EFFECTS OF IMPLEMENTING A VAT COLLECTION SYSTEM IN THE UAE AS A WHOLE AND RAS AL-KHAIMAH EMIRATE SPECIFICALLY
EFFECTS OF IMPLEMENTING A VAT COLLECTION SYSTEM

IN THE UAE AS A WHOLE AND

RAS AL-KHAIMAH EMIRATE SPECIFICALLY

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ABSTRACT

The six member states of the Gulf Cooperation Council (GCC), which includes the United Arab Emirates (UAE), have agreed to launch a common market, with the intent of increasing investment and trade between GCC member countries. To facilitate such an increase in investment and trade, the GCC countries have also agreed to implement a Value Added Tax (VAT) system. This study examines the likely impact of the proposed arrangements on the UAE, with a particular focus on its implementation in, and impact on the Emirate of Ras Al-Khaimah (RAK). The study examines and analyses issues surrounding the implementation of VAT regimes in other economies, together with perceptions of various sectors of RAK industry and the community. It identifies the most appropriate VAT policy options for RAK in the context of a federal revenue sharing system, and key policy and administrative imperatives that must be addressed to ensure effective implementation of the proposed regime.

Based on the findings of the current research, it is considered that Australia and New Zealand have both implemented efficient models which the UAE could emulate. New Zealand is favoured due to the simplicity and perceived fairness of its arrangements. It consists of a single rate that is applied uniformly to most goods and services, has very few exceptions and a zero rating for exports. In this regard, requirements are simple and clear and administration and compliance is less costly.
The research findings have also pointed to the need for members of the UAE to reach agreement on a number of key policy issues as a matter of priority. These include VAT type, applicable rates, exemptions, zero-rating, central or local administration, methods of collection, treatment of other taxes, financing of administration and collection, and, perhaps most importantly, revenue sharing. A number of revenue sharing methods were examined. The optimal revenue-sharing method for RAK is determined to be one in which 30 per cent of the tax revenue remains in the Federal Government account, with the remaining 70% to be shared among the Emirates according to an agreed formula. It is concluded that this option will not only provide the Federal Government with its own discretionary funding, but also provide the Emirates with their individual budgetary requirements. For RAK, a fair and clear system of revenue sharing is extremely important and a system which properly recognises the geographic location where the revenue is generated is considered to be the most practical. In this context, the research findings indicate that one aspect of the revenue sharing models that is likely to prove critical to the effective operation of a VAT system is the way in which the revenue distribution formula is constructed and agreed.

The research has also pointed to the need to ensure that the scheme is widely understood, and that the associated regulatory requirements are simple, clear and predictable. Ultimately, the private sector’s perception of the new tax arrangements will be based on their experience in meeting the regulatory requirements. As such, it will be important to minimise the regulatory burden on the various sectors by providing as efficient a system as possible.
With regard to implementation of the new taxation arrangements, the research has identified a number of priority issues. First, there is need for Government clarification of its taxation strategy, including key elements of the new arrangements. Second, communication of the new arrangements to the public and business community, including consultation on issues of implementation wherever possible is of particular importance. This may include details of the proposed regulatory compliance program and the rights and responsibilities of taxpayers. Third, it will be necessary to establish a government authority with a well-trained, professional workforce with the necessary knowledge, skills and competencies to effectively and efficiently administer the new arrangements. Finally, there is a need to develop and deliver public and industry information campaigns and education programs to ensure that taxpayers are fully aware of their rights and responsibilities, and the likely impact the tax will have on them.

In essence, the basic advantage for RAK is an opportunity to move away from its current reliance on revenue from customs tariffs and other fees and charges, by providing both the UAE and RAK with a long term, sustainable and predictable broad-based source of tax revenue. If implemented judiciously and in phases, it is considered that the new taxation regime can be understood and accepted by the public and commercial entities, and professionally administered by the authorities, thereby raising needed revenue effectively and efficiently.
ACKNOWLEDGEMENTS

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<td>Sub Saharan Africa</td>
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<tr>
<td>AS</td>
<td>American and Small island</td>
</tr>
<tr>
<td>ATO</td>
<td>Australia Tax Office</td>
</tr>
<tr>
<td>ACBPS</td>
<td>Australian Customs and Border Protection Service</td>
</tr>
<tr>
<td>BAS</td>
<td>Business Activity Statement</td>
</tr>
<tr>
<td>CBRO</td>
<td>Central Europe, the Baltic, Russia and other nations formally belonging to the Soviet Union</td>
</tr>
<tr>
<td>CET</td>
<td>Common External Tariff</td>
</tr>
<tr>
<td>CGE</td>
<td>Computable General Equilibrium</td>
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<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
</tr>
<tr>
<td>COAG</td>
<td>Council of Australian Governments</td>
</tr>
<tr>
<td>EEC</td>
<td>European Economic Community</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>EU+</td>
<td>European Union plus Norway and Sweden</td>
</tr>
<tr>
<td>GAO</td>
<td>Government Accountability Office (USA)</td>
</tr>
<tr>
<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<tr>
<td>GST</td>
<td>Goods and Services Tax</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>HFE</td>
<td>Horizontal Fiscal Equalisation</td>
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<td>HST</td>
<td>Harmonised Sales Tax</td>
</tr>
<tr>
<td>IRD</td>
<td>Inland Revenue Department (New Zealand)</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>MIG</td>
<td>Municipal Infrastructure Grant</td>
</tr>
<tr>
<td>NMED</td>
<td>North Africa and Middle East</td>
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<td>NRF</td>
<td>National Revenue Fund (South Africa)</td>
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<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
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<td>PAYG</td>
<td>Pat As You Go Tax</td>
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<td>RAK</td>
<td>Ras Al Khaimah</td>
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<td>RAKIA</td>
<td>Ras Al Khaimah Investment Authority</td>
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<td>RST</td>
<td>Retail Sales Tax</td>
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<td>Full Form</td>
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<td>SI</td>
<td>San Marino</td>
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<td>SME</td>
<td>Small and Medium Enterprises</td>
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<td>SARS</td>
<td>South African Revenue Service</td>
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<td>SMIF</td>
<td>Special Municipal Infrastructure Fund</td>
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<td>TRS</td>
<td>Tourist Refund Scheme</td>
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<td>UAE</td>
<td>United Arab Emirates</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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<td>VFI</td>
<td>Vertical Fiscal Imbalance</td>
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Figure 8-1: Rise in GDP in United Arab Emirates, Years 2002-2012
CHAPTER 1: INTRODUCTION

Background to the Study

On 1 January 2003, the six member states of the Gulf Cooperation Council (GCC)\(^1\) became a customs union, that is, a free trade area with a common external customs tariff. In January 2008, the six GCC member states further agreed to launch a common market, with the intent of increasing investment and trade between GCC member countries. To facilitate such an increase in investment and trade, the GCC countries also agreed to implement a Value Added Tax (VAT) system across the GCC, and with the assistance of the International Monetary Fund (IMF), they agreed to adopt a ‘New Zealand-type’ VAT system, with a three to five per cent VAT rate being recommended.

In 2011, the United Arab Emirates (UAE) announced that it was embarking on a process of introducing a VAT, at a projected rate of 5%, with full implementation by 2014 or 2015. At that time, the UAE Ministry of Finance reported that it had completed a study on the social and economic effects that VAT would have on the nation and that full implementation would take three years from the point at which the general principles were agreed collectively within the GCC.

It is widely agreed that, if implemented, the initiative to introduce a VAT will have a significant impact on the economies of the countries that adopt it (Deloitte and

\(^1\) The GCC countries include the United Arab Emirates, the State of Bahrain, the Kingdom of Saudi Arabia, the Sultanate of Oman, the State of Qatar and the State of Kuwait.
Touche, 2008). In particular, it will impact on the revenue collection and sharing arrangements of the seven Emirates which constitute the UAE\(^2\). Most significantly, it will replace the current arrangements in the Emirates whereby government revenue is collected by way of customs duties. Potentially, therefore, this may translate into a substantial variation in revenue receipts for some of the Emirates, including Ras Al-Khaimah (RAK).

RAK is one of the seven Emirates of the UAE, a federation located in the eastern portion of the Arabian Gulf. RAK has a population of about 300,000, out of the UAE total population of almost four million. While citizens of the Emirates officially comprise less than 20% of the UAE population (due to an influx of foreign workers), this proportion is greater in RAK, where Emiratis are believed to comprise about half of the population (Simmons, 2005).

The federal government is a civilized democracy and has sole authority over foreign affairs, defence and the federal armed forces, education and health, federation finance, taxes, customs and loans, mail, telephone, other communication services, social security, air traffic control, currency, and immigration. The states (i.e. the individual Emirates) have complete authority over their territories, including law enforcement, public services, formulation of

\(^2\) The seven Emirates that constitute the UAE are Abu Dhabi, Dubai, Fujairah, Sharjah, Ras Al Khaimah, Ajman and Um al Quwain
social and economic standards, local ordinances and, perhaps most significantly, natural resources (Simmons, 2005).

Because RAK is not a major petroleum producer, it has placed a particular emphasis on the development of its industrial sector. RAK inaugurated the UAE’s first cement plant at the start of the 1970s and is currently the UAE’s largest manufacturer of cement. In the following decade, RAK founded Ras al-Khaimah Ceramics, which is presently the largest ceramics company in the world. In addition, the Emirate created Gulf Pharmaceutical Industries, Julphar, which was the first pharmaceutical company in the region. RAK also benefits from non-oil mineral resources which have significantly increased its non-oil based economic growth. Finally, the Emirate is an important agricultural centre and a significant commercial port for the UAE (The RAK Investment Authority [RAKIA], n.d.).

Presently, the Emirate is concentrating on attracting foreign investment, including outsourcing and off-shoring. To this end, new laws and regulations have been introduced in both RAK and the UAE. In particular, security and confidentiality are guaranteed to foreign business ventures. In addition, in situations where a foreign enterprise has only international clients, its activities will not attract local taxes. Furthermore, foreign entrepreneurs may open a local bank account, make tax-free investments, and acquire mortgages to invest in local assets. Foreign firms can own property in UAE Free Trade Zones, including those based in RAK, and currently there is no income, wealth, or sales tax in RAK, nor are corporate
taxes levied. There is no VAT. Finally, there are no foreign exchange controls, no
currency restrictions, no withholding, and no import or export taxes (The RAK
Investment Authority [RAKIA], n.d.). To attract foreign investment, the UAE offers
employment visas. At present, executives and workers from India, the Middle
East, Europe, America, Africa, and South East Asia are employed in RAK.

These types of policies reflect the current government emphasis on attracting
international business as it withdraws from overseas investments (Carlisle,
2010). For example, RAK is presently relying heavily on attracting tourists from
around the world. At the same time, RAK is withdrawing from foreign ventures
that are concentrated in developing markets, such as Indonesia, Africa, and the
Caucasus states. The establishment of RAKIA, the Emirate’s sovereign wealth
fund is an example of this trend. It aims to convert RAK into a manufacturing hub
for automobiles and vehicle parts. Japanese companies are already present and
European companies are currently being courted.

There is no doubt that the introduction of a VAT will impact on such initiatives.
The purpose of this research is to analyse the proposed new VAT system and
identify how it may impact the economy of the UAE, with a particular focus on its
implementation in, and impact on RAK. In doing so, it identifies policy imperatives
that must be addressed in order to ensure an economically viable outcome for
RAK.

It is critical that the basic principles of a VAT taxation regime are critically
examined and understood before adopting it. Aizenman and Junjarak (2008)
observe that countries new to the system often encounter significant challenges. They also note that revenue recovery for middle income countries following trade liberalization may be weak - about 50 cents for each dollar of lost trade revenue (Baunsgaard and Keen 2005, as cited in Aizenman and Jujarak 2008, p.392). In this context, it is essential for the government of RAK to ensure that the UAE is able to strike a balance between complying with the requirements of GCC member countries (of which the UAE is a part) and maintaining economic viability in order to continue to attract international investment.

**Research Objectives**

As noted above, this study seeks to identify the likely impact of the proposed VAT arrangements on the UAE, with a particular focus on its implementation in, and impact on RAK. A key element of the study is its critical analysis of the factors that must be addressed when implementing the new taxation regime in order to preserve RAK Government policy imperatives, while minimising disruption to both the private and public sectors.

The research analyses both qualitative and quantitative data in order to evaluate the potential impact of a VAT regime. In doing so the researcher seeks to achieve the following objectives:
1. To critically examine the direct and indirect effects of implementing the proposed VAT scheme on RAK;

2. To assess the validity and viability of the proposed VAT scheme, including the associated revenue sharing arrangements, and the potential it holds for the future financial landscape of RAK;

3. To establish and determine the issues surrounding the implementation of VAT regimes in other economies. This will provide a broad overview of a typical VAT system, the basis for considering viable alternative approaches to policy and administrative aspects of a VAT regime, methods of distributing VAT revenue among member states, and compliance management strategies;

4. To identify key issues that will impact on the successful implementation of the new taxation arrangements in the UAE and RAK; and

5. To identify the most appropriate VAT policy options for RAK in the context of a federal (UAE) revenue sharing system being applied.

Research Questions

The research questions focus on key elements of the proposed VAT regime, how the RAK Emirate will cope with the introduction and implementation of VAT policies and what the likely impact will be on its ability to continue to attract investment and generate revenues. The specific research questions may be stated as follows:
1. What economic and political policies should support the principles of implementing a VAT regime?

2. What are the potential advantages and disadvantages of adopting a VAT regime for RAK?

3. What VAT models around the globe have been successfully implemented in selected countries?

4. What are the basic compliance requirements of a VAT regime, and how would such a regime impact business sectors in RAK?

5. What is the optimal revenue-sharing method for RAK?

6. What will be the likely effect of implementing the VAT on the public sector and the social economy of the Emirate of RAK?

**Significance of the Study**

The overarching significance of the research is based on the foundation that as participants in global trade, the UAE should seek to maximise its position in the international market. It is important that RAK is able to explore all options before implementing the VAT regime. In this context, it is also essential to critically analyse the VAT regime and how its principles and policies are likely to impact free market trading. This study will also serve to enhance the limited research on VAT regimes in the context of the impact on the Gulf States, with a particular focus on issues of revenue sharing, revenue generation and its impact on investment. This will not only inform the debate on implementation of the
proposed VAT regime, but it will also provide guidance for those who may wish to engage, negotiate or initiate business with the Gulf State.

In addition, the study may also identify a variant form of the proposed VAT system to satisfy the specific requirements and socio-cultural nature of the population in the UAE. This will serve to increase the study’s importance. Also, results of the investigation may inform the debate on a suitable structure and the required technology to manage the proposed new system.

Limitations, Delimitation and Assumptions

Limitations in research are identified as the weaknesses of the study (Creswell, 2002). It can be expected that the conclusions of the present research will be limited by the amount of information and data discovered in the documents, reports, and studies comprising the literature review and the data collected from surveys and interviews. However, as Babbie (2003) has noted, similar limitations inhibit the validation of findings of any study or research project. In addition, the findings, may not be applied generally to all countries, nations, or principalities because the data collected from this investigation will primarily focus on only a selected location, i.e. that of RAK which is one of seven emirates of the UAE.

A further potential limitation is that the researcher, because of his position as a resident of RAK, may exert some influence on the participants in the study. Hammersley and Atkinson (1983) assert that it is not possible to entirely eliminate the actual influence of the researcher; rather, the researcher needs to
understand the potential influence and use it wisely. Accordingly, the researcher has attempted to maintain a perspective of critical subjectivity throughout this study, which has been defined by Reason (1994) as “a quality of awareness in which we do not suppress our primary experience; nor do we allow ourselves to be swept away and overwhelmed by it; rather, we raise it to consciousness and use it as part of the inquiry process” (p. 325).

Delimitations of a research study allow the researcher to taper and streamline the scope of the research study (Creswell, 2003). This study confines itself to visits to four countries in which federal jurisdictions have been established and interviews with selected individuals who have expertise and knowledge in the area of their country’s taxation system. Furthermore, information obtained through the surveys enriches the study and provides the additional information required for the analysis of issues.

Research assumptions are identified as the ideas, beliefs, values, principles, or ethics one thinks is true in regards to the research without proof or evidence to substantiate the assumption (Leedy and Ormrod, 2005). A major assumption of the study is that the participants will be honest in expressing or providing information. In answering the survey questionnaires, the researcher assumes all participants have been honest and forthright, without any known biases in participating in the study. It is also considered by the researcher that questions in the survey questionnaire interviews are sufficiently comprehensive to address
the research questions posed in this chapter and to collect the necessary data required for comprehensive analysis.

**Structure of the Study**

The current chapter introduces the study. It provides an overview of the research problem including background relating to the proposed introduction of a VAT regime both in the UAE and the broader GCC. It provides the reader with information on important issues that have been faced in these countries and the need to change the present taxation system to a form of VAT. It outlines the purpose and significance of the study and highlights the need to analyse key aspects of the proposed new VAT system in order to identify how it may impact the economies of the UAE and more specifically, RAK.

**Chapter 2**

Reviews the literature that addresses the history of the value added tax which was first embraced by France in 1954 and at present is widely adopted among the European Union and other countries worldwide. It includes a review of the literature that examines different types of VAT, their advantages and disadvantages. It also reviews literature relating to the adoption of the VAT in several different countries including federal VAT sharing methods.

**Chapter 3**

Describes the methodology that will be employed by the researcher to collect and present data to answer the research questions. This section of the study
describes the two-stage approach to the study, involving international and local research, as well as the research design, sample population, test instrument, and ethical considerations.

**Chapter 4**

Discusses the more significant concepts of taxation in the context of defining the terms used in the study including consumption tax, goods and services tax and value added tax. It then proceeds to examine the different types of VAT, issues relating to revenue sharing, an overview of VAT in developed countries.

**Chapter 5**

Introduces the background to the VAT scheme that is being proposed for the GCC region and the proposed adoption of such a system by the UAE and RAK. It is based on some publicly available references, but includes information that has been supplied by the governments of the UAE and RAK on a confidential basis for the purposes of this research study.

**Chapter 6**

Presents the research findings and analysis of the four reference countries, namely Australia, the United Kingdom (UK), Germany, and South Africa. It incorporates an examination of country-specific literature together with interview responses from country experts with first-hand experience with the introduction and administration of their economy’s VAT system. In particular, the chapter examines the various methods of revenue sharing, issues of federal and state
sovereignty and responsibility, retention of existing sales and other taxes at the local and federal level. It also examines issues of regressivity and offsetting by means of rates, exemptions, and zero-rating as well as associated issues relating to the implementation, administration and compliance management of VAT regimes in the reference countries.

**Chapter 7**

Presents the findings and analysis of surveys and interviews of various sectors of RAK that will be affected by the proposed VAT. These include the general public, corporations, service firms, international firms currently operating in RAK, and Free Zone firms.

**Chapter 8**

Concludes the study with a presentation of conclusions and recommendations based on the findings of the research.
CHAPTER 2: LITERATURE REVIEW

Introduction

The previous portion of the study introduced the research. This chapter examines the literature that addresses relevant aspects of a VAT system, including the genesis of the VAT, reasons for implementing a VAT, different forms of the tax and their advantages and disadvantages. Literature relating to key issues in VAT design and administration are also reviewed, in addition to the associated policy issues. Finally, the body of knowledge relating to revenue sharing methods under a VAT system are examined. The chapter closes with a brief summary and conclusion.

Genesis of the VAT

Prior to the development of what is now known as VAT, indirect national taxes were generally levied on the sales and turnover of specific products such as alcohol and tobacco. These so-called ‘turnover’ taxes were imposed on commodities at different stages of their production regardless of the value that might be added. Thus, the tax that was imposed on a particular commodity was the summary product of the number of taxable levels in the chain of its production. This caused what is referred to as a “cascading” tax burden (Owens, 2005), which provided producers with a motivation to substitute new processes
that reduced the number of taxed inputs, resulting in methods of production that were privately profitable but inefficient for society as a whole. A further economic distortion occurred because such taxation arrangements provided industry with an incentive to integrate vertically merely as a way of decreasing tax liabilities. This trade liberalisation significantly reduced the income from import tariffs and motivated the governments to identify improved methods of taxation as a way to raise alternate forms of revenue. (Aizenman and Jinjarak, 2008). It is interesting to note that the same drivers for tax reform remain valid today that is, the need to redress distortions in existing tax arrangements, and the need to find appropriate sources of revenue to replace import duties.

Maurice Lauré, Joint Director of the French Tax Authority, the Direction Générale des Impôts is credited with first proposing a VAT, which was introduced in France on April 10, 1954. This is despite the fact that a German businessman, Wilhelm von Siemens proposed a similar tax in 1918 in Germany, shortly after the end of World War I. While this new form of taxation was initially applied to large corporations, its application was gradually expanded to encompass all industrial sectors in France. For the French government, the VAT has become the most significant source of state financing, comprising almost half of state revenues (Les Recettes fiscales, 2009). Some advocates of the VAT in the United States also proposed that it be implemented as a substitute for excise taxes imposed after World War I. However, only the state of Michigan adopted the resultant ‘Business Activities Tax’, an accounts-based form of VAT, in 1953 (see
for example Hines, 2002). Thus, the VAT was not actually implemented at a national level until its adoption by France.

The next major milestone in the development of the VAT occurred in 1967 when the Council of the European Economic Community (EEC) mandated the general adoption of the VAT to replace existing turnover taxes in order to join EEC members together in a shared system of taxation. The Council adopted the VAT with the intention of increasing foreign trade, which was being hampered by the somewhat complex regulatory requirements of the turnover system of taxation. Following this EEC directive, nations that did not belong to the EEC, such as Austria, Brazil, Greece, Peru and Sweden also implemented some variant of the VAT, by either adding to or replacing their existing national tax systems. During the same period, in Africa, manufacturing level VATs were implemented, including in Côte d’Ivoire in 1960 and in Senegal later in the 1960s (Ebrill, Keen, Bodin and Summers, 2001).

The next major period of development and spread of the VAT occurred during the years 1987 to 1997 when the VAT system of taxation was adopted in several Eastern European nations, ex-members of the former Soviet Union and Asia, with Bangladesh, China, the Philippines and Thailand all adopting the tax during the 1990s. During that same decade, the number of African nations instituting a VAT rose from two to 30. By the beginning of the millennium, VAT had become the primary constituent of the taxation systems in over 120 nations, with tax rates ranging from 5 to 25% (Ebrill, Keen, Bodin, and Summers, 2002). According to
Ebrill et al (2002), the rapid expansion of the VAT was the most dramatic and probably the most significant development in taxation that took place towards the end of the twentieth century, and continues today. Similarly, Cnossen (1998) comments that, “The nearly universal introduction of the value added tax should be considered the most important event in the evolution of tax structure in the last half of the twentieth century” (p.399). Its extensive global usage is evident from Ebrill, Keen, Bodin, and Summers (2001) categorization of nations in which VAT systems have been implemented: Sub-Saharan Africa (AF); Asia and the Pacific (AP); Present members of the European Union (EU), plus Norway and Switzerland (EU+); Central Europe, the Baltics, Russia, and other nations that belonged to the former Soviet Union (CBRO); North Africa and the Middle East (NMED); the Americas (AS); and small island economies, with under one million people, and San Marino (SI).

As noted by Cnossen (1998), “Since the late 1960s, the VAT has become the main consumption tax in 105 industrial and developing countries. Although the specific reasons for adopting the VAT differ from one country to another, the main argument has been that a properly designed VAT raises more revenue with lower administrative and economic costs than other broadly based consumption taxes” (p.399).

Similarly, other commentators (e.g. Ebrill et al, 2002 and Bird, 2005) note that, while there were several logical and practical reasons for the adoption of a VAT that were common to many countries, the underlying drivers appear to vary in
each case. In Western Europe, for example, acceptance of the VAT was closely related to the drive for increased economic integration among the member states of the European Communities. This was because the VAT system was especially effective in circumventing the trade distortions that accompanied the cascading indirect taxes that were previously in effect in those countries (Ebrill et al., 2002). In South America, however, VAT was viewed as a more effective method of raising revenue that would be compatible with the increasingly external orientation of the country’s economic policies. At the same time, transitional economies realised that their current tax regimes, that previously met the needs of emerging market economies were no longer suitable. VAT was considered a suitable substitute for their traditional sources of revenues and they were relatively quick to accept this as an alternative. (Bird, 2005).

In several developing nations, implementation of VAT has been motivated by the long term revenue implications of trade reform. In other words, economic efficiency arguments favouring the VAT have been strengthened as revenues from trade taxes have been threatened by increasing trade liberalization. It is also worth noting that, on occasion, VAT adoption was motivated simply by the fact that it was a prerequisite for joining the European Union. In other words, it was a model that had been implemented by the EU, and those countries that wished to become members of the EU were required to adopt it (Bird, 2005).
Types of VAT: Advantages and Disadvantages

There are three principal types of VAT, which are categorised according to their treatment of the deductibility of capital equipment – gross product VAT, income VAT and consumption VAT (Schenk and Oldman, 2001). According to this typology, a gross product VAT contains the largest tax base. It permits only a limited choice of deductions, such as cost of raw materials. Thus, it levies a tax on purchases of capital investments. On the other hand, an income VAT permits additional deductions. It allows the deduction of depreciation of capital goods as a net investment purchase (gross investment minus depreciation). Finally, a consumption VAT allows deduction of the total capital investment, with business purchases being deducted or excluded. The result is a tax base of totally private consumption.

Despite the wide range of VAT structures and disparate methods of implementation, which are examined later, there is broad consensus on some fundamental issues. First, there is agreement that VAT is essentially a consumption tax, as the final base of the tax is consumption. A consumption VAT that credits tax on capital goods does not distort the prices that manufacturers encounter when buying and selling to each other, and thus, has the advantageous characteristic of maintaining production efficiency. And, because it is imposed at each level of production, while guaranteeing that the tax only affects consumption, it is necessary to allocate complete credit of the tax paid on inputs with no breaks in the VAT chain (Ebrill et al., 2002; Owens, 2005).
The three basic methods of calculating VAT liability are: credit-invoice method; subtraction method; and addition method (Schenk and Oldman, 2007). However, there is almost universal international consensus that the credit-invoice method is the most efficient (with the prominent exception of Japan) (Owens, 2005 and Grindberg 2009). It is not the intention of this review to examine commentary on the differing methods of calculation in any detail, although this is addressed briefly later in this chapter. However, at this point it is pertinent to note that of the principal reasons that the credit-invoice method is regarded as the most efficient is the fact that by clearly linking the tax credit on the buyer’s inputs to the tax remitted by the provider of those inputs, false undervaluation of intermediate sales is discouraged. In other words, the way in which the credit-invoice method is designed helps to prevent a major method of VAT tax fraud, thus enhancing compliance. In this regard, Grinberg (2009) notes that the essential difference between the credit-invoice method and the subtraction-method is the requirement for the invoice. Grinberg concludes that, “The invoice requirement performs two basic functions – it limits the ability of a registered trader to reduce its VAT burden by an offset for the cost of its business inputs to an offset for business inputs purchased from other registered traders, and it ensures that offset is exactly equal to the amount of VAT paid. By ensuring symmetry between deductions and inclusions, the invoice requirement substantially reduces tax avoidance opportunities in the VAT” (p40).

The following subsections examine commentary on advantages and disadvantages of a VAT system in relation to a number of specific aspects of the
tax, including issues of compliance; impact on savings, capital accumulation, consumer behaviour, productivity, and growth; economic efficiency and fairness; and tax structure.

**Compliance, Fraud, and Tax Evasion**

As noted above, Grinberg (2009) highlights a key aspect of the credit-invoice method that assists in reducing the likelihood of tax evasion. Other commentators also point to self-enforcing features of the VAT that positively impact on tax compliance by hindering fraud and creating a trail to identify fraud if it does occur (see for example Arizonan and Jinjarak, 2008). In this regard, the essential mechanism of the system is the absence of two-sided or joint economic rewards for over-reporting or under-reporting. Commentators argue that, theoretically, under this system taxpayers have economic inducements to produce an invoice for the correct total of a transaction and thus leave a trail that can be detected in an audit. For example, it would be difficult for a vendor to persuade a consumer to under-report the amount of a transaction because the consumer would have his/her VAT credit lowered as a result of the lowered amount of the vendor’s underreporting. On the other hand, a vendor is unlikely to collaborate with a consumer who wanted to over-report a sale because the vendor would have to pay a higher VAT due to the consumer’s over-reporting. Therefore, mutual economic incentives exist for both the vendor and consumer to correctly report the value of the transaction.
Some observers note that, in theory, a VAT system should also discourage failure to report taxable transactions. For example, if a vendor and a consumer conspire to lower a price by the amount of the VAT and not report the sale, the vendor will not apply the reduced price unless a client of the conspiring consumer agrees not to report his/her transaction. If a client of the colluding consumer decides to report his/her transaction with the colluding consumer in order to obtain a VAT credit, the colluding consumer must give him/her an invoice, therefore becoming liable for a VAT payment without being allowed a VAT credit from the transaction from the colluding vendor. The colluding vendor must then pay the required VAT amount. (Oldman and Woods, 1983).

In spite of these factors, in reality, fraud does occur. And countries like Australia, Canada, France, New Zealand, and the United Kingdom have allocated considerable resources to handling compliance issues that exist in even a simple VAT system with a broad base that has few exemptions of goods or services (GAO, 2008). According to Bird (2005), VAT is the only tax system in which the government collects a considerable amount of money from the private sector but also returns a large amount of it to them as input tax credits. In this system, an invoice functions as a possible claim on government funds and fabricating these kinds of claims is probably the most common form of VAT fraud. Therefore, it is necessary for tax administrators to obtain detailed information regarding the usual or anticipated pattern of credits and liabilities for businesses in the various types of industries subject to the VAT in order to effectively manage tax compliance. Collecting such data in a useable form clearly requires a high
degree of automated processing, and even though the standard operation of a
VAT may produce such data, frequently such information is not collected in
usable form or utilised to develop an effective risk management strategy,
especially in developing and transitional countries (Bird, 2005).

However, commentators also emphasise that VAT fraud is not only an issue for
developing countries but is also a problem in higher-income countries,
sometimes with spectacular incidents, such as occurred in the UK when a
businessman defrauded the government of $8 million in a period of only four
months. Such incidents of VAT fraud have even distorted trade statistics (Keen
and Smith, 2007).

While real or estimated compliance rates are poorly documented in many
countries, the UK estimates a tax gap and VAT revenue losses resulting from
non-compliance on a yearly basis (GAO, 2008). Over the period of 2002 - 2007,
the estimated VAT tax gap varied from 12.4% to 16.1% of the VAT Theoretical
Tax Liability (VTTL) computed by the UK using national consumption data. Some
European nations have recorded estimates which, while not as precise as those
of the UK, suggest VAT losses due to fraud of around 10% of total VAT gaps
(Keen and Smith, 2007).

According to Keen and Smith (2007), in addition to false claims for credit or
refund, several types of fraud are unique to a VAT system and provide the
greatest challenge to enforcement. These include fraudulent claims regarding
the export of commodities, which are an inherent issue for the VAT due to the
universal zero–rating of exports. This situation presents a dilemma for administrators of the VAT who wish to pay refunds quickly in order to facilitate trade and avoid converting the VAT into an export tax, but must also protect government revenues. Other types of fraud include credit claimed for VAT on acquisitions that are not legally creditable; and bogus traders that have created corporations with the sole intent of producing invoices that permit recovery of VAT. These 'invoice mills' take advantage of the impracticality of cross–checking every invoice against data to verify that tax has in fact been paid (Keen and Smith, 2007) which, as noted above, can pose an enforcement problem for both developed and developing economies.

'Carousel fraud' is a special kind of VAT fraud, which is referred to as 'missing trader intra–community fraud' (MTIC) in the UK. This kind of fraud takes advantage of the zero–rating of exports in combination with the 'deferred payment' method of collecting VAT on imported goods that is a special feature of EU VAT regulations. According to this rule, adopted in the EU with the elimination of fiscal border formalities in 1992, VAT on imports from another member country is not collected at the border but rather it is collected at the time of the next periodic return. To exploit this feature, 'missing traders' establish phony businesses with the solitary aim of obtaining VAT on sales and then vanishing without remitting VAT to the government (GAO, 2008; Keen and Smith, 2007).

