FISCAL AFFAIRS

Designing a Progressive VAT*

2024 ATI GENERAL ASSEMBLY

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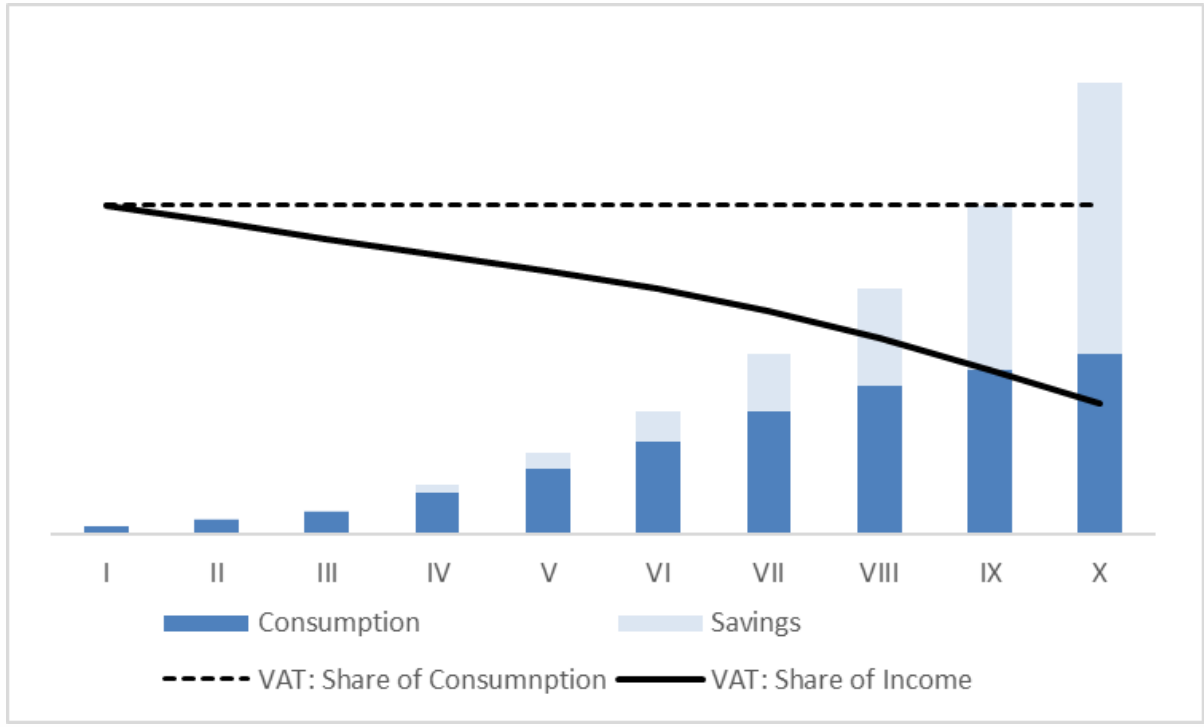
Context

- VAT a good revenue raiser
  – the most important tax in the world
  (almost 30 percent of all tax revenue)
- Nearly perfect tax but **seen as regressive**
- To address regressivity most countries resort to exemptions and zero-ratings:
  - Driving up policy gap and…
  - Foregoing substantive revenue,
  - With little impact on income redistribution

