



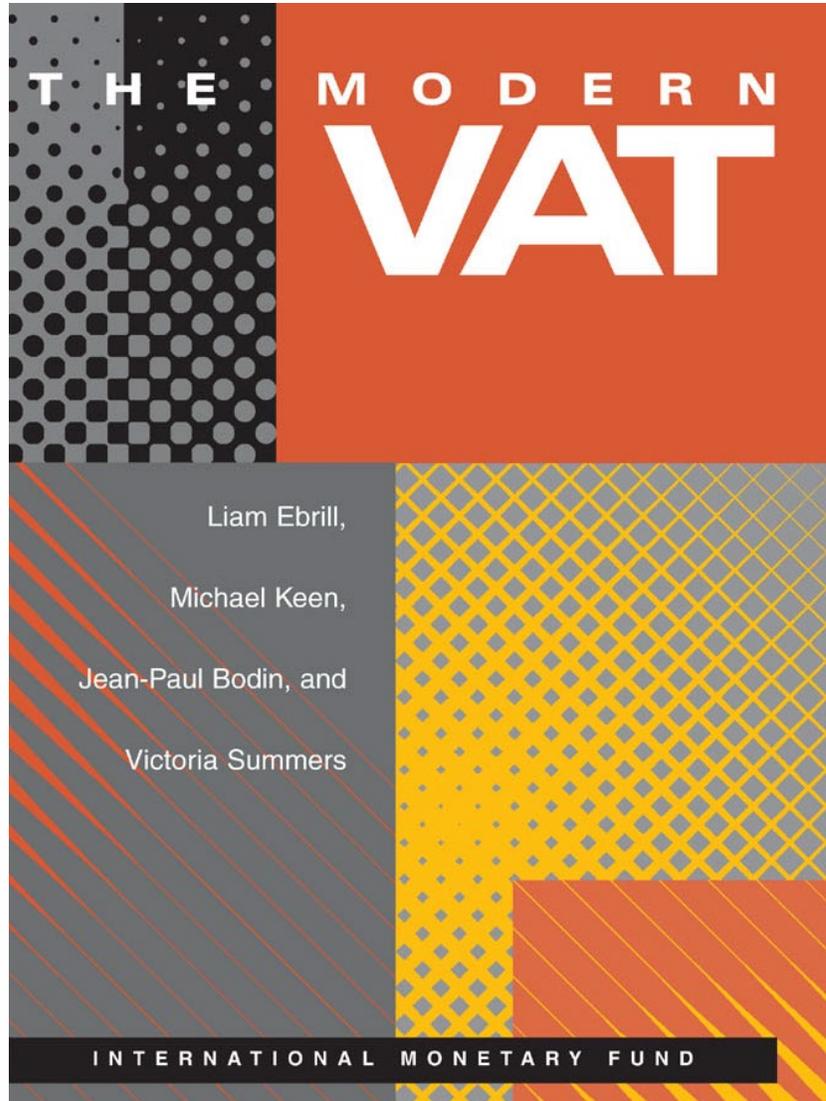
FISCAL AFFAIRS

VAT Efficiency

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Why efficiency?



- VAT has long been a mainstay of IMF tax policy advice
- Why?
 - ▶ Mainly because of its efficiency and effectiveness properties
- 25 years on from *The Modern VAT*, what have we learned?
 - ▶ Focus here is on **efficiency**
 - ▶ Other issues of concern to VAT policy makers not addressed here
 - ◆ De Mooij et al. (2025) Efficiency Aspects of the Value Added Tax (WP/25/165); Forthcoming IMF book

Dimensions of VAT efficiency

- As a revenue raiser
- As a macroeconomic policy tool
- For other policy objectives?

First: Why tax consumption and at what rate?

