

# **Value-Added Taxes in Developing and Transitional Countries: Lessons and Questions**

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### **Abstract**

The value-added tax has, in recent decades, become the most important single tax in most developing and transitional economies. This paper reviews some problems that have emerged as important as more experience has been gained with how VATs really work in many such countries and suggests some lines of research that need to be explored further to overcome those problems.

Key words: value-added tax, developing countries, transitional countries

JEL classification: H25, O23, P35

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## 1. Introduction

Few fiscal issues are more important in developing and transitional economies (DTE) than the value-added tax (VAT). Over the last few decades, VAT has swept the world. The principal reasons for the rapid spread of this form of taxation were, first, the early adoption of this form of taxation in the European Union (EU) and, second, the key role played in spreading the word to DTE by the International Monetary Fund (IMF) in particular and by international agencies and advisors more generally. The success of VAT in the EU showed that VAT worked. The consistent support and advocacy of this form of taxation by the IMF and others in a variety of countries, first in Latin America, and then around the world, encouraged and facilitated the adoption of VAT by countries with much less developed economic and administrative structures than those in the original EU member states. At the same time, for various reasons of their own, all the non-EU countries of the OECD apart from the United States have also, one by one, introduced VATs, most recently Australia in 2000.

Of course, to a certain extent, as the background paper (ITD, 2005) observes, the VAT label covers a variety of taxes in different countries. Countries that belong to the EU have necessarily all adopted the same model of VAT, essentially as laid out by the Sixth Directive of 1977, although some important differences remain between VATs in EU member states (Mathias, 2004). Other countries influenced by the EU such as the recent and prospective ‘accession’ countries of central and eastern Europe have also largely followed this model. Elsewhere in the world, however, while the influence of the EU model (and some member-state variants) is clear in, for example, some former colonies of EU member states, other models have been developed and adopted, notably in New Zealand and Japan. Equally importantly, the IMF’s Fiscal Affairs Department, the leading ‘change agent’ in this respect for in much of the world has over time evolved what is essentially its own ‘model’ of an appropriate VAT for DTE, as set out initially, for instance, in Tait (1988, 1991) and most recently in Ebrill et al. (2001). While VAT countries have introduced many local variations into whatever basic ‘model’ they may have

started from,<sup>1</sup>, as Victor Thuronyi (2003, p.312) has recently noted, “ while there are differences in VAT from one country to another, compared with the income tax VAT laws are remarkably similar.”

When DTE have a VAT, it is invariably among the most important sources of government revenue. Indeed, anyway one cares to look at it VAT has clearly been an enormous success. Not only has it swept the world almost clear of contending general sales taxes but in many DTE it dominates the income tax as the mainstay of national finances. No previous fiscal innovation has been adopted in such a wide variety of countries so rapidly.

Not all is sunshine in VATland, however. Clouds of varying sizes and shapes seem to be looming on the horizon in all VAT countries but perhaps particularly in DTE that have become increasingly dependent on VAT and hence more vulnerable to potential problems. Some of these problems have always been inherent in the structure and operation of VATs but are exacerbated by the increased fiscal weight being placed on the many DTE under pressure for new fiscal revenues for example to offset revenue losses from tariff reductions needed to accord with WTO requirements. It is thus perhaps time for a new look at the role of VAT in DTE.

Specifically, are the VATs now in place in most DTE as good as they could be in economic, equity, and administrative terms? Must ‘good’ VATs in such countries always follow the same pattern? Must every DTE have a VAT? Can all DTE administer a VAT sufficiently well to make the introduction of the tax worthwhile? Is a VAT always the best way to respond to the revenue problems arising from trade liberalization? Can VATs be adapted to cope with the rising demands in some countries, especially federal countries, for more access to revenues by local and regional governments? Can they deal with such new problems as those arising from changes in business practices with financial innovations and digital commerce? The answers to such questions are not only critical to the fiscal stability of many DTE but also to their economic growth and development. Are the VATs already in place in many DTE the efficient, simple, revenue-raisers some claim? Or, as others argue, are they so inequitable as to exacerbate social

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<sup>1</sup> For a small sample of early country experiences, see e.g. Gillis (1990), OEA (1993), Yoingco and Guevara (1988), and OECD (1998), and for a sample of the discussion in an important current case, that of India, see e.g. Shome (1997), Chelliah (2001), and Empowered Committee (2005).

and political tensions? Does VAT provide a way to tap the informal sector or does it instead tend to expand that sector?

No brief paper can answer such complex questions, of course, so the objective of this paper is considerably more modest. Taking the background paper prepared for this conference (ITD, 2005) as its starting point, the aim of this paper is simply to provide a few additional reflections on some lessons that seem to emerge from experience to date with VAT in DTE – countries in which, for the most part, tax reality is much more dominated by administrative capacity on one hand and political necessity on the other than in the European home of so much VAT experience and thinking. There is indeed much room and need for sharing experiences between developed countries and DTE, but there are also some important differences that need to be explicitly taken into account when doing so. To paraphrase the conclusions of the late Jean Jacques Laffont (2004) in a recent survey of public utility regulation in DTE, not only do we as yet have surprisingly little solid empirical knowledge of some critical factors but the relevant economic theory also remains rather sketchy and we know even less about the relevant political economy context. For the most part, this paper simply attempts to flesh out these observations in a little more detail with respect to VAT in DTE. In doing so, it should perhaps be noted that although the points made are stated in general terms for the most part they are inevitably shaped by the author’s limited personal experience with various aspect of VATs in a number of DTE over the years. In a sense, however, this is perhaps not a limitation since it is precisely through closer analysis of, and reflection on, the experience of such case studies that we can best discern the real challenges facing VAT in DTE and the questions that most need further attention. Such at least, is the approach taken here.<sup>2</sup>

## **2. Lessons from Experience**

At the risk of repeating some of the many good and sensible things said in the background paper, this section discusses briefly five major lessons that emerge from the

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<sup>2</sup> In contrast to the disclaimer in the background paper, it should perhaps be explicitly noted that, while the author has learned a great deal about these topics from the staff of the World Bank, the IMF, and the OECD and is in addition grateful to Pierre-Pascal Gendron for helpful comments, he alone is solely responsible for all views expressed in this paper.

