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VALUE-ADDED TAXES

Potential Lessons for the United States from Other Countries' Experiences

Statement of James R. White, Director
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Highlights of [GAO-11-867T](#), a testimony before the House Committee on Ways and Means

Why GAO Did This Study

Dissatisfaction with the federal tax system has led to a debate about U.S. tax reform, including proposals for a national consumption tax. One type of proposed consumption tax is a value-added tax (VAT), widely used around the world. A VAT is levied on the difference between a business's sales and its purchases of goods and services. Typically, a business calculates the tax due on its sales, subtracts a credit for taxes paid on its purchases, and remits the difference to the government. While the economic and distributional effects of a U.S. VAT type tax have been studied, GAO issued a report in 2008 that looked at lessons learned from VAT administration in Australia, Canada, France, New Zealand, and the United Kingdom. These countries provided a range of VAT designs from relatively simple to more complex.

This statement, which is based on the 2008 report, focuses on (1) the effect VAT design choices, such as exemptions and enforcement mechanisms, have on compliance, administrative costs, and compliance burden; (2) Canada's experience with administering a VAT in conjunction with several different subnational consumption tax arrangements; and (3) the experience that some countries had transitioning to a VAT.

View [GAO-11-867T](#) or key components. For more information, contact Jim White at (202) 512-9110 or whitej@gao.gov.

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What GAO Found

VATs have grown in popularity over the past five decades with recent estimates showing more than 130 countries worldwide using a VAT. Nonetheless, like other tax systems, even a simple VAT—one that exempts no goods or services—has compliance risks and, largely as a consequence, generates administrative costs and compliance burden. For example, all of the study countries reported devoting significant enforcement resources to compliance issues. Like an income tax, VATs can be vulnerable to compliance schemes that either result in undercollection of taxes due or overclaiming of credits for taxes paid. Also, as with other taxes, adding tax preferences—such as exempting certain goods or services from tax—generally decreases revenue, increases complexity, and increases compliance risks. Increased complexity also increases the record-keeping burden on businesses and government resources needed for enforcement.

Major Types of Compliance Risks for a VAT

Undercollection of tax due on sales		Overclaiming of tax paid on inputs	
Missing-trader fraud	A business is created for purposes of collecting VAT on sales and disappears without remitting VAT to the government.	Fraudulent refunds	A business or fraudster submits false returns requesting VAT refunds from the government.
Failed businesses	A business fails or goes bankrupt before remitting VAT collected to the government.	Misclassifying purchases	A business falsely claims input tax credits by misclassifying personal consumption expenses as business expenses.
Underreporting cash transactions	A business either charges a lower, VAT-free price for cash transactions or underreports cash sales and retains VAT collected.	Fictitious or altered invoices	A business creates or alters invoices to inflate the amount of input tax credits it can claim.
Import fraud	A business or individual imports items for personal consumption and undervalues them for VAT purposes.	Export fraud	A business creates fraudulent export invoices for goods that are not exported to claim input tax credits.

Source: GAO.

Canada's experience administering a national VAT along with a variety of provincial VATs and sales taxes demonstrates that multiple arrangements in a federal system are feasible, but increase administrative costs and compliance challenges for both governments and businesses. Businesses, particularly retailers, in provinces with a sales tax face greater compliance burdens than those in other provinces because they are subject to dual reporting, filing, and remittance requirements.

When implementing their VAT, Australia, Canada, and New Zealand all devoted considerable resources to educate and assist businesses subject to the new tax. Both Australia and Canada provided direct monetary assistance to qualifying small businesses to help meet new bookkeeping and reporting requirements. Both had trouble getting businesses to register for the VAT by the implementation date.

Chairman Camp, Ranking Member Levin, and Members of the Committee:

I am pleased to be here to discuss our prior work on the lessons the United States can learn from other countries' experiences with a value-added tax, or VAT.¹ VATs have grown in popularity over the past five decades with recent estimates showing more than 130 countries worldwide using a VAT. The United States is the only member of the Organisation for Economic Co-operation and Development (OECD) without a VAT.