Consumption is considered an appealing tax base because:

- It is relatively **easy to observe**
 - ▶ *Not consumption per se, but the acquisition of commodities for consumption*
- It is linked to the **ability to pay**
 - ▶ *But this is inherently difficult to calibrate on a transaction-by-transaction basis*
- It is **more efficient than taxing production**
 - ▶ *Taxing production reduces output available for final consumption*

Efficiency arguments for a **uniform rate** are grounded in practicality rather than theory:

- Theory suggests higher rates on **inelastic commodities** and **complements to leisure**, BUT:
 - ▶ Serious difficulties in identifying what these are—both in theory and in practice
 - ▶ Other instruments are generally more efficient to address externalities
 - ▶ Equity

VAT as revenue raiser

Why use a VAT to tax consumption?

VAT is generally considered superior to other ways of taxing consumption:

- **Turnover taxes**
 - ▶ Simplicity is appealing, but input taxation is very distortionary (rising exponentially with tax rate, share and substitutability of taxed inputs—multiplied by stages)
- **Retail sales taxes**
 - ▶ Theoretical equivalence to VAT breaks down in practical implementation (though VAT is not immune to the ‘last mile’ problem)
- **Tariffs**
 - ▶ As with turnover taxes: easy, but narrower tax base and distort production
- **Personal income tax (& transfers)**
 - ▶ Some equivalence with VAT base, except that PIT includes savings
 - ▶ More efficient than VAT for achieving progressivity

Evidence of VAT revenue efficiency

Evidence of VAT efficiency ('welfare gains') is emerging from empirical work

First, VAT introduction has generally *increased* countries' **Tax-to-GDP ratios**:

- By ~1.5% across income groups, for both early and late (post-2000) adopters
- Noticeably higher revenue gains for sub-Saharan African countries (~4%)

Secondly, there is evidence that a VAT *reduces* the **Marginal Cost of Public Funds (MCPF)**:

- Based on studies of the difference in MCPF between countries with/without VAT, and changes in MCPF before/after VAT introduction
- Ranges found translate in welfare gain of respectively up to 0.9% and 2% of GDP, on a recurring basis

But who bears the burden of the VAT?

- VAT incidence matters, not just for equity but also for efficiency:
 - ▶ *If not the consumer, does the efficiency argument for a VAT break down?*
- Full 'pass-through' is generally assumed, but increasing body of research shows that this is not always the case:
 - ▶ While country and context specific, studies show some trends
 - ◆ Standard rate changes are (almost) fully passed through
 - ◆ Reduced rate changes are only partially passed through
 - ▶ But many questions remain
 - ◆ Studies are based on advanced economies
 - ◆ Who bears burden of incomplete pass-through...?
 - ◆ Who benefit from VAT thresholds?

VAT as a macro policy tool

Evidence of VAT effectiveness for macro policy

Using VAT for short-term effects:

- To suppress/stimulate demand by increasing/decreasing the rate:
 - ▶ *Generally effective, especially in recession*
 - ▶ *Selective rate cuts not so much*
- To bring forward demand through temporary rate reduction or announcing a future rate hike:
 - ▶ *Both are shown to be effective, in particular for durables*
 - ▶ *But both are also followed by demand slump*

Using VAT for long-term effects:

- Effect on trade:
 - ▶ *VAT neutrality generally holds, but evidence of negative impact from imperfect crediting/refunding to exporters, especially in developing countries*
- Effect on growth:
 - ▶ *VAT is generally less distortive to growth than income tax (if well-designed!)*

VAT to pursue other policy objectives

VAT is generally less effective for achieving other policy objectives

- VAT is ineffective at compensating for the externalities/internalities from the consumption of certain commodities (e.g., drinking, smoking, burning fuel):
 - ▶ **Excises** are more effective for this:
 - ◆ The harm is usually proportionate to the amount of use, rather than price
 - ◆ The harm may not be limited to use for final consumption (e.g. fuel is also burnt in production)
- VAT ineffective as an industrial policy tool to stimulate domestic production of:
 - ▶ Commodities for final consumption, since any benefit will also accrue to imports
 - ▶ Intermediate goods, since any benefit will be undone in next/final stage of production

Thank you!