extensive experience with introducing and implementing VATs in DTE. First, and most importantly, as the background paper says, VAT works. Despite some recent criticisms by reputable analysts, for the most part it remains true that, if a country needs or wants a general sales tax, it is well advised to have a VAT. Secondly, nonetheless VAT does not always work well in many DTE, principally because some are simply not ready for ‘self-assessment’. Thirdly, what this suggests for tax design is what may be called ‘the NOSFA principle’ – No One Size Fits All – although it may be that several ‘sizes’ (patterns) of VAT may prove suitable for different groups of countries in similar circumstances. Fourthly, the major lesson for tax administration that experience in DTE suggests is that the oft-cited ‘18-24 months’ needed for successful VAT implementation vastly understates the nature and time scale of the task in many countries. Many DTE cannot be simply, as it were, ‘given’ a good VAT administration: they need to ‘grow’ it themselves and the process may take a long time in some cases. Finally, since tax policy is always about politics as much or more than it is about tax design and administration, we must always remember that, as Ken Messere (1999, p.342) once said in a discussion of OECD countries, tax policy “...is about trade-offs, not truths.” To some extent at least, the future of VAT in DTE lies in much closer understanding of the critical political economy dimension of VAT policy and administration.

## ***2.1. VAT Works***

VAT works as well as or better than possible alternatives in most countries, whether developed or DTE. Nonetheless, over the last few years, some important questions have been raised with respect to VAT, questions that will no doubt be much further explored in subsequent academic research and that may perhaps eventually come to influence policy to some extent. Three such questions are discussed briefly here: the effects of VAT on revenues, on trade, and on the underground economy.

As the background paper shows, VAT is by no means necessarily the ‘money machine’ that it has sometimes been called. The effects on revenue of introducing a VAT in particular contexts remains a matter open to interpretation and question, as recently underlined by some who have questioned the capability of VAT to replace revenues from trade liberalization in some

DTE (e.g. Rajaraman, 2004). While it is true that there may indeed be a somewhat stronger case for retaining some taxation on international trade on revenue grounds than has been conventionally asserted, this case rests less on defects of VAT as such than on the assumed relative inefficiency of VAT administration compared to border tax administration (see also section 2.4). If a VAT can be administered adequately, the conventional conclusion that it offers the best way for a country to make up revenue losses from trade liberalization holds, though perhaps in less sweeping terms than originally argued.<sup>3</sup> Indeed, the equally conventional conclusion that a VAT is the most economically desirable and administratively effective way in which to collect a given share of national income through a general consumption tax also holds -- provided, again, that the capacity exists to administer VAT adequately. When a country introduces a VAT, whether to replace another form of general sales tax or as a new tax, there need not necessarily be an aggregate increase in revenues (either from consumption taxes or in general). As a rule, however, the economic cost of collecting revenues will decline, thus making society better off. Similarly, as with any tax, although increasing the rate of an existing VAT rates will neither necessarily increase revenues proportionately nor be costless, it may nonetheless be the economically most sensible way to expand revenue shares in DTE, if that is the policy goal.

An important rationale for the original adoption of VAT in Europe was to facilitate trade by turning the then existing sales taxes into true destination-based consumption taxes both by 'untaxing' exports (and removing hidden subsidies) and by placing the taxation of imports and domestic production on the famous level playing field. While the theoretical necessity for this step in a world of at least imperfectly flexible exchange rates is still debated by some, on the whole VAT's effects on trade have been considered to be largely beneficial, with economists applauding the level playing field for imports and governments generally paying more attention to the removal of barriers to exports. Recently, however, some (Desai and Hines 2002) have suggested that VAT may actually deter rather than facilitate trade in DTE. Others (e.g. Keen and Ligthart, 2002) have begun to explore in more detail the theoretical framework linking VAT, tariff reform, trade and welfare, turning up some interesting and to some extent disquieting

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<sup>3</sup> On this, compare the rigorous analysis in Keen and Ligthart (2002) with the equally rigorous, but different, analysis in Keen and Ligthart (2004).

results. Although, as is not uncommon practice has preceded both theory and econometrics since most DTE already have a VAT, much room remains for further theoretical and empirical work in this area. No doubt some interesting points will emerge from this literature in the future: for now, however, there seems no reason to call the fundamental soundness of VAT as the primary form of consumption taxation in the world into question. So long as countries have general sales taxes, VAT remains the best choice in virtually all circumstances.

Finally, analysts have also recently begun to discuss the implications for VAT of the considerably larger underground or shadow economies found in DTE as compared to developed countries. Some analysis suggests that in the presence of a substantial 'informal' sector, a tax like VAT that falls on the formal sector acts to deter the growth and development of the economy as a whole (Emran and Stiglitz, 2002). Indeed, one recent study (Hines 2004) concludes that increasing consumption taxes definitely fosters the expansion of the hidden economy if (as seems plausible) the labor-intensity of production in that sector is greater than in the formal sector. Yet another study suggests that even governments aware of such problems may have nonetheless choose to impose higher taxes, including VAT, on the formal sector of the economy because with their relatively weak tax administrations the best way for them to raise revenue may be to increase barriers to entry to the formal sector, thus creating 'rents' that may then be taxed (Aurioll and Walters, 2003). All this is interesting and certainly well worth further exploration and discussion.

In the end, however, as with the revenue and trade discussions, although those who dislike VAT for any reason will no doubt seize on such arguments to bolster their case, it seems unlikely that any of this recent discussion seriously detracts from the overwhelming case for VAT as the best form of general consumption tax of which we know. One may certainly criticize VAT in both theory and practice, and much more such analysis and criticism is not only to be expected but also welcomed. In the end, however, as the background paper argues, VAT almost certainly works better in both theory and practice in most countries than any feasible alternative. Its central position in the revenue systems of most DTE seems unlikely to be challenged.

## ***2.2. But It Does Not Always Work Well***

So VAT works, in most countries, even DTE, better than other forms of general sales tax. This does not, however, mean that it necessarily always works well. While there are many different reasons for this conclusion in different countries, only two points will be mentioned here. First, the policy process appears, almost inevitably, always to leave some problems in VAT design, and such problems are more likely to be exacerbated over time in the circumstances of DTE than those of developed countries. Secondly, as the background paper properly emphasizes, the right way to implement a VAT is through ‘self-assessment.’ What is perhaps not emphasized sufficiently, however, is how far some DTE still seem to be from being able to run their tax systems on this basis.