Dissatisfaction with our current federal tax system has fueled a debate about fundamental tax reform due to concerns about the current federal tax system's economic inefficiency, unfairness, and complexity. Part of this debate has involved switching to a consumption tax or combining a consumption tax with an income tax. One type of consumption tax that some have proposed is a VAT. A VAT is applied to the difference between a business's sales of goods and services and its purchases of goods and services (excluding wages). Thus, businesses pay tax only on the value they add to the goods or services they sell. Unlike retail sales taxes, VATs are collected at all stages of production and distribution process. All types of businesses, not just retail businesses, are subject to the tax, and sales to both consumers and other businesses are taxable.

My testimony today will discuss five countries' experiences with their VATs. These study countries are Australia, Canada, France, New Zealand, and the United Kingdom. They represent a range of VAT design options from relatively simple to more complex and include some with federal systems and some that recently implemented a VAT. Specifically, I will cover (1) the effect that VAT design choices, such as the number of tax rates and tax exemptions, have on compliance, administrative costs, and compliance burden; (2) Canada's experiences with administering a national VAT in conjunction with several different subnational consumption tax arrangements; (3) the experiences that countries had transitioning to a VAT; and (4) our concluding observations on the lessons the United States can learn from these countries' experiences.

¹See GAO, *Value-Added Taxes: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition*, [GAO-08-566](#) (Washington, D.C.: Apr. 4, 2008).

This testimony is based on our report issued in 2008. Although some time has passed since our report was released, the challenges that our study countries encountered in implementing and administering VAT systems remain insightful to the United States should it consider a national consumption tax. For that report we selected our study countries based on several criteria, including the complexity of VAT design, the age of the VAT system, and whether the country had a federal system. For each country, we performed in-depth literature reviews and conducted extensive interviews of government officials and VAT experts. We also collected and analyzed documents and data on the countries and their VAT systems. Additional information on our scope and methodology is available in our published report.

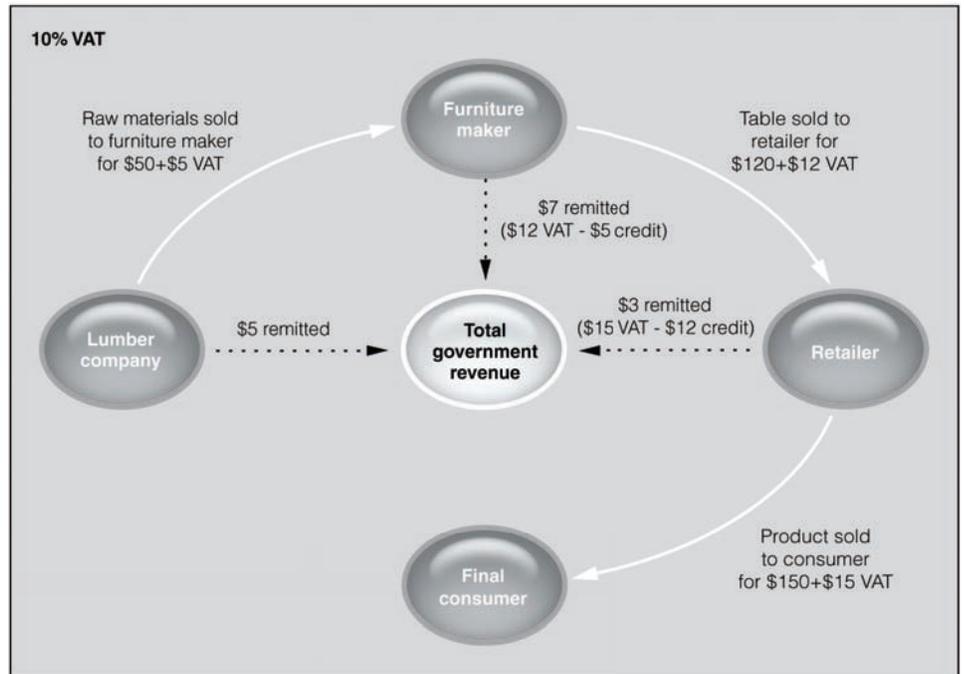
We conducted the performance audit work that supports this statement in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provided a reasonable basis for our findings and conclusions based on our audit objectives. We did not make any recommendations.

Background: How a Simple VAT Works

Under a VAT, businesses pay tax on the value they add to the goods and services they purchase from other businesses. VAT liability is typically calculated in industrialized countries using what is known as the credit-invoice method. Under this method, businesses apply the VAT rate to their sales but claim a credit for VAT paid on purchases of inputs from other businesses (shown on purchase invoices). The difference between the VAT collected on sales and the credit for VAT paid on input purchases is remitted to the government.