Stylized VAT incidence

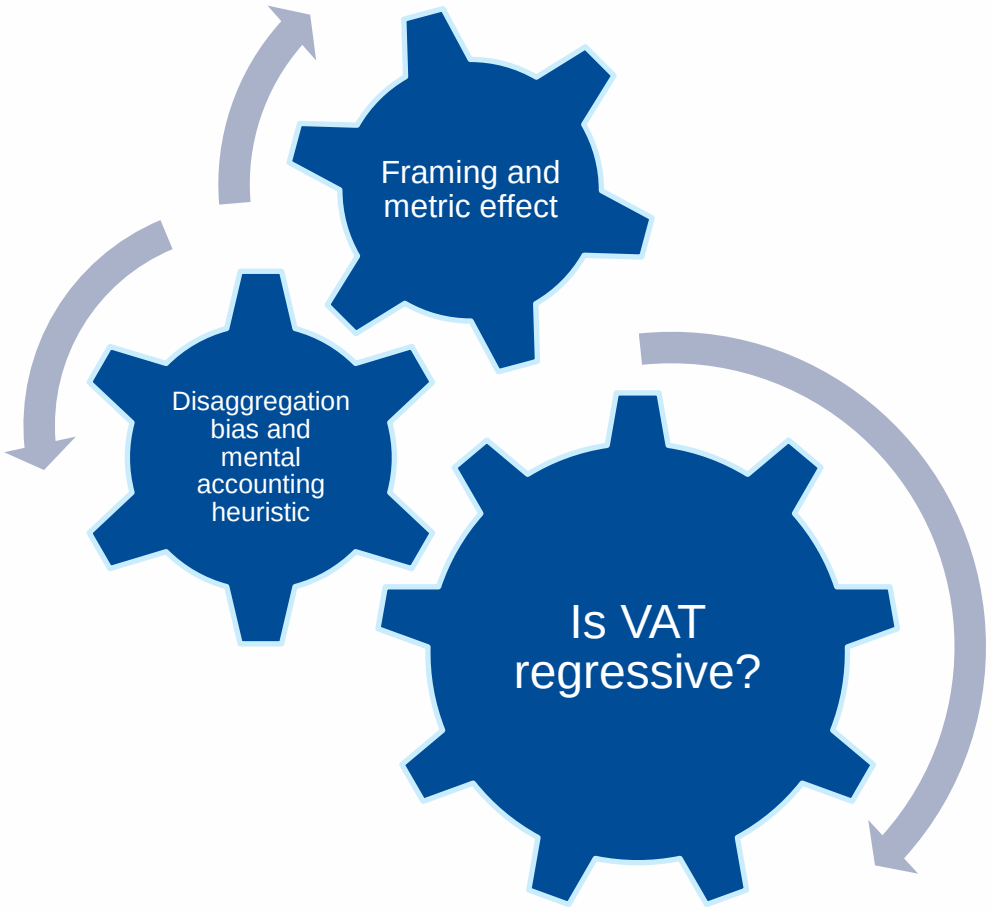


Context

- Countries tend to stick to the old European VAT model ("**Traditional approach**"), with few exceptions.

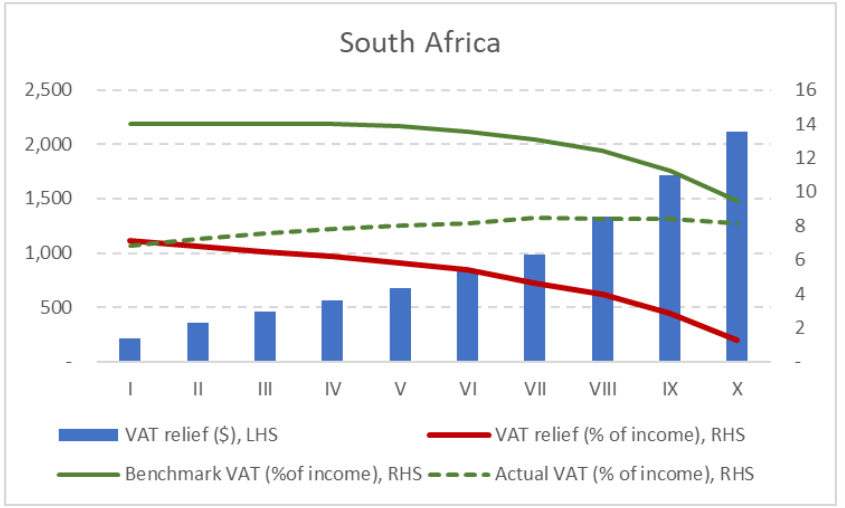
- Standard policy advice on how to address regressivity:
  - Broad base (and single rate) with…
  - (Targeted) transfers to low-income households