Potential taxpayers have many ways to escape the fiscal system in DTE: they (or at least their tax base) may, for instance, flee abroad; or they may remain but hide in the shadow economy; or they may secure some form of favourable treatment by exerting influence in various ways to have changes made in the law or its interpretation; or, if somehow trapped within the taxation system, they may finally seek relief by forgiveness of arrears through amnesty laws. Indeed, in some cases they may combine all of these methods of avoiding taxation. In some DTE the record over the years suggests that such processes have been at work, given the discouraging picture of repeated erosion of the base of the VAT through concessions at many levels as well as general administrative weaknesses.

The initial VAT legislation, usually close to standard international models in DTE, as time goes on tends to become both more complex and to some extent ad hoc in how it is actually applied. The structure of VAT becomes littered with privileges and exemptions that minimize its revenue impact and make it difficult to manage. Sometimes, once concessions enter the system, they have been subsequently enlarged surreptitiously without quick response from the tax administration, becoming in effect almost a ‘self- assessment’ system without the necessary administrative systems and safeguards to support such a system. Concessions thus feed on themselves, encouraging taxpayers to lobby for still more concessions, just as tax amnesties create an incentive to defer payment in anticipation of future amnesties. Little assistance in

coping with these complexities is offered in the way of taxpayer services. Nor is much done to guard against abuse, with most so-called VAT ‘audits’ in many countries amounting to little more than simple numerical checks. Widespread base erosion facilitates both evasion and also, when taxpayers are subject to audit, corruption. Those with influence often have their tax debts forgiven. VAT reality has in these ways failed to live up to VAT’s initial promise in some DTE.

With the tax base being eroded in such ways, governments hard-pressed for revenues are sometimes driven to discretionary and unpredictable enforcement efforts – collecting money where they can and (as the common problem with refunds suggests) keeping it when they get it. On the other hand, they have sometimes resorted to introducing still more legislative changes (such as VAT withholding) to close gaps arising from previous political and administrative decisions. In some DTE the result has been almost a continuous cycle of changes in the effective tax structure, subsequent erosion of the tax base, and unrelenting pressure on the tax administration to meet revenue targets. Those taxpayers who remain subject to the full rigor of the formal tax system in such countries face uncertain (and often increasing) tax burdens. No one can say with certainty how any transaction will be taxed today, let alone tomorrow. Savings and investment are deterred and misallocated. Trade may be discouraged as VAT refunds to exporters are not paid out but are instead kept in the treasury and used to meet budgetary needs. The shadow economy expands. Revenues fall, with the result that tax pressure is again increased on those who cannot escape, and the cycle continues.

The underlying problem when VAT performance is this dismal does not, as a rule, lie in poor tax design. Rather, it usually reflects one or both of two more basic problems. One problem is the existence of a fundamental gap between the institutional requirements for good VAT administration and the real fiscal institutions in place in a country. The other is the extent to which the VAT is in effect being used to reward political supporters or perhaps, in some countries, as an instrument of industrial or regional policy. As tax economists have long argued, even the best-designed tax concession or incentive is likely to prove a useful tool of public policy only when a country has both a stable macroeconomic environment and a stable political and administrative system. Since few DTE can meet these criteria, attempts to use VAT ‘incentives’ seem unlikely to yield good results.

Of course, relatively little can (or perhaps should) be said from outside a country about the inevitable political dimension of VAT. In contrast, however, as the background paper shows, much can be said, and often has been said, about how DTE should set up and run a VAT. Most of what is said on this subject in that paper is both sensible and probably correct. Nonetheless, it is striking how seldom many of the most obvious administrative truths about VAT seem to have been taken into account in practice. To illustrate, if a country does not collect VAT properly on imports it is unlikely to do much better with the more difficult application of the tax in the domestic economy. Yet some countries do not seem to do nearly as well as they should at the border – for instance, letting goods enter the country without paying tax (e.g. on the basis of an unsecured promissory note) or not applying exchange rate changes immediately on invoice values. Even if VAT is collected effectively at the border, the uneven and halting horizontal flow of information between border agencies and the VAT officials responsible for ensuring the validity of claims for input credits and refunds often puts the integrity of the tax at risk.

More generally, as hinted earlier, what is really at issue in such countries is not so much such specific problems -- all of which may in principle easily be corrected if desired -- but rather the fundamental question of whether they are really ready for the ‘self-assessment’ approach that the background paper properly asserts is how a ‘good’ VAT works. If a country is not ready in this regard, should it have a VAT at all? And, if it does (as many already do), is the best VAT for it always the same as the ‘model’ implicitly set out as a standard in most of the literature? The question is discussed further in the next two sections.

### ***2.3. Tax Design: The NOSFA Principle***

The ‘NOSFA principle’ is simply that no one size fits all. The questions that must be answered in designing and implementing any VAT are in principle the same in all countries. But since the context within which they must be answered differs significantly from country to country (and indeed over time within any one country), it is only to be expected that different tax designs may be ‘best’ for different countries. VAT features -- such as a single rate or zero-rating only for exports, or full and immediate refund of input tax credits – that may be

‘universally’ desirable in some sense may nonetheless either not be attainable or indeed neither essential nor desirable in the context of a particular country at a particular time.

Anyone who has ever tried to design and implement a VAT in any DTE is of course well aware of such realities. Nonetheless, to date surprisingly little effort appears to have been made to help those engaged in such tasks to deal with some important questions. For example, which critical factors define the VAT design that makes most sense for a particular country? Various studies over the years have mentioned such factors as industrial concentration, literacy, openness, ‘tax morale,’ public sector size, and administrative capacity – itself a vague concept, of course. But nowhere can one find either a clear picture of the relationship between such features and VAT design or any clear basis for assessing the manner or extent to which the choice of particular design features in particular contexts may affect outcomes.

Two important, related but distinct, research agenda thus seem to need further development with respect to VAT design for DTE. First, is there a taxonomy within which countries can be placed? That is, although one size might not fit all, might eight (or six, or twelve) VAT structures encompass all possible designs that would be both feasible and desirable? Some interesting pioneer work along these lines, albeit in rather general terms, was done some years ago (e.g. Shoup, 1990) but the question seems subsequently to have been left aside in the ‘rush to VAT’ in DTE. It is perhaps time to go back and take another look at this question, as has recently been done, for example, with respect to the almost contemporaneous ‘rush to decentralization’ in many DTE (e.g. Devarajan and Reinikka, 2003).