Figure 1 illustrates a VAT with a 10 percent rate. A lumber company cuts and mills trees and has sales of \$50 to a furniture maker. Assuming no input purchases from other businesses, to keep the illustration simple, the company adds the tax to the price of the goods sold and remits \$5 in tax to the government. The purchase invoice received by the furniture maker would list \$50 in purchases plus \$5 in VAT paid.

Figure 1: Example of How a VAT Works



Source: GAO.

If the furniture maker has sales of \$120 to a retail store, \$12 of VAT would be added to the sales price but the furniture maker could subtract a credit for the \$5 VAT paid on purchases and remit \$7 to the government. The retailer would receive an invoice showing purchases of \$120 and \$12 of VAT. Similarly, if the retailer then has sales of \$150, \$15 of VAT would be added but the retailer could subtract a credit for the \$12 paid on purchases and remit \$3 to the government.

In total, the government would receive VAT equal to 10 percent of the final sales price to consumers. Thus, a 10 percent VAT is equivalent to a 10 percent retail sales tax in terms of revenue. Under both taxes, the final consumer ultimately bears the economic burden of the tax (\$15), except in a VAT, the tax is collected in stages, not just in the final sale.

Like Other Taxes, VATs Have Compliance Risks, Administrative Costs, and Compliance Burden That Increase with the Complexity of the Design

Our study countries' experiences with noncompliance suggest that even a conceptually simple VAT—one that applies a single tax rate to all goods and services—would have compliance risks and would generate significant administrative costs and compliance burden. Further, like other types of taxes, adding complexity through preferences increases these risks, costs, and burden. While our study countries had VATs of varied designs and complexity at the time of our original review in 2008, they all devoted significant enforcement resources to addressing compliance issues that would be found in even a simple VAT.

Compliance Risks

As shown in table 1, compliance risks for a VAT can stem from either underpayment of taxes owed on sales, or overstating taxes paid on purchases.² These risks include refund fraud and missing-trader fraud. VATs are vulnerable to refund fraud because businesses with taxable sales less than taxable purchases are entitled to refunds. All of our study countries were concerned about illegitimate businesses or fraudsters submitting fraudulent refund claims that result in the theft of funds from the government. In the case of a missing trader, a business is set up for the sole purpose of collecting VAT on sales and then disappearing with the proceeds.

²Similar compliance risks exist for an income tax stemming from either understating income or overstating deductible expenses.

Table 1: Major Types of Compliance Risks in a Conceptually Simple VAT System

Undercollection of tax due on sales		Overclaiming of tax paid on inputs	
Missing-trader fraud	A business is created for purposes of collecting VAT on sales and disappears without remitting VAT to the government.	Fraudulent refunds	A business or fraudster submits false returns requesting VAT refunds from the government.
Failed businesses	A business fails or goes bankrupt before remitting VAT collected to the government.	Misclassifying purchases	A business falsely claims input tax credits by misclassifying personal consumption expenses as business expenses.
Underreporting cash transactions	A business either charges a lower, VAT-free price for cash transactions or underreports cash sales and retains VAT collected.	Fictitious or altered invoices	A business creates or alters invoices to inflate the amount of input tax credits it can claim.
Import fraud	A business or individual imports items for personal consumption and undervalues them for VAT purposes.	Export fraud	A business creates fraudulent export invoices for goods that are not exported to claim input tax credits.

Source: GAO.

Because of compliance risks, even simple VATs require enforcement activities, such as audits and record keeping by businesses, that create administrative costs for the government and compliance burden for businesses. Of course, compliance risks and the associated administrative costs and compliance burdens are not peculiar to VATs. While the specifics may vary, other types of taxes also carry compliance risks.

Administrative Costs

A VAT, like any tax system, will require government resources to administer. The drivers of administrative costs in many tax systems include the number of taxpayers (businesses, individuals, or both) subject to the tax, how often they file returns, and the percentage of taxpayers audited. In the case of a VAT, administration requires the government to process tax returns and provide certain services to businesses. Even a simple VAT warrants education and assistance services, in part to address compliance risks. Tax administrators also need to spend significant resources on audit and enforcement activities.

