Battling fraud ranks among challenges of value-added tax

Close to 130 countries—with the notable exception of the United States—have adopted the value-added tax (VAT) over the past 30 years or so. The VAT is a broad-based tax on all domestic sales that allows businesses to take a credit or receive a refund for the tax charged on their inputs so as to ensure that the tax bears only on final domestic consumption. The distinctive structure of this powerful source of revenue gives rise to special problems of control—an issue that formed part of the agenda of a March 14–16 conference held in Rome, organized by the International Tax Dialogue (ITD)—a joint initiative of the IMF, the Organization for Economic Cooperation and Development, and the World Bank (see box).

The conference, hosted by the Italian Ministry of Economy and Finance, was ITD's first global conference, bringing together tax officials from more than 100 countries and international organizations. They discussed a broad range of VAT policy and tax administration issues, with a particular focus on the need to combat fraud, ease administrative burdens for businesses, and explore means to improve international cooperation.

A universal concern among participants was the question of what to do about VAT fraud. Most VAT payers routinely and legitimately receive refunds on the basis of VAT shown on invoices issued by the taxpayer's suppliers. But fraudulent refund schemes arise when a refund claim is based on counterfeit invoices or on VAT shown on an invoice issued by the taxpayer's supplier, which in fact the supplier has not paid to the government. The VAT is sometimes described as self-policing, because the failure to collect tax at any point in the distribution chain is automatically made up at subsequent stages. Of course, it is this very self-policing feature—and the reliance on invoices issued by a chain of suppliers—that creates an opportunity for fraud.

Traditionally, two of the most effective weapons against fraud have been a good VAT policy framework and a fairly sophisticated risk-based auditing system designed to distinguish between legitimate and fraudulent claims. Given the prevalence and high cost of fraud, and its constantly mutating nature, some countries have also experimented with such innovative approaches as the use of electronic invoices (which prevent counterfeiting) and, more controversially, special bank accounts (which help ensure that the taxpayer's supplier in fact pays the VAT being claimed). Many participants suggested that fraud could also be thwarted by a greater exchange of information among national authorities, but at the same time, participants underscored the need for reducing businesses' compliance burdens and improving audit selection and execution.

Handling international assistance

A topic that attracted particular interest at the conference was the tax treatment of international assistance. It has been a common practice for donors—who provide assistance,

The International Tax Dialogue (ITD)

The ITD is an initiative of the IMF, World Bank, and Organization for Economic Cooperation and Development. It is designed to facilitate experience sharing, networking, and other means of bolstering cooperation among tax officials throughout the world, including by greater information sharing on technical assistance activities in taxation. The ITD's chief communication tool is its website (*www.itdweb.org*), which provides information on key issues in tax policy and administration and on tax laws and practices around the world. The ITD website will be used to facilitate information sharing and coordination of research in preparation for its next global conference. Papers presented at the March 14–16 conference in Rome are also available on the website—including a background paper that summarizes countries' experiences with value-added taxation. Looking ahead, a priority for the ITD is to increase the number of participating countries and expand the opportunities for tax officials in different countries to network with their counterparts.

including through loans—to insist on exemptions for imports and, in the case of loan finance, to stipulate that the loans not finance tax payments. But, in the case of the VAT, participants pointed out that exemptions on imports result in distortions in favor of imported goods, fraud, and complication of VAT administration. Participants were interested to learn of a change in World Bank policy on this, toward being more open to financing taxes on procurements under loan-financed projects. They also debated possible changes in the donors' attitudes toward expanding the scope of allowable taxation by aid recipients.

Some old issues . . .

While most participants agreed that differentiating rates and using exemptions were poor ways to pursue equity objectives, many participants argued that political realities often made the ideal of a single rate on a broad base hard to achieve. Views differed more strongly as to the appropriate level of the VAT threshold—the level of turnover at which registration for the VAT becomes compulsory. While some argued for a relatively high threshold so as to focus scarce administrative resources on the most important taxpayers, others said a low threshold could play an important role in fostering awareness of and compliance with the wider tax system.

. . . and some new challenges

As tax officials grapple with a more globalized world, one particularly challenging area is financial services, because it does not include easily identifiable transactions that could be charged with a VAT. The prevalent approach of simply exempting financial services is becoming increasingly problematic, and some countries have been experimenting with new approaches—including taxing financial services that involve a specific charge and zero-rating services provided to businesses.

Francis Dean/Dean Pictures

The value-added tax—levied on the value added at all levels of production of a good or service, including, in many countries, on clothing—is now a part of the national tax system in a wide range of countries.

The best way to treat purchases by government bodies, which are often exempted, was also discussed. Some countries now seek to limit revenue leakage from this source by applying the VAT to most government entities. Moreover, international services present practical problems of identifying a taxpayer who can be subject to tax in the jurisdiction and conceptual issues of determining the jurisdiction where the services ought to be taxed. Also problematic are exemptions for services provided by the nonprofit sector and the public sector.

Value-added tax close to universal[1]

Over the past 30 years or so, most countries across the world have adopted the value-added tax.

	Sub-Saharan Africa	Asia and Pacific	European Union 15 plus Norway and Switzerland	Europe and Former Soviet Union	North Africa and Middle East	Americas	Small Islands[3]
Total[2]	**33 (43)**	**18 (24)**	**17 (17)**	**27 (28)**	**9 (21)**	**23 (26)**	**9 (27)**
1996–present	18	7	0	6	2	1	3
1986–1995	13	9	5	21	5	6	6
1976–1985	1	2	0	0	2	6	0
1966–1975	0	0	11	0	0	10	0
Before 1965	1	0	1	0	0	0	0

Source: *The VAT: Experiences and Issues,* available at *www.itdweb.org*.

[1]Regions defined as in Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT* (2001), except Serbia and Montenegro included in Central Europe.

[2]Figure in parenthesis is number of countries in the region.

[3]Island economies with a population of less than 1 million, plus San Marino.

More cooperation, please!

Participants saw greater scope for international cooperation in VAT matters, including through regional cooperation, information sharing among tax administrations, and even international agreements to allocate taxing rights among countries on international services. The next global meeting of the ITD is tentatively set for 2007, with the taxation of small and medium-sized businesses topping the list of possible topics. ■

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