This type of fraud is summarised by Ainsworth (2006) as follows:
'Carousel (missing trader intra community, or MTIC) fraud works when a seller (A) in member state X makes an exempt intra community supply of goods to a (soon to be) missing trader (B) in member state Y. B acquires the goods without paying VAT and later makes a domestic supply to a third company (C). C is frequently called the broker. B collects VAT on its sale to C, the broker, but doesn’t pay the VAT to the government. B disappears with the VAT.

When C claims an input credit on the VAT it paid to B, the missing trader, the government suffers the loss. In a fully operational carousel, C will resell the goods back across the border to the initial seller, A. That sale is also an exempt intra community supply. The same goods can then be sold once again on the carousel to B. When A, B, and C are in collusion and are aware of the fraud, it’s a relatively easy matter to apply joint and several liability provisions and hold C liable for the VAT not remitted by B.

A common practice has developed whereby legitimate companies called “buffers” are placed between the key operatives in the scheme to both distort trading patterns and make investigations difficult, and to make it more difficult to apply the joint and several liability provisions in VAT statutes. Buffers may be completely unaware of the fraud, although with the irregularity of the
transactions, they may suspect, but have no direct knowledge, that something is amiss” (Ainsworth, 2006, p.444).

As the above literature suggests, the self-enforcing system is often exaggerated and does not function well in a number of cases (Keen and Smith, 2007). In particular, the system functions poorly in cases where the colluding consumer is a retailer, because consumers do not report their acquisitions. Additional methods that are often successfully employed to avoid paying VAT include inflating declarations for VAT paid on inputs (which has been discussed earlier), avoiding registration for the VAT, and rerouting zero-rated exports to the domestic market (Agha and Haughton, 1996). Such evasion strategies can be employed under a single-rated VAT system, and to illustrate this, Table 2-1 summarises the types of compliance risks that exist in a simple VAT system as identified by the GAO (2008).

In general, commentators agree that the experience of individual countries suggests that a VAT, like any other tax will always be susceptible to some form of tax evasion, but some features may make the tax more susceptible than others. For example, if a VAT design includes multiple-rates, zero-rates, and tax-exemptions, the opportunity for avoidance increases (Agha and Haughton, 1996). Also, some European nations, such as Italy, have experienced severe tax evasion issues as a result of the design of their VAT system (Oldman and Woods, 1983; Keen and Smith, 2007). In view of these kinds of compliance risks, even simple VAT systems need mechanisms of enforcement, including audits
and documentation that generate administrative expenses for the government and a compliance burden for companies.

**Table 2-1:**

**Major Types of Compliance Risks in a Conceptually Simple VAT System**

<table>
<thead>
<tr>
<th>Compliance risks</th>
<th>Under-collection of tax due on sales</th>
<th>Over-claiming of tax paid on inputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Missing trader fraud</td>
<td>A business is created for purposes of collecting VAT on sales and disappears without remitting VAT to the government.</td>
<td>Fraudulent refunds</td>
</tr>
<tr>
<td></td>
<td></td>
<td>A business or fraudster submits false returns requesting VAT refunds from the government.</td>
</tr>
<tr>
<td>Failed businesses</td>
<td>A business fails or goes bankrupt before remitting VAT collected to the government.</td>
<td>Misclassifying purchases</td>
</tr>
<tr>
<td></td>
<td></td>
<td>A business falsely claims input tax credits by misclassifying personal consumption expenses as business expenses.</td>
</tr>
<tr>
<td>Underreporting cash</td>
<td>A business either charges a lower, VAT-free price for cash transactions or underreports cash sales and retains VAT collected.</td>
<td>Fictitious or altered invoices</td>
</tr>
<tr>
<td>transactions</td>
<td></td>
<td>A business creates or alters invoices to inflate the amount of input tax credits.</td>
</tr>
<tr>
<td>Import fraud</td>
<td>A business or individual imports items for personal consumption and under values them for VAT purposes.</td>
<td>Export fraud</td>
</tr>
<tr>
<td></td>
<td></td>
<td>A business creates fraudulent export invoices for goods that are not exported to claim input tax credits.</td>
</tr>
</tbody>
</table>

Impact on the Economy and Consumer Behaviour

Most commentators support the view that a VAT promotes savings and investment because it taxes consumption rather than income (Charlet and Owens, 2010). Moreover, data accumulated by OECD researchers indicate that a VAT is more pro-growth than an income or corporate tax (Johansson, Heady, Arnold, Brys and Vartia, 2008). However, in many cases, a VAT may be neutral regarding whether individual taxpayers save or spend money on consumer products. In any case, a consumption tax is only levied on current consumption, not on saving during a specific period of time and is therefore considered to be economically more efficient than other forms of taxation (GAO, 2008).

According to classical economic theory (Ahiakpor, 2010), saving by individuals does not promote economic productivity and growth if it consists of hoarding cash. However, saving does not hinder economic growth if it does not comprise only cash hoarding. Savings can consist of the possession of interest- or dividend-earning financial assets, such as bank deposits, certificates of deposit, stocks and bonds, etc. In that case, the saving is not characterised by the hoarding money but the transfer of money from income earners to borrowers who spend the money from interest-accruing investment, which stimulates productivity and economic growth.

The literature suggests that, in the commercial context, a consumption VAT favours the accumulation of capital because capital goods are entirely exempt from the levy. When capital goods are purchased it is necessary to pay the VAT,
but credit can be declared immediately against the next VAT tax period’s sales liability. When buying large capital goods, such as large plant and equipment or a new buildings, the credit in a single tax period can be much greater than the tax liability. In some systems, this net credit is reimbursed immediately by the government, while others permit it to be set only against future VAT liabilities (Tait, 1999).

Classic economic theory also indicates that daily purchase decisions by individual consumers determine aggregate demand, in the short term, and economic growth and welfare, in the long term (El-Ganainy, 2006). To determine the impact of VAT on household consumption, El-Ganainy (2006) examined data from fifteen member nations of the European Union (EU) during the years 1961-2000. He employed a reduced form aggregate consumption function that permitted consideration of a broad range of consumption determinants. El-Ganainy (2006) found that the VAT was negatively correlated with the level of per capita private consumption (p. 5). In particular, a one per cent rise in VAT rate was found to correlate with almost a one per cent decline in the level of aggregate consumption, other things being equal.

It is the view of some commentators that this finding regarding the impact of VAT rates on consumer spending might be magnified in the wake of the current recession, impacting firms, industries, and a nation’s economy. For example, the United Kingdom has raised the VAT rate from 17.5% to 20% in an effort to cut their large public finances deficit. The high amount of revenue generated by VAT
seemed to make it the best choice for increasing tax returns. Moreover, the legislation would provide for an annual increase. On the other hand, the new higher rate of VAT could cause inflation, create cash flow issues that could force a number of firms into insolvency, and result in higher interest rates, which could all thrust the economy back into recession. Actually, in the UK, a 20% VAT rate could cause prices to rise approximately 2%, which would have a considerable impact on inflation. In turn, rising inflation could cause interest rate hikes, risking a ‘double-dip’ recession (Finch, 2010).

Trade groups and other financial experts maintain that retail stores and restaurants would face a difficult decision in determining what would hurt their business the most, absorbing the additional tax burden or suffering an expected decline in customer demand if they pass the tax on to consumers (Finch, 2010). Finch observes that consumer spending, already down from the recession, has begun to recover slightly but could fall once more; and firms in the business-to-business sector will be impacted the least since they can reclaim any VAT they pay back from the UK tax authority.

However, banks and charities could suffer a strong negative impact from the higher rates. In the UK, banks cannot recover VAT. As a result, their profits would be directly affected (Finch, 2010). At a time when the banking sector is weak and continues to lag in lending to small and medium sized enterprises (SMEs), a rise in the VAT rate could further diminish lending to this sector. Even sectors which can reclaim VAT will be impacted adversely. A higher VAT would
consume cash flow, which could force a number of firms into bankruptcy. At the same time, it is predicted that the higher VAT would add to costs for charities and decrease funds for charitable activities (Finch, 2010).

In general, El-Ganainy’s (2006) model of the effect of a VAT on economic growth showed that savings was the conduit through which consumption taxes impacted capital accumulation and growth in productivity, while these effects then impacted general growth in GDP. However, his study results further demonstrated that the effect of a VAT on the rate of savings, and therefore on economic growth, was unclear because it was dependent upon the interaction between utility parameters, interest rates, and tax structure.

El-Ganainy concluded that a VAT impacts sources of growth differently. While it influences physical capital accumulation significantly, its effect on productivity growth is not statistically significant. However, when both influences are joined, a positive significant influence on overall economic growth is evident. In particular, a one percentage point rise in the VAT rate would result in a 0.23 percentage point rise in the rate of growth and a 0.28 percentage point rise in the capital growth rate, other things being equal. Based on these findings, he concludes that VAT has a more positive impact on capital accumulation, rather than productivity, which in turn, effects economic growth.

**Economic Efficiency and Fairness**

In general, promoters of VAT maintain that this system of taxation is superior to an income tax for several reasons, including economic efficiency and fairness,
though the latter is subject to debate (Ebrill et al., 2002; Emran and Stiglitz, 2005). Improved efficiency accompanying the implementation of a VAT system is difficult to assess directly. The conventional method of measuring the efficiency of VAT for increasing revenue is the 'efficiency ratio', that is, the ratio of VAT revenue to GDP, divided by the standard VAT rate. However, according to Ebrill et al. (2002), this method is problematic because errors in measuring GDP taint it. More significantly, the proper standard should be entire consumption (the ideal VAT base), not GDP. To illustrate, they provide the example of a policy error that drew a quantity of investment into the tax base that raised the efficiency ratio although it actually signified a poorer VAT. To avoid this issue, they examined the 'C-efficiency ratio', the ratio of VAT revenue to consumption, divided by the standard tax rate in order to determine if nations with a VAT raise revenue more efficiently. According to this formula, a VAT that was levied on all consumption at a standardised rate, the IMF benchmark, would have a C-efficiency of 100%.

Their data revealed that variables associated with comparatively high C-efficiency include a comparatively high ratio of trade to GDP (probably because it is reasonably easier to collect VAT on imported items than those produced domestically); high literacy rates; and length of time – that is, the longer the VAT has been in effect, the more efficient it is (Ebrill et al., 2002).

Holding other variables constant, including per capita GDP and the extent of openness of the economy, these researchers found support for the assertion that the VAT is correlated with a higher ratio of general government revenue and
grants to GDP. However, evidence was weaker regarding an association with a higher ratio of general government tax revenue by itself; and there was no evidence that it was associated with a higher (or lower) ratio of central government tax revenue. Overall, they concluded that the VAT may boost revenues efficiently.

In another study, Aizenman and Jinjarak (2008) found the collection efficiency of a VAT is dependent upon key structural and political economy variables. A higher degree of political instability and polarization tends to diminish tax efficiency, probably due to fewer resources available for tax enforcement. Likewise, economic structures that raise the expenditure on enforcement, such as fewer urban areas, a lower degree of trade openness and greater share of agriculture, lower the collection efficiency of the tax, probably by increasing the ease of tax evasion.

From the same study data was examined relating to annual VAT revenues, economic, and political variables in 44 nations over the period of 1970–99. Over this period of almost 30 years, the collection efficiency of VAT systems varied from 2.4% in Belarus, 9.6% in Mexico, to 45.2% in Finland. The data also yielded a broad range of other findings regarding VAT. For instance, no systematic disparity in statutory VAT rates was found between developed and developing nations. The amount of VAT revenue as a proportion of entire tax revenue ranged from 6.6% in Japan, to 40.5% in Chile. Moreover, VAT revenue to GDP varied from 0.1% in Guinea to 10% in Norway. In fact, an OECD (2008) report
found that nations with the same standard rates (Luxemburg and Mexico, for example) can have considerably different revenue from the tax. In Mexico and Luxemburg, for example, rates may have been different before December of 2008, so even if the rates were standardised on December 2008 to make them relate appropriately, the revenue would still differ after the date due to the initial differences before the date.

Considering all nations, Aizenman and Jinjarak (2008) found that VAT revenues to GDP rise with real GDP per capita and degree of urbanization, and decline with the agricultural share of GDP.

A number of experts argue that the expenditure for collecting a VAT is less than for the collection of the same amount of money with an income tax (for example, Cnossen, 1987, 1989). This efficiency is based on the broader tax base of a VAT. In addition, the model of a consumption tax is comparatively simpler than that of an income tax.

However, because of this ease of collection, a VAT has been viewed as a money machine that encourages governments to collect progressively more revenue so they can spend more money and construct a bigger government without limitation (Aizenman and Jinjarak, 2008). This possibility is not necessarily a disadvantage since taxpayers as citizens can prevent this kind of outcome by voting out of office lawmakers who spend too much. Otherwise stated, it is the citizens in a democracy, not the VAT that will determine the size of the government via their local systems of checks and balances and legislators will
carry out their will regarding the amount of revenue realised and the size of their government (Keen and Lockwood, 2006). Actual data regarding countries with a VAT bears out this assertion. For example, Japan, Korea, and Mexico have a VAT but still maintain smaller governments than the US. Thus, even though governments with a VAT raise more money than those with other systems of taxation, there is only a weak contributory correlation between VATs and bigger government (Keen and Lockwood, 2006).

On the other hand, the possible regressive nature of a VAT is a potential disadvantage. A consumption tax might disproportionately impact the underprivileged. Without specific provisions, VAT payments may comprise a larger percentage of the incomes of low-income individuals than of high-income individuals. However, a consumption tax, which does not tax savings or investments, may be levied according to a taxpayer’s income level, which is an essential attribute of an income tax. With this method, a VAT can allocate the tax among taxpayers progressively, similar to an income tax. In a number of OECD nations, such as Mexico and the U.K., the VAT is applied at a reduced rate or even a zero rate to a broad range of goods, such as food and education to offset the regressivity of the tax (Heady, 2002). New Zealand’s VAT system incorporated the principle of horizontal equity, i.e. similar treatment of individuals in similar circumstances by means of a stronger degree of redistribution via one-off benefit adjustments, when their tax reform was introduced and thereafter through compensating income supplements (Charlet and Owens, 2010). Also, New Zealand’s 2010 tax reform aimed to offset the higher VAT rate by increasing
payments to seniors and retired individuals, families, and students. On the other hand, in developing countries, where a VAT is difficult to administer, some governments have allocated an exemption to small-scale agriculture. Their reasoning for this digression in taxation policy is to provide a discount for the food that is eaten primarily by the poor, which has been the practice in such poor third world countries as Uganda and Zambia (Heady, 2002).

**Tax Structure**

Commentators generally agree that a key advantage of a VAT is the relative simplicity of the system of taxation. A major portion of the intrinsic simplicity of a VAT comes from its character as a consumption tax. In comparison with an income tax, a consumption tax eliminates the idea of an individual's income because it eliminates the need for information regarding the tax status of income-like entitlements. Specifically, a consumption tax is not concerned with a buyer’s income level. With a consumption tax, each denomination of currency spent is taxed equally, independent of the buyer’s level of income. Another characteristic that makes the system simple is that it permits a business to declare the full expense of the total amount of a purchase of capital goods. As a result, there is no need for regulations concerning the treatment of capital assets or depreciation (Fleming, 1995). Likewise, it is not necessary for a VAT to include regulations concerning capital gains or losses. Finally, there are no independent entity regimes.
An additional aspect of a VAT’s design that is considered to make it simple for
the taxpayer is its use of the invoice method. Using this method, a firm’s tax is
simply a total of the tax amount displayed on each invoice. As such, a business
is only required to total its invoices and pay the aggregate amount.

On the other hand, the system may not necessarily be easy to administer. A
large number of firms must complete tax returns, making the system more
complex (Fleming 1995). In this regard, some commentators conclude that, if a
VAT is designed with specific procedures to reduce its regressive effect, such
procedures will increase complexity. The only procedures that do not reduce its
regressive effective are zero-rate transactions, exceptions, and exemptions. This
is mainly true in developing economies (Heady, 2002).

There are a number of key issues to consider in designing a VAT system (Ebrill
et al., 2002). According to Bird (2005), VAT designers should follow the ‘NOSFA
principle,’ i.e., “no one size fits all” (p. 11). While issues that must be addressed
in designing and applying any VAT are in theory similar for all countries, the
political and economic environment varies considerably from country to country
and even with the passage of time in any one country. Thus, different VAT
designs may be optimal for different countries. In this regard, constituents of a
VAT, such as a single rate or zero-rating only for exports, or total and
instantaneous rebate for input tax credits might be generally favourable but may
be either not feasible or nonessential or undesirable in the context of a specific
country at a particular time (Bird, 2005).
Such observations are relevant to the following sections of the literature review examine the following areas that present challenges and suggest best practices: (a) methods for determining VAT liability; (b) comparison between VAT and Retail Sales Tax; (c) rates (minimum, maximum, and threshold); (d) exemptions; and (e) zero-rating.

**Methods for Determining VAT Liability**

The following three discrete methods can be used to calculate an amount of value added under a VAT system: subtraction, invoice credit, and addition (Ebrill et al., 2002). Using the subtraction method, the value added is calculated from the total amount of sales transacted by a company to customers minus the total purchase amount by the company during a given period. However, the subtraction method does not compute a VAT amount for each sale. A business subtracts the total purchase sum from the total sales sum, and then multiplies the resulting figure by a VAT rate. On the other hand, using the invoice credit method, the VAT amount the firm has paid on acquisitions is subtracted from the VAT amount due on firm sales to determine the VAT liability. With this method, the VAT amount is computed for each individual transaction and the total VAT is then calculated for the given period. While these two methods might seem the same, their results are different.

As previously noted, it is necessary to allocate complete credit of the tax paid on inputs with no breaks in the VAT chain, because it must be imposed at each level of production. The addition method is one of the three methods of calculating
VAT liability to comply with this objective (Schenk and Oldman, 2007). It uses an equation that requires that the value added is equal to factor payments plus net profit. To determine the value added, the firm adds the expenses for all of the constituents of the value that was chosen - such as salaries, rent, interest, and net profit. The VAT is the resulting amount multiplied by the VAT rate. The addition method generates a compliance burden for SMEs (small medium enterprises) because it necessitates a complicated accounting analysis of each component in the production process each tax year (Kim, 2008). While large corporations normally keep the cost-accounting records needed to compute all of the components involved in production and net profit, smaller firms might not.

Moreover, because of the accounting difficulty, it is not easy to levy a VAT on a frequent basis. Recurrent levies of a VAT using the addition method would subject firms to unreasonable burdens for the tax calculation. Almost all national level VAT systems presently use the credit invoice method form (Ebrill et al., 2002; Keen and Smith, 2006). However, Japan uses a subtraction method VAT. Other types of VAT are occasionally implemented at lower levels of government. For example, the Italian IRAP (Imposta Regionalasulle Activita Produttive) is a subtraction method VAT.

The credit invoice system is considered to have many benefits in comparison with the subtraction method (Grinberg, 2009). As noted previously, the use of invoices, which indicate the tax paid at each transaction, enables tax authorities to track the flow of cash that is involved in a transaction. It is in the consumer’s
interest to request the vendor to provide an invoice at the time of the transaction to enable him/her to receive credit for VAT paid. If the vendor does not issue an invoice, it is possible that the purchaser might decide not to complete the purchase.

While all three methods of calculation can achieve the same result, many commentators advocate the invoice method as being the better of the forms for calculating tax liability, whereby the tax rate is applied to gross sales (Bird, 2005). Businesses take a tax credit for the tax that has been paid on intermediate and capital goods purchases. This is the method that many European countries use for their VATs and it is believed that the existing administrative structure of state sales taxes could easily be adapted to implement this method, as these are viewed as destination based taxes (Francis, 1993).

Also, the invoice credit method can modify a VAT’s regression by exempting a levy on particular chosen items. Survival items (such as food items and different types of medicines that are needed especially by low income taxpayers, for example) could be specifically VAT exempted which would change the regression. While the subtraction method can provide exemptions on entities also, it does not permit modification of tax exemptions on specific items. This is because the subtraction method charges the tax on an item-by-item basis.
Comparison between VAT and Retail Sales Tax (RST)

Theoretically, assuming absolute forward-shifting of both taxes, the VAT and the retail sales tax are basically identical if all goods and services are taxed at the same rate (Cnossen, 1987), that is, government revenue collected by a retail sales tax (RST) and by a VAT would be the same. The sole distinction is that the VAT collects tax at each level of production, while the RST collects the entire levy at the final level, which is the customer’s purchase. Because of this feature, in theory, the RST is more efficient and less expensive to administer than a VAT.

However, a VAT actually has many advantages that the RST does not. Among these benefits is the fact that a VAT automatically differentiates between the customer and the manufacturer of products, while an RST frequently encounters compliance issues regarding exemptions of manufacturer products (Cnossen, 1987). This is because an RST is levied only on sales to an end consumer and not on those who manufacture a product using the item bought in that sale.

Items that are exempted from an RST are usually referred to as producer goods. The rationale for exempting them is to avoid taxing a product more than one time. However, with an RST, producer goods are frequently taxed more than once because each constituent of the final product has been taxed when sold to a vendor that is a retailer. Exempting such producer goods causes compliance and administrative issues (Cnossen, 1987). For example, a number of producer goods might actually be purchased by end-users. Designers of the tax must clearly identify what the producer goods are when introducing the relevant
regulations. In contrast, a VAT does not discriminate between sales to manufacturers and sales to end consumers. Rather, a VAT automatically distributes levy amounts based on the value added at each stage.

Moreover, a VAT system facilitates compliance because it secures revenue when it is collected at each stage of the chain of production, in contrast with the RST, where all revenue is lost if there is evasion at the end stage (Charlet and Owens, 2010). Consequently, with an RST, if a single vendor fails to report his or her sales tax liability, the government may lose all of the tax. Alternatively, with a VAT, the tax at each level is obtained even if an individual vendor fails to report because levy sums equivalent to the value added at each level are divided and accounted for individually. Together with the invoice method, this attribute is considered to reinforce VAT compliance.

Finally, services are easier to tax under a VAT than an RST because the latter is primarily applied to sales of material items (Shoup, 1973). From a theoretical point of view, an RST could also be used to tax service transactions. In some jurisdictions some services are already subjected to an RST while others are not. Still, it would be too difficult from an administrative standpoint for an RST to levy a tax on services as extensively and efficiently as a VAT. The reason for this is that all the tax revenue under an RST is obtained at the end stage of a sale to a customer. But this end stage encompasses diversity of subcategories, and, with an RST, tax administrators and tax payers must decide if each service is provided to an end consumer at the taxable level of service or producers who are
exempt when deciding if a service is subject to the RST. If an RST ignores this issue by removing tax exemption for producers, other issues occur (Cnossen, 1987). On the other hand, a VAT levies a tax at each production level while eliminating cascading effects, and does not require providers of services or tax administrators to determine the reason for buying the service. This feature would be an advantage in economies that are becoming more service-based.

To summarise, Table 2-2 lists the differences between a VAT tax and RST. As indicated in the table, the VAT is considered to be a broad based tax. Almost all sales are taxable, including sales of services, whereas the tax base of the RST is limited to the sale of tangible personal property and only listed services are taxable. In addition, entities may recover the VAT that is paid on any intermediate transaction, which is not the case for the retail sales tax system.
<table>
<thead>
<tr>
<th></th>
<th>VAT</th>
<th>RST</th>
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<tbody>
<tr>
<td><strong>VAT</strong></td>
<td>A multistage tax collected at every stage</td>
<td>A single-stage tax collected at the final sale to consumer.</td>
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<td></td>
<td>of the production process; widens number</td>
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<td></td>
<td>collecting/remitting tax</td>
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<td></td>
<td>Entites collecting/remitting tax</td>
<td>Entity collecting/remitting the tax needs to verify status of</td>
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<td>does not have to verify status of customer as a business.</td>
<td>The customer.</td>
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<td><strong>RST</strong></td>
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<tr>
<td><strong>Tax</strong></td>
<td>Tax is calculated based on the</td>
<td>Tax is calculated based on the</td>
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<td></td>
<td>Value added at each stage of</td>
<td>total value (sales price) paid</td>
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<td></td>
<td>Production to the consumer.</td>
<td>by the final consumer.</td>
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<tr>
<td><strong>VAT</strong></td>
<td>A broad-based tax; almost all</td>
<td>Tax base is generally limited</td>
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<tr>
<td></td>
<td>sales are taxable, including</td>
<td>to sale of tangible personal property; only enumerated</td>
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<td></td>
<td>sales of service.</td>
<td>services are taxable.</td>
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<td><strong>RST</strong></td>
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<td><strong>Entities</strong></td>
<td>Entities may recover the VAT</td>
<td>Certain intermediate</td>
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<td>they paid on any intermediate</td>
<td>transactions are exempt;</td>
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<td>transaction (input tax credit)</td>
<td>others are subject to the tax.</td>
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<td>tax cascading may be minimized</td>
<td>Potential tax cascading effect</td>
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<td>But over taxation may result if</td>
<td>may occur on previously paid</td>
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<td></td>
<td>tax input chain is broken.</td>
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<td><strong>VAT</strong></td>
<td>Exempt from VAT means the</td>
<td>Exclusion from RST simply</td>
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<td>Entity would not impose VAT</td>
<td>means that the transaction is</td>
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<td></td>
<td>and not be entitled to input</td>
<td>outside scope of the tax. Taxi-</td>
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<td></td>
<td>tax credit paid on its purchases on its purchases.</td>
<td>payer has no burden to prove</td>
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<td><strong>RST</strong></td>
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<td>the transaction is excluded</td>
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<td><strong>Zero rating</strong></td>
<td>Zero rating means that the</td>
<td>Exemption from RST means the</td>
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<td>entity would impose VAT but at</td>
<td>transaction is within the scope</td>
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<td>a rate of zero and would be</td>
<td>of the tax but is specifically listed</td>
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<td>entitled to input tax credit for VAT paid on its purchases.</td>
<td>as exempt from tax. Burden of</td>
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<tr>
<td><strong>VAT</strong></td>
<td>Entities need to distinguish</td>
<td>proof rests on taxpayer.</td>
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<td>sales that are taxable, exempt, or zero rated.</td>
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<tr>
<td><strong>RST</strong></td>
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<td>Entities need to distinguish</td>
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<td><strong>Use of</strong></td>
<td>Use of invoice to self-enforce</td>
<td>sales that are either taxable</td>
</tr>
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<td></td>
<td>the tax; harder to evade.</td>
<td>or exempt.</td>
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<tr>
<td><strong>VAT</strong></td>
<td>May require refunds if inputs</td>
<td>Exemption certificates may not</td>
</tr>
<tr>
<td></td>
<td>exceed outputs.</td>
<td>effectively police the use of exemptions.</td>
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<td><strong>RST</strong></td>
<td></td>
<td>Refunds are generally limited</td>
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<tr>
<td><strong>Source</strong></td>
<td>Source: Cabaltica (2008). Comparing the value-added tax to the retail</td>
<td>to overpayment of tax.</td>
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<td>sales tax. American</td>
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<td>Institute of CPA’s. p. 2.</td>
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Rates (Minimum, Maximum, Threshold)

Many nations use multiple tax rates rather than the single rate that the International Monetary Fund (IMF) generally recommends (Ebrill et al., 2002). The use of multiple VAT rates impacts the efficiency of the system and enhances complexity, which might then result in higher administrative and compliance costs (Charlet and Owens, 2010). According to these researchers, higher income nations can be assigned to two expansive categories, which are:

(a) those countries which have implemented a VAT based on the French and European model, and

(b) those countries which have implemented a dissimilar VAT.

The first group (many of which are EU members) generally adopt a number of reduced rates which results in a tax base subject to the standard rate that is rather limited. Articles 96 to 99 of VAT Directive 2006/112/EC of November 28, 2006 permit EU member states to implement a standard rate that cannot be lower than 15% as well as a maximum of two reduced rates that cannot be lower than 5%. In addition, the VAT directive permits older members to possess 'reserved rights', which allows them to continue using a reduced rate that is lower than the established minimum provided that rate was in place prior to 1991 (Charlet and Owens, 2010).

In contrast, less developed countries generally employ single-rate VAT systems. For example, among the 21 African nations that implemented a VAT from 1990
to 1999, 14 use a single-rate system, and eight out of nine African nations that implemented a VAT after 2000 use a single-rate VAT system. However, nations with a broader base at the standard rate often use a standard rate less than the EU minimum. For example there is a standard rate of 5% in Canada, 12.5% in New Zealand, 7% in Singapore, and 14% in South Africa (Charlet and Owens, 2010).

As noted by Cnossen (1998), “In high-income countries, it is increasingly being realized that VAT-rate differentiation makes little sense on equity and administrative grounds. In low-income countries, which face major constraints on administrative capacity, VAT-rate differentiation continues to be defensible, particularly in the form of lower-than-standard rates (including exemptions)” (p.409).

The primary rationale for using a different rate structure in Europe was to offset the levy on goods and services that comprises a greater share of expenses for low-income households. A number of countries had higher rates for particular luxury goods, similar to earlier sales taxes that were limited to luxury items. However, EU regulations required that they eliminate the luxury tax rate and use only a single standard rate. A few nations, like Algeria (where the luxury rate ranges between 20-110%), that are not members of the EU, continue to apply a luxury rate.

Other economies have begun to implement a single standard rate. For example, in Switzerland proposals for reform toward a single rate were considered by the
Swiss parliament in June 2008. The initial part of the reform, a simplification of the administration of the VAT, became law in January 2010. It is expected to lower compliance costs for companies, even though the costs will be transferred to the Swiss tax administration (Charlet and Owens, 2010). The second component of the reform, which remains a proposal at this point in time, would eliminate the three current VAT rates of 2.4%, 3.6%, and 7.6%.

The second group of nations, including Australia, Canada, Korea, New Zealand, Singapore, and South Africa, use a much wider base at the standard rate. In 1986 New Zealand established a broad-based VAT with a low single standard rate, a low registration threshold, and few exemptions (Charlet and Owens, 2010). New Zealand has the highest score on the OECD VAT revenue ratio (the ratio between the actual VAT revenue obtained and the revenue predicted if the VAT were applied at the standard rate to all final consumption). Australia implemented the GST in 2000, with a comparatively broad base. However, it applies several zero rates, called “GST free supplies” for health and medical care, educational products, child care, food and beverages.

OECD studies which commenced in the 1980s and are continuing to the present, consistently support the claim that a broad-based, single-rate VAT is the best design (Charlet and Owens, 2010). However, a Copenhagen Economics study (cited by Charlet and Owens, 2010) provides some evidence in support of reduced rates if particular conditions are met. It indicates that reduced rates for cautiously targeted sectors might have some beneficial outcomes, in particular, if
the local service sector employs a large number of low-skilled individuals. In addition, these targeted reductions may move do-it-yourself work or some of the shadow economy to the formal sector. However, in an internal market similar to the EU, reducing a VAT rate could distort cross-border trade somewhat when the origin principle is applied to most business-to-consumer supplies since it tempts customers to buy items in the low-VAT-rate state. On the other hand, this should not occur if lower rates are applied solely to local services.

Researchers have also observed that economies tend to establish registration thresholds at much lower turnover levels than recommended (Ebrill et al., 2002). This may be due to the fact that liberal minimum thresholds simplify administration, and most areas that are difficult to assess are not included such as small farmers, street vendors, and independent contractors of business services (Tait, 1999). According to Ebrill et al. (2002), the threshold issue is significant because a low early threshold in a number of countries has been noted as a primary weakness of a VAT. For example, it was cited as the main reason for the failure of Ghana’s VAT when it was initially implemented in 1995 at a registration level of $20,000 in comparison with $75,000 when it was successfully re-established in 1999. Some commentators note that if there were no administrative or compliance costs, the most efficient threshold would be zero (Ebrill et al., 2002), but in reality, no such case exists. Moreover, compliance costs are comparatively greater for smaller firms than large corporations (Bird, 2005). Therefore, Ebrill et al. (2002) suggest setting the threshold at a point where the savings in collection costs are balanced against the loss in revenues.
Since, in most nations, the value-added base is concentrated among comparatively few businesses, a high threshold is normally the most efficient choice. However, these researchers found that economies tend not to adopt this approach for several reasons, in particular, the belief that not including smaller businesses is unfair and creates a perception that taxing more businesses will generate more revenue. While this may sometimes be the case, these authors believe that such inclusiveness is frequently overshadowed by the advantages of targeting the VAT on comparatively few, large industries.