Some available data from our study countries indicate a VAT may be less expensive and easier to administer than an income tax. In 2006, the tax administration agency in the United Kingdom measured administrative costs for the VAT to be approximately half a percent of revenue collected compared to over one and a quarter percent for the income tax. Officials

at the New Zealand Inland Revenue Department also told us that administering their VAT was easier than administering some of their other taxes. For example, only 3 percent of VAT returns submitted to New Zealand's revenue agency are found to have errors, compared to approximately 25 percent for income tax returns.

Compliance Burden on Taxpayers

As with other taxes, compliance burden with a VAT is mostly driven by record-keeping requirements, filing-frequency requirements, and time and resources to deal with audits. The "fixed cost" nature of many compliance costs associated with a VAT means that smaller businesses often face a proportionally higher burden than larger businesses in complying with the VAT. The three most comparable studies we identified estimated that the compliance burden as a percentage of annual sales in Canada, New Zealand, and the United Kingdom ranged from approximately 2 percent for businesses with less than \$50,000 in sales to as low as 0.04 percent for businesses with over \$1,000,000 in sales. Private accounting and tax experts we spoke with also agreed that as the size of the business grows, the VAT compliance burden decreases per dollar of sales.

Adding Complexity through VAT Preferences Decreases Revenue and Generally Increases Compliance Risks, Administrative Costs, and Compliance Burden

All of the countries we studied have added complexity to their VAT designs, mainly through the use of tax preferences. Tax preferences—also called tax expenditures—result in foregone tax revenue due to preferential provisions that generally shrink the tax base. Tax preferences can also exist in other tax systems, such as income taxes or retail sales taxes. In our study countries, some economic sectors, such as certain consumer essentials like food and health care and public-sector organizations are often provided VAT preferences because of social or political considerations. Other sectors, such as financial services, insurance, and real estate, are provided exemptions or exclusions because they are inherently hard to tax under a VAT system.

Countries' use of VAT preferences—such as exemptions and reduced rates—generally results in reduced revenue and greater compliance risks, administrative costs, and compliance burden.³ However, some

³In some instances where an exempt good or service is used in the production of a taxable good or service, exemptions can produce a cascading effect, whereby a good or service is sold with an embedded tax in the price, resulting in a tax on the tax. In this case, the exemption may lead to an increase in tax revenue.

preferences, such as thresholds for businesses, may not increase administrative costs and compliance burden because they reduce the number of entities subject to VAT requirements. Additionally, in most study countries, certain financial-services and real-estate transactions are exempt for administrative purposes, which could result in reduced compliance burden.

VAT preferences used in our study countries included exemptions, exclusions, and thresholds. An exempt good or service is not taxed when sold, and businesses that sell exempt goods or services cannot claim input tax credits for inputs used in producing the exempt output. While no VAT is collected with the final sale, the government still collects tax revenue throughout the stages of production. Tax is paid and collected on inputs. In contrast, excluding a good or service, more commonly referred to as zero rating, removes it entirely from the tax base resulting in an effective tax rate of zero. For goods and services that are zero-rated, VAT that was paid in the production of the good or service can be fully recovered through input tax credits. As a consequence, no net VAT revenue is actually collected by the government from the sale of zero-rated goods and services.

A threshold is a type of exemption that excludes businesses below a certain size from collecting and remitting VAT and from being able to claim input tax credits. Businesses with sales below the threshold are not required to charge VAT on their sales and cannot claim input tax credits for VAT paid on purchases. Businesses with annual sales above the threshold level are required to register with the tax agency, and collect and remit the VAT.

In Canada, Tax System Complexity and Compliance Burden Varied among Provinces Depending on Level of Coordination with a Federal VAT

One issue the United States would face if it adopted a national VAT is its interaction with retail sale taxes levied by states and localities. Although there are several countries with a federal system of government, Canada is the only country that we identified that has a national VAT administered alongside a variety of subnational consumption taxes. Canada administers its federal VAT and provincial consumption tax systems differently in different provinces. The four types of national/subnational consumption tax structures in Canada are:

- a separate federal and provincial VAT, both of which are administered by the province;
- a joint federal and provincial VAT administered by the federal government;

-
- a separate federal VAT and provincial retail sales tax administered separately; and
 - a federal VAT only.