A second possibly rewarding approach to explore would be to recast the familiar (if implicit) ‘decision-tree’ approach to VAT by setting out in more detail the implications of different nodal decisions (e.g. zero-rating) for other design aspects, then working out the optimal sequence of such decisions for particular countries (or groups of countries), and finally assessing how dependent the ‘rightness’ of particular decisions is with respect to different characteristics of the environment within which the VAT is expected to function. While of course many elements of such an approach are to be found in the literature (e.g. Ebrill, 2001), as yet little has been done to set out the relevant decision-points and their interdependence in a systematic

fashion or to quantify them in any meaningful way, although the interesting recent work on VAT thresholds (Keen and Mintz, 2003) is a good first step in this direction. Many more such steps are needed.

#### ***2.4. Tax Administration: Growing into a Good VAT***

As noted in the background paper, countries are generally advised that a preparatory period of between 18 and 24 months is necessary to set up a VAT. This advice seems both reasonable and to some extent accords with experience in DTE. On the other hand, such experience also suggests that in some cases this period may be too long in the sense that often the window of opportunity open to introduce major tax changes may simply be too short to permit such relatively leisurely and measured preparation. Countries that adopt a VAT must sometimes, for better or worse, take what may be called the ‘big bang’ approach. Of course, when this has happened the experience has seldom worked out well, which is probably one reason so much stress is put on the need to follow the ‘normal’ time schedule mentioned above. Nonetheless, it would be helpful to separate out more clearly than is usually done the really critical steps in this process and any necessary sequence such steps must follow, as distinct from what might perhaps be called the ‘complete’ process. If it has to be done quickly, or not at all, what really has to be done, and in what order?

On the other hand, much DTE experience suggests that two years is not nearly long enough to have a good (or even an acceptable) VAT system up and running well. Ten years -- or at least five -- is perhaps closer to reality. Moreover, progress in this task is most unlikely to follow an even or smooth path. Policy innovation often follows a sort of logistic path, with an initial leap forward at the time of creation when attention levels and reward expectations are high, a subsequent period of letdown and perhaps even regression, and then, finally, if all goes well, a period of gradually settling into the ‘normal’ bureaucratic pattern. This path may be particularly noticeable in the many DTEs in which a new VAT is intended to serve as either a pilot or a catalyst for the reform of revenue administration more generally, not least because the success or otherwise of VAT is, of course, intimately related to the ability and willingness of a

country to create the needed conditions for successful self-assessment -- an issue that itself requires much closer examination than it seems to have received.

Two corollaries may be suggested. First, as already mentioned, one implication is simply that both the sequencing and the time scale of the ‘normal’ schedule need reconsideration. Which elements are most critical in the sense that if they are not in place the tax simply will not function? Which are most urgent in the sense that if they are not done, other critical things cannot be done? How much time and effort is really needed in the circumstances of particular DTE to do the critical and urgent things as distinct from the nice and perhaps eventually desirable ones?

Secondly, as with respect to tax design, more thought seems needed with respect to what one really has to know about a country in order to devise the ‘right’ implementation schedule for its particular circumstances. What matters most and in what ways? Is it the size distribution of the potential tax base? Or the relative importance of ‘key’ base components (such as imports and excise goods) and the degree of administrative control that can realistically be expected with respect to those components? Or the level of accounting skills in the potential taxpayer population? Or the detailed industry-by-industry flow of ‘VATable’ items between different sectors and different sized firms? Or the capacity of tax officials to administer an accounts-based tax and in particular attention to audit such a tax? Or, perhaps most fundamentally, the degree of existing ‘trust’ between officials and taxpayers and how quickly (and in what ways) that trust can be built up sufficiently to support a self-assessment system? Or is it all of the foregoing and more? Whatever one’s answers to such questions, what seems clear is that one cannot expect success simply by transferring experience from very different developed country settings to DTE with fragmented economies, large informal sectors, low tax morale, rampant evasion, and total distrust between tax administrators and taxpayers. The research agenda with respect to VAT administration in DTE is thus even larger and probably more important than that with respect to VAT design in such countries.

## ***2.5. Tax Policy is an Art, Not a Science***

Finally, perhaps the most basic lesson that may be drawn from experience to date with implementing VAT in DTE is simply that doing it right is in most respects a matter more of art than of science. A principal rationale for conferences such as this is to provide a forum for exchanging ideas and experiences in order to provide some help for those responsible for existing VATs in DTE in adapting to changing circumstances as well as to those responsible for deciding whether to adopt a VAT (and what kind of VAT) in the first place. But even the most careful consideration of the experiences of other countries is of little use in the absence of close knowledge of how one's own economy really functions. If, for example, the extent and behaviour of the informal sector depends, as some recent literature (Gerxhani, 2004) suggests, largely on the interaction between formal institutions such as the tax administration and the prevalent norms and customs in a country, the 'best' VAT design and implementation in many DTE will undoubtedly be rather different from that suggested by experience to date in the EU and other developed countries.

In the end, what VAT looks like and how it performs in any country inevitably reflects political factors and calculations as much or more than economic and administrative considerations. As a rule, of course, the critical political dimension of the policy process must simply be accepted as given by those directly concerned with tax design and implementation. Nonetheless, it is obviously desirable that they are as fully aware as possible of the manner in which such factors may impact on, and are in turn affected by, such central elements of VAT design and implementation as exemptions (see section 3.2 below). To be forewarned that a particular sector is politically 'untouchable' may, for instance, enable policy designers to be able to work around the problem in a way that does less damage to the tax as a whole than might otherwise be the case.<sup>4</sup> Somewhat curiously, however, despite the proliferation of real world examples available for study, few careful 'political economy' studies of VAT implementation appear to have been done in DTE as yet. As such studies begin to appear, they will in all likelihood often suggest still further questions calling for still more scientific (empirical and

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<sup>4</sup> A common joke among development economists years ago was along the following lines: "What difference would it make to development policy in country X if all the political scientists in the world disappeared?" The expected answer, of course, was "No difference at all." While no doubt serving its intended purpose of making economists feel perhaps a bit more useful (at least in relative terms), this joke is very wrong indeed. As we have begun to understand with the recent upsurge of the political economy literature, few things matter more for better policy design and implementation in any country than deeper understanding of how politics works in that country.

theoretical) research that may, in the long run, provide more useful advice than can yet be offered to those engaged in the precarious art of policy design and implementation in DTE.

