The Financial Express

Published: 27 May 2017

The VAT debate: More heat than light

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The discussions on the upcoming budget continue to be bogged down in the controversy over the introduction of the new Value Added Tax (VAT) law. Unfortunately, the fierce debates on this issue over the last couple of years have created more heat than light. One has to now wait until the actual post-budget implementation to determine the real worth of the arguments that have been made for and against the new law. Why has the resolution of the issues proved so difficult?

The problem mainly arises from the application of a smart modern tax system, which the VAT is, to an economy where there is poor tax compliance, business record-keeping is often dubious and unreliable, and informal business intermediaries proliferate. The new law, in short, proposes collecting VAT at the full rate, and not at a truncated rate, from the retail and wholesale businesses, while allowing for deductions for the VAT paid at the earlier stages of value chains. The major problem arises from the existing poor tax compliance, resulting in the vast majority of tax-eligible businesses currently lying outside the VAT net. In the existing supply chains, the informal or tax-evading businesses intermingle with the tax-compliant ones without much difficulty, since no deductions are required for VAT paid, or not, at the source of supply. With the application of the full VAT rate, these deductions become an integral and logical part of the system, thus making it necessary for each stage of the supply chains to be tax-compliant with necessary documentation. It is not clear how the remaining parts of businesses will fit into this system.

The large-scale non-compliance is also the reason why the revenue from VAT comes from only a few items, some of which are widely used production inputs like gas, power and cement. Being an indirect tax on consumption, VAT should be collected as far as possible at the sale points of final consumer goods and services. It is for the reliance on VAT collections on intermediate goods and production inputs that the need has now arisen for the complicated process of keeping records and claiming deductions at various stages of the values chains.

The actual impact of the new VAT law will, however, depend on how well the law is enforced. There may be various types of business responses. Depending on the strength of market competition and the consequent impact on market prices, some non-compliant businesses may now try to pass on the full VAT on prices without actually paying the VAT .At the same time, some of the compliant businesses may now pay the full VAT without claiming deductions because they are unwilling to be transparent in their business accounts or they lack capacity for appropriate record-keeping or they procure from non-VAT-compliant businesses. Again, the small businesses paying turnover VAT may be at a disadvantage in selling their wares to VAT-compliant stores who may not be able to claim deductions on such purchases.

In the absence of any rigorous analysis of how all this will work out, the likely impact on prices and tax collection remain anybody's guess; consequently, much of the on-going debates between the business community and the tax authorities have been rather in the nature of shadow-boxing. What can be said for sure is that there is a lot of uncertainty and apprehension both among the business community and within the tax authorities. There could have been an alternative route of actual experimentation instead of persisting with the unresolved debate. The existing system of truncated VAT rates could continue alongside the new system of full VAT with deductions, but the former tax rates could be so fixed that there would have been an in-built incentive in the system for the businesses to shift to the new one with improved record-keeping and tax compliance. But it may be too late for such experimentation and the only sensible way will be to observe and analyse the impact of the new law and to be willing to amend and adjust the law as and when necessary.

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Source: http://www.thefinancialexpress-bd.com/2017/05/27/71801/The-VAT-debate:-More-heat-than-light