Canada's experience administering a national VAT along with a variety of provincial VATs and sales taxes demonstrates that multiple arrangements in a federal system are feasible, but results in increased administrative costs and compliance challenges for both government and business. Businesses in provinces where the provincial and federal VATs tax the same goods and services and are administered by the federal government have a relatively lower compliance burden since they only have to comply with one set of requirements. In contrast, businesses, particularly retailers, in provinces with a sales tax face greater compliance burdens than those in other provinces because they are subject to dual reporting, filing, and remittance requirements.

VAT Implementation Involved Considerable Resources to Educate, Assist, and Register Businesses

Australia, Canada, and New Zealand, the study countries that most recently implemented a VAT, all built on preexisting administrative structures. All had national consumption taxes that were paid by businesses prior to transitioning to a VAT. Despite the preexisting structure, implementation of the new tax in these countries involved multiple agencies, the development of new policies and processes, and the hiring of additional staff. Interagency committees were also established in all three countries to facilitate and coordinate implementation efforts. These three study countries took 15 to 24 months to implement the VAT and devoted a great deal of time and effort to education activities.

Before entities subject to VAT requirements can be expected to comply, they must know what those requirements are and what they mean to specific economic and industry sectors. According to International Monetary Fund guidance on VAT implementation, development and testing of tax forms early in the implementation process is important because they are a key part of the education effort. For Australia, Canada, and New Zealand, this also included extensive outreach efforts through a variety of direct and indirect assistance. For example, Australian officials said a key part of their education and outreach strategy was to target key players in various industry sectors, such as local chambers of commerce. Both Canada and Australia also provided direct monetary assistance to qualifying small businesses to defray the costs of acquiring the necessary supplies needed to meet new bookkeeping and reporting requirements.

Despite significant efforts to encourage businesses to submit materials early for VAT registration, both Australia and Canada still had difficulty getting businesses to register prior to the VAT implementation date. In both countries, this resulted in significant spikes in registration and education-related workload just prior to implementation. In Canada, for example, only 500,000 or 31 percent of the 1.6 million total registrants had voluntarily registered 3 months prior to VAT implementation.

Potential Lessons for the United States

The experiences of our five study countries show that all VAT designs have compliance risks that generate considerable administrative costs and compliance burden and that, similar to the U.S. tax system, adding complexity to the tax's design increases these risks, costs, and burden. While our study countries had VATs of varied designs and complexity, they all devoted significant enforcement resources to addressing compliance that would be found in even a simple VAT. Enforcement activities, such as audits, and record keeping by businesses create administrative costs for the government and compliance burden for businesses. Of course, compliance risks and the associated administrative costs and compliance burden are not peculiar to VATs. While the specifics may vary, other types of taxes also carry compliance risks.

One overriding lesson about VAT design is that, like our income tax system, adding tax preferences to the system may satisfy economic, distributional, or other policy goals but at a cost. Tax preferences—in the form of exemptions, zero rates, or reduced rates—often reduce revenue, add complexity, and increase compliance risks. To mitigate the increased risk, countries have imposed additional record-keeping and reporting requirements on businesses, delayed refunds, and done more auditing of businesses. The end result is an increase in compliance burden for businesses and administrative costs for the government.

The choice of tax type is typically heavily influenced by criteria other than administrability. Revenue needs, effect on economic performance, and distributional consequences are prominent considerations and have been at the forefront of the debate in the United States about tax reform.⁴

⁴See GAO, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*, [GAO-05-1009SP](#) (Washington, D.C.: September 2005).

Administrability and the details of how a new tax would be implemented often get less attention. However, administrability and design details do matter. The benefits of a new or reformed tax system, in terms of revenue, economic performance, or equity, would be at least partially offset by poor design that unnecessarily increased compliance risks, administrative costs, and compliance burden.

Chairman Camp, Ranking Member Levin, and Members of the Committee, this completes my prepared statement. I would be happy to respond to any questions you may have at this time.

Contacts and Acknowledgments

For further information on this testimony, please contact James R. White at (202) 512-9110 or whitej@gao.gov. In addition, contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. In addition to the individual named above, Jay McTigue, Assistant Director; Brian James; and Danielle Novak made key contributions to this testimony.

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