**Exemptions and Zero-Rating**

Exemptions refer to the provision whereby a VAT is not applied to an output but also is not recovered on input. According to Ebrill et al. (2002), exemptions are more widespread than is desirable and often cause distortions of input decisions, as well as diluting the transparency of a VAT system. Supporting this view, (Bird 2005) maintains that VAT systems in some developing nations incorporate large numbers of concessions and exemptions that have the effect of reducing revenue and making administration problematic. Occasionally, when exemptions are created they are later expanded ‘secretly’ without rapid response from tax administrators, evolving into a system of ‘self- assessment’ that lacks the required administrative systems and protections to manage such a system (Bird, 2005). These kinds of exemptions act as incentives for taxpayers to push for still more exemptions, similar to tax amnesties that provide an incentive to postpone payment in expectation of future amnesties. In many of these countries, the
administration does very little to explain complexities or to prevent fraud. Actually, VAT audits in a number of countries mainly consist of numerical checks, and as attrition of the base facilitates tax evasion, corruption is identified when individuals are audited (Bird, 2005; Keen and Smith, 2007).

However, as noted previously, many countries initially provide concessions and exemptions to counteract the regressive nature of a consumption tax. They do this by lowering VAT rates or providing exemptions for specific basic necessities, such as food, commuter transport, medical services, and cooking fuel (Bird, 2005). That research also proposes that many theorists believe that the small amount of progressivity that might be gained by these kinds of policies could be more efficiently and fairly obtained by means of minor changes in the income tax or by modifications of transfer payments. In nations where the underprivileged are not usually subject to income tax or in receipt of transfer payments, the latter policies would not be relevant. Because this is the case, some exemptions seem necessary, even when they also benefit upper income taxpayers.

As noted by Cnossen (1998):

“The arguments in favor of a single VAT-rate in high-income countries do not apply to low income countries that face major constraints on administrative capacity in taxing personal income and in operating income support programs. Low-income countries, moreover, often have dualistic economies with class-differentiated consumption patterns that lend themselves more easily and effectively to the alleviation of the regressive
impact of consumption taxes. In these countries, poor families purchase most of their goods from local small-scale producers whose output must either be exempted or escapes taxation, while rich families are likely to buy more factory-made or imported goods that can be taxed more effectively. Thus, there are good grounds in these countries for exempting (no VAT on sales, no tax credit for VAT on inputs) a (limited) number of unprocessed foodstuffs that are sold in their “original” or “natural” state” (p.410).

Zero-rating occurs when sales are not taxed, but VAT paid on inputs can be recovered. According to Ebrill et al. (2002), the practice of zero rating is advisable solely on exports but, actually, is quite prevalent for other transactions. Bird (2005) maintains that zero-rating on distributive grounds might be imprudent in nations that are encountering issues with VAT refunds and where exemptions enhance cascading and hinder efficient enforcement by breaking the VAT chain. That same research also suggests that a reduced rate might be the optimal choice, but that cautious analysis is necessary to determine precisely what level and kind of relief is optimal for each case in each country. Also, even when a decision has been made rationally for a specific point in time, the situation should be revisited periodically due to the tendency of exemptions to increase because conditions change and because the expectation of what is considered reasonable may also change.
Administration and Policy Issues

According to Tait (1999), the costs of VAT administration vary extensively as a result of the types of exemptions, thresholds, zero-rating, number of tax rates, frequency of audit, together with the allied responsibilities of other agencies, such as customs. In the EC, the ratio of VAT revenue collecting staff to taxpayers ranges from 1:123 in Belgium to 1:726 in Italy. It has been estimated that with a registration threshold of $25,000NZ, a yearly rate of audits at 10.6%, with an average audit length of 12 hours, (using approximates average work rate data for the UK and New Zealand), 18,850 staff years would be necessary to administer the system for 12 million taxpayers (1:637). If the threshold were at the higher level of $100,000, the ratio would fall to 1:529.

In this context, there is evidence to suggest that a VAT might be less expensive to administer than an income tax (GAO, 2008). According to the UK tax administration agency, administrative costs for the VAT are 0.55% of revenue collected in contrast with 1.27% for income tax. Furthermore, the New Zealand Inland Revenue Department claims that administering their VAT is easier than administering a number of their other levies (Dalsgaard, 2001). This section examines the commentary on major organizational issues and auditing methods encountered in the administration of a VAT.

Organizational Issues

Countries face a number of organizational and administrative issues when introducing a VAT. For example, the relevant administrative agencies in
Australia, Canada, and New Zealand faced a number of significant challenges when implementing their VAT arrangements. These include the requirements for the development of new policies, practices and procedures, as well as appropriately skilled staff to undertake the various tasks associated with administering the new system (GAO, 2008). All three nations built on their existing administrative arrangements to implement the new VAT arrangements, and also adopted a variety of strategies to educate and help businesses in order to ensure taxpayers were fully aware of their rights and responsibilities under the new arrangements. Nonetheless, it was found that motivating a number of commercial entities to register for the VAT ahead of implementation was still a difficult task.

Constructing the administrative framework for the VAT in Australia, Canada, and New Zealand required cooperation among a number of government agencies (GAO, 2008). In each of these economies, this collaboration also encompassed the establishment of interagency committees to assist and organise implementation endeavours. In Canada, for example, the former Customs and Excise Division was in charge of administering the Excise Tax Act and the Department of Finance was in charge of sales tax policy and legislation. In comparison, New Zealand’s introduction of the VAT encompassed collaboration among five government agencies. The Ministry of Finance had public assemblies and managed communication from constituents. At the same time, the New Zealand Treasury’s primary task was the creation of VAT policy, while the Inland Revenue Department managed VAT registration and compliance. The Ministry of
Social Welfare was given the assignment of managing the benefit increases that accompanied VAT implementation and the overall tax reform process. Lastly, the Customs Service was tasked with ending the wholesale sales tax process and collecting the VAT levied on imports. In general, each of these nations assigned specific supervisory tasks to the relevant agencies during the transition, together with management of the impact of VAT on consumer pricing. In particular, these agencies took action to prevent businesses from artificially inflating prices to exploit uncertainty during implementation of the tax (GAO, 2008). In this regard, it was observed that a significant amount of inter-agency cooperation and collaboration was required in order to ensure smooth and effective implementation of the new taxation arrangements.

While all of these nations already had experienced and qualified staff in place for the administration of their existing taxation systems, all identified a need to hire and train significant numbers of additional employees (GAO, 2008). For instance, Canada needed to hire more than 3,900 additional staff during their transition. The new human resources required was three times the total staff formerly needed to administer their sales tax regime. Of these new employees, around 1,500 were hired to undertake a variety of educational activities, including walk-in services, seminars, communication, information sessions for business, advisory visits (a form of audit to be discussed subsequently), as well as the preparation and widespread distribution of printed information materials.
These activities demonstrate the important aspect of VAT administration, which is the requirement to provide the taxpayer with sufficient information and support to ensure that they are able to meet their statutory obligations under the new taxation arrangements (GAO, 2008). Such education was found to be an important aspect of implementation, as taxpayers cannot be expected to comply with the tax regulations until they know what they are and how they apply to particular entities and industries. For Australia, Canada, and New Zealand, this requirement led to the creation and administration of wide-ranging education and community service activities, employing a diversity of direct and indirect help.

While all of these nations instituted education and community service programs, Australia’s procedures are the most recent and offers the most detail regarding the requisite strategies and activities to implement the new regime (GAO, 2008).

The primary attribute of Australia’s education and outreach strategy was to contact particular entities in the various industry sectors and motivate them to educate others within their industry. This was often undertaken through national industry groups and associations, and it cost the Australian Government about $464 million to conduct these education programs. To achieve the effective operation of these programs, Australia created a Start-up Assistance Office within the Department of Treasury that helped SMEs and the community sector to prepare for and implement the VAT. This office implemented and managed the programs that are listed and described in Table 2-3.

Table 2-3: Strategies Used in Australia to Educate and Assist Business
| Grants to community groups and organizations | Program issued over 220 grants to a variety of community organizations, industry groups, and other organizations that worked with or on behalf of specific economic sectors. For example, grants were given to state chambers of commerce to develop and administer education programs to member businesses. |
| Advisor education | Program provided a series of tax education classes and seminars to a large network of informal advisors, such as accountants and tax preparers, who could then pass on their knowledge to the businesses or community and educational institutions with which they were affiliated. |
| Business skills education | Program developed and distributed a range of products and services to interested businesses that would be subject to VAT requirements. This included a telephone helpline, two VAT-specific Web sites, over 16 publications covering many topics of interest to VAT businesses, and specialized assistance to non-English speaking businesses. |
| Direct assistance to small businesses | Program delivered a A$200 (US$186) certificate to qualifying small business and community groups. The certificate could be redeemed with a registered supplier for goods or services that would assist the registrant in preparing for the VAT. The certificate could be redeemed to provide computer hardware, computer software, stationary, training courses, and financial advice. Over 1.9 million certificates were issued and could be redeemed at over 14,000 suppliers. |

Audit and Investigation

Once a VAT has been implemented and those subject to the tax have been educated and registered, enforcement of compliance becomes a major task of VAT administration. As the previous discussion of compliance issues, fraud, and tax evasion suggests, in order to decrease the gap between the tax reported by individuals and the statutory tax, it is necessary to implement an appropriate audit plan. This also needs to be widely publicised to ensure that taxpayers are made fully aware that the tax administration has both the data and the operational ability to enforce sanctions efficiently if they try to avoid paying the tax (Casanegra de Jantscher, Silvani and Holland, 1991).

In the course of enforcing compliance, tax administrators engage in several types of VAT audit and related compliance management activities. The first of these is the advisory visit. While an advisory visit is frequently undertaken by an auditor, it is not strictly considered to be an audit. Specifically, it is the first level of intervention that should occur almost immediately after the registration of a business or other taxable organization. The purpose of the advisory visit intervention is twofold. First, the primary objective is to educate the new registrant regarding the VAT in question, and second, it is an opportunity for the auditor to gather basic data that will assist the tax administration in its future interactions with the newly registered entity (GAO, 2008).

The desk audit or office audit comprises the second level of intervention. The office audit consists of a screening process undertaken by an auditor in a tax
administration office that includes examining tax returns for accuracy and completeness. The entity being audited might not be aware of the audit since it does not require discussion with the taxpayer. Basically, the audit involves the primary functions of checking for arithmetical accuracy, calculating ratios, and so forth. As a result, it should be automated (computerised) to the greatest extent possible. (Siddiqi, 2007).

The next level of audit is referred to by different names in different tax administrations, including field audit, verification audit, control audit, and routine control audit (Casanegra de Jantscher et al., 1991). Basically, this audit comprises close examination of particular features of the entity’s commercial operations, books, and financial records onsite. The purpose is to identify potential errors and deception, as well as providing the visiting auditor with an opportunity to observe the company’s trading operation in comparison with the business records and also to create the foundation for the entity’s future compliance. However, these audits are often not complete financial audits.

The main steps in this type of audit include the following (Casanegra de Jantscher et al., 1991):

1. Examining financial records;

2. Examining external data, such as customs documentation and information from customers and suppliers;
3. Examining physical records, including units of production, inventory, and use of materials data;

4. A number of tax administrators also collect sample invoices from customers and suppliers for verification of these documents when the customer is audited; and

5. Finally, amended returns are filed that include the admission by the taxpayer of errors or omissions that were found by the auditor.

The final level of audit is an in-depth investigation of entities subject to the VAT that usually occurs following a VAT audit where evidence of possible fraud has been detected. However, a fraud investigation might also result from referrals made by registration or collection units, income tax officials, or private citizens. Normally, if an auditor believes the taxpayer has engaged in deception, the case will be referred to a special investigation unit, where facts will be accumulated and examined by specialists to determine whether tax evasion has occurred. The members of this unit receive specialised training in undertaking an audit for fraud (Casanegra de Jantscher, Silvani, and Holland, 1991).

However, commentators contend that initiatives such as audit activities should only form part of a much broader compliance management framework (see for example Sparrow, 2000 and Widdowson, 2005). Such commentators highlight the importance of ensuring that the taxpaying community has certainty and clarity regarding their regulatory obligations, and is appropriately informed of their rights and responsibilities. In this way, it is argued, taxpayers will have the necessary
knowledge to appropriately assess their liabilities and entitlements. Such strategies include:

- Consultation and cooperation;
- Clear administrative guidelines;
- Formal rulings;
- Education and awareness;
- Technical assistance and advice; and
- Appeal mechanisms.

According to Widdowson (2005), there is a “need to provide the commercial sector with the ability to comply with [regulatory] requirements. This involves establishing an effective legislative base … and an appropriate range of client service strategies … including effective consultation arrangements and clear administrative guidelines. Such strategies are necessary to provide the commercial sector with the means to achieve certainty and clarity in assessing their liabilities and entitlements” (p.95).

**Information and Communications Technology**

A common feature of the VAT systems in developed economies is the automation of their processes. As noted above, Siddiqi (2007) highlights the importance of automated systems to assist the audit process. Sophisticated information and communications technology (ICT) is also used widely to manage the operational processes of taxation including lodgement, payment, verification, authorisation, notification and so forth. Not only do such systems facilitate the
management of taxation regimes from the administrator’s perspective, they can also assist to minimise the regulatory compliance burden for taxpayers. Indeed, effective ICT is essential to achieving business objectives, and commentators note that regulatory compliance costs can often make or break a commercial operation, and that even a small automated process can assist a country’s traders to gain a competitive edge over their competitors in other countries (see for example McLinden et al, 2011).

According to McLinden et al (2011), “… agencies in both the developed and developing world can take advantage of existing and emerging strategies and can access and share experience and good practice approaches. There should be few incentives to reinvent the ICT wheel when information is available about what works, what doesn’t, and why. The challenge is to learn from current best practice and create solutions that are innovative, flexible, and scalable. All reformers and policymakers need to understand what these terms mean and how they affect a choice of ICT solutions” (p.116).

Commentators also note that inefficient taxation systems often result from a lack of, or inadequate ICT infrastructure. For example, GTZ (2009) comments that, “… many developing countries lack an efficient tax collection system, leaving in some cases more than 60% of the tax potential untapped. In these countries, sustainable development and fiscal independence can only be achieved through an improvement of taxation processes. Information and Communication
Technologies (ICT), by enhancing efficiency and transparency, can contribute to the improvement of tax assessment and collection systems” (p.1).

The far-reaching impact of current and future developments in such technology, and its contribution to regulatory compliance management, is highlighted by McLinden et al (2011), in reference to the use of ICT by border management agencies. In this context, they state that:

“… developments in technology will allow system interoperability, promoting greater sharing of information and intelligence not just within agencies, but across a wide range of stakeholders (for example, other national government departments, border management agencies in other countries, and traders and their agents). Border management agencies will adopt web based services and service oriented architecture to make services interoperable for various business domains. Identity management, remaining a key common component, will include biometric identification and identity verification. Barcode and radio frequency identification (RFID) tags will be further developed to track and trace legitimate goods.

“Intelligent and mobile devices, such as integrated personal digital assistants, global systems for mobile communications (GSM), and global positioning services (GPS) will further new applications. Business system processes, supporting services, and ICT applications will be more responsive to changes in the global economy. State of the art ICT will be
key to achieving required growth and competitiveness nationally, regionally, and internationally. Also noteworthy will be the emerging ICT and systems requirements for dangerous goods and supply chain security initiatives. Thanks to the latest technological evolutions, such as service orientation architectures, services orchestration within a coordinated process map has become more accessible. Improved services and new ones have become faster and easier to deliver. Collaboration across departments has become technically more feasible. In summary, sharing of effort across different agencies, countries, regions, and around the world on common processes is now constrained only by the need for prior agreement and genuine goodwill” (p. 117).

When examining the use of ICT in the context of a developing economy (Tanzania), Chatama (2013) concludes that, “The impacts of ICT use can be seen in a number of ways, including; reduced administrative and collection costs; decreased need for personnel; time savings for taxpayers due to fast processing; transparency in assessment, collection, and related processes; reduced tax compliance costs; reduced communication costs; and timely access to information which results into plugging all revenue loss and improve efficiency and performance in revenue collections” (p.99).

**VAT Sharing Methods**

The popularity of VAT raises an important issue for the finance of regional governments, such as states and provinces, because the literature suggests that
VATs only function well if they are levied by a central government (Bird and Gendron, 2001). However, these views are beginning to change as governments decentralise and federations adopt VATs. This section of the review briefly examines the literature relating to international trends, with a focus on three different VAT revenue sharing methods as exemplified by three countries with federal/local political entities.

**International Trends**

The Commonwealth of Australia was formed in 1901 when six sovereign colonies agreed to unite in a federation. These six states and two territories that have recently attained self-government constitute the Australian nation today. The fundamental rationale of the Federation was to safeguard the benefits of internal free trade. A concurrent reason was to levy a common external tariff. Because customs and excise initially held responsibility for the primary tax base, these goals resulted in the federal government being given jurisdiction over the primary tax base. At the same time, the states were given control over domestic tax policy. According to McLean (2002, 2004), a consequence of this approach was that vertical fiscal imbalance (VFI) existed in Australia from the beginning of its federation, and still remains an issue today.

As time passed, the resources and the economic interests of the states differed. From 1901-1933, the states of Western Australia and Tasmania gained the least from the tax arrangements, and consequently the current organization of fiscal federalism essentially developed from demands in these states. The outcome is
a system of taxation that attempts to achieve the greatest degree of horizontal fiscal equalization (HFE) of any democratic federation (McLean, 2002, 2004). Taxation and revenue sharing is supervised by the Commonwealth Grants Commission (CGC), a non-partisan body that separates itself from politicians.

Since 1933, vertical fiscal imbalance has become more prominent because the Commonwealth (that is, the Federal Government) has monopolised income tax and implemented the first broad-based VAT, called the goods and services tax (GST), presently at a rate of 10%. As per the original agreement between the federal and state governments, practically all revenues from the GST are distributed to the Australian states and territories (GAO, 2008). The aim of the VAT (or in this case, the GST) is to take the place of a group of formerly ineffective state taxes that were believed to be hindering economic growth. The federal and state governments consented to the present arrangement whereby the federal government administers the GST as a representative of the states and territories. In return for federal administration, the states and territories compensate the federal government for administrative costs, but apart from these fees, they receive almost all of the proceeds collected. Alteration of the GST base and rate or amendments to the original agreement must obtain the unanimous support of the states, federal government approval, and agreement by both houses of Australia’s Parliament.

Considering adoption of elements of the GST for the UK, McClean (2002, 2004) suggests that parts of the Australian GST that should be adopted include the
nonpartisan agency and the target of HFE between constituent parts. Other elements that should be examined and possibly adopted include the extremely wide-ranging equalization, such as the levelling of the impact of grants for special purposes. However, he recommends against adopting what he calls the cumbersome formulae, as well as a few of the detrimental methods of other required calculations. The Australian method of sharing will be discussed in more detail in Chapter 5.

Canada has both a federal VAT and sub-national VAT systems. The complexity and compliance burden of the tax system range widely among the Canadian provinces, depending on the degree of coordination between the federal VAT and sub-national levies. Canada has numerous consumption tax systems throughout its provinces, including the following arrangements: (a) individual federal and provincial VATs administered by a single province (Québec); (b) shared federal and provincial VATs administered by the federal government; (c) individual federal VAT and provincial retail sales taxes (RSTs) administered independently; and (d) a separate federal VAT. The least compliance burden exists for industries in provinces where the provincial and federal VATs are levied on the same goods and services and are administered by the federal government because these industries are only required to meet the terms of one set of regulations (GAO, 2008).

The province of Québec administers the federal VAT as a representative of the federal government in conjunction with a provincial VAT. The cost of joint
administration is shared between both governments. While permitted some flexibility, Québec is required to follow the same regulations as the federal government when choosing entities for audit; performing compliance activities; and administering registration, payment, and methods of dispute resolution.

There are a few primary distinctions between the local tax in Québec and the federal VAT that produce some added administrative costs and compliance burden since businesses have to comply with two sets of regulations when determining tax liabilities. For instance, specific financial services that are exempt from the federal VAT are zero-rated under the local tax. In addition, Québec also requires commercial entities to have both a provincial registration number and federal registration number (GAO, 2008).

Since 1997 three Canadian Atlantic provinces have abolished their provincial RSTs and implemented the Harmonized Sales Tax Arrangement (HST), which is similar to the federal VAT, apart from the fact that it adds a tax rate of 8 per cent to the federal VAT rate. The pooled rate is presently 13%. The federal government administers the HST at no charge to the three provinces and returns HST revenues back to the provinces. These provinces have reduced their tax administration costs by replacing their RST with the HST in this arrangement (GAO, 2008). On the other hand, these provinces also anticipated a revenue loss because the HST rate of 8% was lower than their previous RST rates. To compensate for part of these losses, the federal government has agreed to pay the provinces a total of Can$961 million over a period of four years.
Five other Canadian provinces impose RSTs in conjunction with, yet independent of, the federal VAT. Retailers conducting businesses in provinces with a RST must register for both taxes, file returns for both taxes, and can receive independent audits in both systems. Differing from the VAT, the provincial RST is levied on very few services. In addition, the RST offers several exemptions. For instance, a number of provinces do not tax children’s clothing, unprepared foods, or energy resources, such as natural gas. These items are either taxed or have different definitions under the federal VAT (GAO, 2008).

Furthermore, while the federal VAT assigns zero rates to specific goods or services, the provincial RST employs exemptions. This distinction is significant and has ramifications for management and bookkeeping (GAO, 2008). For instance, a grocery store must decide which goods are zero-rated under the VAT system, but are exempt under the RST. As a result, the store must keep track of purchases and sales and decide independently how they are categorised under each system of taxation. Thus, a number of entities in provinces with RSTs suffer disadvantages in comparison with their counterparts in the other provinces because they must meet the terms of two taxes. Retailers in these provinces must also file both a federal VAT and provincial RST return.

On the other hand, neither Alberta nor any of the Canadian territories have introduced a consumption tax at the local level. Thus, purchases in these provinces only attract the federal VAT. As a result, commercial entities in these locales have less of a compliance burden than those in provinces with a RST.
According to Canadian tax administrators, one problem that concerns these regions is interprovincial sales, because some Canadians who live in one province will travel to Alberta or the territories to make purchases so they can avoid paying the provincial RST or VAT in their own province. The outcome is lost tax revenue (GAO, 2008).

In the United Kingdom, taxation occurs at two primary levels of government: the central government level under Her Majesty’s Revenue and Customs and at the local level under various local governments. Revenue at the central government level is generated mainly by income tax, National Insurance contributions, a VAT, a corporation tax, and a fuel levy. Revenues at the level of local government are mainly derived from grants from central government revenue, business rates in England and Wales, Council Tax, and various local fees (McLean and McMillan, 2003).

Initially, the VAT was established in the UK in 1973 at a standard rate of 10%, with subsequent variations in an additional higher rate for luxury items. The VAT has raised the third largest amount of tax revenue, with a previous rate of 17.5% on goods and services. Specific goods and services are exempt from VAT, while others are taxed at a reduced rate of 5% (domestic gas supplies and home heating costs, for example) or are zero-rated for items such as most food and children’s clothing, (HM Revenue and Customs, 2010). As in most VAT systems, the purpose of these exemptions is to offset the regressive nature of the tax by maintaining the tax burden on essential goods and services while still imposing
the full tax on luxuries (Charlet and Owens, 2010). From January 2011, the VAT standard rate rose to 20%, and the reduced rate increased from 5% to 6%.

According to McLean and McMillan (2003), it is broadly acknowledged that the allocation of UK central government revenue to the regional and territorial governments, administrations, and authorities is based on a mismatched variety of poorly designed formulae. They cite as an example, the Barnett formula, which allocates funds to Wales, Scotland and Northern Ireland (called devolved governments), with variations applied according to changes in spending levels assigned to public services in England, England and Wales, or Great Britain. This formula is not based on need or other local considerations. As a result, it has been widely criticised, and its effects recently described as unfair by its creator, Lord Barnett (“The Barnett Formula,” 2009). McLean and McMillan (2003) assert that the method by which funds are shared with local authorities within the English regions has been discarded by the government, even though a substitute method has not yet been identified. They conclude that a universal basis for government spending across the regions and territories of the UK would be more balanced and efficient, and would depoliticise the financial structure of the UK. This finding illustrates the kinds of problems that a central or federal government might encounter in the development of an equitable system of revenue sharing. The UK system will also be discussed in more detail in Chapter 5.
Revenue Distribution

Revenue distribution, unlike other aspects of tax administration, is a matter of policy, not efficiency, and consequently when considering this issue it is necessary to understand the underlying principles that guide and direct revenue distribution. Revenue sharing involves distribution of part, and in some cases the majority, of the income generated by a federal tax to states and municipalities. This distribution can be quite complex, and there are added challenges and issues when there is more than one system of taxation, that is, at the federal, state and/or municipal level (GAO, 2008). For example, Canada has implemented a national VAT combined with a diversity of provincial VATs and sales taxes. Their system shows that a federal system can include a variety of VAT arrangements. However, doing this raises administrative expenses and compliance issues for both the relevant governments and other entities that are impacted by the arrangements. For example, in provinces with a sales tax, companies, especially vendors, encounter more compliance burdens than retailers in other provinces since they are subject to dual reporting, filing, and payment regulations (GAO, 2008).

According to Keen and Hellerstein (2009, p1), "The core issue of economic principle in relation to the VAT, as with commodity taxes more generally, is commonly posed as the choice between destination and origin principles". By way of example, bringing the full rate of tax to imports fully into tax and zero-rating exports is a demonstrable method of implementing the destination principle. In this example, the destination - that is, the importing jurisdiction
collects all the tax whilst the exporting or the origin jurisdiction collects none. But definitions can be described in several different ways and all lead to the same end. Theoretically, the exporting country could charge export tax similar to the way in which it collects tax on domestic sales, with the importing country allowing this as a credit against its own tax charge. While not all revenue accrues to the import country, this method is still consistent with the destination principle.

This proposition is further debated by Cnossen (1998) who argues, “In the professional literature, it has long been argued that the substitution of the origin principle (tax on exports, no tax on imports) for the destination principle would obviate the need for border tax adjustments and hence border controls, yet would not affect real trade. After all, since exports are exchanged for imports, a tax on exports is equivalent to a tax on imports and compensating exchange rate and wage adjustments would simply restore the original position” (p.411).

For some time the norm with respect to international trade and the norm sanctioned by WTO rules has been the destination principle with revenue accruing to the country of import (Keen and Hellerstein, 2009). Some variations did exist among the Commonwealth of Independent States did exist in the past as regards the origin principle taxation, but this is no longer considered true. (Baer, Summers, and Sunley (1996).

Keen and Hellerstein (2009) argue that there is no clear-cut view of taxing consumption but not production where it occurs. Thus, the principle of revenue distribution is a method of applying the VAT according to the destination rather
than the origin principle and this view is well supported. Of course, there are situations which both lead to the same real outcome so the choice of principle is irrelevant.

In summary, the destination principle is a rule of tax administration that is seeking to identify the actual consumption location, but it is not a theoretical ideal (Keen and Lahiri, 1998). However, the associated difficulties relate to implementation, and it is important to remember that consumption (the ultimate object of taxation) is by people, not businesses, so in this respect the destination principle provides no guidance as to where the VAT should be levied. According to Keen and Hellerstein (2009), only practical considerations can guide the choice by the government in question.

Central governments in many nations, including Australia, the UK, Germany, and South Africa, employ fiscal equalization models for the distribution of revenue to sub-national governments (Petchey and Levchenkova, 2004). Equalization grants consist of cash allocations from a central point to local subdivisions with the goal of compensating for disparities in accessible revenue or in the expense of supplying public services. Fiscal equalization models differ to some extent in their configuration but they do possess similar attributes. For instance, Australia estimates the revenue and spending needs of sub-national governments when allotting grants, while other nations estimate only the revenue needs of regions. This type of equalization is nearly always driven by the goal of guaranteeing equality of access to public services wherever a nation’s citizens reside.
Equalization grants are frequently calculated based on the scale of the disparity between local fiscal need and fiscal capacity. However, fiscal capacity and fiscal needs are not normally considered to be the same as the measures of fiscal income and expenditure. This practice is based on the belief that if they were considered to be the same, it might encourage negative incentives to local governments to diminish their fiscal efforts.

However, regional cost variations are also integrated into models that consider expenditure needs. The reasoning is that expensive regions require more funding than lower cost regions in order to deliver the same level of service. The supplementary funding is necessary to offset the comparatively higher costs in the expensive subdivisions (Petchey and Levchenkova, 2004). The UK considers such cost variations when apportioning grants from the central government to sub-national governments, and identifies such variations by way of cross-section regression analysis.

**Summary and Conclusion**

This literature review leads to a number of general observations and conclusions regarding the VAT. First, while distinct in some specifics, the administration of a VAT consists of many of the same basic issues and challenges of other tax systems, such as organization, education, compliance, administrative costs, and revenue sharing. Secondly, though motivated by progressive goals, tax preferences like exemptions, zero rates, or reduced rates frequently decrease revenue, add complexity, and raise compliance risks. In VAT Administration that
use these rating systems, the literature suggests that there is an increased compliance burden for businesses and greater administrative costs, especially in relation to audit activity and fraud prevention (GAO, 2008).

Because each country’s history and political economy differ, it is impossible to maintain that one VAT system is superior to another without regard to the environment of the country adopting the VAT. However, there is widespread agreement that the New Zealand model represents a fair and efficient VAT system (White, 2007) as it is seen to have several advantages over other countries’ systems. For example, taxpayers are only required to pay tax on the difference between taxable sales and taxable supplies, whilst only a few exemptions are allowed. Also, tax returns are less complex, thereby enabling many companies to prepare their own tax returns. As a result, corporations only need a small number of GST specialists and there is little policy monitoring required by the relevant regulatory authorities. The conclusion that a broad-based single rate VAT appears to be the optimal design is further supported by Charlet and Owens (2010), although the researchers also point to the fact that methods of redistribution and transfer of payments can create difficulties, and minimal exemptions are usually necessary to offset the regressive nature of the tax.

There is also broad consensus that the invoice credit method that has been adopted by most countries is the best method of calculating VAT liability (Grinberg, 2010) as it is considered to be the most efficient in terms of deterring a
major method of VAT tax fraud. However, it is also recognised that fraud and tax evasion remain a continuing issue for the VAT as well as other systems of taxation (Keen and Smith, 2007).

In conclusion, the literature suggests that before introducing a VAT system, especially in a federal form of government, it is necessary to resolve the following issues:

(a) federal and state sovereignty/ responsibility regarding the VAT;
(b) methods of revenue sharing between the states/local governments and federal government;
(c) agreement on methods for determining VAT liability;
(d) types of audit and approaches to compliance management in order to address fraud and tax evasion by individuals and entities;
(e) whether to retain existing sales and other taxes at the local or federal level; and
(f) issues of regressivity and offsetting by means of rates, exemptions, and zero-rating.
CHAPTER 3: METHODOLOGY

This chapter discusses the methodological approach adopted in the study, including its adoption of a mixed method approach, the sample population, method of data collection and ethical considerations.

**Mixed Method**

This investigative study employs a mixed method approach to the research, wherein both qualitative and quantitative data are used to examine the effects of implementing a VAT taxation system, and the potential implications of the introduction of such a regime for the Emirate of Ras- Al-Khaimah (RAK).

According to Creswell (2002), a qualitative approach develops one of three themes: (1) philosophical ideas, (2) procedural developments, and (3) participatory and advocacy practices. The qualitative research approach involves collecting data from the study participants through the use of interviews. The questions that are put during the course of the interviews are relatively broad and quite general in nature. This, according to Creswell, enables the respondents to ‘respond freely’ and to provide the researcher with responses that are not limited by strict investigative parameters. A quantitative approach, on the other hand, is centres on the adoption of key quantifiable variables and uses statistical
methodologies to analyse their impact on the problem that is the subject of the research.