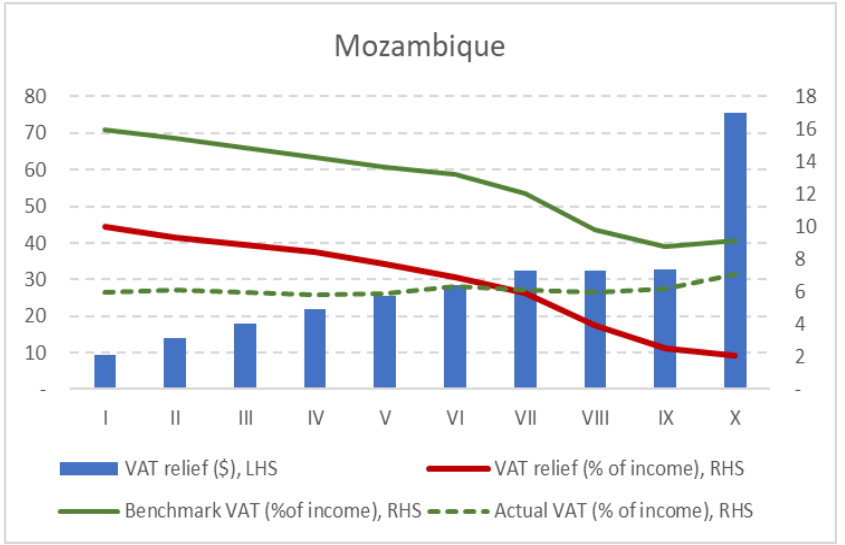
- However, take-up of this model ("**Modern approach**")—used since 1980s—has been limited
  - Challenge: disconnect between revenue and expenditure side of fiscal policy



Traditional Approach to Addressing VAT Regressivity: VAT reliefs

- Analysis of VAT incidence has grown in recent years
  - time and again it points to **inefficiency of VAT in addressing equity concerns**
- Most VAT reliefs granted on food (but they often go beyond that)
- Regressivity decreases slightly, but at very high revenue cost (most benefits accrue to top deciles)



