

Facing economic meanings of VAT

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Value-added tax, commonly referred to as VAT, has been around since 1954 when it was first implemented in France and gradually spread to other countries of the world.

It is now a key component of the tax system in more than 120 countries, covering about 70 per cent of world's population. VAT generates about \$18 trillion in tax revenue, more than one-fourth of the world tax revenue.

Lately, there has been talk about United Arab Emirates (UAE) introducing VAT of two to five per cent on consumer goods and services in early 2009. This is to compensate for the lost revenue as a result of the abolition of the import tariffs in the context of UAE's planned Free Trade Agreements (FTAs) with countries such as US and EU. The decision to implement VAT has attracted a lot of attention in the UAE.

Questions have been raised whether: (i) Is VAT regressive? (ii) Is VAT inflationary? (iii) Is Vat appropriate for the UAE economy?

A VAT is often considered to be essentially a retail sales tax, in which tax is collected only at the point of sale to the final consumer. However, a VAT differs from a retail sales tax in that it is collected at each stage of the production and distribution process, not solely at the stage where a product is sold to the consumer (i.e. retail sales tax).

Is VAT regressive?

It is often argued that VAT is a regressive tax since it taxes consumption and since lower-income households spend a greater proportion of their incomes on consumption than higher-income households. This argument has some merit. Proponents of VAT argue that VAT increases government revenue and that some of VAT revenue could be used for increased welfare spending which would otherwise help the lower-income households.

However, in the context of UAE, the poor are mainly the unskilled expatriates and are not entitled to social benefits. As the VAT is replacing custom duties, it would be considered regressive if prices of items purchased predominantly by lower-income households rise relative to prices of purchases made by higher-income households.

Nevertheless, to partly alleviate the regressiveness of VAT, the UAE government can either exempt basic goods (e.g. food, clothing) from VAT or tax these goods at a rate lower than the basic rate. Generally, certain products and services (e.g. medicine, transportation, postal, and banking) are exempted from VAT since the concept of VAT is difficult to apply.

Is VAT inflationary?

A major policy concern about the implementation of a VAT is whether it will trigger further inflation. There has been some debate lately over this issue. For example, Mohsin Khan, IMF's regional director in the Middle East, has claimed that VAT will increase inflation rate by one to two per cent in the UAE and the GCC. In reply, Abdul Rahman Al Saleh, executive director of Dubai Customs, has said that VAT would increase inflation rate by no more than half a per cent.

Imposition of a VAT, by itself, cannot be considered inflationary. For example, a uniform VAT would result in a one-time increase in the general price level. However, this would not necessarily lead to inflation, since inflation is a continuous increase in average prices over time and does not refer to a once-and-for-all increase in prices.

In UAE's context, introducing a VAT may not fully result in a one-time increase in overall level of prices because the VAT is not a supplement to existing taxes; rather it is substituting the custom duties. Thus, the final price effect of a VAT would depend on the trade-off between reduction in custom duty and the cost to businesses of administering the VAT.

A VAT can result in inflation only if the VAT either induces the monetary authority to increase the money stock or increases the velocity of the existing money stock (equivalent to a reduction in real money balances). If neither of these situations occurs, a higher general price level cannot be sustained since consumers would be unable to make all of their previous purchases at higher prices. Consequently, changes in production and employment will occur and things may get complicated depending how government react to these changes.

VAT and UAE economy

The issue whether VAT is appropriate for UAE economy can be answered from the experience of the other countries that have adopted the VAT. For example, a 2001 study by four IMF economists finds that revenue gains from VAT are likely to be higher in an economy with higher level of per capita income, lower share of agriculture, and higher level of literacy.

The same study concludes that the VAT performs relatively well in small countries with population of less than five million. Moreover, the efficiency of VAT tends to improve with more international trade. These results hold great promise for the implementation of the VAT in UAE since it shares many positive elements outlined by the IMF study.

This article bypassed many issues and challenges involving the meaningful implementation of VAT. Yet, the speed with which VAT has spread around world clearly indicates that its benefits outweigh the costs. Tax is always a debatable issue and time never seems right for its implementation. UAE's bold step of introducing VAT will help other GCC states to follow suit.

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