According to Hurmerinta-Peltomäki and Nummela (2006), mixed method research techniques represent a combination of both qualitative and quantitative data collection and/or analysis, which the researcher incorporates into a single study. Such data could be “collected concurrently or sequentially and combined at one or more stages in the research process” (Hurmerinta-Peltomäki and Nummela, 2006, p.441). According to these commentators, “researchers may combine qualitative and quantitative data collection and analysis in any one or throughout the four phases of the research process. In this regard, the four phases are described as initiation (before data collection starts); implementation (when data is collected); integration (when data is sorted and analysed); and interpretation (when conclusions are drawn)” (p.441). These researchers also contend that the number of phases during which the qualitative and quantitative data are combined is likely to vary from one research study to another.

The current research employs triangulation to validate key issues relating to the implementation of VAT systems in developed economies, and in this context, Hurmerinta-Peltomäki and Nummela (2006) suggest that the degree of triangulation in the research is of some significance and depends on the reason why the researcher decides to adopt mixed method as the research methodology. For example, “it may be the researcher’s intention for qualitative values to serve as a trajectory to quantitative elements of the study or vice versa”
These commentators also contend that the use of mixed method is preferred by those researchers who intend to further validate their study, and they consider this to be of particular importance in the context of cross-cultural studies where the researcher’s intent is to validate the same sets of observations from different countries. Finally, a mixed method is utilised because researchers would like to “acquire a deeper understanding of the research subject” (Hurmerinta-Peltomäki and Nummela 2006, p.442).

Vitale, Armenikas and Feild (2008) utilised a mixed method in studying organizations. Their study utilised both closed- and open-ended questions within the same questionnaire in order to derive responses from their subjects. The researchers found mixed method to be an appropriate methodology for use in action research, indicating that this is particularly true if the interest of the researcher is to derive information that would be helpful in instituting change within an organization or system. The researchers also found that when the research is focused on potential problems of the organization, it is a viable approach to incorporate closed- and open-ended questions within the same survey in order to extract more meaningful responses. The technique of “attaching open-ended questions to a quantitative standardised survey instrument is a statistically supported technique when problems in the organization are the primary interest of the change practitioner” (p.102).

Mixed method, when applied correctly, is considered to benefit business research studies, particularly those involving investigations that compare multiple
countries and cultural environments. When Hurmerinta-Peltomäki and Nummela (2006) reviewed several international business research studies using a mixed method approach, they found that the methodology lends more credibility to the findings of such studies, and the researchers were able to validate their results when comparing them to research studies that used the traditional single approach to investigations. These commentators concluded that, “not only were the researchers able to employ triangulation to validate their data, they also had the opportunity to delve deeper into the contextual and broader description of their studies through the use of qualitative data” (Hurmerinta-Peltomäki and Nummela 2006, p.452).

When using a mixed method, it is considered to be more advantageous if such methodology is applied in several phases of the research process in order to maximise its value. In this regard, while the application of mixed method in several phases of the study may entail additional effort on the part of the researcher to evaluate the data, the result is considered to be rewarding as it creates additional opportunities for the researcher to contribute new knowledge to the discipline. The nature of international business research requires the application of a more innovative approach. In this context, it is considered that mixed method offers an alternative means of studying emerging international business phenomenon such as the rise of emerging markets attributed to globalization, the impact of joint ventures, cross-country business strategies and, of particular relevance to the present study, the implementation of a new taxation regime and how it may affect a country’s economy. In this regard, valuable
insights are likely to be gleaned from other countries that have already experienced the impact of the introduction of a VAT system. Furthermore, additional insights may be obtained from those who have personally experienced the implementation process and have first-hand knowledge of the generally undocumented issues that confronted those economies at the time of, and following the implementation of, the new taxation arrangements.

While there may be positive outcomes in employing mixed method research, it is also recognised that the methodology demands more from the researcher. For example, mixed method requires more resources from the researcher (time and finance) to complete the study. It also requires researchers to acquire skills that will enable them to fulfil both qualitative and quantitative research requirements, noting that often, researchers are able to fully master only one type of research method (Hurmerinta-Peltonäki and Nummela 2006, p.453). Taking into account these additional challenges, at the onset of the research initiative, the researcher must have adequate preparation and detailed planning, including the provision of targeted purposes at each phase of the research process, which employ both research strategies. More stringent and disciplined research is also required in accumulating the data that will require evaluation and analysis.

Some of the key problems that Hurmerinta-Peltonäki and Nummela encountered in their review of previous research studies that utilised the mixed method approach are the failure of some researchers to incorporate sufficient description of the elements studied, the inadequacy of reporting at each phase of the
research process where mixed method was employed and the inadequate
descriptions of empirical design (p. 454). Nevertheless, the authors see the
mixed method approach as an opportunity to increase value-added contributions
to the body of work in the field of international business.

In terms of the current research, the qualitative aspects of the research involve
the researcher conducting interviews with resource persons working within the
industry. The current research also adopts the phenomenological approach to
interpreting the qualitative research.

According to Cope (2005), phenomenological inquiry aims “to understand the
subjective nature of ‘lived experience’ from the perspective of those who
experience it, by exploring the meanings and explanations that individuals
attribute to their experiences” (p.168). The objectives of a phenomenological
approach to inquiry is “covering an array of interpretive techniques which seek to
describe, decode, translate, and otherwise come to terms with the meaning, not
the frequency, of certain more or less naturally occurring phenomena in the
social world” (Van Mannen 1983, p. 9 cited in Cope 2005, p.169). Important to a
phenomenological approach to inquiry is the ability of the researcher to translate
the accounts of respondents and provide an explanation to the phenomena or
experiences within the context of “here and now” that represents the
“photographic slice of life” (p.170). Within this framework, the researcher also
renegotiates his or her relationship with the participants. The researcher must
maintain his or her neutrality and impartiality as a detached observer. In this
respect, the researcher provides a personal interpretation of the interpretations provided by the participants (p.170).

**Two-Stage Approach**

The research in the current was conducted in two distinct stages. Stage 1 involved an examination of the international context by researching economies that have already established a VAT system, and Stage 2 examined the domestic context by researching the attitudes of various sectors within RAK to the potential introduction of a VAT regime.

**Stage 1: International Research**

Four economies have been selected for the purposes of providing international comparisons against which the implications for the UAE and RAK in particular may be considered. The four economies chosen for the purposes of this exercise were South Africa, the United Kingdom (UK), Germany, and Australia. All these economies have introduced a VAT system, all have had several years of experience with the operation of such regimes, all are regarded to be advanced economies and all are comprised of a central government with one or more additional tiers of government.

In Stage 1, the researcher examines the introduction of VAT systems in each of these economies in order to gather data relating to methods of revenue sharing, issues relating to federal and state sovereignty and responsibility, retention of VAT at the federal level, and issues of regressivity and offsetting through the use
of rates, exemptions and zero-rating. In order to achieve this, during this stage of the study, research was conducted into the VAT regimes that were introduced into these countries, including key policies and administrative procedures, fiscal equalization and compliance management.

In order to gain further insight into the issues associated with the implementation of the VAT arrangements in each of these countries, the researcher interviewed a number of senior executive level administrators of VAT functions in their respective countries that had first-hand knowledge of the way in which the VAT system was introduced in their economy, and key issues that were faced by the administering authorities, both during its introduction and following its implementation. The interviews were conducted following the participants’ completion of brief questionnaires which addressed in fairly broad terms general matters relating to the VAT system that operated in their country, including methods of revenue sharing. The questionnaire used during this phase of the study is presented at Appendix A (‘Interview of VAT Administrators’). The selection of the officials was purposive and not random, specifically consisting of executive administrators in each of the selected economies, that is, Australia, Germany, South Africa, and the UK. This approach to the selection of interviewees is supported by commentators (see for example Strauss and Corbin, 1998), who indicate that these kinds of study participants are normally selected because they have experienced the phenomenon under investigation.
As noted above, all interviewees were senior executive level administrators that had a comprehensive knowledge of VAT functions in their respective countries, and who had experienced the process of VAT implementation in their respective economies, including key issues that were required to be addressed both during and following implementation of the new regime.

Stage 2: Domestic Research

During stage two of the study, the researcher surveyed a random sample of members of various industry and community sectors within Ras Al-Khaimah regarding the introduction of the VAT in order to gauge the views of these groups and to therefore assess the likely issues that will need to be addressed when implementing the new system. The sectors comprised of the general public, corporations, Free Trade Zone firms, service firms, and international firms. The questionnaires used during this stage of the research are presented at Appendix B (VAT Adoption Survey for RAK and UAE: the Public), Appendix C (survey of Free Trade Zone firms), Appendix D (survey of corporations), Appendix E (survey of international firms) and Appendix F (survey of service firms). The surveys were despatched under cover of an explanatory letter (see Appendix G) which introduced the researcher and explained the background to the study.

Test Instrument

Cross sectional surveys of the type employed in the present study are designed to gather data at a particular point in time, and each time such questionnaires are administered, a new sample of the population is surveyed. In the case of the
current research, interviews were conducted to obtain the necessary information from the selected VAT managers, and a discrete set of questionnaires were used as the basis for the individual interviews. The research instrument represents a structured interview/survey and was administered personally by the author to ensure that all entries were completed to avoid invalidating the process. The first section of the questionnaires was designed to collect demographic and general information for general analysis, while the second section consists of open-ended interview questions where the subjects were free to offer their opinions on the various topics and to provide as broad a perspective as possible on issues surrounding the topics. A key benefit of open-ended questions is that they offer such an opportunity to obtain more in-depth data because respondents can generate their own answers.

According to Babbie (2003), interviews help the researcher to more completely understand a respondent’s experiences, and also enable the researcher to be flexible with the study participant. However, disadvantages of interviews are that they can be time consuming, hard to compare and analyse, and expensive to administer. Furthermore, there is a potential that they risk response bias due to the researcher’s presence during the interview, expectations of the interviewer, and respondents’ possible concerns regarding interviewer judgments of their responses (Glesne, 2005). In order to help counteract the potential for this kind of bias in the current study, the researcher provided interviewees with a clear explanation of the purpose of the study, and provided an assurance that confidentiality would be maintained.
Completed responses were analysed qualitatively and quantitatively, with survey responses discussed and summarised, and open-ended questions analysed quantitatively by using content analysis to identify thematic elements and patterns (see for example Norwood, 2000).

**Ethical Considerations**

To ensure ethical treatment of study participants, the purpose of the study, research procedures, and treatment of the results were explained to the survey participants. To achieve this aim, a comprehensive description of the research was provided. In this context, the researcher also identified himself, noted his residency in RAK, and the reasons for his interest in the topic. In addition, participants were advised that it was not necessary for them to participate in the study if they did not wish to do so. All were informed that participation was voluntary and that, even after having completed the survey, they may request that their responses not be included in the subsequent report of the study. Also, as noted above, prospective participants were advised that their responses would not be linked to them personally and they would not be identified by name. The privacy of survey respondents will be protected rigorously. The tacit understanding is that the findings of the research are likely to prove mutually beneficial to both the participants and to the researcher.
CHAPTER 4: VAT AND SIMILAR TYPES OF TAXATION

This chapter starts by discussing the more significant concepts of taxation in the context of defining the terms used in the present investigative research. It then proceeds to examine the different types of VAT, issues relating to revenue sharing, an overview of VAT in developed countries, and finally examines the New Zealand model that has been recommended for introduction in the UAE and is generally regarded as the most successful VAT system currently in existence (White, 2007).

Types of Taxation

Several common terms are used throughout the research study. The following is designed to define these terms and to describe the essential character of various forms of taxation in the context of the present investigation.

**Consumption Tax**: A consumption tax is generally perceived to be a value added tax as opposed to an income tax (Cabaltica, 2008). Consumption taxes are a significant source of revenue for governments, and they currently account for more than 30% of overall taxation in OECD member countries (OCED, 2005).

A consumption tax is one imposed on an individual’s spending or utilization, and consequently no tax is levied on what is not consumed. The precise definition of a tax is important, especially regarding consumption taxes because they assume many forms. A general definition of a consumption tax is that it is a form of taxation that is paid by consumers when making a retail purchase, and is a
percentage of what they spend, which makes purchases more costly than they would be without the tax.

A more precise definition of a consumption tax requires identification of the taxable base, the individual paying the tax, the activity that is taxed, and the outcome of the tax payment. Table 4-1 lists standard rates of consumption taxes in major economies worldwide as of the year 2005.

Table 4-1: Standard Rates of Consumption Tax (VAT) in 2005*

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>25.0</td>
</tr>
<tr>
<td>Norway</td>
<td>25.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>25.0</td>
</tr>
<tr>
<td>Denmark</td>
<td>25.0</td>
</tr>
<tr>
<td>Iceland</td>
<td>25.0</td>
</tr>
<tr>
<td>Poland</td>
<td>24.0</td>
</tr>
<tr>
<td>Finland</td>
<td>24.0</td>
</tr>
<tr>
<td>Ireland</td>
<td>24.0</td>
</tr>
<tr>
<td>Belgium</td>
<td>21.0</td>
</tr>
<tr>
<td>Italy</td>
<td>22.0</td>
</tr>
<tr>
<td>Austria</td>
<td>19.0</td>
</tr>
<tr>
<td>France</td>
<td>19.0</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>19.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>16.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>16.0</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>15.0</td>
</tr>
<tr>
<td>Turkey</td>
<td>15.0</td>
</tr>
<tr>
<td>Greece</td>
<td>24.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>17.5</td>
</tr>
<tr>
<td>Spain</td>
<td>15.0</td>
</tr>
<tr>
<td>Germany</td>
<td>16.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>12.8</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>16.0</td>
</tr>
<tr>
<td>New Zealand</td>
<td>15.0</td>
</tr>
<tr>
<td>Korea</td>
<td>10.0</td>
</tr>
<tr>
<td>Australia</td>
<td>10.0</td>
</tr>
<tr>
<td>Switzerland</td>
<td>19.0</td>
</tr>
<tr>
<td>Canada</td>
<td>15.0</td>
</tr>
<tr>
<td>Japan</td>
<td>8.0</td>
</tr>
</tbody>
</table>


As indicated, during this year, the highest consumption tax rate was imposed in Sweden, Norway, Hungary, and Denmark. Specifically, the amount was 25%.
Japan had the lowest rate, at 5%, while Canada came in second lowest at a rate of 7%.

**Value Added Tax (VAT):** A value added tax (VAT) is a tax that is levied on and paid by commercial organizations in proportion to the value they add to the goods and services they manufacture and sell (Cabaltica, 2008; Ebrill, Keen, Bodin, and Summers, 2002). The value added is the sum that a commercial organization obtains from its business transactions minus the sum that it pays to other firms during a specified period of time (value sold minus value bought). In other words, the VAT is a levy on the estimated market value added to a product or substance at each point in its manufacture or distribution, eventually passed on to the customer. For example, farmers are taxed on the wheat they sell, flour mills are taxed on their flour, bakeries are taxed on their bread, and restaurants are taxed on the bread they serve diners with their meals. Each entity is given a credit for all the taxes previously levied on their suppliers (Miller, 2010).

In sum, a VAT is a tax that is collected fractionally, using a system of partial payments in which sellers charge a VAT on all of their sales with an equivalent claim of credit for the VAT they have been charged on all of their purchases (Ebrill et al., 2002). Even though this is one of the most straightforward definitions of a VAT, many additional factors must be considered to fully evaluate a VAT.

**Goods and Services Tax (GST):** This is also referred to as the New Zealand VAT system and is generally recognised as being the most successful VAT system that has been implemented worldwide, having gained worldwide attention
globally through the years because of its success, according to White (2007). That research also considers the New Zealand VAT system to be the best practice model of this kind of tax and is preferred over the European VAT system (White, 2007). New Zealand GST-registered entities only pay the VAT on the difference between taxable sales and taxable supplies. The New Zealand GST will be described in greater detail below.

**Three Major Types of VAT**

As explained by Schenk and Oldman (2001), there are three chief types of VAT according to their treatment of the deductibility of capital equipment. According to this typology, a *gross product VAT* contains the largest tax base. It permits only a limited choice of deductions, such as cost of raw materials. Thus, it levies a tax on purchases of capital investments. On the other hand, an *income VAT* permits additional deductions. It allows the deduction of depreciation of capital goods as a net investment purchase (gross investment minus depreciation). Finally, a *consumption VAT* allows deduction of the whole capital investment.

The typology is based on the size of the tax-base of each VAT. The income based VAT has almost the same tax base as a general income tax and functions in a similar manner. Because the gross product VAT does not eliminate taxes on the acquisition of capital goods, it places a hindrance on purchases of capital goods. As a result, it may act as a deterrent to capital investment, similar to an income tax, because capital investment is taxed twice by this kind of VAT. The tax is levied when the capital goods are acquired and again when the products of
the capital goods are sold. This disincentive tends to have a negative impact, discouraging capital intensive methods of production, and delay capital improvement. On the other hand, with a consumption VAT, business purchases would be deducted or excluded. The outcome would be a tax base of totally private consumption. This kind of VAT is based on the New Zealand VAT System, which will be discussed in detail in a subsequent section.

The following three methods of calculating VAT liability may be used:

- credit-invoice method;
- subtraction method; and
- addition method (Schenk and Oldman, 2007).

The credit-invoice method is used the most extensively. The credit-invoice method emphasises the VAT’s most significant attribute, that is, the use of an output tax (collected on sales) and an input tax (paid on purchases). A taxpayer usually computes his or her VAT liability as the difference between the VAT charged on taxable sales and the VAT paid on taxable purchases (Schenk and Oldman, p. 39). This technique involves the use of an invoice that lists the VAT element of all taxable sales separately. The invoice used by the seller becomes the invoice used by the buyer. The seller’s invoice shows the output tax collected and the buyer’s invoice shows the input tax paid. In sum, taxpayers use the credit-invoice method to calculate the amount of VAT to be paid to the tax authorities in the following manner:

1. Total the VAT shown in the sales invoices (output tax);
2. Total the VAT shown in the purchase invoices (input tax);
3. Subtract the input tax from the output tax and pay any balance to the tax authority; and
4. If the input tax is greater than the output tax, it is usual that the taxpayer receives a refund.

Although the VAT is a universal consumption tax, applying to all final expenditure, there are cases where a VAT is not levied. For instance, in a pure VAT system, the tax base would hypothetically comprise government services, sales of individuals’ personal effects, and sales of individual services, but, no country has a VAT system with this tax base due to administrative, political, or social reasons (Schenk and Oldman, 2007). Thus, a VAT system offers exemptions or a zero tax rating for some transactions. The exemption signifies that the seller does not collect a VAT on its sales and does not obtain credits for a VAT paid on its acquisitions. A zero rating signifies that the seller is responsible for an actual rate of VAT, which is zero, and receives a credit for VAT paid. Similar to transactions, prospective taxpayers can be exempt or zero rated. An exempt seller is not required to participate in the VAT system and is regarded as a final buyer. A zero-rated firm does not collect VAT on sales transactions but receives refunds for any input VAT it pays (Cabaltica, 2008).

According to economic theory, it is implied that the collection efficiency of the VAT is influenced by political economy variables, such as increasing polarization and political instability that would diminish the efficiency of tax collection.
(Aizenman and Jinjarak, 2008). Moreover, collection is affected by structural variables impacting the facility of tax evasion. These variables include urbanization, agricultural share, and openness. In this case, collection efficiency is determined by the possibility of audits and by the punishment for underpayment. Delays in implementation of improved policy would continue to impact on the efficiency of the tax system in the next period.

Data from a general IMF study indicate that a VAT is associated with a higher ratio of general government revenue and grants to GDP (Bird and Gendron, 2007). The correlation seems greater the higher GDP per capita and the lower the percentage of agriculture in GDP. The latter finding thus supports the usual exclusion of most agricultural activity from a VAT system. Moreover, the study found that when the revenue effect of VAT appears to be smaller the import ratio is higher. This may simply reflect the fact that tariffs or other imposts might be equally efficient in these nations. In contrast, with everything else being considered equal, and where there is more significant international trade, the more revenue can be collected from VAT. It is expected that the application of border regulations and the controls completed by a customs service make the collection of VAT on imports comparatively easy. Most significantly, there is an extreme variation across nations in the revenue performance of VAT, mirroring an immensely broad range of variables including disparities in tax design, economic situation, and other attributes, such as literacy in different nations (Bird and Gendron, 2007).
VAT Revenue Sharing

A common definition of revenue sharing in the context of VAT is distribution of part of the income from a federal tax to states and municipalities. If a VAT tax is administered by a central government, the tax base is very broad, including imports, as well as production and different phases of sale. However, if the tax base is split between a federal government and local political entities or states, the chain might not function well, making tax evasion easier as well as impacting the tax base of the states. In nations where the VAT system is managed by a federal government, collection of revenue on imports comprises a greater percentage of total VAT revenues. Since tax evasion on mass imports is not easy, a VAT on imports also aids in monitoring tax evasion at succeeding levels of the tax chain. In this regard, VAT tax fraud has been a major problem in Europe, costing an estimated EUR 60 billion (White, 2007).

McLure (2005) argues that in the U.S., federal implementation of a VAT would enable the states to significantly improve their tax systems by eliminating their present retail sales taxes (RSTs) that are inadequate, replacing them with state VATs or modifying their RSTs. Nevertheless, a risk exists that RSTs would become worse, rather than improve. Furthermore, with a lack of effective coordination between state and federal revenue authorities, compliance and administration costs could rise due to the need to meet the requirements of two very distinct systems of taxation. On the other hand, combining either state VATs or state RSTs with a federal VAT would be difficult and could involve
considerable loss of state fiscal sovereignty. It would be especially difficult to achieve destination-based taxation of interstate trade. The presence of local sales taxes would further complicate the process.

According to Bird (cited by McLure, 2005), the only way in which two tiers of government can impose sales taxes with rational costs is by approving a common tax base and permitting one tier of government to collect the tax for both levels. While the VAT still might be the optimal of all potential sales taxes in general, as has frequently been asserted, in a federal nation, where both levels of government tax sales, a retail sales tax administered by one tier of government (with the possibility of both collecting revenues from it) is probably more sensible.

The VAT in Australia (Goods and Services Tax) might be an example of the above theory. It is collected by the Australian Federal Government, with subsequent allocation to the state and territory governments. The Australian Constitution limits the capacity of individual states to assess sales taxes, and although the GST rate in Australia is presently 10%, there are numerous domestically used items that are at 0%, including fresh food, medical services, and education.

**VAT in Developed Countries**

The VAT was first implemented in the more developed nations of Europe and Latin America but, over the past twenty five years or so, it has been established
in numerous developing and transitional nations. The rapid development of the value added tax (VAT) is considered by some commentators to be the most remarkable, perhaps, most significant advancement in taxation at the close of the twentieth century, continuing today (see for example Ebrill et al., 2002). While the tax was unrecognised outside of academic discussions just 40 years ago, today, it is a primary constituent of the tax system in more than 120 nations, generating almost 25% of the world’s tax revenue (Ebrill et al., 2002).

In 1984, the United States Treasury Department commissioned a report for then President Reagan on tax simplification and reform, which evaluated a VAT as a possible new federal tax, but the tax was not adopted. Just over 20 years later, the bipartisan President’s Advisory Panel on Federal Tax Reform again evaluated a VAT as a possible tax reform (President’s Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System, November 1, 2005, 191-92). In addition, many other non-governmental papers have also recommended a VAT as a possible new tax system for the U.S.

Portugal (1986), Slovak Republic (1993), Spain (1986), Sweden (1969), Switzerland (1995), Turkey (1985), and the United Kingdom (1973) (OECD, 2006). In fact, the U.S. is currently the only major nation that has not yet introduced a VAT.

In addition, economies that have joined the European Union (EU) must enroll in the European Union Value Added Tax Area. The EU VAT applies to the consumption of goods and services in the European Union Value Added Tax Area. To establish which state will collect the VAT and what VAT rate will be assessed, the EU VAT administrator verifies where the supply and use occurred. Furthermore, each member nation’s VAT laws must fulfil the provisions of EU VAT legislation as established in Directive 2006/112/EC, which provides the basic framework for the EU VAT, but permits member nations flexibility in implementation of the tax (The Council of the European Union, 2006). For instance, different VAT rates are permitted in disparate member countries. On the other hand, they must establish a minimum standard rate of 15% and one or two lower rates not less than 5%. As part of their EU Accession Treaty, a number of member nations have a zero per cent VAT rate on particular supplies, such as specific periodicals and newspapers in Belgium. The maximum VAT rate is currently 25%, though members are permitted to have higher rates.

According to the provisions of the Directive, specific goods and services must be exempt from the VAT (The Council of the European Union, 2006). For instance, mail services, health care, insurance, lending, and gambling must be exempt.
Additional goods and services are exempt, but an EU member is permitted to levy a VAT on supplies, for example, land and specific financial services. While input VAT attributed to exempt supplies is not recoverable, a business can raise its prices so, in effect, the consumer pays the price of the VAT.

Denmark provides an example of an individual member state. In this country, the VAT is applied at a single rate. Generally, except for a few instances, it is not split into two or more rates. This is the common practice in other nations such as Germany where lower rates are applied to essential goods like food. The present standard VAT rate in Denmark is 25% and the country is one of the member states with the highest VAT, together with Norway and Sweden (see Table 4-1 for more details on percentages for various nations and countries). However, some services are excluded from the tax, including public transportation of private individuals, medical services, newspaper publishing, rent of buildings, (although the lessor may voluntarily register as a VAT payer, with the exception of residential property), and operation of a travel agency.

**New Zealand VAT System**

Even though New Zealand is only one member nation in the OECD, with little more than four million people and limited research resources, it has produced a sound VAT, called the Goods and Services Tax (GST) that has influenced VAT/GST systems globally since its implementation in the 1980’s. For example, as India plans to implement a national GST; and the members of the Cooperation Council of the Arab States of the Gulf, as well as Asia-Pacific nations, are
considering the implementation of VAT/GSTs, one model they are examining very closely is the New Zealand VAT/GST (White, 2007).

The New Zealand GST was established October 1, 1986 with a rate of 10%. The rate was raised to 12.5% on July 1, 1989, and was subsequently raised to 15% on October 1, 2010. Consumers pay the GST on all required goods and services directly since the price of goods and services incorporates the levy, including most imported goods and some imported services (Inland Revenue Service, 2010). Over 20 years since its inauguration, the New Zealand VAT system is still considered to be the best practice model of this kind of tax and is preferred over the European VAT system (White, 2007).

Economists and tax specialists consider the New Zealand GST to be best practice due to the fact that the tax consists of a single rate applied uniformly to almost all goods and services with very few exemptions and zero rating (exports) (James and Alley, 2010). In this regard, requirements are simple and clear and administration and compliance is less costly. Moreover, citizens of New Zealand tend to view it as fair because it applies equally to everyone. Finally, revenue generated by the GST contributes 25% to overall tax revenue (White, 2007).

New Zealand GST-registered entities only pay the VAT on the difference between taxable sales and taxable supplies. In other words, they pay the tax on the difference between what they have sold and what they have purchased. They do this by reconciling levy received via sales and levy paid via purchases at standard periods, usually every 2 months, with some businesses permitted to
choose one-month or six-month periods. Then, they either remit the difference to the Inland Revenue Department (IRD) if the GST obtained from sales is higher, or they are given a refund from IRD if the tax paid on purchases is greater.

Differing from most VAT systems, only a small number of exemptions are permitted. For example, all kinds of food are subject to the GST at the same rate. On the other hand, exceptions comprise rent collected on residential rental properties (Cnossen, 1996), interest income, financial services, and donations. Also, commercial enterprises exporting goods and services from New Zealand are assigned a zero rate for their products. In effect, they charge GST at 0%. This allows the commercial enterprise to request back the input GST but the ultimate, non-New Zealand based buyer does not pay the GST. Companies that produce exempt supplies cannot claim back input GST.

Due to the fact that commercial enterprises claim back their input GST, the tax inclusive price is normally not considered by a business when making purchasing decisions, except in the context of cash flow. As a result, wholesalers frequently set prices that do not include the GST, but must collect the entire GST-inclusive price when they complete the transaction and are responsible to the IRD for the GST collected. However, in advertising and at the store, the price must at all times include the GST. On the other hand, firms that have primarily wholesale customers are exempt from this requirement. For all others, advertising a GST-exclusive price is illegal.
The New Zealand GST collects about a quarter of total tax revenue (White, 2007). GST tax returns are also considered to be relatively easy to complete, which leads to a number of companies attending to their own tax returns rather than relying on the services of tax agents. Only a small number of GST specialists are employed by large corporations. Another advantage of the New Zealand GST is that it needs comparatively little policy monitoring, either by the IRD or the Treasury. Interestingly, though, the GST has not been investigated to any great extent by New Zealand researchers, academia, or the media, in spite of the fact that New Zealand depends more on VAT/GST revenues as a portion of total taxation than any other OECD nation. Moreover, the GST is levied on the so-called ‘untouchables’ of food, children’s clothing, books, and medicine.

The proper handling of housing and housing services, as a component of the broader category of immovable property, tends to be one of the more complex and difficult issues in the theory and practice of the value-added tax (VAT). In most industrial nations, housing services, including rents and rental values of owner occupied residences, comprise 15% or more of total annual consumption expenditures as calculated for national accounts purposes (Cnossen, 1996). This seems to be too great a percentage to disregard under a broad-based VAT. However, conceptual problems, as well as administrative and political issues seem to rule out the taxation of housing services in an acceptable and fair manner.
Most nations with a VAT exempt rents and rental values as well as taxation of newly built houses, which generally satisfies established criteria of horizontal equity, neutrality, and feasibility (Cnossen, 1996). However, according to Cnossen (1996), the tax method of New Zealand, that is - tax all immovable property unless exempted, but exempt housing services and the sale of previously occupied residences - is better than the exemption method, that is, exempt all immovable property, except new residences. The tax method fully taxes commercial use of immovable property, other than houses. On the other hand, with the exemption method, rising values of commercial housing services are not taxed. In addition, elective taxation has disparate effects. In general, according to VAT theory, it is better and easier to define selective exemptions than to define selective charges to tax (Cnossen, 1996).

As noted by (Gharee and Al Abed, 1997), when the GST scheme was originally introduced in New Zealand, it was charged at two rates: a standard (currently 12.5%) rate and a zero-rate. Nevertheless, even in New Zealand some exemptions are allowed, specifically:

- Financial sector (principal transactions only; explicit fees charged by agents and brokers are taxable);
- Non-profit sector; and
- Rental and sale of residential property.

New Zealand VAT also offers zero-rating for particular domestic supplies such as TOGC (transfer of going concern) and B2B (business to business) transactions in
the financial sector. There is now a reverse charge mechanism for cross-border services in the financial sector, as well. In summary, the New Zealand system is widely acknowledged as the international standard for nations newly introducing a VAT (KPMG, 2008) and is preferred over the European system (White, 2007). With few exemptions, the NZ VAT even taxes basic foods and other non-traditional items.

As noted above, the NZ VAT arrangements consistently collect around 25% of total tax revenue and it appears to require few specialist GST partners especially with respect to large professional firms. In addition, little policy monitoring is required by the New Zealand Inland Revenue Department or the New Zealand Treasury. As a result, New Zealand has the highest reliance on VAT/GST revenues as a percentage of total taxation of any OECD country (White, 2007). On the negative side, the refund/remission mechanism in place means that there is no floor to the revenue risk from VAT/GST fraud and loopholes.

**Summary and Conclusion**

This chapter addressed a number of common terms that are used throughout the study. It included a discussion of consumption tax, VAT and GST, including the three major types of VAT, being *gross product VAT*, *income VAT* and *consumption VAT*. It also examined different methods of calculating VAT liability, and issues of revenue sharing. The chapter then discussed the development of VAT in developed countries and finally examined the New Zealand system, which is considered by commentators to be best practice due to the fact that the
tax consists of a single rate applied uniformly to almost all goods and services with very few exemptions and zero rating (James and Alley, 2010).