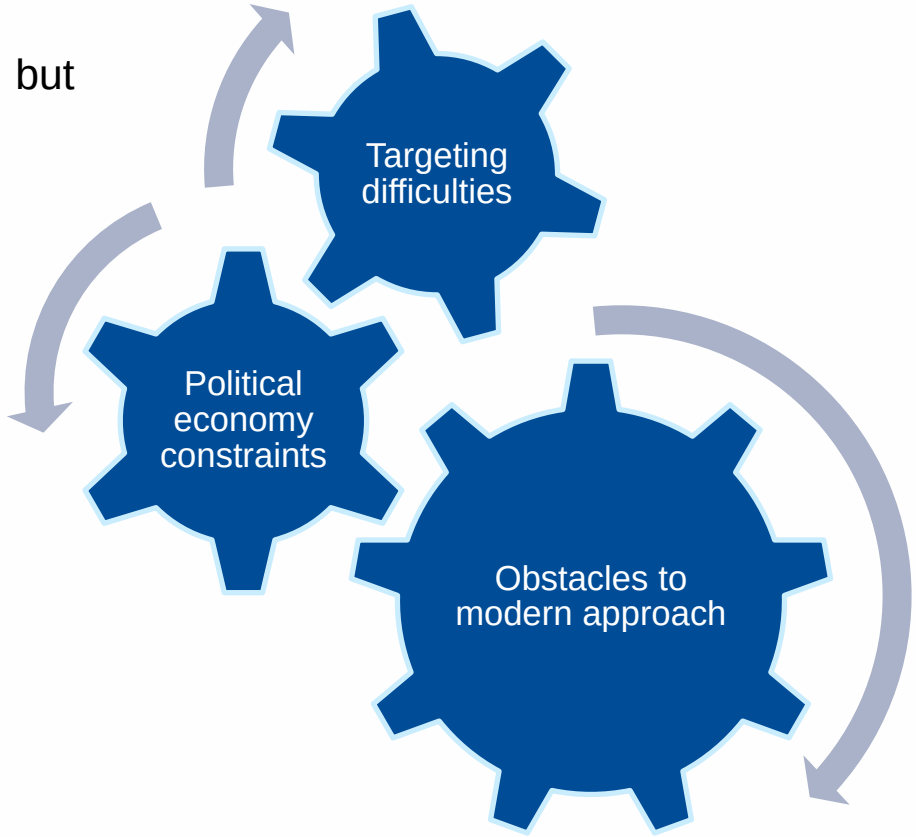


Modern Approach…: Transfers

- Addressing VAT regressivity through expenditure side rather than tax base
  - Compensation for removal of exemptions
- Superior solution—focus on overall fiscal policy (not the incidence of VAT only):
  - Recognizing the *in rem* nature of VAT
  - Loss of revenue undermines ability of public expenditure policy to carry out redistribution
- Mostly adopted in countries with newer VATs
  - Few countries adopted the purest approach, except for New Zealand
  - A hybrid system most common – some VAT reliefs still used
  - Sometimes complemented by tax side interventions—PIT credits (e.g., Canada) and deductions (e.g., Ecuador, Paraguay)

Why Modern Approach is not widespread?

- Targeting difficulties
  - So far, few available instruments, esp. in low-income countries, but improving
- Political constraints
  - Comprehension of proposed tax policy
    - Information asymmetry: VAT neither intuitive, nor salient
    - Lobbying/manipulation by special interest groups
    - Framing and fairness narrative
  - Trust in proposed tax policy
    - Cognitive dissonance
    - Status-quo bias and loss aversion
    - Skepticisms towards two-step policies
- Room for a “Progressive VAT”- granting a new benefit at the time when the old one is removed



Overcoming political economy challenges through harnessing digital technology

What is a Progressive VAT

Key features of our progressive VAT:

- Concept:
  - Not progressive *de jure*, but progressive *de facto*
  - Single rate / no exclusions from the base
  - VAT **returned in real-time** to low-income individuals
- Method:
  - Real-time software systems – data warehousing – used primarily for anti-fraud purposes (SK, Israel, Russia, Portugal, Uzbekistan) to identify LIH, and to return VAT paid
  - Mobile / digital money (Kenya, Colombia) – the impact of the pandemic experience

Progressive VAT: Key Design Features

Core Design Features

Tax Base	Compensation Mechanism	Payment Method
Broad-base tax: one rate, no merit exemptions.	Compensation for VAT paid by low-income individuals or households, at the moment of payment.	Real-time compensation through digital technology.

Optional Design Features

Compensation Mechanism		Payment Method
Subjective Scope	**Objective Scope**	
Unit of assessment: by individual; or by household. **Scope:** given to citizens on low incomes; or to all citizens, if targeting not possible.	**Scope**: targeted compensation to low income; or one standard payment (universal subsidy), if targeting not possible. **How much I**: if targeted compensation possible, what threshold level (e.g. only decile 1, or all up to decile 8); if targeting not possible (universal subsidy), how much. **How much II**: if targeted compensation possible, all paid VAT; or VAT up to a ceiling based on average consumption.	Through integrated personalised tax system, and centralised bank transfers, if possible; or through digital wallet / money, and mobile devices, if not possible to integrate banking system.