### **3. Other Issues**

Many questions have already been raised about VAT in DTE, and some possible directions in which to search for answers have been tentatively suggested. In this part of the paper, five issues are singled out for a bit more discussion. Section 3.1 raises a prosaic but surprisingly important question: do VAT systems generate the information needed both for sound analysis and good management? Section 3.2 returns to the issue of exemptions mentioned in section 2.2 above, placing it in the more general context of the equity of VAT in the circumstances of many DTE. Section 3.3 focuses on some aspects of the surprisingly controversial questions related to VAT and small business, and section 3.4 continues downward, as it were, into the realm of the ‘shadow’ economy and asks how effective VAT can be in DTE in which such activities constitute a critical sector of the economy. Finally, section 3.5 raises the question of how, if VAT already faces as many problems as discussed here in many DTE, it can possibly cope with such changes as those associated with the looming rise of electronic commerce around the world.

#### ***3.1. Missing Data***

In most DTE, a more systematic approach to assembling and analyzing data would help greatly in facilitating major improvements in VAT policy and administration. Even in the relatively few such countries in which detailed VAT data are available in an accessible form, two characteristics are noticeable. First, considerable effort is generally required to put such data to any useful purpose, whether to analyze and improve the effects of VAT structure or to monitor and improve VAT administration. Secondly, most DTE have neither the resources nor, it seems, the desire to make such an effort. This situation is curious. It is, for example, obviously important for good tax administration to keep a close watch on trends and changes in taxpayer behavior, in order for instance to allocate administrative resources effectively and to develop

appropriate audit strategies. Any good revenue administration surely needs at least some data gathering and analysis capacity. Yet not only do units devoted to such purposes seldom exist, but even those most concerned with improving VAT administration seem seldom to put much emphasis on the need to improve matters in this respect, perhaps because they give higher priority to other, more pressing needs or, perhaps, less understandably, because of the almost certainly mistaken belief that the presumed ‘best administrative practices’ observed elsewhere can and should simply be copied.

Good data are also needed to formulate good revenue policy: for example, surely quantitative assessment of the revenue forgone as a result of different exemptions and exclusions is essential in determining the revenue and distributive effects of various policy options. Again, however, almost never is reliable information available along these lines in DTE, even though a regular reporting system with respect to such ‘tax expenditures’ is needed to ensure that revenues forgone through tax policy measures intended to achieve distributive or allocative objectives are subject at least periodically to some form of monitoring. In the absence of such estimates, once an interest group has received a tax concession it can forever after enjoy the results without having to show the public that the benefits it receives warrant the costs incurred. Better data (e.g. on a sectoral and commodity basis) are also often necessary to address empirically such issues as the substitutability and complementarity of tariffs and VAT. As a rule, the problem is less that such data simply cannot be obtained but rather that at present it is in no one’s clear interest to make the effort to do so. The combination of the ‘public good’ aspect of data and the possible adverse effect better data might have on the interests of some groups has, it seems, been sufficient in most countries to ensure that an amazing amount of tax policy continues to be made more on the basis of faith than evidence.

Of course, such comments may be applied to any tax. Two features make them especially applicable to VAT, however. In the first place, one unfortunate consequence of the adoption of VAT in replacement of other indirect taxes in many DTE has been the virtual disappearance of any information on the composition of the effective base of consumption taxation. Most studies dealing with this important question infer the tax base indirectly from

national income accounts or survey data.<sup>5</sup> Two simple examples of matters important to understanding how VAT really works in DTE that are amazingly difficult to discover in many countries are the real importance of imports in the VAT base and the importance of excise commodities in that base. Similar data gaps make it difficult in many countries to estimate the likely revenue consequences of base and rate changes in VAT. All these problems are in principle unnecessary, since all the needed information is necessarily generated in the process of administering VAT. But almost never are such data available in a usable form, let alone used.

Secondly, VAT is the only tax that involves the government not only in collecting substantial money from the private sector but also in paying a good deal of it back to them in the form of input tax credits. Since any VAT invoice constitutes a potential claim on the treasury, and falsifying such claims is perhaps the most common form of VAT fraud, it is critical from an administrative perspective to have a detailed knowledge of the ‘normal’ or ‘expected’ pattern of credits and liabilities for firms in all the different lines of business subject to VAT. Again, however, although the normal operation of an invoice-credit VAT generates such information, it is striking how seldom such data are either collected in usable form or used (e.g. for devising a risk management strategy). Perhaps even more surprising is that this whole question has apparently not as yet received much attention from the international community of VAT experts. It should.

### ***3.2. Equity Issues***

Equity is of course always and everywhere a central issue in taxation. Indeed, from one perspective, the principal rationale for taxes in the first place may be thought of as an attempt to secure equity. After all, governments do not need taxes to secure money because they print the money in the first place. The role of the tax system is instead to take money away from the private sector in as efficient, equitable, and administratively least costly fashion as possible. Equity, with efficiency and administrability, is thus one of the three principal objectives in designing any tax system. Of course, exactly what is considered to be equitable (or fair) by any

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<sup>5</sup> For an interesting recent example, though still a rather simple one, of the information that can be drawn from VAT revenue data about the tax base for EU member states, see Mathis (2004).

particular person may differ from conceptions held by others and in the end only through the political institutions within which countries reconcile (if they do) conflicting views and interests can a country's views of what constitutes an equitable tax system be defined and implemented -- although of course the results of this process may diverge widely from what others may think of as fair.