The following chapter examines the VAT system that is being proposed for the GCC, UAE and RAK.
CHAPTER 5:
PROPOSED VAT SYSTEM FOR GGC, UAE AND RAK

This chapter introduces the background to the VAT scheme that is being proposed for the GCC region and the considered adoption of such a system by the UAE and RAK. It is based on some publicly available references, but includes information that has been supplied by the governments of the UAE and RAK on a confidential basis for the purposes of this research study.

GCC Customs Union

The GCC countries include the United Arab Emirates, the State of Bahrain, the Kingdom of Saudi Arabia, the Sultanate of Oman, the State of Qatar and the State of Kuwait. The 23rd Session of the GCC Supreme Council, which is the highest authority of the organization and is composed of the heads of member states, agreed to establish a customs union. The agreed procedures for establishing the customs union, which came into effect on 1 January 2003, include the following principles (GCC, 2003):

- “A Common External Customs Tariff for products imported from outside of the GCC customs union
- A Common Customs Law
- Unified customs regulations and rules applicable in all member States
- Unification of the internal customs, financial and administrative regulations and procedures relating to importation, exportation and re-exportation in the GCC States
- The free movement of goods among the GCC States without customs or non-customs restrictions, while taking into consideration the implementation of the veterinary and agricultural quarantine regulations and the prohibited and restricted goods
- Treatment of the goods produced in any of the GCC States as national products."

In addition, noting that a single point of entry into any economic community is a key principle for establishing a customs union (similar to the concept applied in the European Union), the following principles were established in relation to the requirement for a single point of entry into the GCC (GCC, 2003):

- "Any land, sea or air customs port of the GCC States that has connection with the external world shall be deemed as a point of entry of the foreign goods into any member State.
- The first customs port of the GCC States vis-à-vis the external world shall conduct the inspection of the goods imported to any member State, verify their conformity to the required documents, ensure that they do not contain any prohibited commodities and collect the applicable customs duties."
• Unification of the restrictions imposed on the goods permitted to be imported subject to the fulfilment of certain conditions in all the GCC States

• The adoption of unified rules for importation and movement of the government imports and of exemptions from customs duties

• The goods whose importation is prohibited in certain member States while permitted in other member States shall be directly imported through the importing State or through another member State that permits entry of such goods provided that such goods shall not transit the territories of the member States that prohibit importation of these goods

• The foreign goods imported into the GCC States from the free zones shall be subject to the customs duties when exiting these zones and shall be treated during movement to the other member States the same as other foreign goods.”

Another key element of the agreed implementation procedures was the establishment of a common external customs tariff, which would ensure that the same rate of duty would be applied to goods imported into the GCC regardless of where they entered the customs union. In this regard, it was agreed that, “The common customs tariff of 5 per cent would be adopted with effect from 1 January 2003 (GCC, 2003), and that:
• “All customs administrations of the member States shall implement the Common Customs Law of the GCC States, its Rules of Implementation and Explanatory Notes …

• Customs duties are collected at the first customs point of entry of the GCC States with the external world as of 1st January 2003. The shares of the member States of the customs proceeds shall be distributed according to the final destination of the goods for the first three years following the establishment of the GCC customs union …”

**GCC Common Market**

In January 2008, the six member states of the GCC further agreed to launch a common market. The intent was to increase investment and trade between GCC member countries. To facilitate such an increase in investment and trade, the GCC member countries agreed to implement a VAT system by 2012. With the assistance of the International Monetary Fund (IMF), the GCC member countries agreed to adopt a ‘New Zealand-type’ VAT system, the key elements of which have been discussed in the previous chapter, with a three to five per cent VAT rate being recommended to compensate for decreasing customs revenues and providing a means to maintain economic growth by way of a sustainable income base (KPMG, 2008). A principal reason for falling customs revenues is the growing number of bilateral and/or regional Free Trade Agreements that have not only caused a reduction in revenues from customs duties, but also from other forms of trade-related taxation (Harrison, 2010). According to Harrison,
“Additional factors for GCC states in considering the introduction of new taxation stem from their economies’ increasing exposure to aspects of globalisation. These include the growing numbers of bilateral and/or regional Free Trade Agreements (FTAs) concluded in recent years such as the Bahrain-US or GCC-Singapore FTAs, and those still in negotiation such as the GCC-EU or GCC-China FTAs. Conditions of these agreements include the abolition of tariffs and other trade-related duties” (p.9). The various member states of the GCC are, however, “at differing stages of readiness for the introduction of a VAT” (KPMG, 2010, p. 10).

At the time of the agreement to establish a VAT across the GCC region, the UAE had already been undertaking work in this area, and its plan was to introduce a 5 per cent VAT in 2013. However, due to the impact of the global financial crisis, a decision has since been made to defer the introduction of a VAT in the UAE until 2015, and possibly later, depending on the state of the national and international economy. The introduction of a VAT regime will form part of a major restructuring of the UAE’s taxation framework, which will eventually include the introduction of a Corporation Tax. It is also important to note that the introduction of a VAT will not eliminate Customs Duty which, as noted above, is currently levied at a rate of 5 per cent across the GCC region in the form of a Common External Tariff (CET).

According to KPMG (2010), “Even in the EU, a relatively mature economy, wide rate divergences still exist despite numerous attempts to harmonise tax regimes.
The situation may prove to be especially complex in the UAE where the interests of seven emirates must be balanced.” (p. 10).

Nevertheless, the need for reform is generally supported by commentators. For example, Thacker (2008) comments that:

“With the financial activities of the UAE expanding rapidly, the importance of public revenues has increased not only as means for financing government activities, but also as a means for building general reserves for the government to meet any unforeseen expenses, as well as providing a means for checking inflation. 24 Additionally, the UAE believes that a balanced public budget is conducive to economic growth in the long run” (p. 725).

Current Taxation Regime in UAE and RAK

With the exception of oil and gas-producing companies and foreign banks in Abu Dhabi, Dubai and Sharjah, presently, there are no direct corporate income taxes in the UAE (including RAK), nor are there any withholding taxes, sales taxes or wealth taxes. Ras al Khaimah currently collects a 5 per cent customs duty tax in line with other Emirates and the GCC member countries. Other fees that are related to commercial licenses, industrial license fees and professional license fees are currently collected, but their removal could be considered in the context of introducing the new VAT arrangements. In addition, consideration has already been given to phasing out customs duties as and when Free Trade agreements
are signed between the UAE and other countries. However, this may cause some administrative difficulties within the GCC, as is already occurring in the case of Oman and Bahrain which currently have Free Trade Agreements in place with the US. The difficulty that is being encountered is that, if US imports that have entered the GCC by way of Oman or Bahrain are subsequently exported to another GCC member state, the goods effectively bypass the customs duty that would otherwise have been collected had the goods been imported directly into that third country. Nevertheless, this is an issue that will in any case need to be addressed at some point, regardless of future UAE arrangements concerning customs duties.

The following is an overview of the tax and accounting regulations presently in effect in RAK:

- **Income Tax** – 100% Income Tax exemption
- **Value Added Tax (VAT)** – There is no VAT in the UAE to date
- **Capital Gains Tax (CGT)** – There is no Capital Gains Tax in the UAE to date
- **Corporation Tax** – 100% exempt
- **Taxation of Dividends** – Dividend profits are taxed only in the state from which the income was earned. Dividend income paid by a UAE company to another company which has a double taxation treaty with the UAE may not be taxable in the foreign company even though no tax was paid in the UAE.
• Taxation of Royalties – Royalty profits are taxed only in the state from which the income was earned.

• Taxation of Interest – Interest earnings are taxed only in the state from which the income was earned.

• Withholding Tax – There is no Withholding Tax

• Capital Duties – 100% Capital and Profit repatriation

• Import / Export Taxes – There are no import or export taxes

• Net Worth Tax – There is no Net Worth tax.

Impact of VAT on UAE

Socioeconomic Impact

According to Deloitte and Touche (2008), in line with international experience, a VAT rate of 5% will cause a rise in the general price level, and a parallel one-off rise in the rate of inflation of 0.4-1.4%, depending primarily on the degree to which it is incremental to a CET. Deloitte and Touche indicate that several factors will determine whether this results in a continued inflationary increase, especially the question of whether employees may be able to obtain higher wages to compensate for the rise in prices, and the manner in which governments react in terms of fiscal and monetary policies.

Deloitte also estimates that a VAT rate of 5% will raise between 0.2 and 0.4 percent of GDP, but clarify this by saying that the outcome will mainly be dependent upon which categories of goods and services are ultimately exempted from the
VAT and how many companies are required to pay the tax. Also, disparities in the coverage of VAT and efficiency of collection are likely to affect this estimate. However, international experience indicates that the VAT can raise significantly more revenue than other forms of taxation (Deloitte and Touche, 2008).

Distributional impacts among households from different ethnic groups, income levels, and Emirates were analysed. Deloitte did not find marked distinctions between nationality groups, but, in general, Western households were likely to be least affected. Regarding household income, the analysis confirmed that the effect of VAT is regressive, impacting poorer households disproportionately. Even when particular expenses, such as food, are exempted, this regressivity remains. On the other hand, the disadvantaged “can be compensated more efficiently in most instances by means of the social security budget that would also have the tendency to balance any negative unequal impact on the smaller Emirates (Deloitte and Touche, 2008). At the same time, it has been recommended that, where more VAT revenue is collected from an emirate, the benefit from those funds would not necessarily be withdrawn from that emirate, depending upon the revenue sharing agreement whereby a large portion of that revenue would be allocated to the relevant emirate government, while the social security budget would be held by the Federal government.

However, when the average impact across Emirates is compared, the effect is assessed to be greater in the smaller Emirates. Table 5-1 displays the contributions of each emirate to the UAE’s GDP. With the exceptions of Abu
Dhabi and Dubai, it is evident from this table that the smaller emirates are heavily dependent upon the larger emirates (Peel, Harrison, Izzeldin, and Pappas, 2010).

**Table 5-1: Percentage contribution of each emirate to UAE GDP**

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2005</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dubai</td>
<td>25.4</td>
<td>28.9</td>
<td>31.0</td>
</tr>
<tr>
<td>Sharjah</td>
<td>9.0</td>
<td>7.4</td>
<td>9.4</td>
</tr>
<tr>
<td>Ajman</td>
<td>1.6</td>
<td>1.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Umm al Qaiwan</td>
<td>0.6</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Ras Al Khaimah</td>
<td>2.4</td>
<td>1.9</td>
<td>1.9</td>
</tr>
<tr>
<td>Fujairah</td>
<td>1.4</td>
<td>1.2</td>
<td>1.2</td>
</tr>
</tbody>
</table>


**Impact of VAT on RAK’s Key Industries**

The Government of RAK needs to obtain the optimal equilibrium between collecting tax revenues and maintaining RAK’s economic success and attraction of global investment. The impact of the VAT on the following key industries is discussed in this section: Heavy industry (cement); Real estate; Tourism; Free trade zones. Other factors considered include: Competitive advantage of being a low cost jurisdiction; and Islamic finance. The examination is based on the
findings of a report by KPMG, commissioned by the UAE Government (KPMG, 2008).

**Heavy Industry**

Heavy industry requires substantial capital investment, especially for the purchase of plant and machinery. Therefore, when a VAT is established, the amount of VAT sustained by such enterprises, especially in the beginning could be significant. In addition, export businesses in this sector will probably be in a constant refund position if exports are zero rated. According to usual VAT regulations, these enterprises should not experience this VAT as a cost impost because they will be able to recover it as input tax.

The primary risk for heavy industry is to their cash flow during the time when they are in a net VAT refund position. Nevertheless, the effect of the VAT on cash flow should not be underestimated and can be a key influencing factor on firms, especially those operating within relatively narrow margins (KPMG, 2008). To help with this, the VAT refund process should be prompt whilst following the tax authorities’ risk management procedures.

**Tourism**

A majority of countries treat the supply of particular services related to international transference as export of services, applying zero rates (exempt with credit). Zero-rating international passenger transportation, food and drink
consumed on global flights and voyages can therefore maintain RAK as an attractive location for tourists and commercial travellers (KPMG, 2008).

Free Trade Zones: In order to maintain the attractive aspect of free trade zones, businesses that operate in free trade zones could be expected to receive an exemption from the VAT. Exemption could be true exemption when input VAT cannot be deducted, or zero-rating, signifying that no VAT is due in transactions in free zones but input VAT is deductible. The latter case maintains the current benefits that are offered by UAE free zones to the greatest extent.

In business to consumer transactions, it is also important to maintain a favourable price level in the case of luxury goods, in order to continue to attract international customers and to sustain tourism. A VAT reclaim for tourists would avoid an increase in prices for such consumers. It could be a special option for travellers purchasing and taking goods over a particular worth outside the country in personal baggage, as is the case in most countries that have introduced a VAT system.

**Low cost jurisdiction**

A low cost jurisdiction is a country (or Emirate) where administrative and other types of expenses for starting and maintaining commercial enterprises are comparatively low. RAK has the competitive advantage of being a low cost jurisdiction. However, establishing the VAT could challenge this advantage (KPMG, 2008). Taxing commercial enterprises, including international businesses, may be expected to have a negative impact. For example, the VAT
could have a one-off inflationary effect increasing the general price level. This is because the tax is charged on real prices. On the other hand, it might only affect final consumption. The tax should not however have a significant impact on income and result in business to business transactions by its neutrality (KPMG, 2008), and it is considered that VAT should be treated as accrued and deferred items. Finally, in order to maintain the benefits of a low cost jurisdiction, as is currently the case with RAK, it is considered that sale and rental of residential property should be exempt from VAT. Also, firms leasing offices should not bear the expense of VAT as a result of the input tax credit.

KPMG (2010) suggests that the concept of low cost jurisdictions is changing in the Middle East:

“The traditional image of the Middle East as a tax-friendly region for companies has rarely seemed more outdated. Although corporate tax rates have fallen precipitously over the past decade, stricter enforcement of collection regulations is likely to become a recurring motif in the near future. Accompanying these new direct tax policies is a fundamental shift towards indirect taxes such as VAT. As a result, businesses must prepare to factor in new pricing structures for both the purchase of materials and the sale of goods.

The imminent adoption of VAT signifies that the GCC states are on the cusp of their biggest taxation reconfiguration in a generation – more of a revolution than an evolution. Several question marks remain. Will a
harmonious system be achieved? Will it succeed in generating new revenues without stifling economies? Legislators would be wise to examine the models of some mature global tax systems, noting the positives and the pitfalls while making appropriate adjustments for the unique features of the GCC’s requirements.

The greatest VAT hurdle facing many states might prove to be making the system as user-friendly as possible. The obligation to comply falls upon individual businesses; therefore electronic filing will need to be introduced to ensure maximum compliance” (pp. 12, 13).

**Islamic Finance**

Islamic Finance is a form of finance that observes the rules of Shariah Law, which is the law that governs features of daily life, not just finance, for Muslims. Regarding financial matters, Shariah law prohibits profiting from lending money because money is considered to be the measure of the value of an asset and not an asset itself. The result is that it is prohibited to earn or pay interest (Riba) (KPMG, 2008). Thus, trading debts and conventional credit and loans are not allowed. Moreover, Shariah Law does not allow extreme ambiguity or speculation in financial contracts (Gharar). Finally, any investment in specific kinds of activities prohibited by Shariah, such as alcohol and gambling is not permitted. Due to the expansion of Islamic Finance in RAK, such as Islamic bonds issued by the Government, the Government will have to decide whether providing a level playing field between conventional finance and Sharia-compliant finance is
suitable and, if so, guarantee that the legislation reaches this goal in any decisions regarding the introduction of a VAT. Similar considerations will of course also need to be made at the federal level.

**Reaching National Agreement**

There are clear indications that Local media reported in 2010 that there is an absence of consensus at both the business level and the governmental level regarding the implementation of a VAT. Indeed, some commentators have pointed to the possibility of inter-emirate divergence over taxation administration and collection because the UAE is still a somewhat loose confederation, with its comparatively autonomous and occasionally disorganised emirate-level powers influencing the state’s development (Peel et al., 2010).

There has been considerable discussion at the national level within the UAE concerning ways in which the revenue that is generated by the proposed VAT should be collected and subsequently distributed among the seven Emirates. Dubai, for example, has recommended that the VAT should be applied to imported goods at the point of importation, whereas other Emirates argue that the tax should be applied at the point that it is sold. Not surprisingly, the vast majority of goods imported into the UAE enter via Dubai, regardless of their ultimate destination. Similarly, a range of different revenue sharing models are currently being debated. Resolution of such issues will prove critical to minimizing implementation problems associated with the new tax. In this regard, it should be noted that, in the case of the broader GCC taxation initiatives that
have been raised, the debate continues within the UAE and other GCC member states regarding possible methods of revenue distribution. This is reflected in The United Arab Emirates Study Paper on Distribution Mechanism of Customs Revenue within the GCC Customs Union (see Appendices J and K) which highlight the need to establish an appropriate mechanism based on the principles of fairness, transparency, clarity and equity.

Studies to date have identified the following three possible alternatives in the case of a UAE VAT supranational authority being established (KPMG, 2008):

1. **Clearing House**: In the case of intra-UAE movement of goods, the trader would charge the VAT rate of the destination Emirate and pay the VAT to the clearing house. The consumer in the other Emirate would also apply for an input tax credit through the clearing house. The total VAT payments and credit claims would be netted and the difference would be allocated to each Emirate.

2. **CVAT – Compensating VAT**: For intra-UAE transactions a distinct uniform VAT rate might be established, for example, a rate equal to the average of the VAT rates of the seven emirates. Irrespective of the nation of origin and destination, traders would always charge this uniform rate for consumers in another Emirate. VAT payments and credit claims would be sent to a central authority at the UAE level. The Emirates must agree on a method of allocation to remit the VAT collected to the Emirates.
3. **VIVAT – Viable Integrated VAT**: With a VIVAT the tax collected not only on the intra-UAE transactions, but on all domestic business to business transactions would pass through a clearing house. The Emirates would only be responsible for the collection of VAT levied on business to consumer transactions. According to KPMG (2008), the Emirates would need to agree on the treatment of cross-border transactions at the federal level. Aside from a distinctive federal level law establishing common place of supply regulations, preferably revenue collection should also be at the federal level because this would result in consistency of regulations and their applications across the Emirates.

**Summary and Conclusions**

This chapter provides the essential background to the proposed implementation of a VAT regime in the GCC member states, including the UAE in the context of establishing a customs union and common market. It examines the potential socioeconomic impact on the UAE and the seven Emirates, and highlights the need to reach agreement on key elements of the new taxation system.
Chapter 6 presents the research findings and analysis of the four reference countries, namely Australia, the United Kingdom (UK), Germany, and South Africa. It incorporates an examination of country-specific literature together with interview responses from country experts with first-hand experience with the introduction and administration of their economy’s VAT system. In particular, the chapter examines the various methods of revenue sharing, issues of federal and state sovereignty and responsibility, retention of existing sales and other taxes at the local and federal level, and issues of regressivity and offsetting by means of rates, exemptions, and zero-rating. It also examines associated issues relating to the implementation, administration and compliance management of VAT regimes in the reference countries. It includes an analysis of the effect of the VAT systems on a range of sectors and socio-economic factors including the public sector, commerce, industry, the social economy, finance and income of each of these countries, with a focus on the issue of fiscal equalization.

Senior/executive level administrators of VAT functions in Australia, South Africa Germany and the United Kingdom (UK) were interviewed. The purpose was to obtain an administrator’s perspective of the nature of their economy’s VAT regime, its benefits, and its challenges. The commentary in this chapter relates to the responses to the reference country interviews unless otherwise indicated.
Australia

Overview

As noted previously, the Commonwealth of Australia was formed in 1901 when six sovereign colonies agreed to unite in a federation. These six states, together with two territories that have recently attained self-government, constitute the Australian nation today. The fundamental rationale of the Federation was to safeguard the benefits of internal free trade. A concurrent reason was to levy a common external tariff and, due to the fact that customs and excise comprised the primary tax base at the time of federation, these goals resulted in the federal government taking policy and administrative responsibility for the nation’s primary tax base. At the same time, the states were given control over domestic policy.

The original purpose of introducing a VAT regime in Australia was to take the place of a group of formerly ineffective state taxes that were believed to be hindering economic growth. Indeed, the tax reform incorporated an agreement that transferred all GST revenue to the states in exchange for their revocation of particular levies, and instead of prior Commonwealth financial aid (Morse, 2011). The policy intent is that, in return for federal administration of the tax, the states and territories compensate the Federal Government for administrative costs, but minus these fees, thereby receiving almost all of the proceeds collected.

Consequently, a small percentage of the VAT collected is retained by the Federal Government as compensation for administration of the scheme as part of the
overall formula agreed at the Council of Australian Governments (COAG), discussed below.

In practice, the introduction of the GST in Australia did not result in the revocation of all state and territory taxes. For example, the states and territories continue to impose taxes and levies such as stamp duty on the sale and transfer of property and motor vehicles within the particular state or territory. Consequently, while the introduction of the new arrangements did reduce state and territory taxes considerably, they were not totally eliminated, and the collection of such taxes impacts on the apportionment of Commonwealth GST shared revenue.

According to McLean (2002, 2004), a consequence of this arrangement is continuing vertical fiscal imbalance (VFI). This is because the Federal (or Commonwealth) Government collects a greater amount of taxes than do the States and Territories, and the states and territories therefore become dependent upon the Federal Government for the resources to fund their programs. It is as a consequence of this that all VAT (which, as previously noted, has been introduced as a GST in Australia) collected by the Commonwealth Government is intended to be dispersed to the States, with such dispersion being undertaken through a 100% sharing arrangement (Searle, 2007).

Currently taxation and revenue sharing among the states and territories is supervised by the Commonwealth Grants Commission (CGC), a non-partisan body and, as per the policy intent, approximately all revenues from the GST are
in fact distributed by the Federal Government to the various Australian states and territories (GAO, 2008)

The Australian state and territory governments consistently question the apportionment of the GST distribution (and indeed other grants made from Commonwealth consolidated revenue collected by the Federal Government), generally claiming that more is being retained by the Commonwealth than is reasonable, and that one state or territory is being advantaged/disadvantaged over others. The distribution is based on complex formulae of population, state tax base, demographics of needs of the state populations and industrial/productivity base, and it is difficult to obtain agreement on the outcome of such formulae. Indeed, while the theory of the Australian System is generally considered to be sound, it is considered that the complex formula for revenue distribution needs to be made simpler and more transparent to the population at large, in order to provide more certainty to the states and territories. On balance however, the general method of revenue distribution appears to be generally accepted.

The peak body for discussing and debating issues of revenue distribution is the Council of Australian Governments (COAG), which is presided over by the Commonwealth Prime Minister, and the Commonwealth Treasurer, all State and Territory Premiers or Chief Ministers and Treasurers are members. Ultimately agreement on distribution is agreed, but the political climate under which the
discussions take place generally results in state and territory leaders claiming that agreement was reached simply for the sake of achieving an outcome.

Once the revenue has been distributed by the Federal Government, no restrictions are placed on the states or territories in relation to how it may be utilised. That is a matter for each individual state and territory, and the funds are simply directed into their consolidated revenue accounts. In other words, once the GST revenue has been transferred to the states or territories it is their decision on how the tax money is spent. Additional revenues are however provided to the states and territories under a state grants scheme through the Commonwealth Grants Commission, and some of these monies are designated for specific projects. For example, some such funding may be earmarked for upgrading a national highway, building a new hospital, undertaking specified regional development projects and the like.

The rate at which GST is currently levied is 10%, and any plan to change the rate of the tax requires the unanimous support of the six States and two Territories, the approval of the Commonwealth Government, and the passage of pertinent laws by both Houses of the Parliament (Commonwealth Grants Commission, 2000). It is clear that any State or Territory that wishes to alter the rate of GST has extremely limited influence, as it would require a collective approach to the Commonwealth Government by all States and Territories, and even then, the joint determination of all States can be blocked by the central government. Due
to the huge VFI favouring the central government, it would prove extremely
difficult for the States to oppose its power.

In Section 90 of the Australian Constitution, the ‘excise clause’ in effect
proscribes the states from imposing taxes on the sale of goods, although it is
possible that the states may still tax services. In this context, while the
introduction of state VATs is not an option under the Australian Constitution, the
federally administered VAT is supposedly designed to provide the states and
territories with a continuing source of revenue (Searle, 2010). According to
Ahmad (2010), this approach is pertinent to execution of a VAT in the UAE but
not the GCC.

Overall, the Australian system is considered to have combated regressivity of the
VAT by increasing transfers to pensioners, amending individual income tax rate
schedules and excluding items of basic need from the GST base. In achieving
this, a relatively small number of supplies have been exempted from GST, such
as health including dental and medical care, educational and childcare,
agricultural products, fresh food and beverages, but not including unprepared
foods. Other GST free supplies are quite specific, and include sale of a ‘going
concern’, a grant of crown land, specific sales of farm land, water, sewerage and
drainage, goods and services that are exported, wages and salaries, rental of a
citizen’s primary place of rental and automobiles for disabled people. As a result
of the exemption of basic necessities from GST, the overall revenue sharing and
distribution system is, in theory at least, not considered to unfairly impact low-
income individuals by increasing unequal distribution of incomes and expenses.

The research did not identify a case for the exemption from GST of further specific services such as independent contractors or business services in Australia.

The theory of the Australian GST system is that the GST should ultimately only be paid once by the final consumer of any good or service, and this appears to be generally accepted. The GST, set at a rate of 10% of the sale price, has not varied since it was introduced in July 2000. Consequently, if a price quoted by a supplier is stated (or invoiced) as being inclusive of tax, the GST equals $\frac{1}{11}$ of the price. It is collected at the wholesale or retail Point of Sale for all Services and goods subject to GST. All businesses, companies, service providers and sole traders must complete a quarterly Business Activity Statement (BAS) which offsets any GST paid for inputs to production/services including capital acquisitions (A) against GST collected for sales (B), if A is greater than B a refund will be given (which is unusual except for business which produce and/or supply goods or services which are exempt GST), or if B is greater than A the difference must be paid to the ATO.

Small Businesses (with turnover below a threshold that is established by the ATO) can elect to complete an annual return. The BAS return is a composite return which includes GST payments/refunds, any Pay As You Go (PAYG) tax withheld from employee salaries, tax withheld from any invoice from customers who provide a service and who do not have an Australian Business Number.
(ABN) and instalments of company tax based on the government’s assessed likely operating profit for the financial year.

GST is assessed by Customs on all imports into Australia based on 10% of the Customs Value plus any Customs Duty (that is, the 10 per cent is applied to the customs duty as well as the value of the imported goods). It is only paid at the time of importation by importers who are not registered with the Australian Tax Office with an Australian Business Number (ABN). Importers with an ABN are able to incorporate the assessed GST on their quarterly Business Activity Statement (BAS) returns.

Australian provisions for refunds of GST paid are fairly straight forward. Firstly, as described above, GST refunds for inputs into production of goods and services will apply if they exceed the GST actually collected on sales. In addition, GST paid at the retail point of sale may be claimed back at the departure point from Australia through the Tourist Refund Scheme (TRS), which is administered by the Australian Customs and Border Protection Service (ACBPS) at International ports and airports. In order to receive the refund on departure from Australia, proof of payment (that is, a tax invoice) and the goods themselves must be produced at the TRS office at the point of departure to receive the refund. Australian citizens can also utilise the TRS scheme, but when returning to Australia must declare any items in their possession on which a GST refund has been paid. In practice this is not policed or enforced by ACBPS unless they are informed of major attempts to evade tax.
Due to the construction of the GST provisions, the system is generally considered not to discourage foreign investment and tourism to any significant extent. Specifically this is due to the ability of tourists to claim a refund for goods purchased in Australia, and the fact that goods and services that are exported are exempt from GST, and GST that would otherwise be payable on inputs to production may be offset against GST paid.

**Fiscal Equalization**

As noted above, the actual distribution of expenditure/service delivery requirements and revenue raising abilities has created severe VFI whereby the central government collects revenue exceeding its expenses while the state and local governments have insufficient funds to meet their responsibilities (Dollery, 2002). Theoretically, VFI can be mitigated using a combination of approaches. Expenditure responsibilities can be reallocated among the distinct levels of government, taxation authorization can be re-assigned, inter-governmental grants can be instituted to reallocate revenue, and new revenue-sharing arrangements can be established. It is pertinent to note that all of these approaches have been used in Australia from the time of federation to the present.

From 1901-1933, the States of Western Australia and Tasmania gained the least from the initial taxation arrangements, and the current organization of fiscal federalism in fact developed from demands in these states. The outcome according to some commentators is a system of taxation that attempts to obtain
the greatest degree of horizontal fiscal equalization (HFE) of any democratic federation (see for example McLean, 2002, 2004). In Australia, HFE is realised when untied funds from the central government are distributed among the states with the result that, “if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard” (Commonwealth Grants Commission, 2005, p.4; Searle, 2007). In general, the aim of HFE is equalizing the ability of sub-national governments to offer services. The goal is the equalization of fiscal capability and ultimately, an even distribution of service provision throughout the country (Searle, 2007). In addition, to diminish VFI countries often give sub-national governments the right to income from natural resources, as is the case in Australia.

Searle (2007) maintains that unequal sharing of revenue from natural resources can be surmounted by an equalization system if the pool of income accessible for reallocation is substantial enough or if the disparities in capability, even if great, are not a significant contributor to total disparities in revenue ability. In the case of Australia, the mining sector represents only 12% of states’ own revenue but the assessment has a greater reallocation impact than any other type of either revenue or expenditure (Commonwealth Grants Commission, 2004).

Nevertheless, the general size of the equalization pool and the fact it is a closed system permits the alleviation of such disparities. If it were greater than the 12% of states’ total own-source income, it would be more difficult to overcome these
disparities. Interestingly, it is considered that the size of the revenue pool in Australia is decided more by the goal of ameliorating VFI and is actually much greater than that needed to achieve HFE (Searle, 2007). According to Searle, in closed systems as in Australia, HFE is realised from the same size pool of revenue regardless of fluctuations in the need for reallocation. HFE is accomplished by redistribution among the states instead of altering the central government budget or the disbursement of resources between the central and sub-national governments. In this context, a closed system like Australia’s rests on the principle that equalization should not cause changes in general public sector outcomes, while an open system permits public sector changes (Searle, 2007).

For the fiscal year 2007-08, the Commonwealth of Australia aided the states by means of fiscal transfers that totalled approximately A$72.5 billion or 7.1% of GDP (Searle, 2010). Approximately 60% of that aid was offered in the form of untied grants, while around 37.5% was offered as tied state grants and around 2.5% was provided for the municipal level of government, mostly untied.

In considering adoption of elements of the GST for the UK, McClean (2002, 2004) suggests that parts of the Australian GST that should be adopted include the nonpartisan agency and the target of HFE between constituent parts. Other elements that were considered should be examined and possibly adopted include the extremely wide-ranging equalization, including the attribute of achieving the balance of the impact of grants for special purposes. However, he
recommends against adopting what he calls the cumbersome formulae, and a few of the detrimental methods of calculating needs.

According to Petchey and Levchenkova (2004), fiscal capacity equalization has the outcome of inter-regional revenue transfers. These kinds of transfers can be rather large, as Table 6-1 demonstrates for Australia. Column 1 of the Table indicates how the pool of grant revenue apportioned to the states is distributed using fiscal capacity equalization. Column 2 reveals how the revenue would be apportioned on a straightforward equal per capita basis, and the last column shows the disparity between the two methods of apportionment. Their conclusion is that it is apparent that New South Wales, Victoria, and Western Australia are disadvantaged by this model of apportionment, while the remaining states and territories benefit.
Table 6-1: Equalization, Australia, 2002-03

<table>
<thead>
<tr>
<th>Distribution using CGC model</th>
<th>Equal per capita distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>$m$</td>
<td>%</td>
</tr>
<tr>
<td>(1)</td>
<td>(2)</td>
</tr>
<tr>
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<td>Queensland</td>
<td>5236.9</td>
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<tr>
<td>Western Australia</td>
<td>2447.8</td>
</tr>
<tr>
<td>South Australia</td>
<td>2641.6</td>
</tr>
<tr>
<td>Tasmania</td>
<td>1118.6</td>
</tr>
<tr>
<td>ACT</td>
<td>519.6</td>
</tr>
<tr>
<td>NT</td>
<td>1423.6</td>
</tr>
<tr>
<td>Total (Pool)</td>
<td>26664.9</td>
</tr>
</tbody>
</table>


Australia’s approach to public sector and non-profit organizations differs from those of other economies that have introduced a VAT. Public sector entities include government departments and ministries, state and local governments, regulatory agencies, and so forth. VAT regimes in many nations frequently treat the output of the public sector, which comprises a mixture of goods and services, as final consumption by the entity rather than consumption by the final consumers (individuals). In Australia, all activities of public and non-profit organizations are subject to the VAT. There are a few special rules that affect charities, gift-deductible units, and government schools. In this regard, specific types of sales are zero-rated when given to these entities. The Australian VAT is
levied on organizations in the public/non-profit sector in the same way as the private sector. The general effect on revenue has been positive and there have been positive economic advantages, including simplicity and less economic distortion (Gendron, 2005). Administrative and compliance costs are also considered to be lower. Finally, taxpayers are thought to benefit because this system eliminates the self-supply bias that occurs when the public sector can avoid the VAT by using its own services, as occurs in nations that exempt the public sector from the levy (Gendron, 2005; 2010).