Three Design Scenarios

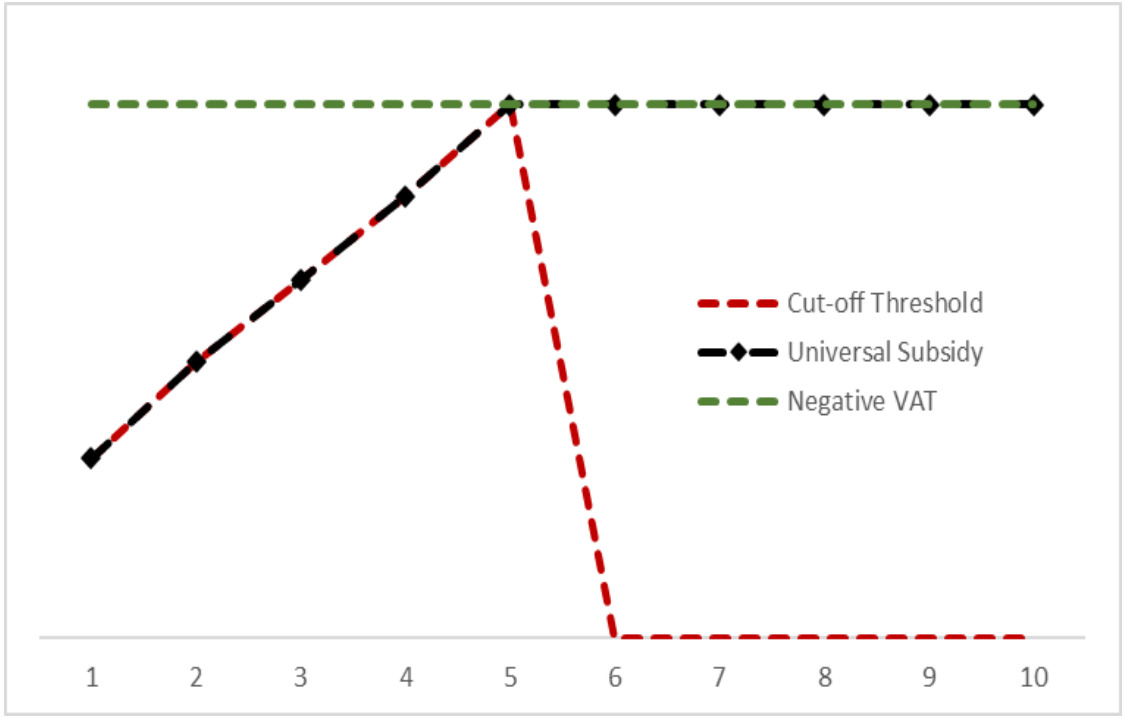
To calculate the revenue and distributional impact we consider 3 scenarios:

Scenario 1: a simple **cut-off threshold**, where households with income below a certain threshold do not pay any VAT (with tapering, if needed)

Scenario 2: a **universal subsidy** VAT where all consumers receive a VAT subsidy up to the threshold amount

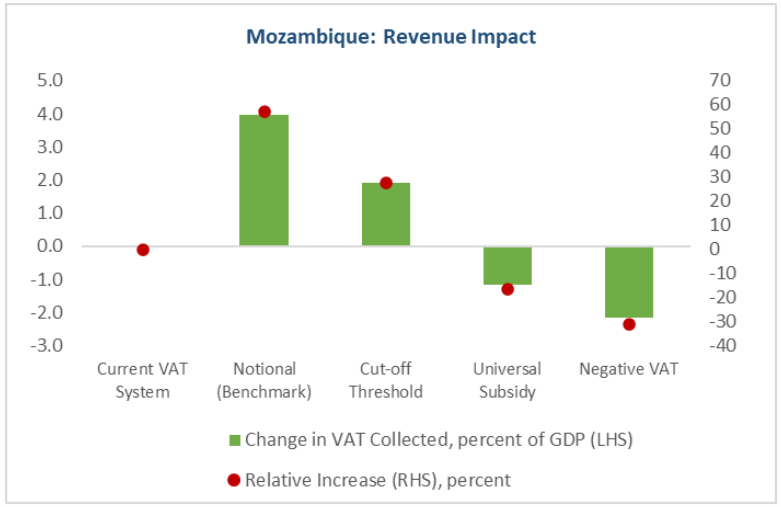
Scenario 3: a **negative VAT** where all consumers receive a VAT subsidy equal to the threshold amount, regardless of their income level