In general, equity issues may be approached at two different levels. First, one may consider the details of exactly how different taxes impose burdens on taxpayers who are in the same and different economic circumstances. Secondly, one may instead focus on the overall effects of taxation on the income and level of well-being of different people. The policy implications of these two different ways of approaching the equity of taxation may be quite different, with economists tending to take the second approach while much popular discussion of taxation instead takes the first approach. Focusing on the implications for equity of details of particular taxes leads, for example, to proposals to alter the rates and structures of particular taxes such as VAT. Although such proposals may improve horizontal and vertical equity within the limited group subject to the full legal burden of the tax, the same changes may sometimes actually exacerbate inequity more broadly considered. From the perspective of social and economic inequality, what matters in the end is surely the overall impact of the budgetary system on the distribution of wealth and income rather than the details of particular fiscal instruments like VAT. Nonetheless, such considerations are seldom given much weight when it comes to tax design, a process which almost invariably proceeds on a tax-by-tax basis.

In many countries, for example, consumption taxes are generally considered to be highly regressive. Some may note that taxes on consumption are less regressive on a lifetime rather than annual perspective, but given the relatively short life expectancies in many DTE and the subsistence level at which many people in such countries live daily, such refinements are likely to carry little weight. It is thus not surprising to find that many DTE provide for reduced VAT rates or exemptions for certain 'basic' items such as some foods, passenger transport, medical services, and cooking fuel. In some countries, substantial differences exist in consumption patterns between income groups. More generally, however, the common riposte to such policies is that whatever small degree of progressivity they may achieve could be more effectively and

fairly attained through small changes in the income tax or by adjustments in transfer payments, although in countries in which the poor do not as a rule suffer from income tax or benefit from transfer payments this observation is largely irrelevant.

The conventional argument that there is unlikely to be much gain in imposing differential ‘luxury’ rates under a VAT even in DTE given the efficiency and administrative costs to which such differentiation gives rise, seems convincing, especially since more can be done with less collateral damage through excise taxes on such commodities, if desired (e.g. Cnossen, 2004). But the conventional case for imposing VAT at a uniform standard rate and on as broad a base as possible in such countries seems less convincing. A uniform VAT is likely to increase the price of many goods essential to the poor (e.g. Ahmad and Stern, 1987). Because the poor may consume a relatively small amount of such products, it is undoubtedly true that, as the background paper notes, much of the benefit of such exemptions will go to the non-poor. Nonetheless, in view of both the relatively heavy tax burden from such taxes on the poor in some DTE and the general inability of governments in such countries to provide offsets to such tax burdens through other fiscal adjustments, some such offset often seems quite justifiable.

Zero-rating for distributive reasons, however, is perhaps inadvisable in countries already facing many difficulties with VAT refunds, and exemptions increase cascading and by breaking the VAT chain make effective enforcement more difficult. Perhaps, therefore, a reduced rate might be the best approach, although more careful analysis is needed of exactly what level and form of relief is best for the particular circumstance of a particular country. There are too many instances in which the items taxed (or not taxed) in different ways appear to have been chosen arbitrarily by fiat rather than in a reasoned fashion to make one comfortable with the state of our knowledge on this issue. Moreover, even if a country has worked out sensibly what is best at a point in time, the issue needs to be revisited from time to time, both because of the ‘exemption creep’ mentioned in section 2.3 and because since circumstances change what is sensible may well change also

A final point that deserves mention with respect to VAT and equity in DTE is the importance of the shadow economy. Many DTE have a large economic sector that is effectively

not subject to direct taxation. This reality clearly should affect how one assesses the effects of different fiscal instruments on equity. It is not at all impossible, for instance, that in some cases even a uniform broad-based VAT may be more progressive than more nominally progressive taxes (such as the personal income tax) that in practice burden only a limited group of wage-earners. The question of VAT and the shadow economy is discussed further in section 3.4 below.

### ***3.3. Small Problems***

In most if not all DTE an astoundingly small number of VAT registrants, sometimes less than a few dozen in number, account for 80 percent, 90 percent or even more of VAT collections. Obviously, it is critical to keep a very close idea on these fiscal ‘whales,’ as much recent literature on tax administration has argued (e.g. Baer, 2002). What has proved much more troublesome in VATs around the world is the question of how best to deal with the ‘minnows’ of the system -- small taxpayers. At least three distinct questions may be distinguished in this respect. The first, discussed in the background paper, is the issue of where to set the threshold. The second is, what, if anything, should be done to ‘simplify’ VAT procedures for small registrants, with different countries reaching answers that range from providing some form of simplified accounting to subjecting them, in effect, to a tax other than VAT. And the third question is how to make sure that those who are treated as ‘small’ by the VAT really are small.

With respect to the first of these points, it is, as the background paper notes, a puzzle why most DTE persist in setting such low thresholds for VAT registration, thus encumbering their already overburdened administrations with a large amount of essentially useless work. While more research is obviously needed on this question, several rationales may perhaps be suggested. First, since good tax administration rests on information – and for no tax is this truer than VAT -- it is obviously advantageous in principle to include as large a share of economic activity in the tax base as possible in order to be sure to capture the necessary information. Such an explanation would be more convincing, however, if there were more evidence that any DTE put such information to good use (see section 3.1 above) and the very countries that set unduly low

thresholds did not so often provide many of those thus caught in the VAT net with escape routes through various simplified systems or, in some cases, simple neglect.

Another, less savoury, rationale may perhaps be the resulting increased demand for large numbers of low-qualified staff as well as, perhaps, the increased opportunities for corruption. Less pejoratively, still another rationale may simply be that the deep distrust of taxpayers prevalent – often for good cause, of course -- in many DTE administrations may perhaps lead them to dip as deeply as possible into the pool of potential taxpayers in order to try to catch some ‘hidden whales’ -- although if this is the rationale, the results seem unlikely to be very positive and may well, by overloading the administration, be negative. As the background paper says, in the end it simply does not seem to make much sense for most DTE to attempt to apply VAT as widely as their laws attempt to do, and it remains a puzzle why so many have followed this path.

Wherever the threshold is set, however, and for whatever reason, it is of course well recognized that compliance costs are relatively more burdensome for smaller firms. As a result, many DTE have attempted to alleviate the blow in various ways. Some have done so in ways that seem unnecessarily complex. One country, for example, has three alternative ‘simplified’ accounting systems that may be used by small firms. Perhaps the most usual approach, however, is in effect to take out of VAT most of the very firms that the unduly low threshold has brought in -- for example, by applying some form of turnover or presumptive levy to firms below a (usually self-reported) threshold. The extreme version of this approach is the ‘simplified’ or ‘unique’ tax that has become popular in some DTE in recent years. This approach may have the not inconsiderable virtue of allowing new and potentially growing firms to escape from often arbitrary tax administrative practices. As noted in section 3.4, however, it has its own problems. Moreover, not nearly enough attention seems to have been paid either to the details of the design and implementation of such ‘supplementary’ or ‘complementary’ (depending on how one views them) levies or to how they relate to the various (often similar) forms of local business taxes found in many DTE. Again, there seems much useful research that can and should be done on such matters.