Bolton and Dollery (2010) conducted an empirical comparison of the macroeconomic impact of the implementation of a VAT in Australia, Canada, and New Zealand. They reviewed data on a number of macroeconomic variables, such as several neutrality measures, aggregate consumer price changes, economic growth effects, tax yield effects, and current account balance effects. On the basis of this data, they concluded that the VAT in these countries was extremely successful in raising tax revenues, but it also had a considerable impact on growth effects, price effects, current account effects, and balancing the budget.

**Compliance and Fraud**

The compliance management philosophy of the Australian Taxation Office (ATO) focuses on improving the level of informed compliance among taxpayers. To achieve this, the ATO has established a GST Annual Compliance Arrangement (GST ACA) which is designed to build the working relationship between the ATO
and large corporate taxpayers by working collaboratively. According to the OECD:

“Traditional audit or verification methods examine historical tax information on a typically substantive basis. The GST ACA operates to move the compliance relationship to a more current and real time approach applying a broader concept of compliance assurance rather than only examining specific areas for compliance. The focus is on improving the relationship between the Tax Office and a large business to facilitate transparency and open dialogue between the parties. The parties agree to operate in an environment of open and full disclosure in relation to matters that are considered to materially impact tax compliance. The parties then seek to mitigate risks or resolve issues in real time.

The GST ACA relationship provides benefits that include:

- increased certainty through a real time compliance relationship delivering timely clarification, understanding and resolution of risks and issues;
- a more timely and participative approach to seeking taxation advice and rulings to clarify and resolve issues; including access to senior staff and decision makers;
- a move away from high resource, long term Tax Office compliance activities;
• improved communication pathways established to raise material tax
  risks and issues through senior contact and escalation points;
• establishing and maintaining Tax Office assurance of compliant tax
  outcomes providing access to concessionary approaches including
  agreed behavioural assessment for administrative penalties in the
  event of tax shortfalls and a reduced rate of General Interest
  Charge (provided there is no evidence of recklessness or fraud);
  and
• Opportunity to explore administrative solutions to compliance
  difficulties including increased thresholds to amend errors and
  mistake in previous returns in a current tax period.” (p.42)

One area of particular concern for Australia is the cash economy. In May 11,
2010, the Commonwealth announced that it would spend $445 million over the
next four years in an attempt to eliminate the estimated fraud within the cash
 economy to promote GST compliance as a part of the federal budget 2010-11.
This spending aimed to recover an additional $3.2 billion in lost revenue, with the
Australian Taxation Office (ATO) focus being on falsified tax returns,
derunderreporting of GST liabilities, non-filing of tax returns, and non-payment of
GST debts. Small to medium-size enterprises (SMEs) are a particular target of
such efforts to eliminate VAT fraud in Australia (Munro, 2010).

The ATO case study relating to compliance management in relation to the cash
economy (see Appendix H) discusses a four phase risk treatment evaluation
methodology (OECD, 2009). This methodology includes articulating the compliance risks involved, defining the outcomes sought and the strategies to achieve them, designing indicators to gauge effectiveness of the risk treatment strategy, and determining the extent of improved effectiveness achieved. In terms of assessing the success of the methodology, the following is reported:

“Focussed attention to assessing the impacts of the strategy revealed indications of increased voluntary compliance, demonstrated through reporting of cash transactions, return filing and payment obligations by those operating in the cash economy. Specifically:

- **Return filing**: Success is evident from an increase in the number of activity statements overall and filed on time. On time filing of quarterly activity statements increased by 12% after the ATO data matched information from shopping centre operators.

- **Correct reporting**: Success is evident from increases in the trend, relative to other industries, of amounts reported by those in the targeted industries. Observations of the restaurant and café industries and the building industry (sub-trades) showed:
  - Increased GST (VAT) reported for businesses audited in 2006-7. While the year’s average for quarterly GST liabilities for all industries increased by 9.5% and 9.7% in the June and September quarters respectively, taxpayers subject to
intervention recorded up to a 60% increase in average net GST (VAT) in the June quarter.

- Average net GST (VAT) in the June 2007 quarter increased by 25% by taxpayers found to be compliant as a result of the ATO’s interventions, suggesting that its audit activities had some indirect effect by increased the GST reported, even by taxpayers found to be compliant.

- Community tolerance: Community reports concerning alleged cash economy activity to the ATO’s tax evasion hotline increased by 74.2% in 2007-08, over the number in 2005-06, reflecting declining community tolerance of cash economy activity.

- Community confidence and engagement: Evidence of increasing confidence and engagement from community sectors (e.g. positive coverage of ATO’s activities in professional media, improved business perceptions survey results, and increased collaboration with trade associations)” (pp. 46, 47).

It is evident from the lessons learned by the ATO that a compliance management philosophy which focusses on informed taxpayer compliance and working collaboratively with industry can prove successful. The success of this approach is, however, predicated on the ability of the tax administration to work effectively with industry and to provide the necessary information, advice and support required of such a strategy.
According to McLinden et al (2011), “Most theories of compliance, particularly those that can be described as normative theories, adopt a philosophy of appropriateness: that is, the subjects of regulation are assumed to act in good faith and to want to obey the law. Such theories will state as their assumption that compliance or noncompliance is affected principally by the capacity of the entity being regulated, in terms of its knowledge of the laws and its financial and technological ability to comply. For that reason, the best approach is a cooperative one. Strategies that follow that theory will provide members of the public with the means to achieve certainty and clarity, identify their rights and responsibilities, and assess their liabilities and entitlements. Such strategies include:

- Consultation and cooperation.
- Clear administrative guidelines.
- Formal rulings.
- Education and awareness.
- Technical assistance and advice.
- Appeal mechanisms.

“In contrast, a more rationalist theory of compliance tends to encourage more prescriptive approaches to issues of compliance and noncompliance, with the greater focus being on noncompliance and the imposition of penalties as the key mechanism for deterrence. … In practice the approach adopted by most modern border agencies is a mix of both normative and rationalist approaches; in other
words, it is the implementation of a compliance management system that encourages voluntary compliance while maintaining a foundation or fallback position of enforcement” (pp. 107-109).

South Africa

Overview

South Africa changed its general sales tax (GST) to a value added tax (VAT) in 1991. This VAT taxes the supply of goods and services and the importing of goods and services, but exempts goods and services that are exported. As is the case for most such regimes, the VAT is considered to be a consumption tax because the customer pays it upon consumption, at the end of production. The South African VAT regime includes a provision for the refund of the tax for intermediate acquisition of commodities and investment. At the point of sale, vendors are charged the statutory VAT rate, which is 14% for almost all goods and services and all commodities with the exception of gold, which is zero-rated and thus attracts no VAT. Vendors also receive a refund for the tax revenue paid on intermediate inputs. The net fee is the statutory VAT rate applied to only the value added for that product or service. This method of collecting taxes is believed to promote “self-policing” whereby producers tend to buy intermediate products from vendors who can confirm that they have paid the VAT due (Go, Kearney, Robinson and Thierfelder, 2004).

Upon initial adoption of the VAT in South Africa there were concerns about whether or not it would be a successful substitute for the GST as a source of
revenue, to what degree it might stimulate inflation, and how regressive it would be (Go et al., 2004). A levy is considered to be regressive when lower-income earners expend a greater proportion of their income on the levy than those individuals with higher incomes, and in this context, indirect taxes such as the VAT are generally considered to be regressive. In other words, a single VAT rate for the widest possible base is fundamentally a proportional tax on consumption and is thus regressive in character (Ebrill, Keen, Bodin and Summers, 2001).

Regarding the first concern, that is, whether the VAT would prove to be a successful substitute for the GST, according to Go et al. (2004), when compared with other principal key taxes in South Africa, the VAT ranks number two as the most significant source of revenue, following income taxes as number one. The South African government regards VAT as a reliable broad based source of revenue (Go et al., 2004). Around a quarter of total tax revenue collected by the Government of South African consists of VAT, and 100 per cent of VAT revenue is allocated to the national government for the National Revenue Fund (NRF), where it is pooled with all other forms of tax revenue. Indeed, all revenue collected in the form of national taxes is paid to the NRF which is administered by the National Treasury within the Ministry of Finance, with allocations of revenue for fiscal expenditure being undertaken via the Budget office by the ministry.

Secondly, to combat the potential regressivity of the VAT, the South African Value-Added Tax Act No.89 of 1991 permits a number of exemptions, exceptions, deductions, and adjustments that substantially lower the impact of
the VAT. Exempted items include financial services (such as interest), residential accommodation, passenger transport by road and rail, educational services, childcare services and donated goods or services provided by a non-profit organisation. Zero-rated items include 19 basic food items, exports (including goods purchased by tourists and taken out of the country), fuel (including petrol and diesel), international transport, services performed outside of South Africa, specific services provided for non-residents and property rates. Moreover, there is a reduced rate on long term commercial accommodation taxing only 60% of the value (SARS, 2011). Also, in an effort to further diminish the regressivity of the South African VAT, paraffin, a source of energy used by the majority of lower-income households, was exempted in 2001. Additional exclusions from the system include small enterprises providing taxable supplies totalling less than R1 million annually, who are not required to register for VAT (SARS, 2011).
### Table 6-2: South African Rates, Exemptions and Zero-Rating

<table>
<thead>
<tr>
<th>TAXED @ 14%</th>
<th>EXEMPTED</th>
<th>ZERO RATED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Almost all goods and Services</td>
<td>Financial services (interest)</td>
<td>19 basic food items</td>
</tr>
<tr>
<td>Unless specifically zero</td>
<td>Residential accommodation</td>
<td>Exports</td>
</tr>
<tr>
<td>Rated or exempt</td>
<td>in a dwelling</td>
<td>Going concern</td>
</tr>
<tr>
<td></td>
<td>Passenger transport by road</td>
<td>Fuel levy goods</td>
</tr>
<tr>
<td></td>
<td>rail</td>
<td>(petrol &amp; diesel)</td>
</tr>
<tr>
<td></td>
<td>Educational services</td>
<td>International transport</td>
</tr>
<tr>
<td></td>
<td>Childcare services</td>
<td>Services physically</td>
</tr>
<tr>
<td></td>
<td>Primary place of residence rental</td>
<td>performed outside SA</td>
</tr>
<tr>
<td></td>
<td>Donated goods or services sold by NPO</td>
<td>Certain services</td>
</tr>
<tr>
<td></td>
<td></td>
<td>supp’d to non-residents</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Property rates</td>
</tr>
</tbody>
</table>

These provisions are provided with the express intention of achieving socio-economic and political objectives and is aimed at reducing the tax burden on the poorer members of the community. However, from a revenue raising perspective, these exemptions, while assisting to minimise the regressivity of the tax, result in reduced government revenue, something which Go et al. (2004) refer to as an efficiency loss.

Fourie and Owen (1993) examined the VAT in South Africa to determine its degree of regressivity following its implementation in 1991. They determined that the VAT was mildly regressive at that time. Defining regressive as the ratio of total VAT payments by a household group to total household income, Go et al. (2004) found in 2001 that low-income households spent up to 3.5% of their income on VAT, but higher income households only spent around 2.5%. They
concluded that the South African VAT was regressive. However, they suggested that this might be counterbalanced by the progressivity of the income tax where higher-income households paid a higher percentage of their income on the levy than low-income households. In this regard, according to Kearney and Van Heerden (2004), the antidote to the regressivity of the VAT would be to raise direct taxes and, thus design a more progressive tax structure, while continuing to produce a positive impact on Gross Domestic Product (GDP). Their research findings demonstrated that zero-rating food in combination with a proportional percentage rise in direct taxes can advance the welfare of lower-income households.

When the VAT was first proposed in South Africa, the most significant debate about its proposed introduction centred on its potential impact on the price of goods and services or the Consumer Price Index (CPI). If VAT increased, prices would increase, but the size of the rise in VAT would not inevitably be mirrored to the same degree in retail prices. The degree to which prices would rise would be contingent upon the ability of producers to shift the tax burden on to the customer, which in turn would be determined by the elasticity of supply and demand. An effect on the CPI appeared to occur when the VAT was initially implemented and when the VAT was raised to 14% in the second quarter of 1993 (Go et al., 2004). Nevertheless, it is difficult to separate the impact of a single incident on the CPI and draw conclusions about the VAT and inflation.
Based on their study results, Go et al. (2004) concluded that the exemption of particular products and services from the VAT levy resulted in an efficiency loss. Furthermore, while the purpose of the majority of the exemptions was to diminish the regressive nature of VAT, in South Africa this tax is still regarded to be regressive. These researchers analysed the efficiency of VAT with a computable general equilibrium (CGE) model and simulated the elimination of the levy from the South African system of taxation. The projected loss in revenue was then restored with a proportional increase in direct taxes. The outcome demonstrated that VAT diminished the general progressivity of the tax system. VAT also lowered the general welfare of low-income households. In contrast, the cost of living for low-income households was considerably lowered when the VAT was eliminated. The existence of a VAT in the South African tax system has had a negative effect on the welfare of poorer households, and according to some commentators, this finding implies that more efforts are needed to reduce the VAT burden on lower-income households (see for example Go et al., 2004).

VAT is collected by registering VAT businesses that are then obliged by VAT law to charge VAT on their sales. They are also allowed to deduct any VAT charged to their purchases with every VAT registered entity being required to submit a periodic return to the VAT Administration. The return may result in a refund, and the difference between the VAT on sales made and the VAT on purchases incurred result in either a tax payable to the SARS or a refund due to the VAT entity. In terms of refund processing, the returns are analysed by way of a risk
identification system, and if no material risk is detected, a refund is made electronically into the entity’s bank account.

**Fiscal Equalization**

Promulgated in 1996, the South African Constitution created three levels of government in a federal system, these being the national government, nine provincial governments and 284 local governments (Etienne, 2005). The primary goal of financial decentralization in South Africa was to increase the effectiveness of the delivery of services by matching sub-national government spending with regional and local needs (Boadway and Shah, 2007).

Indeed, the federal system in South Africa is distinguished by a comparatively high level of financial decentralization regarding administration and expenditure responsibilities (Elhiraika, 2007). Nevertheless, due to severe historical disparities across provinces and cities, constitutional and institutional agreements only permit highly restricted revenue autonomy. In comparison with other developing nations, South African sub-national governments are extremely dependent on intergovernmental transfers from the central administration, with income produced by the provinces alone representing only a small percentage of their total budget. Beginning in 1997, provinces obtained their primary share from the central government in single block grants (Lodge, 2005). For example, in 2001-2002, R117 billion of the nation’s total revenue of R273 billion was allocated to the provinces in grants ranging from R23 billion for KwaZulu-Natal to R2.7 billion for the Northern Cape (Lodge, 2005). The amount of the grants they
were given was based on the recommendations of the Financial and Fiscal Commission. In turn, these recommendations were based on census statistics and indications of poverty. For example, provinces with a larger population of rural residents and school-age children were eligible for proportionally higher grants.

According to Josie (2008), the Bill of Rights in the South African Constitution stipulates that specific public services be offered to all citizens as a component of their economic rights. Based on their responsibility to deliver such assigned services governments can be held responsible for guaranteeing that citizens’ economic rights are met. The responsibility for a number of these services is a component of the roles and functions of municipalities in South Africa. According to the Constitution:

(1) An Act of Parliament must provide for a. the equitable division of revenue raised nationally among the national, provincial and local spheres of government; b. the determination of each province’s equitable share of the provincial share of that revenue; and c. any other allocations to provinces, local government or municipalities from the national government’s share of that revenue, and any conditions on which those allocations may be made.

(2) The Act referred to in subsection (1) may be enacted only after the provincial governments, organised local government and the Financial and Fiscal Commission have been consulted, and any
recommendations of the Commission have been considered, and must take into account a list of general conditions, such as the national interest. (Loots, 2004, pp. 1-2).

Regardless of how the conditions in section 2 are interpreted, it still seems that the requirement in section 1(a) that the allocation of revenue raised at the national level must be fair applies to them. Thus, fiscal equalization is an important aspect of revenue sharing in South Africa.

As of 2004, the Local Government Equitable Share (LGES) formula weakened a significant principle of fiscal equality, that is, the principle of horizontal equalization (Loots, 2004). Moreover, according to Loots (2004), if the principle of horizontal equalization in South Africa is not applied across municipalities, it can have highly adverse economic and social costs for local areas. The ultimate outcome is that it might compromise the aim of equalization to guarantee that all citizens of the nation receive at least the basic services.

As noted above, the primary fiscal policy aims for sustainable local government in South Africa are the result of constitutional obligations (Josie, 2008). These obligations mandate municipal organization, and development and budgeting of systems that enable equitable provision of basic services and socio-economic development for all citizens of the nation. Municipal budgets and municipal infrastructure grants are the primary policy tools for guiding expenditures to achieve infrastructure service delivery in municipalities. Insufficient municipal infrastructure adversely impacts the provision of services and economic growth.
In spite of the high degree of funding for municipal infrastructure by the central government through Municipal Infrastructure Grants (MIGs), current trends demonstrate that municipalities have not progressed in construction, maintenance, and repairs of basic infrastructure. According to Josie (2008), if these problems are not resolved the attainment of sustainable local government as imagined in the Constitution will be deferred and the disparities that are characteristic of South African society will worsen.

In South Africa, distribution of MIG funding to municipalities is based on a specific formula. The formula comprises percentage allotments for five distinct constituent parts representing elements of municipal infrastructure needs. The following is a summary of the formula (Josie, 2008):

\[ MIG = B + P + E + N + M \]

Where:

- B represents the amount for fundamental residential infrastructure, including water, sanitation, roads, electricity, and garbage disposal;
- P represents the amount for new and renovated municipal service infrastructure;
- E designates the amount for building social service institutions and micro-enterprises;
- N represents the allotment for nodal development and renewal programs in specified urban and rural municipalities; and
M is a performance related modification to the total MIG allocation for a municipality.

Additionally, each constituent is weighted by a selected socio-demographic parameter that represents disparities between metropolitan and local municipalities. If the parameters for each of the five constituents are designated by b, p, e, n and m respectively, then each one is a weighted modification for the corresponding constituent. The purpose of the modifications is to account for socio-demographic factors that differentiate the urban municipalities from the local municipalities (Josie, 2008). While the five constituents represent extensive categories of infrastructural services the socio-demographic factors are associated with sub-constituents within these extensive categories. In addition, MIG grants also include a portion that is not based on a formula and is called a Special Municipal Infrastructure Fund (SMIF) for project applications by municipalities that qualify according to a group of pre-determined criteria.

A significant element of the design of grant systems is the consideration of cost disparities in the resources needed to reach comparable service levels (Josie, 2008). These disparities occur as a result of differences in demography, geography, and socio-economic inequality among sub-regions. Historical disparity in stages of development, including serious capital surfeit, is another major cause of regional differences. However, according to Reschovsky (2007), calculating the disparities in sub-regional input costs that ought to be included in a grant model can be contentious and highly political because provincial interests
play a significant role in deciding what sub-regional aspects, attributes, and indicators are considered. Without unambiguous accounts of how the parameters in the MIG formula are estimated and costed there will constantly be a risk they were selected for political and/or parochial reasons.

At any rate, South African provinces still do not possess sufficient revenue of their own to have a positive role in effective public service delivery. They are not permitted to have their own VAT or income tax and in general, sub-national governments possess highly restricted powers of taxation in comparison with most developing nations (Elhiraika, 2007). Furthermore, there are several restrictions on the provinces in relation to how they are entitled to use the revenue provided by the national government. National Budget allocations to departments are required to adhere to the Public Finance Management Act which governs how such allocations are to be spent. Moreover, wealthier provinces seem to organise their own revenue primarily to finance services other than key services such as education and health. In spite of the emphasis of sub-national government financing on equity and redistribution, large inequalities exist across provinces regarding per capita income and per capita expenditure on health and education, for example. South Africa is still one of the most economically unequal nations in the world (Frye, 2007).

**Compliance and Fraud**

Due to the above mentioned distributional issues, sub-national governments depend to a large degree on user fees – particularly utility charges – to acquire
the necessary income to finance government operations. Conversely, a significant fiscal issue in many cities in South Africa is the insufficient collection of service fees as a result of extensive non-payment. A popular analysis of the situation attributes non-compliance to poverty and the presence of an “entitlement culture” (Fjeldstad, 2004). Nevertheless, enormous disparities in compliance are present both within low-income communities and between communities with similar income. Thus, Fjeldstad (2004) believes non-compliance is also related to whether taxpayers believe the local government will act in their interest and trust that other people will pay their fair share. The exact cost of this type of fraud as well as specific instances of VAT fraud is not reported in the literature.

**Germany**

**Overview**

With a population of about 82.3 million (CIA, 2011), the Federal Republic of Germany has the world’s third largest economy based on nominal GDP (Europe’s largest) and until very recently, was the largest exporter of goods (exceeded by China in 2009/10). In Germany taxes are assessed by the Federation (*Bund*), the 16 states (*Länder*), and municipalities (*Gemeinden*). Two of the 16 states (Hamburg and Berlin) are actually city states. Among all taxes levied, the income tax and VAT are the most significant revenue generators. In spite of the fact that Germany is a federation, 95% of all taxes are levied by the Federal Government.
The principles of taxation are outlined in Germany’s constitution. The right to promulgate and levy taxes is divided as follows: (a) The federation has jurisdiction regarding customs (Art. 105 para. 1 Grundgesetz); and (b) The federation and the states jointly collaborate on all other tax law. Officially, the states can declare an absence of federal rule. However, there actually is federal jurisdiction regarding all taxes (Art. 105 para. 2 Grundgesetz); (c) The states have jurisdiction regarding local excise taxes (Art. 105 para. 2a Grundgesetz); and (d) The cities have authority regarding a number of minor local taxes, such as dog taxes.

VAT is calculated as a percentage of the price. That means it is possible—during every stage of production and sale circulation—to individually advise the consequent tax value for each stage. In principle, the VAT is levied on all goods and services produced by a business enterprise and consumed in Germany. The German VAT exists as a component of the European Union (EU) VAT system. The EU VAT is deemed to be a general tax on consumption, imposed on the added value which is collected from the sale of goods or provision of services. Goods that are imported into the EU are subjected to that tax. All services and goods that are sold to customers that reside outside the EU are exempted from the Value Added Tax.

Specific products and services of both German and international enterprises are legally exempt from the VAT, including export deliveries; supply of goods within the community; services provided by specific professions, such as physicians;
financial services, such as loans; long-term leasing of real estate; cultural
services, such as museums, theaters, zoos, and others; specific institutions
offering general education or vocational training; and honorary or voluntary
services. Similarly, in Germany, VAT is not imposed on exempted goods and
services sold to customers (usually the end-user consumers). For example, that
tax exemption covers businesses related to the public interest - medical care,
education and the like - as well as some other insurance and financial services.
The current VAT rate in Germany is 19%. However, a reduced tax rate of 7% is
assessed for particular groceries, books, magazines, flowers and forms of
transportation.

The VAT due on any sale is a percentage of the sale price but from this the VAT
registered taxpayer is entitled to deduct all the tax already paid at the preceding
stage of the process. Therefore, double taxation is avoided and tax is paid only
on the value added at each stage of production and distribution. In this way, as
the final price of the product is equal to the sum of the values added at each
preceding stage, the final VAT paid is made up of the sum of the VAT paid at
each stage. Registered VAT traders are allocated a unique number and are
required to show the VAT charged to customers on invoices. In this way, the
customer, if registered trader, has a complete record of claimable deductions,
and in turn, the consumer knows how much tax has been paid on the final
product or service. In this way the correct VAT is paid in stages and to a degree
the system is considered to be self-policing.
No later than ten days after the end of the filing period each calendar quarter, a commercial enterprise must provide the tax office with a preliminary tax return with its calculation of the VAT for the previous calendar quarter (Ainsworth, 2011). As usual, the quantity that must be paid is the VAT the business has invoiced, minus any amounts of deductible input tax. The deductible input tax is the VAT that the business owner has been charged by other commercial enterprises. Major businesses, that is, those business enterprises whose previous year’s VAT has surpassed €7,500, must file such a tax return each month. In addition, individuals that have recently started professional or for profit enterprises must also file an advance return each month during the first and second calendar years of operation. At the close of each calendar year, the business owner must also file an annual VAT return in which the tax has been calculated once again. Finally, small businesses are not required to pay a VAT if their income, including the relevant VAT, has not exceeded €17,500 in the previous calendar year and is not expected to surpass €50,000 in the current calendar year. On the other hand, in these circumstances these small enterprises are not permitted to deduct any tax on inputs which they have paid.

Fiscal Equalization

A set portion of VAT collected by the member states of the European Union goes to the Treasury of the EU which is deemed to be one of the main income sources for the Union. This is due to the fact that the European Union of itself does not have the ability to impose tax as its members are able to do.
Tax revenues are apportioned among the individual regional administrative
governments on the basis of own assigned revenues and revenue sharing. For
instance, total revenues from the real property tax are accessible to the
municipalities, while the latter also are allotted a fixed per cent of the revenue
from the VAT and the personal income tax (Werner and Shah, 2005).

The apportionment of the most significant tax revenues in 2003 is displayed in
Table 6-3.

**Table 6-3: Tax revenues assignments between the German central
government, the federal states and the municipalities in 2003**

<table>
<thead>
<tr>
<th></th>
<th>Central Government</th>
<th>Federal States</th>
<th>Communities</th>
<th>Revenues 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(Billion)</td>
</tr>
<tr>
<td>Consumption tax</td>
<td>100.0 %</td>
<td></td>
<td></td>
<td>€ 60.75</td>
</tr>
<tr>
<td>Inheritance tax</td>
<td></td>
<td>100.0 %</td>
<td></td>
<td>€ 3.069</td>
</tr>
<tr>
<td>Property tax</td>
<td></td>
<td></td>
<td>100.0 %</td>
<td>€ 9.076</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>42.5 %</td>
<td>42.5 %</td>
<td>15.0 %</td>
<td>€141.396</td>
</tr>
<tr>
<td>Value added tax</td>
<td>51.4 %</td>
<td>46.4 %</td>
<td>2.2 %</td>
<td>€138.935</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>50.0 %</td>
<td>50.0 %</td>
<td></td>
<td>€ - 0.426</td>
</tr>
<tr>
<td>Interest rebate</td>
<td>44.0 %</td>
<td>44.0 %</td>
<td>12.0 %</td>
<td>€ 29.846</td>
</tr>
<tr>
<td>Trade tax</td>
<td>14.8 %</td>
<td>7.7 %</td>
<td>77.5 %</td>
<td>€ 24.533</td>
</tr>
</tbody>
</table>


Germany emphasises the goal of fiscal equalization as a result of its history
(Buettner, 2008). For a long period of time Germany consisted of a loosely
connected group of small countries. Even though the German Empire created in
1871 still contained a large degree of local autonomy, World Wars I and II
caused severe fiscal difficulties leading to a considerable degree of official
collaboration regarding the revenue side of the budget, which has features of
centralization. Although the Federal Republic still retains a significant vertical organization of the public sector, the close collaboration on the revenue side results in widespread use of revenue sharing and fiscal equalization among governments.

The three tier arrangement of the public sector in Germany consists of a system of vertical and horizontal fiscal equalization. To balance the spending power among the states, reimbursement among richer and poorer states is mandated by the constitution (Horizontal Finanzausgleich or Länderfinanzausgleich [Balancing of Federal Budgets], Art. 107 para. 2). Vertical Finanzausgleich refers to apportionment of tax revenues between the central government and the states and municipalities. The vertical dimension of revenue sharing provides a substantial amount of public funds to the sub-national governments. The large amount of funds available to the sub-national governments is the result of significant revenue sharing initiatives. Specifically, the states receive greater shares of personal and corporate income taxes and the VAT. While the cities also receive some of the personal income tax and the VAT, they also have some tax autonomy regarding local business levies. In other words, the German system of equalization consists of three elements: (a) revenue-sharing of the Value Added Tax (VAT); (b) HFE; and (c) Bundesergänzungszuweisungen (BEZ), being special needs-based federal grants.
The liability of the state for fiscal equalization payments is calculated according to fiscal capacity and fiscal need. A state is entitled to receive fiscal equalization grants if its fiscal need exceeds its fiscal capacity. More affluent states are required to make fiscal equalization payments according to a progressive rate, which reaches 75% once the state's surplus reaches 121% of the fiscal need but maximum payments cannot exceed 72.5% of its surplus.

The constitution also provides a comprehensive guide for Vertical Fiscal Imbalance, *Finanzausgleich*, with a differentiation between a *Trennsystem* and a *Verbundsystem*. The *Trennsystem* apports taxes as follows: (a) Mineral and oil is allocated to the central government; (b) Kraffahrsteuer, beer tax, and IHT are allocated to the States; and (c) The trade tax and land tax, the municipalities. Under the *Verbundsystem*, the most important taxes (Personal, Corporate Income Tax (CT), and VAT) are pooled and apportioned according to a specific formula between the federal government, the states, and the municipalities, as of 2007: (a) Personal income tax: Federal, 42.5%, States, 42.5%, Municipalities, 15%; (b) VAT: Federal, 44%, State, 43.6%, EU, 10.4%, Municipalities, 2%; (c) CT: Federal, 50%, States, 50%; and (d) Withholding tax: Federal, 44%, States, 44%, and Municipalities, 12%.

In their study, Hepp and von Hagen (2011) found that tax revenue sharing between the states and the federal government as well as the fiscal equalization mechanism (*Länderfinanzausgleich*) had diminished the disparities in per-capita state incomes by approximately 40% in Germany from 1970 - 2006. However,
this outcome was reduced significantly after the incorporation of the East German states in 1995. In addition, the German fiscal system offers almost perfect protection for state government budgets against asymmetrical revenue shocks. Finally, its redistributive outcome for state governments is very strong.

In 2001 the states and the federal government of Germany ratified a Solidarity Pact II reform of the fiscal equalization system, affecting the following (Werner and Shah, 2005):

• The allotment of the individual VAT share to the federal states;

• Fiscal equalization among the federal states;

• The distribution of supplementary funds by the federal government; and

• The “German Unity” fund.

After 2005, when allotting each state a portion of the VAT, the replenishment rate of 100% was to be substituted with a relative replenishment system. By varying this rate, a higher total VAT amount was to be distributed, and states that are more financially weak were to obtain the financial benefits of the residual portion of the VAT.

According to Werner and Shah (2005), this method of equalization has advantages and disadvantages. First, this system of equalization diminishes the economic inequalities among the states. Even though East and West Germany were reunited over a decade ago, enormous disparities still exist between the
West and East German states in a number of areas of daily living. At the same time, equalization provides a kind of insurance for the states, which reduces the risk of external shocks. In this way, the German method of equalization achieves the goal of stability.

However, the enormous degree of equalization creates some negative effects because the donor states and the receiver states have no incentives to draw new revenue sources or to tap the already accessible tax resources totally (Werner and Shah, 2005). The German method of equalization penalises every additional tax administration effort of the states because of the tremendously high rates drained off. As a result, a number of states have determined to reduce their tax administration.