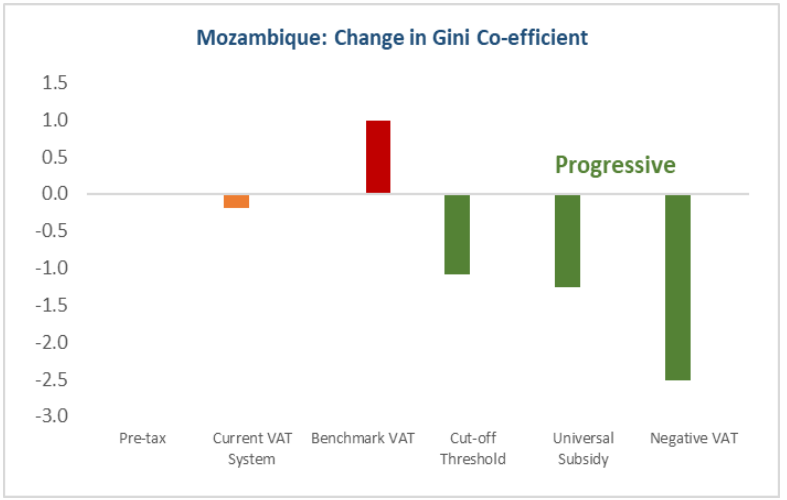
Stylized VAT subsidy amount

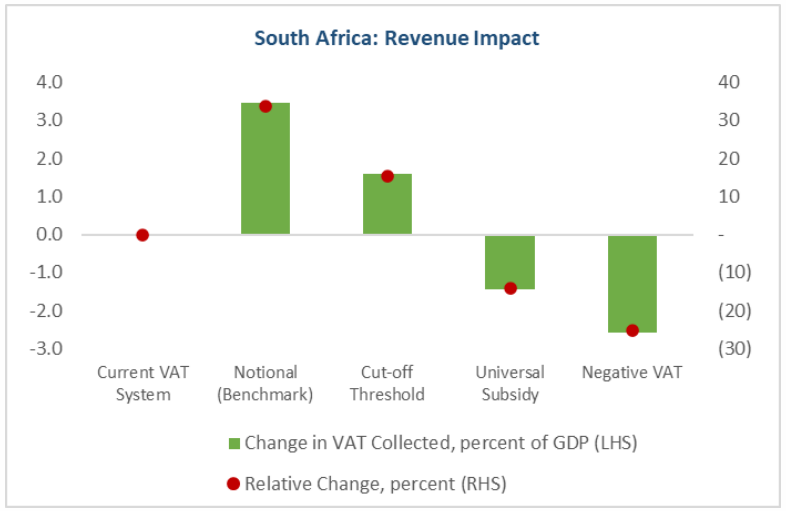


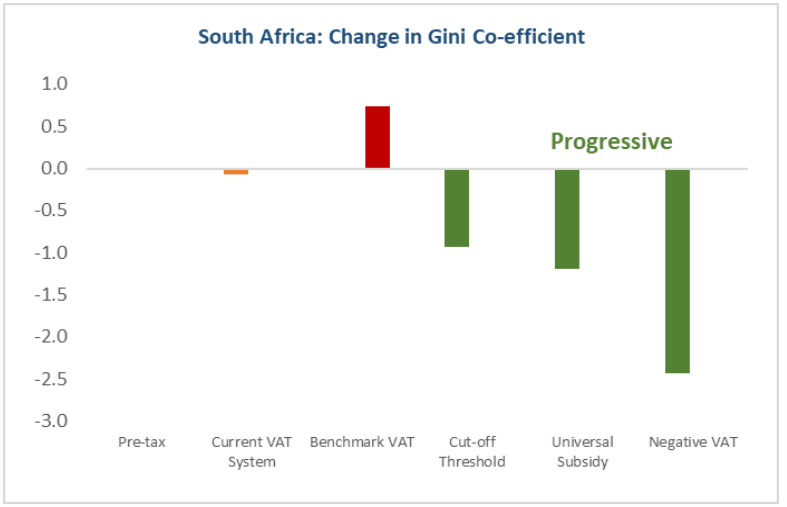
Results: Balancing Revenue and Equity Objectives

- Regardless of what option is taken, there's scope to improve progressivity compared to current VAT design
- Actual design needs to balance revenue and equity objectives: the more revenue is forgone, the higher levels of progressivity can be achieved
- Our preference: cut-off threshold (Scenario 1), but universal subsidy second-best if targeting impossible (Scenario 2)

