapter 5 suggests the clearing house mechanism would be the best model for China to use to shift to a consumption-basis system.

The export VAT rules sit far from the international norms as exports are generally not zero-rated in China. Two reasons explain the partial relief from tax on exports. First, the relief has been used by the government as an economic management tool. Second, the incomplete relief is a result of the government's revenue constraints. Recent move towards the destination principle in terms of exported services indicates that economic management objectives might have an increasingly smaller impact on the VAT policy for exports. Any fundamental reform in this area, however, would be subject to a successful renegotiation with the province of current agreements on responsibility for input tax on imports and sharing of the cost of refunds of VAT on exports. Design flaws in one area may restrict reform options for other areas.

CONCLUDING REMARKS

The VAT has been an important revenue source for over sixty years and the spread of VAT is likely to continue. While the design norms have endured, views on what constitutes a good VAT in practice are evolving, reflecting changing conditions in the wider political and economic environment, and the opportunities and challenges that technological developments and globalisation create for effective tax administration. The traditional VATs designed for an economy in the 1960s are increasingly unsuitable in the 21st century. Applying the theoretical benchmark to the real-world VATs becomes an ever more challenging task as policy makers are confronted with shifting political constraints, technical limitations and administrative difficulties in the fast-changing world.

In this context, this thesis develops a practicable benchmark that provides a starting point for policy makers and legislators to reconsider what a good VAT is and how to apply the theoretical benchmark to the design of a good real-world VAT. The thesis highlights five specific areas of VAT in which the application of the design norms – a single rate and broad base and the destination principle – raises difficulties.

The use of concessions that causes the VAT to deviate from the single rate, broad-based tax on consumption norm reflects political pressures and processes faced by law makers. The solution begins with greater transparency of factors that could inform policy decisions in this area, namely, the effectiveness of concessions and their revenue impact and efficiency implications, as revealed through a tax expenditure analysis. Where the removal of concessions is politically unattainable, concessions could be better targeted to reduce the negative consequences.

Issues arising from the application of VAT to small businesses relate to the excessive administrative and compliance burden relative to revenue collected. A broad-based VAT may not be the best choice where the administrative capacity is low. The optimal threshold should be set at the level where the revenue lost from excluding small businesses from the VAT is offset by administrative and compliance cost savings. Small business regimes, either for simplification or smoothing purposes, should be used with great caution as experience shows that they often do not achieve the intended objectives while incurring efficiency and revenue costs.

Financial supplies and insurance services are one of the few areas where it is technically difficult to apply the VAT and therefore require special arrangements. The best option to bring the sectors into full taxation is to use a separate (reduced) rate approach to tax intermediary loan services, a cash-flow model to tax insurance services and to categorise the issue and transfer of financial securities as zero-rated supplies.

International cross-border issues provide an example where technological developments create significant challenges to tax policy, legal drafting and tax administration. In particular, the rapid growth of cross-border sales of low value goods and services provided from abroad in recent years has forced policy makers to rethink how to collect tax on B2C imports. A few countries have unilaterally responded to the problem with rules requiring foreign suppliers and intermediaries to be liable for remitting the tax. Another challenge is how to refund the VAT incurred on business expenditure by non-resident businesses. The unilateral approaches, a registration system and a direct refund system, that are currently in use are grossly inefficient in removing foreign VAT embedded in the business cost. A better solution to both problems might be to seek for a higher level of international cooperation by using treaties as is done in the field of income tax. VAT on imported B2C supplies could be collected in the supplier's country and then transferred to the consumer's jurisdiction via a clearing house mechanism. Foreign VAT could be refunded by the resident country which would then be compensated by the country in which the VAT is incurred via the clearing house.

The design of VAT sharing in the context of federations or economic communities remains a technically difficult area in the VAT. No single benchmark is possible because appropriate design relies heavily on the political and structural factors in federations. The clearing house model appears to be the best option to distribute VAT revenue in most circumstances where sub-central jurisdictions have their own VATs, subject to an adequate level of technological and communication capacity.

While the practicable benchmark developed in this thesis takes into account commonly confronted political, administrative and technical difficulties, the political constraints and administrative capacities are not the same in any two countries and the benchmark thus has to be modified when applying to any particular country to accommodate local factors. The actual design of a real-world VAT system reflects not only features of the political, social, economic and administrative contexts in which it operates, but also a government's perception on the right balance between efficiency, simplicity and other objectives of a good tax system.

These difficulties are typically greater in developing countries, which explains their greater departures from the benchmark. China's VAT deviates from the benchmark in every aspect. Reduced rates and exemptions are used extensively. A turnover tax is still used in the small business sector. Non-recoverable VAT is imposed on B2B supplies in some cases and refund of excess input tax credits is generally denied. Domestically the VAT revenue is allocated among provinces on an origin basis. The international cross-border rules do not provide zero-rating treatment for exports.

The design of China's VAT is shaped more by political factors than VAT principles and benchmark norms. The deviations are mostly the result of unique political constraints. China has no doubt made significant progress towards modernising the VAT over the past few decades. The major VAT reforms have largely been responsive than proactive, however, promoted either by political agendas or carried out when the economic growth was seriously undermined by the negative consequences of the design flaws.

Although the gap between the current system and the benchmark is not small, a review of the current system suggests that in some areas it might be technically easier for China to move to the benchmark than in other countries. For example, it would be easier to apply the separate rate approach to intermediary loan services and the Australian simplified cash-flow model to general insurance in China than in traditional VAT countries where these supplies are characterised as exempt supplies. The Chinese experience with VAT and financial supplies shows that the tax replaced by the VAT also has an important role to play in the design of the VAT. Predecessor turnover taxes in Europe, for example, provided no stepping stone for a VAT solution, suggesting it will be more difficult to bring this sector into the VAT in Europe. The implementation of a vendor collection model to imported B2C services may also be easier in China than in other countries because of the wider regulatory environment.

Revenue constraints may nevertheless be a difficulty for further reforms in China. In particular, design flaws in one area of the VAT (for example, reduced rates and exemptions) may considerably limit the scope of revenue needed for reforms in other areas (for example, the small business regime and the financial sector). This may also be a problem in other developing countries. These countries should start from the removal of at least some concessions to raise the revenue capacity for reforms in other areas of VAT.

This thesis, along with the existing literature, seeks solutions to problems arise in the VAT. The problems, however, do not have an easy fix and the proposed solutions are not perfect. The practicable benchmark may be one of the best available solutions to the long-standing problems. Another approach that merits consideration for future research may be a fundamental rethinking of whether the VAT as it currently stands is the best form of consumption tax in a 21^{st} century economy. Many countries have in fact moved away from the logic of VAT by seeking retail sales tax-like solutions to VAT problems, including the use of reverse charge mechanism to tax cross-border sales and the use of B2B zero-rating or out of scope treatment in situations such as intra-group transfers, supplies of precious metals, and sales of going concerns. Is the VAT actually morphing into another tax and will that provide a better solution to taxing consumption?

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