The following figure provides an overview of the revenue sharing arrangements in Germany. From this figure it can be seen that the German mixed system operates as follows: Tax revenues within Federal Republic of Germany are distributed according to a "mixed system" consisting of two patterns. The First pattern: 'Joint System': where a division of the tax revenues is consolidated centrally before it is distributed among other levels (authorities) during a second stage. The Second Pattern: 'Divided System': where the remaining division of the tax revenues is directly and individually transferred to the Federal State, States and Local Authorities.

75% of the designated shared tax (Community Taxes) is allocated to one shared tax base referred to as the Biggest Tax Base, (The Biggest Tax Base is regulated
by the principal law, Item 106, Paragraphs 3 and 4). This form of tax - the shared tax, or Community Taxes, includes the income tax, sales tax, and taxes paid by companies and enterprises, all of which represent the main sources of funding for the state budget. The tax revenues are divided amongst the three levels according to a firmly statutory principal equation. Nearly 25% of the overall tax revenues are entitled by rights to be provided to the Federal State, Regional States and Local Authorities individually. For example, the principal law dictates that taxes imposed on inheritance, gifts and beer exclusively belongs -by rights - to the States. Additionally, there are some types of taxes which are only considered a right to the Federal State such as the insurance tax, and taxes imposed on tobacco, in addition to some other taxes.
Figure 6-1: Shared Tax (Community Taxes)

Taxes Paid by Companies and Enterprises

Income Tax (Fees and Salaries included)

Sales Tax /Value Added Tax

Federal States

Unilateral Tax

Federal State

Local Authorities

Federal (Regional) States

Energy Tax
Insurance Tax
Electricity Tax
Others

Inheritance Tax
Beer Tax
Lottery Tax
Others

Landscape Tax
Dogs Tax
Commercial tax
Others

European Union

.15

Source: Werner and Shah, 2005
Compliance and Fraud

In recent years, Germany’s VAT revenue had been declining despite growth in GDP (Gebauer, Nam and Parsche, 2007). Even though there are a number of possible causes, such as alterations in the legal structure and increasing business failures, tax evasion is believed to be the primary variable leading to the losses. In particular, the increase in carousel fraud/missing trader intra-community fraud (MTIC) inside the borderless EU single market appears to have negatively impacted German VAT returns to a significant degree. In carousel fraud, intra-EU enterprises continually engage in cross-border buying and selling of products and services, enabling the fraudulent withholding of revenue. An enabler of this form of tax evasion is the elimination of border controls for intra-EU trade, with a resultant weaker administrative collaboration (European Commission, 2010; Price Waterhouse Coopers, 2010). Electronic data processing (EDP) control systems of individual countries also have provided options for avoiding VAT taxes in the EU.

Germany’s Federal Supreme Court (Bundesgerichtshof) is especially concerned about the prevalence of an potential for MTIC/carousel fraud (see for example Ainsworth, 2011). According to The European Economic and Social Committee, MTIC causes losses in the EU ranging from €200 billion to €250 billion. German authorities report their annual VAT losses at €17 billion, with €6.8 billion due to illegal trade and €2.1 billion to carousel fraud and manipulation of EU VAT regulations (“A Tax Net Full of Holes,” 2006). In response to this situation, the Bundesgerichtshof has imposed criminal penalties for failing to immediately
adjust a preliminary return that is identified as erroneous. Actually, the introduction of this ruling has not been sufficient to allay national concerns. In fact, Germany and Austria have been so worried about this kind of scam that they have officially proposed transforming the EU VAT into an American style retail sales tax (Ainsworth, 2011).

In addition, the structure of the German VAT also enables another kind of fraud (Gebauer, et al., 2007). The German form of input tax deduction requires an extremely complex system of bookkeeping requirements and significant administrative costs in addition to disbursement among enterprises and between enterprises and tax authorities. As a result, less than a quarter of the VAT due as documented in invoices is estimated to be truly collected by the tax authority in Germany. Moreover, the input tax statement of goods and services is not directly connected to the actual payment of VAT. In special situations input tax claims may be submitted before the actual payment of charges, and this procedure lends itself to potential abuse as a form of interest-free credit. In situations of business insolvency, revenue losses can result when such businesses buy inputs, as well as when they sell goods and services. As a consequence of these innate factors, the tax authorities not only risk weakening tax collection but are also at risk of reimbursing input taxes that are not actually charged in the initial period.
United Kingdom

Overview

As noted previously, in the United Kingdom (UK), taxation occurs at two primary levels of government: at the central government level under Her Majesty’s Revenue and Customs (HMRC) and at the local level under various local governments. Revenue at the central government level is generated mainly by income tax, National Insurance contributions, a VAT, a corporation tax, and a fuel levy. Local government revenues are mainly derived from central government grants, business rates in England and Wales, Council Tax, and various local fees (McLean and McMillan, 2003).

Initially, the VAT was established in the UK in 1973 at a standard rate of 10%, with subsequent variations in an additional higher rate for luxury items. To meet increased needs for revenue the VAT rate was subsequently raised to its current rate of 20% in January 2011. The VAT has generated the third largest amount of tax revenue on goods and services. Most goods and services are liable to VAT at the current UK standard rate of 20%. Some goods, for example basic food; books and newspapers, are taxed at a zero (0%) rate of tax. A small number of supplies are taxed at a 6% reduced VAT rate including gas supplies and home heating costs. In addition, certain types of supplies are exempt from VAT. These include goods and services that are considered to be too complex to tax, such as financial services and transport, or which for social or other reasons it would be inappropriate to tax, such as health care. (HMRC, 2010).
Full details of the VAT liability of each type of supply are set out in the main UK VAT legislation (The VAT Act 1994).

As in most VAT systems, the purpose of these exemptions is to offset the regressive nature of the tax by justifying the tax burden on essential goods and services, while still imposing the full tax on luxuries (Charlet and Owens, 2010).

As of August 2011, Consumer Price Index (CPI) inflation stood at 4.5% (Office for National Statistics, 2011). According to Mervyn King, the Governor of the Bank of England, causes of the spike in CPI inflation are temporary effects, but include the increase in VAT to 20%, with other causes being the fall in the pound and soaring commodity prices (Sadlier, 2011).

VAT is charged on most goods and services supplied by VAT registered businesses in the UK. It is also charged on goods and some services that are brought into the UK from other EU countries or imported from countries outside the EU. It is the responsibility of the VAT registered business to collect and send to the tax authority the net amount of VAT it collects each month or quarter (i.e. the VAT output tax it charges to its customers minus the VAT input tax it is charged by its suppliers). If a VAT registered business is required to pay VAT on goods or services it receives in another jurisdiction where the business is not established, it can apply for a VAT refund to the tax authority of the other jurisdiction if it provides appropriate supporting evidence (e.g. copies of the invoices).
During each accounting period (which may be monthly, quarterly or annually) most VAT registered businesses recover the VAT they incur by deducting their VAT input tax, that is the VAT they are charged by their suppliers, from the VAT output tax they charge and collect from their customers.

**Fiscal Equalization**

According to McLean and McMillan (2003), it is broadly acknowledged that the allocation of UK central government revenue to the regional and territorial governments, administrations, and authorities is based on a mismatched variety of poorly designed formulae. They cite as an example, the Barnett formula, which allocates funds to Northern Ireland, Scotland, and Wales (referred to as devolved governments), according to changes in spending levels assigned to public services in England, England and Wales, or Great Britain. This formula is not based on need or other local considerations. As a result, it has been widely criticised, and its effects recently described as unfair by its creator, Lord Barnett (The Barnett Formula, 2009). McLean and McMillan (2003) assert that the method by which funds are shared with local authorities within the English regions has been discarded by the government, even though a substitute method has not yet been identified. They conclude that a universal basis for government spending across the regions and territories of the UK would be more even-handed and efficient, and would depoliticise the financial structure of the UK. This finding illustrates the type of problems that a central or federal government might encounter in developing an equitable system of revenue sharing and the challenges of fiscal equalization.
Several alternatives to Barnett are suggested in the literature (Kay, 2005). The first is HFE according to the customary version of territorial justice that employs a formula based on need. The fundamental approach is to assume a hypothetical equal level of public services per unit of measured need throughout the UK, envisioning it as a unitary nation. The level of financing for each devolved government is calculated with the aim that they will have the capacity to offer an equal level of public services in their territory (Kay, 2005).

However, in relation to VAT, there are no restrictions as to how the central UK government can use the VAT revenues it collects. Indeed, UK VAT revenues (of approximately £80b per annum) are not shared. Rather, this important revenue source is retained by the state at the national level and used to help fund the central government’s expenditure program.

**Compliance and Fraud**

In the UK, as in all other countries where tax is collected, the VAT is vulnerable to evasion and fraud. Because of the mechanism for credit and refunds of tax the VAT regime offers considerable opportunities for abuse, by persons who do not wish to fully comply with the VAT regulations. VAT fraud is described as deliberate or dishonest evasion of paying VAT. In the judgement of the House of Lords in relation to fraud, the opinion of the Lords of Appeal stated that “fraud is the product of dishonest application of the system of value added tax.”
Tax fraud is also when someone pays too little tax or wrongly claims a tax repayment by acting dishonestly" \(^3\)

Similar to other EU nations, Missing Trader Intra-Community fraud (MTIC) /carousel fraud is draining large amounts of VAT revenue from the UK Treasury (Ainsworth, 2007). This type of fraud takes advantage of the zero–rating of exports in combination with the “deferred payment” method of collecting VAT on imported goods that is a special feature of EU VAT regulations. In addition, another kind of market-place dependent VAT fraud has developed in the UK, known as car-flipping. All of these scams take advantage of exemptions in the VAT. Overall, the UK estimates a tax gap and VAT revenue losses resulting from noncompliance on a yearly basis (GAO, 2008). Over the period of 2002 - 2007, the estimated VAT tax gap varied from 12.4% to 16.1% of the VAT Theoretical Tax Liability (VTTL) computed by the UK using national consumption data. Every year, MTIC fraud costs the UK an estimated £2billion in lost revenues (Mcdermott and Chapman, 2011). The gap analysis methodology utilised by HMRC is quite complex (see Appendix I) and involves:

- “assessing the total amount of expenditure in the economy that is theoretically liable for VAT;
- estimating the tax liability on that expenditure based on commodity breakdowns of the expenditure data;

\(^3\) Opinion of the House of Lords in the appeal of Her Majesty’s Revenue & Customs vs Total Network SL (a company incorporated in Spain) 12 March 2008
• estimating the value of tax on the VAT-able expenditure, to derive the gross VTTL;
• subtracting any legitimate refunds (deductions), occurring through schemes and reliefs, to arrive at the net VTTL;
• subtracting actual VAT receipts from the net VTTL; and
• assuming that the residual element, the gap, is the total VAT loss due to any cause” (OECD 2009, p.38).

There are a number of different types of fraud that are regularly employed by those who wish to evade the payment of the correct amount of VAT payable. These include, but are not limited to those identified in Table 6-4.
<table>
<thead>
<tr>
<th>Type of Fraud</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suppression of sales:</td>
<td>This is the simplest form of VAT fraud. The taxable person will usually suppress sales and corresponding purchases, and declare lower VAT figures in both internal records and on the VAT return. They may also suppress all of their taxable income in order to avoid becoming registered for VAT.</td>
</tr>
<tr>
<td>Persons who do not register for VAT</td>
<td>This fraud is committed when the value of the person’s turnover exceeds the prescribed limit. Taxable persons who are in business and are either making or intending to make taxable supplies, relevant EC acquisitions, distance sales or supplies of certain assets may be liable or entitled to register for VAT. A person who is liable to be registered for VAT but deliberately does not register is committing a fraud. Likewise, a taxable person who is in business and isn’t registered for VAT but charges VAT on his goods or services and does not account for that VAT is committing a fraud.</td>
</tr>
</tbody>
</table>
| False invoicing                   | A VAT invoice is used as evidence for receipt or the making of a supply of goods or services. VAT Inspecting Officers will seek to ensure that any invoices seen are bona fide. Examples of indicators that the invoices might be false include, but are not limited to:  
  • manually raised invoices (e.g. from a ‘Challenge’ type book);  
  • copies, not originals;  
  • computer generated from information obtained nefariously about other traders; and/or  
  • prepared using genuine invoices, or letterheads, obtained by theft, collusion or purchase from existing, insolvent or redundant traders. |
| Manipulation of liabilities        | VAT is charged at the standard rate on all supplies of goods and services unless they fall specifically within the UK legislation - VAT Act 1994, Schedule 7A (reduced rate), Schedule 8 (zero rate) or Schedule 9 (exempt). A taxable person making a supply for VAT purposes can reclaim his input tax, except generally (but subject to certain rules) for services falling within Schedule 9. It is therefore tempting for some taxable persons to deliberately:  
  • mis-describe the supply by them so that it would attract a lower rate of VAT; (possibly even zero rated) and/or  
  • collude with the supplier to mis-describe the supply so that it attracts a higher rate of VAT for the purchaser to submit a claim for refund of a higher amount. |
| Manipulation of accounting schemes | Various schemes in operation are designed to assist taxable persons to declare the right tax at the right time. Whilst the majority of taxable persons use the schemes correctly there are some who will attempt to use them to fraudulently evade VAT or manipulate them to gain a cash flow advantage. |
| Smuggled goods                    | Goods smuggled into the UK from other EU Member States will normally follow the pattern set out in Missing Trader Intra-Community (MTIC) fraud, but on occasions this may not always be the case as the goods might end up being diverted for sale into the UK’s shadow economy, although the taxable person will claim to have exported or dispatched them. Taxable persons who smuggle goods into the UK from outside the EU may fail to pay import VAT and duties. Although these consignments might follow the system of an MTIC type fraud, they also might end up being diverted for sale into the UK, with the taxable person claiming to have exported or dispatched the goods. |
| Missing Trader                    | Missing trader fraud occurs when a trader imports goods VAT-free, sells them...
| **fraud** | on for a sum including VAT and then disappears before passing the tax on to the Revenue. In a more sophisticated version of the scam, "carousel" fraud, the goods are repeatedly imported and exported, and VAT charged each time |
| **Missing Trader Intra-Community (MTIC) fraud** | As the name suggests, MTIC fraud contains two elements: a missing trader and an intra-community supply. There are two types of MTIC fraud - acquisition and carousel - as well as one variant - contra trading. This type of fraud has been considered to be a serious attack on the payment system and considerable work has been expended to attempt to combat the problem. |
| **Acquisition fraud** | Acquisition fraud is a commodity based fraud in which standard-rated goods or services are purchased zero-rated for VAT purposes from a supplier based in another EU Member State and sold in the UK for domestic consumption. The importer, who is known as the 'acquirer', subsequently fails to account for the VAT due on the standard-rated taxable supply to its UK customer(s). |
| **Carousel fraud** | Carousel fraud is an abuse of the VAT system resulting in the fraudulent extraction of revenue from the UK Treasury. It may involve any type of standard-rated goods or services. As with acquisition fraud, A VAT registered trader acquires goods or services zero-rated from the EU. The acquirer then goes "missing", without accounting for the due amount of VAT on the onward supply. However, the goods or services do not become available in the UK for consumption, but are sold through a series of companies in the UK and then exported or dispatched, prompting a repayment from HMRC to the exporter/dispatcher. This process can be repeated over and over again using the same goods or commodities. When this happens it is called "carousel fraud". Carousel fraud often uses high value, items with small physical size to enable the consignment to comprise a large quantity of items and therefore a high value of tax to reclaim, e.g. computer process chips, mobile telephones |
| **Contra trading** | In order to hinder the detection of MTIC fraud, fraudsters often attempt to complicate it. One such way is through the use of 'contra trading'. The term 'contra trader' refers to a UK taxable person that participates in two separate types of transaction chain during the same VAT period, where the output tax from one chain is designed to off-set the input tax incurred on the other chain. The two types of transaction chains are: |
| |  • ‘tax loss chains’, where the taxable person incurs input tax on UK purchases and makes zero-rated supplies of those goods to customers in other EU Member States; and |
| |  • ‘contra chains’, where the same taxable person typically acquires goods from another EU Member State and sells them on in the UK, acting as an acquirer and generating an output tax liability from the onward UK sale. |
| | The tax loss chains will trace back to a defaulting acquirer, or occasionally to another UK contra trader (where this occurs it is known as a ‘double’ or ‘multiple’ contra scheme). There will usually be no tax loss specifically within the contra chains for the simple reason that the contra trader is acting as the acquirer (and will have input tax to off-set against its output tax liability) |
| **Defaulting contra traders** | It is not usual for the contra trader to default on its tax liabilities, but some do. In such cases the contra trader is not treated as the ‘default’ but is still treated as a ‘contra’, albeit one that has failed to render a VAT return and/or pay tax liabilities and part of the fraudulent tax loss within the overall scheme |
Labour provider fraud

Labour provider (LP) fraud involves fraudulent evasion of VAT by a defaulter. LPs (also sometimes known as ‘Gang masters’) are traditionally found in industries such as agriculture, construction, leisure, food, transport, security and cleaning, where the person recruits labourers and supplies them to businesses who require such personnel.

Typically, in a LP fraud scheme the end user will contract with the Main Contractor (MC) to provide labour, who may then sub-contract the provision to a further labour provider. The actual employer of the workers may be the Main Contractor, the Sub-contractor or in some cases the End User themselves.

The end user actually receives the supply of labour, and will be invoiced for this by the MC. The Sub-contractor will in turn invoice the MC, and will then disappear or default on the output VAT shown on those invoices. That VAT will be claimed as input tax by the MC, who will in turn invoice the End User for the supply of labour. Alternatively, in some cases there may be only two parties involved, with the MC taking on the role of defaulter. There may be indications of hi-jacked VAT Registration Numbers also being used.

In respect of supplies made by labour providers (sub-contractors) in the construction industry, there are examples of providers also supplying plant machinery (JCBs, excavators, trucks etc.) and materials to Middlemen or Main Contractors - again supplied by missing traders, and in some cases by ex MTIC Traders.

In addition to VAT fraud, it is very likely that LPs will also be committing other types of revenue fraud by failing fail to comply with the numerous other tax requirements for income tax and national Insurance contributions that an employer is required to submit for the personnel that he employs.

Source: Adapted from HMRC, 2013

Proposed Arrangements in the Context of the Reference Countries

Firstly, it is important to note that, regardless of the type, level, or construction of any VAT system that is introduced into the UAE, it is considered to be essential that such fundamental changes in the country’s taxation system must be developed and introduced with the agreement and support of all Emirates.

Recognising that there will always be some points of contention and that full consensus will be difficult to achieve, without such support, a relatively smooth introduction of the system will be extremely difficult to achieve.
Federal Level Regulation

It is evident from the research that, if each Emirate was to determine its own level of taxes, a distortion in consumption patterns would result as different levels of local turnover taxes may motivate people to travel to make purchases in an Emirate where the turnover tax is lower. This would result in a general loss of revenue across the UAE. Even a federal system, under which each Emirate has the authority to decide its VAT rate and reliefs, would be difficult to administer due to the absence of internal borders, and would also prove to be administratively more complex and inefficient. In particular, such a system would require a complex system of handling inter-jurisdictional crediting of VAT. As such, it is considered that a single VAT system is the most appropriate way forward for the UAE, as it will prove to be far simpler to introduce and require significantly less administration, as is the case in all reference countries.

Revenue Sharing Among the Emirates

The UK model is not seen to be a feasible option for the UAE, as a key requirement is the distribution of revenue among the seven Emirates. In the UK, funds are not shared in this way.

There are two primary ways in which VAT revenue collected by the Federal Government may be shared among the Emirates. One option is to distribute a portion of the tax revenue collected among each of the Emirates on the basis of an agreed formula, as is the case with Australia, South Africa and Germany. Alternatively, the tax revenue collected from taxpayers in each Emirate may be
distributed to the pertinent Emirate (see for example KPMG, 2008). Based on a common VAT rate across the Emirates, it is commonly surmised that the most equitable method of distribution would be to permit each Emirate to receive a share of revenue that is based on their population size, local infrastructure expenses and other variables related to their local economy rather than merely the VAT generated from firms in their state. This is the method generally adopted by the reference countries. However, it would be important to ensure that any formula adopted should be constructed in such a way as to ensure its on-going relevance by accounting for changes in socioeconomic variables both locally and nationally. This is considered to be particularly important given the different level of development of the various Emirates and the rapid economic development that is occurring throughout the UAE.

As discussed in Chapter 5, there has been considerable discussion on ways in which the revenue from the proposed VAT may be shared among the seven Emirates. Dubai, for example, has recommended that the tax be paid to the entity of origin, that is, the Emirate in which the VAT is collected. Other Emirates are opposed to this proposal, and as a consequence, the Federal Government has formed a committee to examine the issue in an effort to reach an agreed solution. The Committee has proposed a sharing system as follows:

- 7 per cent of the total revenue generated should be allocated to each Emirate equally, which will account for 49 per cent of the total revenue collected; and
• The remaining 51 per cent will be divided as per the trade balance of the Emirates. This will provide Dubai with the largest share of the revenue, then Abu Dhabi, followed by Sharjah, RAK and the remaining three Emirates.

However, it is considered that other options for revenue sharing should also be examined prior to any decision being made. These include:

**Option 1**: All VAT revenue to remain in the Federal Government account, to be earmarked for expenditure on national infrastructure and other Federal Government expenses that would benefit all the Emirates;

**Option 2**: 30 per cent of the tax revenue to remain in the Federal Government account, with the remaining 70% to be shared among the Emirates according to an agreed formula; and

**Option 3**: The tax revenue is to be shared as per the percentage of the Emirate representation in the federal parliament, which reflects size of the Emirate in terms of population count.

In addition to revenue sharing by way of a VAT formula, the Australia model is also seen as a viable model with regard to the fact that additional financial assistance is provided to states and territories in the form of a grants scheme through the Commonwealth Grants Commission. It would be worth exploring the introduction of a supplementary grants scheme such as this when considering the introduction of a VAT system in the UAE. A grants scheme of this type would
be useful in providing financial assistance to deal with situations that could not have been forecast and other extraordinary requirements, particularly in the case of RAK and other smaller Emirates.

In this context, it is considered that the UAE could employ a fiscal equalization model for the distribution of revenue to sub-national governments to address the implementation problem of disparities in accessible revenue between and among areas. As previously noted, equalization grants consist of cash allocations from a central point to local subdivisions with the goal of compensating for disparities in accessible revenue or in the expense of supplying public services (Petchey and Levchenkova, 2004). Fiscal equalization models possess similar attributes. For instance, Australia estimates the revenue and spending needs of sub-national governments when allotting grants, while other nations estimate only the revenue needs of regions. This type of equalization is nearly always driven by the goal of guaranteeing equality of access to public services wherever a nation’s citizens reside. Also, cost could be integrated into a model that considers expenditure needs in light of the fact that expensive regions require more funding than lower cost regions to deliver the same level of service.

However, the research findings indicate that one aspect of the revenue sharing models that is likely to prove critical to the effective operation of a VAT system is the way in which the revenue distribution formula is constructed and agreed. For example, it is evident from the results that in two of the countries surveyed, Germany and Australia, there is an extreme distrust of the distribution methods
that are being applied. This has not been reported in the New Zealand model. In this regard, however, it is pertinent to note that no studies have been identified that critique the New Zealand model from this perspective, and little information exists in the field of research in this respect.

Type of VAT Regime

In general, the European-style VAT regimes are fairly complex, with many derogations, exemptions, zero-rated supplies and other special arrangements. These systems offer instant input tax credit for businesses, and the destination principle is followed regarding goods. For services, however, the supply location is determined by relatively complex legal regulations. According to KPMG (2008), the purpose in most nations with this kind of VAT system is to accept the destination principle for services as well, and in the future, the reverse charge mechanism will be the primary rule for cross-border services.

In contrast, GST regimes, typified by New Zealand have a broad tax base, single, relatively low rate and limited exemptions. Among the countries surveyed for this study, Australia and South Africa have similar types of VAT systems. In this regard, commentators indicate that such regimes are generally considered to be modern, efficient and fair (see for example KPMG, 2008).

At the time that RAK decides to initiate a viable and efficient VAT model, authorities should be advised to avoid the mistakes of the European VAT arrangements. Problems include (but are not limited to) multiple rates, open-ended exemptions for health, education, and governments, and poorly conceived
treatment of agriculture, commercial real estate, and non-profit organizations. As noted, it is considered that the best model to adopt in order to avoid such problems is that of a New Zealand style VAT scheme, which is largely reflected in the way in which Australia has introduced its GST system. All goods and services, with only a few exceptions, are taxed at a single rate, with only exports being zero rated.

The key elements of the proposed scheme to adopt the New Zealand model are actually in the simplicity of rules. A simpler VAT system would reduce the operational cost to taxpayers and to tax administrations as well, thereby increasing the net benefit to the Treasury. Almost all goods and services should be taxed at a single rate. Exemptions to the tax should be those that are similar to New Zealand. For example, exports are zero rated. In addition, only rent paid for a private home, charitable contributions and interest earned are exempted. Also, if RAK decides to copy the New Zealand model, it should consider dropping at least one current source of revenue - customs duty.

Also, different from New Zealand, the emirates such as RAK must contribute to the federal budget (Gharee and Al Abed, 1997). According to Article 127, "member emirates shall contribute a specified proportion of their annual revenues to cover the annual general budget expenditure of the Union." This leaves the capacity to implement federal laws contingent on the funds provided by the individual Emirates (Simmons, 2005).
VAT Fraud

In general, an effective strategy for reducing VAT fraud includes the following:

a. An effective targeted system of auditing;

b. Implementation of a simple VAT regime with a high threshold; and

c. A deliberate policy to reduce all kinds of VAT evasion, including suitable penalties (KPMG, 2008).

Ainsworth (2010) cautions that before a country adopts any kind of VAT scheme, it is essential to reflect on the scams that are facilitated by that particular form of taxation and to address them prior to implementation of the new arrangements. In particular, the tax authority needs to use technology to counteract the technology that might be used by potential fraud perpetrators and scammers. The development of an all-inclusive IT strategy is essential to the efficiency of a modern VAT regime. The IT system must have the highest level of security reinforced by layered access controls and integrity checks on staff to defend against abuse or corruption (KPMG, 2008).

In this context, it is considered that the introduction of electronic invoicing (e-invoicing) for all business to business (B2B) transactions should be a feature of the UAE VAT system, as it would assist in reducing the regulatory burden of business taxpayers and also mitigate the risk of revenue fraud. As noted in Chapter 2, the use of enabling technology is essential to ensuring the effectiveness and efficiency of a taxation regime. Specifically, efficiency and effectiveness could be improved by reducing the regulatory burden of
transactions between and among businesses. Further, tax authorities could obtain information significantly faster than they do now if all invoice data was sent in real time to a central VAT monitoring database, either in RAK or one of the other Emirates. If such a system was expanded to include other regulatory requirements, a number of current obligations could also be reduced or eliminated through such an initiative. In this innovative electronic age it is important that government services take advantage of such technological innovations, including e-invoicing and other electronic accounting procedures. Once achieved, the impact on the UAE and the individual Emirates would be significant.

As previously noted, VAT is the only tax system in which the government collects a considerable amount of money from the private sector but also returns a large amount of it to them as input tax credits. In this system, an invoice functions as a possible claim on government funds. The use of e-invoicing would significantly reduce the possibility of invoice fraud at all levels within the system. Also of the greatest importance to successful implementation of any system that takes advantage of e-invoicing is the hiring and/or training of suitably qualified personnel who are capable of effectively and efficiently operating the new electronic system, that is, institutional readiness. Too often new systems are put in place, but personnel have not been appropriately trained and are therefore insufficiently knowledgeable about their use. Once personnel have been trained in e-invoicing and have assumed the level of readiness, their work can lead RAK
and other Emirates in creating and maintaining a more efficient and user-friendly tax system.

In particular, it is considered that the risk of carousel fraud, a specific type of VAT fraud that has been discussed at length in previous chapters, can be significantly mitigated, if not eliminated, in the UAE if a federal VAT system with appropriate technological support and a single VAT rate is implemented. This is because the federal VAT would be charged by the supplier for goods remaining in the UAE including those moving between Emirates. Nevertheless, currently, the IMF recommends that intra GCC transactions in the future might be handled in the same manner as intra EU transactions and that internal borders across the GCC might be eliminated. Then, goods will pass freely among GCC nations. However, if this occurs, the risk of carousel fraud will inevitably increase, but may be offset by the use of innovative technological solutions to support the management of compliance.

In this regard, McLinden et al (2011) identify twelve factors that are critical to the success of ICT usage:

1. “An aligned legal and regulatory framework. A modern legal and regulatory basis needs to be in place before any ICT design or implementation. The time needed for regulatory or legislative change can easily exceed the time needed to develop new systems, so it is important make the two overlap: for example, time used to prepare amendments to laws may also be used for prototyping and testing ICT
prior to system design or even procurement. Because regulatory change may have unforeseen outcomes that then require new processes, a close relationship between regulators and technologists during this process is desirable (though in practice uncommon).

2. Clarity about business outcomes. Business outcomes are not always well described before or during ICT program design, which can result in poor service delivery. Service level agreements with key dependent partners and stakeholders should be defined and agreed on as early as possible in ICT program planning. It is important to align the envisioned business outcomes with overall outcomes in the agency’s vision and strategy.

3. Effective governance. A governance model, setting out the roles and responsibilities of stakeholders, must be established. If the decision-making process and procedures for issue escalation are not established and rigorously followed, a loss of direction can ensue—wasting time, raising costs, and delaying the delivery of required benefits.

4. Specific ICT policy issues. Further ICT policy issues arise with newer border management systems because the systems often involve more than one government agency, each silo based and each with different policies (if any) for such things as security and identity management. Policies might need to be mutually agreed on for issues including:

- Privacy.
• Identity management.
• Security.
• Accessibility and digital inclusion.
• Intellectual property rights.
• Standards and interoperability.
• Governance, architecture, and procurement.
• Green computing.
• Social networking.

5. A robust business case. A robust business case is often essential to securing the necessary political backing, investment, and resources for an ICT development. Business cases for ICT investments often have relied on a traditional cost-benefit analysis … Information on cost is often readily available. More difficult is to quantify the benefits and project an accurate return on the investment—many benefits are not quantifiable in monetary terms. An ICT program may increase trader education and compliance, improve performance management for staff, and enhance collaboration with other agencies and stakeholders. A suitable business case will combine an analysis of the investment required with a wider view of both quantitative and qualitative benefits.

6. Operational aspects. Who does what? How is it financed? Though critical, the answers to these questions are not always well articulated and agreed on before a program starts. If the lead time necessary for a complete analysis of delivery model and procurement options is not
allowed, unplanned financial and time constraints can result, making deployment, operation, and the cost of delivery problematic.

7. **Business process efficiency.** An important factor in the most successful ICT programs is the link to business process efficiency. Experience suggests that any program lacking a complementary project to review and align the processes in an organization will generally fail, requiring users to work around incompatibilities to operate a shadow or backup system. Without exception, an initial review of existing business processes should inform the design of required business processes, so that the new ICT system will in turn be designed to enable the new processes.

8. **Change management.** A retrospective view of ICT program deployment reveals that most project managers, if they were starting their program again, would have invested more in change management. A change management program should consider required changes in behavior, support the required training and learning, and help with role and job design and restructuring.

9. **Organization performance.** The design and implementation of any new ICT program requires competent and skilled support resources. Organization and human resource management are critical. Success metrics (generally referred to as key performance indicators), which measure operational efficiencies and improvements, need to be determined at the start of a program and then gathered and monitored.
during implementation and operation. Regular progress reporting, using concise and accurate measures, must ensure that both the client management and those who put the program in place have the right information to make decisions on intervention.

10. Interoperability. As effective border management increasingly relies on sharing information and intelligence among varied stakeholders (including those based outside the home nation), interoperability is increasingly required. Developments such as systems oriented architecture improve the ability to link existing systems. Future ICT systems must allow secure links to other national and international systems.

11. Data privacy and protection. Privacy and protection become even more important as the demand grows for more data sharing, data reuse, and adherence to national and international data protection legislation.