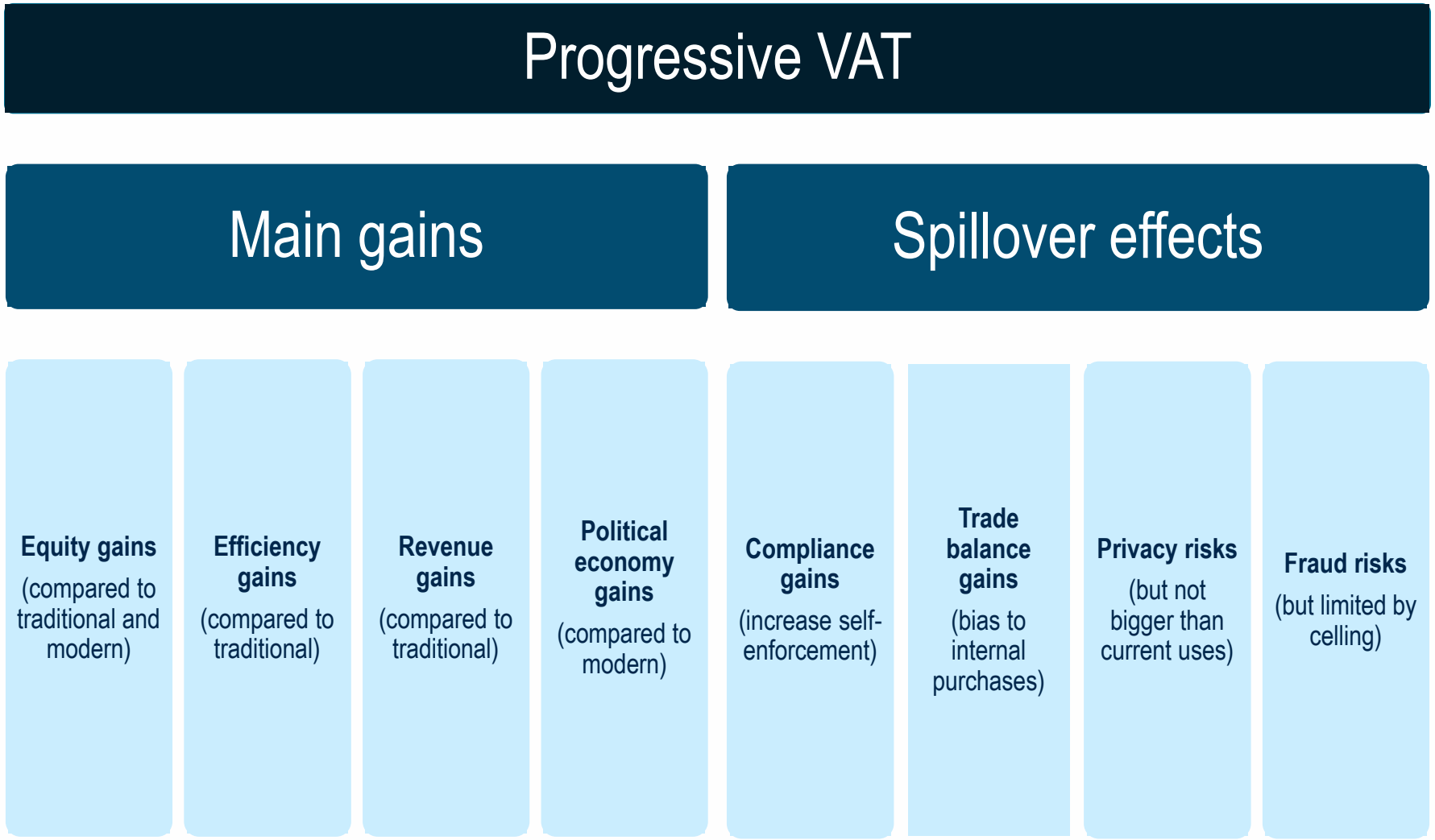








Advantages of Progressive VAT



Progressive VAT: Case of Uzbekistan

How low-income citizens can get 12% off their purchases of meat, eggs and butter in Uzbekistan

From May 1, citizens of Uzbekistan from the social register will be able to receive a VAT refund (12%) when buying meat, eggs and butter. The Tax Committee told how this mechanism will work.

As explained in the Tax Committee, in order to return VAT, the consumer must download the Soliq mobile application , register using Face ID and scan the QR code of the purchase receipt in the application.

San Marino's SMaC (though applicable to a sales tax, not a VAT) also resembles a Progressive VAT—more on the digital side (design issues still present).

Thank you