A quite different approach to the perceived and real problems of dealing with small taxpayers is the so-called ‘VAT withholding’ found in some countries (and mentioned in the background paper). In effect, this practice assumes that VAT will not be reported properly by small firms and hence requires those selling to such firms to ‘withhold’ an additional VAT on such sales to make up for the VAT those firms are supposed to collect (but are expected not to remit even if they do collect) on their own sales. Such ‘dual price’ systems are usually imposed at arbitrary rates and make no logical or administrative sense; nonetheless, they are sufficiently common, and are suggested sufficiently often in countries in which they do not now exist, to call for closer examination than they seem so far to have received. For example, what is the best way to determine the appropriate ‘withholding’ rates (essentially presumptive taxes) in different circumstances? Are such ‘withheld’ VAT ever credited against VAT actually reported by the firms from whom they have been withheld? What is the net effect on revenue of such systems?

Finally, most discussion of the appropriate treatment of small firms appears to assume that there is no difficulty in telling which firms are small. As with giraffes, it appears that one is supposed to know one when one sees one. As discussed in the next section, however, this assumption is probably wrong in many DTE.

### ***3.4. Chasing Shadows***

Much recent discussion of taxation in DTE has focused on the so-called ‘shadow’ (underground, informal) economy. Recent studies suggest that in at least some such countries not only has the informal sector been becoming more, not less, important but also that persons and enterprises at all income (and size) levels are engaged to varying extents in the informal sector (de Ferranti, 2004). Many businesses in DTE seem to operate in both the formal and informal sectors at the same time. Of course, although firms operating in the shadow economy may escape VAT liability on their sales they are also not able to reclaim credit for any VAT paid on inputs. For this reason, it has often been suggested that one way to impose an appropriate tax burden on those in the informal sector is precisely through a VAT. On the other hand, as noted earlier (section 2.1), others have argued that increasing taxation of the formal sector may expand,

not reduce, the amount of hidden economic activity taking place as some current market-based activities may be able to disappear into the shadow sector.

In response to such problems, a number of DTE have engaged in various activities intended to chase ‘shadows’ back into the fiscal light. At one level, tax officials may simply walk along the street, sweeping hawkers and peddlers into the tax net, entering premises and confiscating records, etc. A more sophisticated approach is to follow the audit trail, starting with those who are in the tax net and working outward on the assumption that it is almost impossible even in the most undeveloped DTE never to have traceable contact with someone who is already known to the tax authorities. Alternatively, operating on the premise that even tax evaders must eat and drink, and perhaps even drive a Mercedes, the authorities may, as mentioned above, attempt to tap the tax potential of the shadow world through indirect rather than direct methods, such as the introduction of presumptive taxes, that is, taxes imposed on bases determined by an official rather than the taxpayer. The widespread existence of presumptions of various sorts even in VAT, as in the case of the simplified accounting systems and withholding mentioned in section 3.3, in effect constitutes formal recognition of the inability or unwillingness of the administration in many DTE to rely on self-assessment for a large part of the potential taxpayer population.

It is, of course, the very essence of the business of tax administration that the “customers” are not very willing and often try to opt out of the system. Those who do so may include not only genuinely small businesses but also profitable large- or medium-sized businesses that only look small as well as firms that are losing money but continuing to function by not paying over taxes such as VAT with respect to which they are in effect withholding agents. Tax administrations in DTE are generally severely constrained in terms of resources and skills. Often, they have to choose whether to go after the larger firms who are already in the tax net, where potential tax revenue payback may be higher, or to pursue instead the less lucrative smaller taxpayers who are largely outside that net. Many have chosen, perhaps rationally, to spend little time on the small but rather to attempt to cope both with them and to some extent with the whole shadow economy issue by adopting some form of specific presumptive tax regime in lieu of VAT (and often other taxes as well).

All too often, however, DTE seem to have great difficulty in distinguishing between small firms who do not keep good books and records but are potentially (and legally) taxable and firms whose activities are clearly large enough to fall within the tax system but are tax evaders. Some in the latter group may be completely off the fiscal radar – the so-called “ghosts” – while others are more like “icebergs,” in that the portion of their activities visible to the authorities may be miniscule compared to the hidden reality (Bird and Wallace, 2004). In these circumstances, since special tax regimes inevitably fragment the tax system they are often inconsistent with good tax administration. Any time that a “disconnect” is created between a special tax regime and the general tax system, problems are likely to emerge. A country can no more long sustain two national tax regimes than two national currencies. Each regime constitutes an integral part of the other and affects the entire system. A good ‘special’ tax regime, whether intended to supplement a ‘normal’ VAT by replacing its complexities with a simplified regime for small business or to extend the reach of the tax further out into the shadow economy, must therefore include explicit transition arrangements to link the special regime to the more general tax system, within the context of the prevailing tax administration constraints. In practice, however, such arrangements seem seldom to exist.

Simplified special regimes usually have the goals of both alleviating some of the compliance burden of complex tax systems (and hence encouraging the growth of small business) and educating taxpayers sufficiently so that they may eventually become members of the regular taxpaying population. Other rationales for such systems may be to reduce opportunities for corruption and harassment of taxpayers, to reduce administrative costs of dealing with small taxpayers, and, by encouraging better record-keeping, to improve tax administration in general (Engelschalk, 2004). In addition, as already mentioned, an important aim is often both to discourage the growth of the informal economy and to increase revenues from this sector, thus equalizing tax burdens between the formal and informal sectors to some extent. A key problem in achieving any or all of these goals is how to keep out of the (simplified) system large and medium enterprises that try to look like small enterprises and hide themselves from the taxman’s eye.

Just as one must ensure that as the truly small become bigger they will graduate into the normal tax system, so one must also ensure that those who are in the normal system already – or who should be in that system – cannot easily migrate into the simplified system, taking on the disguise of smallness to shield themselves from taxation. The temptation to shelter from the fiscal blast within such systems is likely to be especially strong when, as experience suggests is usually the case, the effective tax rates applied to those who make it to the ‘safe harbor’ of the simplified system are considerably lower than those in the normal tax system.

An additional problem such systems impose for VAT is that firms within such special tax regimes are often not included in the VAT chain, thus increasing the number of transactions legally outside the VAT system and exacerbating the general administrative problem. In principle, of course, since purchases from these taxpayers by regular VAT sellers cannot be used to claim input credits, an incentive is created for them to voluntarily (or under pressure from their customers) enter the VAT system. How effective this incentive is likely to be, however, is far from clear given the general difficulties DTE face in policing the fringes of the VAT system. For example, other registered sellers – some of whom themselves may be conducting significant ‘shadow’ business -- may agree to issue VAT receipts in their own name, a practice that seems not unlikely in the context of countries with large shadow economies and generally weak tax auditing capacity. In short, attempts to supplement a VAT by some kind of simplified system intended to help the small or catch shadows may end up making matters worse by creating the risk of migration to the less expensive system, particularly when, as is too often the case, firms once safely hidden in the ‘small’ sector can stay there almost indefinitely with little or no risk of audit or exposure.

One reason such regimes have been created in some DTE is because the normal tax regime is considered (by those who put it in place, presumably) to be too complex and often also too harshly applied and perhaps unduly prone to corruption, extortion, and harassment. Insulating selected (sometimes self-selected) taxpayers from such problems does not make the problems disappear. On the contrary, it is likely to make them more difficult to deal with, both by complicating tax administration as a whole and by reducing political pressure to fix the basic problems with tax administration. Taking people out of the VAT system is a particularly bad

idea since information is the lifeblood of an effective VAT administration. Every effort should be made to avoid breaking the information chain, rather than encouraging firms to do so, as simplified systems in effect do.

### ***3.5. Changing with the Times***

A final general observation is simply that, as with all taxes in all countries, no VAT in any DTE, however well designed and well administered it may be, will forever remain the same. Times change, and so do taxes. Keeping up in taxation requires an ability to read the winds -- to detect important emerging tax issues, to work out in detail how best they may be dealt with, and to devote time and energy to changing tax design and administration to cope with changing circumstances. As in so many respects, life is more difficult for those concerned with tax matters in DTE simply because, almost by definition, such countries are not only more likely to change, especially if they succeed in growing and developing, but they are also likely to be more vulnerable than most developed countries to winds coming from abroad and of course to have less capacity to cope with such problems.

To take only one example, consider the ‘digital revolution’ and its implications for VAT around the world. Few subjects have given rise to more discussion among those concerned with tax matters in recent years than electronic commerce. Governments, international organizations, and pundits have poured forth reams of material on this subject. The general OECD line that taxation should be neutral and equitable between all forms of commerce, electronic or otherwise, while simultaneously minimizing both compliance and administrative costs and the potential for tax evasion and avoidance, seems both reasonable and persuasive. But what, if anything, does e-commerce imply for VAT in DTE? Some have argued, for example, that real success in taxing e-commerce can be achieved satisfactorily only by increased co-operation between governments, and perhaps even by the adoption of explicit ‘base-sharing’ arrangements. It is hard enough to see how such a nirvana can be achieved among developed countries, let alone to envision how and when any such arrangements might be extended to DTE.

Fortunately, at least for the near and perhaps medium future this issue seems unlikely to be critical for most DTE. In principle no special problem arises under any VAT with respect to the B2B (business-to-business) services that continue to constitute the bulk of all e-commerce transactions, since in effect the most difficult cross-border issues are handled simply by taxing buyers indirectly (since they receive no input credit to offset against output tax). To work well, however, this system, like all VAT administration, ultimately depends on the efficacy of tax audit, notoriously the weakest point of tax administration in DTE, so most DTE will indeed face some problems in practice when it comes to taxing even B2B e-commerce. Moreover, DTE, like all countries, will face further problems in dealing with sales of digitized services to non-registered taxpayers – B2C (business-to-consumer) transactions. Developed countries find it difficult to compel non-resident sellers of such items to register or buyers to report their purchases. The success ratio for DTE attempting to follow this path will almost surely be even lower.

By the time this last problem become significant for most DTE, however, perhaps some better way of dealing with it may have been discovered. For the next few years, probably the main advice one should give to DTE with respect to VAT and electronic commerce, as with respect to such other ‘frontier’ issues as the treatment of the financial sector and the public sector, is simply not to worry much about such esoterica but rather to concentrate on the difficult task of first getting an appropriate VAT into place and then running it effectively. The basic question in many DTE is not how to deal with ‘new’ issues but rather how one can make a tax like VAT, which essentially depends on self-assessment, function adequately in countries that in many instances do not appear to have satisfied the necessary preconditions for a self-assessment system. The answer, as suggested earlier, may be to spend more time and effort trying to determine what kind of less-than-perfect VAT will function best in such countries and then working out in more detail the best way in which they can move over time from such unsatisfactory (though necessary) initial positions to a good VAT. Good answers along these lines can in all likelihood only really be determined in the context of close study of particular countries.

## 4. Conclusion

To sum up, VAT is of course not ‘the answer’ to the fiscal problems of DTE. Despite the many problems and questions raised above, however, some form of VAT almost certainly constitutes a critical ingredient in such an answer. Even the best possible VAT will not solve all the problems of DTE: the VAT they have may not always work well; in some instances it could be designed better to fit the context of the country; in many instances, it could certainly be administered better, even in the face of adverse political and capacity factors. Nonetheless, so long as a general consumption tax makes sense as a key part of a country’s fiscal system, as is surely true in most DTE, VAT remains the best available fiscal instrument we have. According to the background paper, 136 countries now have a VAT of some sort. Information from the IBFD (Annacondia and van der Corput, 2003) suggests that there remain at least 63 countries that do not have VATs, 41 of which now have some other form of general consumption tax and 23 of which appear to have thus far been able to avoid facing the problem. When the next Global conference on VAT takes place, it is thus a safe prediction that yet more countries will have VATs. It remains to be seen to what extent the various issues raised above will have been either dispelled or more adequately dealt with by that time.

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