12. Standards and frameworks. Success requires the application of standards to ICT system design, development, and implementation approach and methodology. All too often ICT developments, particularly when custom built, result in poor service and high costs because process, data and interchange standards were not applied” (pp. 118-119).
The Research Questions

At this point, it is possible to answer a number of the research questions postulated in the first chapter of this study based on the interview responses and research findings. Here, research findings 1, 2, 3 and 5 are addressed. The remaining research questions are addressed in the following chapter.

Research Question 1: What economic and political policies should support the principles of implementing a VAT regime?

A number of key economic and political policies need to be developed and agreed to by all members of the UAE regarding VAT type, applicable rates, exemptions, zero-rating, central or local administration, methods of collection, treatment of other taxes, financing of administration and collection, and, perhaps most importantly, revenue sharing. Introducing a relatively complex tax such as the VAT to a federation with little or no experience with a modern system of taxation could encompass a major change in administrative processes (Deloitte, 2008) and raise new political issues regarding revenue sharing. However, the current structure administering customs tariffs and collecting various fees could serve as a base upon which to build new structures.

Research Question 2: What are the potential advantages and disadvantages of adopting a VAT regime for RAK?

In essence, the basic advantage is a replacement of revenue from customs’ tariffs and cumbersome fees and charges for Emirates that are facing the long-
term depletion of supplies of oil and gas (see also Deloitte, 2008). In this regard, the introduction of a VAT would provide the UAE and RAK with a long term, sustainable and predictable broad-based source of tax revenue. The disadvantages include risks of unfair taxation of the poor and disadvantaged since the VAT is generally regarded as a regressive tax, excessive administrative burdens on the government and on businesses, loss of business and investment, inflation, and fraud. Implementing an efficient structure with trained personnel and education of the public and commercial entities will be costly and time consuming. On the other hand, if done judiciously and in phases, the tax can be understood and accepted by the public and commercial entities and professionally administered by the authorities, raising needed revenue as is the case in Australia and New Zealand.

**Research Question 3: What VAT models around the globe have been successfully implemented in selected countries?**

Based on the findings of the current research, it is considered that Australia and New Zealand have both implemented efficient models. New Zealand is favoured due to its simplicity and perceived fairness. It consists of a single rate that is applied uniformly to most goods and services, it has very few exceptions and a zero rating for exports. In this regard, requirements are simple and clear and administration and compliance is less costly.
Research Question 5: What is the optimal revenue-sharing method for RAK?

The following options are proposed based on the research findings:

**Option 1**: All VAT revenue to remain in the Federal Government account, to be earmarked for expenditure on national infrastructure and other Federal Government expenses that would benefit all the Emirates;

**Option 2**: 30 per cent of the tax revenue to remain in the Federal Government account, with the remaining 70% to be shared among the Emirates according to an agreed formula; and

**Option 3**: The tax revenue is to be shared as per the percentage of the Emirate representation in the federal parliament, which reflects size of the Emirate in terms of population count.

In general, the options can be based on population, GDP growth, Parliamentary representation, or consumption (Deloitte, 2008). For RAK, a fair and clear system is extremely important and a system which properly recognises the geographic location where the revenue is generated would be the most practical.

**Summary and Conclusion**

In this chapter the researcher examined and analysed four different federal VAT sharing systems in the following countries: Australia, South Africa, Germany, and the United Kingdom (UK). Various effects of the VAT systems, revenue sharing,
and the role of fiscal equalization in the distribution of revenue to sub-national
governments were considered. Findings indicated there are many similarities
among the four VAT regimes. In effect, the central government controls the major
taxes in all four nations. With the exception of the UK, a considerable portion of
the revenue is distributed among the states or local areas according to some
system of fiscal equalisation. Each tries to counteract regressivity with
exemptions or reductions for some items, though this can result in efficiency loss.
However, each country has serious issues with compliance and fraud and loses
revenue to non-compliance. In the UK and South Africa, an initial rise in VAT
also was correlated with a rise in CPI. The most successful of the models studied
appears to be that of Australia where the federally administered VAT is designed
to provide the states and territories with a continuing source of revenue (Searle,
2010). According to Ahmad (2010), this approach is pertinent to execution of a
VAT in the UAE.

In response to issues of VFI, Australia has developed a system of taxation that
tries to obtain the greatest degree of horizontal fiscal equalization (HFE) of any
democratic federation (McLean, 2002, 2004). This approach creates an ideal
model for fair treatment of all states in a federation regardless of unequal own
revenue or lack of natural resources, and the like. In addition, Australia’s closed
system enables HFE without altering general public sector outcomes (Searle,
2007). The use of a nonpartisan agency of administration is also considered to
be a benefit of the Australian system. In addition, unlike other nations with a VAT,
in Australia all activities of public and non-profit organizations are subject to the
levy, resulting in simplicity and less economic distortion (Gendron, 2005). Finally, the VAT is extremely successful in raising tax revenues (Dollery, 2010), as it is in the other nations as well. However, one particular problem with the Australian system that would need to be addressed is the lack of confidence by the states and territories in the revenue distribution arrangements. Provided that the issues surrounding the revenue distribution formula could be adequately addressed, the Australian system would be a good model on which to base the proposed UAE VAT system.

The elimination of a number of current paperwork obligations, the use of e-invoicing, the creation of a central VAT monitoring database in RAK, and the adoption of a system similar to that used in Australia would ensure an economically viable outcome for RAK. The investment effects of implementing such a VAT scheme for RAK would not only supply businesses with a better scheme, it would also provide incentives for further modification of a plan that already exists.
CHAPTER 7: RESEARCH AND ANALYSIS – RAK
STAKEHOLDERS

Introduction

In this chapter the researcher presents the findings and analysis of surveys and interviews of various sectors of RAK that will be affected by the proposed VAT. These include the general public, corporations, service firms, international firms currently operating in RAK, and Free Zone firms. The surveys and subsequent interviews were designed to gauge the view of these groups to assess the likely issues that will need to be addressed when implementing the new system. The commentary in this chapter relates to the responses to the various stakeholder surveys and interviews unless otherwise indicated.

VAT Adoption for RAK and UAE as Perceived by the Public

Demographics of the Sample

The Public was the second largest group to respond to the survey on VAT adoption for RAK and UAE. Of the 100 questionnaires that were sent, 51 responses were received, i.e. a response rate of 51%. Table 7-1 provides demographic information on the respondents from this particular sample. Information includes gender, age, job position, and general knowledge and understanding of how a VAT may affect their financial situation.
As indicated, males comprised the majority of the respondents in this group. The majority were also UAE nationals who were knowledgeable about VAT, but not experienced in the operation of such taxation arrangements. The median current age was between 21 and 29. While background information on the possible introduction of VAT in the UAE and RAK was publicly available through media reports, only a small number of those sampled had researched issues that may have a bearing on their particular financial situations. The average profile of respondents in this particular group can be summarised as being male, between the ages of 21 and 29, a UAE national a manager of one type or another, knowledgeable about the VAT, but not experienced in its application.
Table 7-1: Demographics of the Public Population Respondents

<table>
<thead>
<tr>
<th>Factor</th>
<th>No.</th>
<th>%</th>
<th>Factor</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
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</tr>
<tr>
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<td>39.2</td>
<td>Yes</td>
<td>34</td>
<td>66.6</td>
</tr>
<tr>
<td>Male</td>
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<td>17</td>
<td>33.4</td>
</tr>
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<td></td>
<td>Knowledgeable about VAT?</td>
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<tr>
<td>21 – 29</td>
<td>22</td>
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<td>Yes</td>
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<td>30 - 39</td>
<td>18</td>
<td>35.3</td>
<td>No</td>
<td>19</td>
<td>37.3*</td>
</tr>
<tr>
<td>40 - 49</td>
<td>3</td>
<td>5.9</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>50 - 59</td>
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<td>13.7</td>
<td>Experienced with VAT Requirements?</td>
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<td></td>
</tr>
<tr>
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<td>Yes</td>
<td>18</td>
<td>35.3</td>
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<td>Job Positions **</td>
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<td>No</td>
<td>33</td>
<td>64.7</td>
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<td>Managers</td>
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<td>Researched VAT Issues?</td>
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<td>Yes</td>
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<td>30</td>
<td>58.8</td>
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<td>Secretaries</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chairman</td>
<td>3</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Banker</td>
<td>2</td>
<td></td>
<td></td>
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<td>Students</td>
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<td></td>
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<td>Accountant</td>
<td>2</td>
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<td>Advisor</td>
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<td>Gov Legal Adv</td>
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<td></td>
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</tr>
<tr>
<td>Misc Other</td>
<td>6</td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

*Percentages are rounded, therefore, some totals exceed 100 per cent. Also, some participants did not provide a response to all questions.

** Variety of titles condensed to general type. Also, some did not state their job position.
The survey of the RAK public included the following five open-ended questions:

1. Do you support or oppose the introduction of the VAT in RAK and the UAE and why?
2. Do you think the VAT will unfairly impact low-income individuals?
3. Should VAT apply to necessities such as food, education, and healthcare as in other countries with VATs?
4. Do you think the decline in customs collection in RAK is likely to be offset by the revenue from the VAT?
5. Do you think that a VAT will impact the Emirates? and Why?

The following reflect the responses to these survey questions.

**Do you support or oppose the introduction of the VAT in RAK and the UAE and why?**

Eleven of the respondents (22%) supported the introduction of the VAT in both the UAE and RAK. Reasons for support widely varied, however. These ranged from a perceived likelihood that consumer prices will be controlled through the introduction of such a system, to the provision of underpinning financial and budgetary support for the country’s infrastructure development. On the other hand, 20 respondents (39%) opposed the introduction of a VAT regime. Again, reasons varied, and included:

- Concerns that the introduction of VAT would result in a higher cost of living;
• Opposition on the grounds that individuals would be the subject of double taxation, being taxed on their income as well as the purchase of goods and services;
• The belief that the VAT would place additional burdens on the UAE and RAK citizens, thereby weakening their financial position; and
• A perception that lower income earners would be affected to a greater degree under such an arrangement.

Do you think the VAT will unfairly impact low-income individuals?

Note that this issue was also raised in response to the earlier question. In response to this question, only four respondents (8%) thought that the VAT would not unfairly impact low-income individuals. On the other hand, some 27 (53%) indicated that the introduction of a VAT would in fact impact low income earners unfairly. Of the remainder, seven (14%) said they did not know, three (6%) commented that the outcome would essentially depend on the actual rate of tax that was applied, and one (2%) indicated that that VAT would affect limited income people in general, and lower income persons in particular, but because the taxation arrangements may be phased in during its early stages of introduction, the initial impact would be minor.
Should VAT apply to necessities such as food, education, and healthcare as in other countries with VATs?

Of the total respondents, 30 (59%) thought that essential goods and services, including those identified in the question, should be excluded from any VAT arrangements. One respondent best summed up the comments of those who answered “no” to this question by saying, “I am not in favour of that because food, education, and health care are basic everyday needs”. Five (10%) had no comment, and one explained, “Since our healthcare and education are more expensive than those of other countries which are in the same level of economic growth, my answer is no.”

Do you think the decline in customs collection in RAK is likely to be offset by the revenue from the VAT?

A total of 29 respondents (57%) agreed that the VAT would be capable of offsetting the current decline in revenue from customs duties, while 8 (16%) did not and 5 (10%) indicated that they did not know. One respondent who appeared particularly knowledgeable about matters of taxation, indicated that, “Collection of customs revenues in Ras Al Khaimah is linked to some other factors and VAT is not one of them, so VAT will not have an impact of collection of customs revenues in the future because VAT is imposed on the total cost of the imported goods”. While the response is technically correct, it assumes that customs duties will continue to be levied following the introduction of a VAT.

Do you think that a VAT will impact the Emirates, and why?
A total of 20 respondents (39%) indicated that a VAT will have an impact on the UAE. Reasons were varied, reflecting the manner in which different members of the public are likely to view the introduction of such a regime. Some respondents focused on the increase in the price of goods and services that would impact citizens financially, while others suggested that the collection of a VAT would enable government agencies to provide improved services to the public. One respondent who held the latter view commented that the VAT would enable the country to develop its capabilities as well as enhance the services provided. Another suggested that the introduction of a VAT would have a positive impact on the UAE as it would provide the country with consistent and predictable source of revenue. On the other hand, one respondent indicated that any rise in the price of goods stemming from the impost of a VAT would have a negative impact on both nationals and expatriates living in the UAE, which was likely to cause public dissatisfaction and complaint.

Some respondents simply indicated that the introduction of a VAT would impact on certain sectors of the economy without providing further details. These included a perceived impact on investment and tourism. Other respondents qualified their answers by indicating that the rate at which the VAT was set would largely dictate its impact on the economy of the UAE, some suggesting that the public would not be concerned if the rate did not exceed 5 per cent. One in particular observed that a decision to introduce a VAT in the UAE but not to introduce such a tax in other GCC countries would be likely to negatively affect
foreign investment in UAE. Finally, three participants (6%) indicated that they did not think that a VAT would impact the UAE, but no specific reason was given.

**VAT Adoption for RAK and UAE as Perceived by Corporations**

**Demographics of the Sample**

The Corporation was the smallest group to respond to the survey on VAT adoption for RAK and UAE. Of the 25 questionnaires that were sent, 6 responses were received, i.e. a response rate of 24%. Table 7-2 provides demographic information on this particular sample. Information includes job position, whether or not a UAE National, knowledge about VAT, experience with VAT requirements, and research of VAT issues that could affect their corporation’s financial situation.

As indicated, the majority of respondents were not UAE Nationals. Half the respondents had previous knowledge about VAT, but none had researched VAT issues that may affect their company’s financial situation, although one had researched VAT issues affecting that individual’s personal financial situation. From this information, a profile of the average Corporation respondent emerges. This person is a manager, is not a UAE National, is knowledgeable about VAT, but has not researched VAT issues affecting either their company or their own financial situation.
The survey of RAK corporations included the following five open-ended questions:

1. How would the introduction of the VAT affect your company financially?
2. Would the compliance burden be harder or easier on your corporation?
3. Would a VAT hinder recovery?
4. Should UAE retain its current corporation tax rate? Should the same be true for RAK?
5. Do you support or oppose the introduction of a VAT? What is the reason for your support/opposition?

Only three of the six respondents provided answers to these open ended questions, which are summarised below.
Table 7-2: Demographics of Corporation Population

<table>
<thead>
<tr>
<th>Factor</th>
<th>No.</th>
<th>%</th>
<th>Factor</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>UAE National?</td>
<td></td>
<td></td>
<td>Knowledgeable about VAT?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>1</td>
<td>16.7</td>
<td>Yes</td>
<td>3</td>
<td>50.0%</td>
</tr>
<tr>
<td>No</td>
<td>5</td>
<td>83.3*</td>
<td>No</td>
<td>3</td>
<td>50.0%</td>
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<tr>
<td>Job Positions</td>
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<td></td>
<td></td>
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<tr>
<td>Hotel Manager</td>
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<td>Experienced with VAT Requirements?</td>
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<tr>
<td>General Manager</td>
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<td>Plant Manager</td>
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<td>Researched VAT Issues Affecting Personal Financial Situation?</td>
<td></td>
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<td>Researched VAT Issues Affecting Company Financial Situation?</td>
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<tr>
<td>Yes</td>
<td>1</td>
<td>16.7</td>
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<tr>
<td>No</td>
<td>5</td>
<td>83.3*</td>
<td>No</td>
<td>6</td>
<td>100.0</td>
</tr>
</tbody>
</table>

*Percentages are rounded, therefore, some totals exceed 100 per cent. Also, some participants did not provide a response to all questions.

** Variety of titles condensed to general type. Also, some did not state their job position.

How would the introduction of the VAT affect your company financially?

One participant commented that the introduction of a VAT would impact on the company as it would be required to increase the price of its services to its customers, thereby increasing the cost to the customer. Another indicated that the new taxation regime may affect the company simply because of the location of the business in the UAE, and that competition with non-UAE companies was getting harder. Notably, one respondent believed that the cost of production would increase and the company would be adversely affected as a result. This
last response indicates that the respondent is unaware of the operation of a VAT system, whereby the tax on inputs may be refunded to the service provider or producer.

Would the compliance burden be harder or easier on your corporation?

One respondent indicated that the regulatory compliance burden was unlikely to be either harder or easier. Another commented that the impact of the compliance burden would be dependent upon the administrative arrangements that are introduced, and the amount of red tape that may be involved. The third participant simply indicated that, in his view, the VAT should be applied to a number of collective companies coming from abroad, but should not be imposed on UAE companies. This view continued to be expressed in supplying responses to the remaining open-ended questions in the survey.

Would a VAT hinder recovery?

According to one respondent, no company should be exempted from the new arrangements, and that, in his opinion, if the recovery of one company or corporation is influenced, all should be. In other words, all should be impacted equally in order to maintain the current level of competition in the market. Another respondent put forward the view that the introduction of a new tax in the form of a VAT would hinder economic recovery, but may also bring with it a number of positives that may assist recovery efforts in the industrial sector. The final participants indicated that the VAT would hinder recovery, explaining that since both the cost of the product and the price of the product would be likely to
increase, the result would be a negative impact on sales. Again, this response indicates that the respondent is unaware of the operation of a VAT system, whereby the tax on inputs may be refunded to the producer, and consequently it should not increase the cost of manufacture.

**Should UAE retain its current corporation tax rate? Should the same be true for RAK?**

In the view of one corporation respondent, the VAT should be implemented in such a way as to reduce the fees of the company, that is, by replacing the corporation tax with the new system of taxation. The second participant, however, indicated that the UAE should retain its current corporate tax rate, and that the same should be true for RAK. However, he was insistent that the arrangements should apply only to non-UAE companies, including those that were members of other GCC states. The third corporate participant indicated that both the UAE and RAK should retain the current corporation tax rate.

**Do you support or oppose the introduction of a VAT? What is the reason for your support/opposition?**

No responses were received to this question.

**VAT Adoption for RAK and UAE as Perceived by Service Firms**

**Demographics of the Sample**
Of the 100 questionnaires that were sent to service firms and companies, there were 24 respondents, 18 of which fully completed the survey.

Table 7-3 provides demographic information on this particular sample. Information includes job position, whether or not the respondent is an UAE National, knowledge about VAT, experience with VAT requirements and research of VAT issues that could affect their financial situation.

As indicated, the majority were not UAE nationals. Specifically, 88% (n = 21) were non-UAE nationals. Almost half were knowledgeable about VAT, with 11 (46%) indicating that they had such knowledge, while 13 (54%) were not. However, the majority of respondents were not experienced with VAT requirements, nor had they researched VAT issues affecting their company or their own situation. Again, a profile of the average respondent emerged from the data. This person was a manager, was not a UAE national, was not knowledgeable about or experienced with VAT, and had not researched VAT issues for himself or his company.

The survey of RAK service firms and companies included the following eight open-ended questions:

1. How would a 5% VAT impact your service company?
2. Would sales and profits be negatively impacted?
3. Should certain services be exempted, such as independent contractors of business services, financial services and/or medical services?
4. Are you in favour or opposed to a VAT: What is the reason for your support or opposition?

5. Will the VAT enable the UAE to diversify away from its reliance on oil?

6. Should the VAT differ for nationals and non-nationals?

7. How would VAT impact your investment?

8. How would the introduction of VAT affect your company financially?

The following reflect the responses to these survey questions.
**Table 7-3 Demographics of Service Firms**

Total Group (N = 24)

<table>
<thead>
<tr>
<th>Factor</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>UAE National?</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes=</td>
<td>3</td>
<td>12.5</td>
</tr>
<tr>
<td>No=</td>
<td>21</td>
<td>87.5</td>
</tr>
<tr>
<td><strong>Knowledgeable about VAT?</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes=</td>
<td>11</td>
<td>45.8%</td>
</tr>
<tr>
<td>No=</td>
<td>13</td>
<td>54.2%</td>
</tr>
<tr>
<td><em>(2 removed; said both yes and no)</em></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Job Positions***

<table>
<thead>
<tr>
<th>Job Position</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Managers</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>3 Travel Consultants</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Branch in Charge</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Finance Professional</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Ticket Coordinator</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Head Corp Finance</td>
<td>1</td>
<td></td>
</tr>
</tbody>
</table>

**Experienced with VAT Requirements?**

| Yes=                            | 4   | 16.7|
| No=                             | 20  | 83.3|

**Researched VAT Issues Affecting Your or Your Company Situation?**

| Yes=                            | 7   | 25.0|
| No=                             | 18  | 75.0|

* Variety of titles condensed to general type.

**How would a 5% VAT impact your service company?**

It would appear from the responses that a number of participants did not have an understanding about how a VAT may impact their business, but responded that it would do so in some way. Six subjects (33% of those who responded to the open-ended questions) simply answered "yes." Other respondents pointed to issues such as the possible regulatory compliance burden, a likely reduction in
the volume of sales, a possible reduction in profit margins, concern about customer reaction to increase prices and the effect that may have on turnover. Those who did not raise particular reasons why the VAT may impact their business simply responded along the lines of “It will affect business”, and “5% VAT may impact negatively”. However, the principal concerns appeared to be centred on the fact that a VAT would increase costs and prices of the respondents’ products and services, and that these would need to be passed on to the consumer.

**Would sales and profits be negatively impacted?**

Almost all respondents from this sector were in agreement that sales and profits would be negatively impacted. Specifically, 16 out of the 18 who responded to this question answered "yes" (89%). Some believed that both profits and sales would reduce as a result of the proposed taxation measures. Some made the point that, while they believed that their sales and profits would be negatively impacted by the VAT, the scale of the impact would however depend on the final details of the VAT regime that is actually implemented in the UAE and RAK. One commented that “production is likely to go up, but the sales volume would take a hit if not on a larger scale as the VAT is bound to be passed on to the consumer ultimately”.

Should certain services be exempted, such as independent contractors of business services, financial services and/or medical services?

Of the total respondents, 11 (61%) answered "yes." Some participants made observations about which services should be exempted from their point of view. For example, one subject suggested that air tickets should be exempted as it would affect the expatriate labourers who visit their home country after 2-3 years of working in the foreign country. This response reflects the approach that is adopted in most economies that have introduced a VAT, in which international as opposed to domestic travel is excluded from the tax. One subject also indicated that such taxes should not be applied to the services provided by travel agencies. One pointed to the fact that exemptions would ultimately impact on government policy, and that such considerations should be taken into account when government policy is being formulated. Low income business was the suggestion of another respondent, and medical services were suggested by another two respondents. It may be concluded that service firms believed certain services should be exempted, but respondents did not necessarily nominate their own service industry when answering this question.

Are you in favour or opposed to a VAT: What is the reason for your support or opposition?

A total of 9 (50.0%) of the service firm respondents were opposed to a VAT, and most noted that this was especially the case during these times of economic insecurity and the current international economic situation that continues to
impact the UAE and RAK, including from those customers based in European countries as well as the Americas. Opposition was credited to the current declining state of business, the effect of a new tax on the potential benefits that may emerge as the economic situation starts to improve, resultant lowering of commission on sales of services and a perceived reduction in sales and profits. One respondent suggested that the Government should consider delaying the introduction of a VAT at this point in time, as “Everyone is suffering losses right now and needs more time to deal with financial problems”. Another respondent opposed the proposed introduction of a VAT because it would “drastically reduce customers and prompt them to find alternative companies with which to do business”. VAT was described by one participant as a double edged sword which, if handled in an efficient manner, could be beneficial to the authorities and to business alike, but if not managed properly would have an adverse impact on businesses and the general economy.

**Will the VAT enable the UAE to diversify away from its reliance on oil?**

Of the total sample, four outright said “no” (22%) and three (14%) said "to some extent." Others responded that they were not suitably qualified or informed to predict and that this was an issue that should be closely examined by competent specialists. Some respondents believed that in the long run the VAT would enable the UAE to diversify away from its reliance on oil, but that the process would take some time and the result would depend on the effective implementation of the VAT regime.
Should the VAT differ for nationals and non-nationals?

When asked this question, respondents from the service sector were again undecided. Of those who responded to the open-ended questions of the survey, six (29%) said “no” but offered no further comment, three (14%) said “yes”, three (14%) thought the VAT should be equal, i.e. that it should not differ for nationals and non-nationals on the grounds of equity. In this regard, "Discrimination is not advisable" was a warning that was given by one such service firm participant. Others did not comment.

How would VAT impact your investment?

A number of widely diverse responses were obtained when service firm participants were asked this question. According to one industry member, "VAT can significantly impact your cash-flow and future economy," while another believed that introducing an additional form of taxation with the current relatively low profit margins would affect his company, and his own, financial investments in a negative way. Most respondents agreed with this sentiment that the introduction of a VAT would have a negative impact on investment due to the perception that the cost of investment would increase and therefore the impact would almost certainly be negative. However, two respondents indicated their belief that the negative impact would be marginal. One respondent indicated that he did know whether the VAT would have an impact on investments.

How would the introduction of VAT affect your company financially?
This final question produced a number of diverse replies. However, all responses indicated a perception that the introduction of a VAT would negatively impact the service industry, as can be observed from the following: “sales may reduce until VAT becomes part of our business”, “margin of profit will further reduce, “our income will be less”, “the benefit will decrease”, “business and profit will go down”, “we will have to include VAT in our costing then only the customer will pay it”, “it will affect the buying capacity of passengers”, and “customers who depend on us for travel and hotel reservation will then go for online services which will affect our business”.

As noted, there was a clear indication among the responses from this sector of industry that the impact of the proposed taxation regime would be negative, regardless of the focus of the answer. In summary, it was considered that benefits and income would decrease, customers would be lost, costs would be passed on to consumers with a negative effect on sales, and profit margins would be eroded.

**VAT Adoption for RAK and UAE as Perceived by International Firms**

**Demographics of the Sample**

Of the 100 questionnaires that were sent to international firms and companies, there were 20 respondents, 18 of which fully completed the survey. Consequently, this sector represented another relatively small group of
respondents that was approached to provide their perceptions of VAT adoption for RAK and UAE. Table 7-4 provides demographic information on this particular sample. Information shown includes job position, whether the respondent is or is not a UAE national, knowledge about VAT, experience with VAT requirements, and research of VAT issues that could affect their financial situation.

As indicated, the majority of respondents were not UAE nationals. Only 11% (n = 2) were nationals. Again, while respondents were knowledgeable about VAT (yes = 61%), less than half have had experience with VAT requirements. Also, only 20% (n = 4) had researched VAT issues affecting their company or their own situation. As for other sectors, a profile of the average International Firm respondent emerges from the demographic data. This person is a manager, is not a UAE national, is very knowledgeable about VAT but not experienced in its application, and has conducted little research on VAT issues that have or are affecting the respondent’s his own financial situation or that of the respective company.

The survey of RAK international firms and companies included the following eight open-ended questions:

1. Should the VAT replace customs tariffs?
2. Will a VAT discourage foreign investment?
3. Will you conduct business elsewhere if a VAT is implemented?
4. Will a VAT discourage tourism?
5. Should VAT differ for nationals and non-nationals?
6. Are you in favour or opposed to VAT? What is the reason for your support/opposition?

7. How would VAT impact your investment?

8. How would the introduction of VAT affect your company financially?

The following reflect the responses to these survey questions.

**Table 7-4: Demographics of International Firms**

<table>
<thead>
<tr>
<th>Factor</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>UAE National?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes=</td>
<td>2</td>
<td>11.1%</td>
</tr>
<tr>
<td>No=</td>
<td>16</td>
<td>88.9%</td>
</tr>
<tr>
<td>Knowledgeable about VAT?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes=</td>
<td>11</td>
<td>61.1%</td>
</tr>
<tr>
<td>No=</td>
<td>7</td>
<td>38.9%</td>
</tr>
<tr>
<td>Job Positions*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managers =</td>
<td>6</td>
<td>31.6%</td>
</tr>
<tr>
<td>MDs=</td>
<td>3</td>
<td>15.8%</td>
</tr>
<tr>
<td>Clearing Agt =</td>
<td>2</td>
<td>10.5%</td>
</tr>
<tr>
<td>Accountants=</td>
<td>2</td>
<td>10.5%</td>
</tr>
<tr>
<td>Head HR=</td>
<td>1</td>
<td>5.3%</td>
</tr>
<tr>
<td>Planner =</td>
<td>1</td>
<td>5.3%</td>
</tr>
<tr>
<td>CEO=</td>
<td>1</td>
<td>5.3%</td>
</tr>
<tr>
<td>Fin Controller=</td>
<td>1</td>
<td>5.3%</td>
</tr>
<tr>
<td>Doc Asst=</td>
<td>1</td>
<td>5.3%</td>
</tr>
<tr>
<td>VP Sales=</td>
<td>1</td>
<td>5.3%</td>
</tr>
<tr>
<td>Experienced with VAT Requirements?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes=</td>
<td>6</td>
<td>33.4%</td>
</tr>
<tr>
<td>No=</td>
<td>12</td>
<td>66.6%</td>
</tr>
<tr>
<td>Researched VAT Issues Affecting Your or Your Company Situation?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes=</td>
<td>4</td>
<td>20.0%</td>
</tr>
<tr>
<td>No=</td>
<td>16</td>
<td>80.0%</td>
</tr>
</tbody>
</table>

* Variety of titles condensed to general type.
Should the VAT replace customs tariffs?

Of the total international firm respondents that completed one or more of the open-ended questions, 10 (56%) answered "no" and 4 (22%) answered "yes." Others did not respond to this particular question. A number of comments were also provided, including one respondent's view that the Government should be able to collect revenue on all value-added activities and not simply impose duties on those goods that are imported into the UAE. From a financial point of view, according to another subject, VAT would be better if the percentage was less than the tariff (which, as previously noted, is currently set at a rate of 5%). Another respondent commented that it would be preferable for a VAT to replace the current customs duty arrangements provided that such an action had no impact on commerce.

Will a VAT discourage foreign investment?

According to one respondent, if the rate of VAT was less than the current customs tariff, it would not discourage foreign investment. Another participant thought it would discourage foreign investment to a certain extent, although some commented that it may not have any impact on foreign investment. Of the total sample, 10 (56%) said that the VAT would discourage foreign investment, while 3 (17%) replied in the negative. Some respondents did not provide an answer to this particular question.
Will you conduct business elsewhere if a VAT is implemented?

When asked if they would conduct business elsewhere if a VAT was implemented, three (18%) representatives of international firms indicated that they would do so, and one indicated that it depended on the details of the new taxation arrangements - "only if the situation demands." Several respondents were not sure and 6 (32%) indicated that they would remain in the UAE regardless of whether a VAT was introduced or not. According to one international firm manager, while VAT was considered to be only one of many factors that would influence his company's decision-making process, it was still considered that its introduction would have a discouraging effect on foreign investment. Another replied that if a better opportunity or option arose elsewhere, they would consider it against the background of the alternative taxation arrangements.

Will a VAT discourage tourism?

The group was also divided on responses to this question. Some did not believe that VAT would negatively impact tourism, while others did. According to one manager, VAT would discourage tourism and while the tourism business may reduce to a certain percentage, its impact may be relatively minor. A total of 4 (21%) replied "yes" to this question, while 6 (32%) replied "no", but all stipulated that a nil effect would only occur under certain conditions. For example, "No, if there is a VAT return system," "No, if there is a VAT return in air ports," "No, if
tourism gets a refund as paid VAT" and "No it will not discourage if inflation decreased."

Should VAT differ for nationals and non-nationals?

An overwhelming majority of international firm respondents (90%) replied "no" when asked if there should be differences in VAT for nationals as compared to non-nationals. Only one respondent replied "yes" and another inferred a yes by saying that the introduction of VAT will have a direct impact on their business which employs a high proportion of non-nationals. This same theme runs through all population groups included in the present analysis - that is, that everyone should be treated equally and that no one group should be favoured above another.

Are you in favour or opposed to VAT? What is the reason for your support/opposition?

A total of 8 (42%) indicated their opposition to the VAT, with one stating that his opposition was based on the fact that there was signs of inflation and any additional tax could increase the effect on companies. Three (16%) participants were neutral and 4 (21%) supported the VAT. "In the end," commented an accountant, "VAT has to be paid by the public." One respondent stated that, "When VAT introduces, normally other taxes are being eliminated, so there is no need to oppose".
How would VAT impact your investment?

The view of four respondents was that the VAT may not affect the investment drastically or even to a great extent. Two respondents, however, disagreed with this on the basis that their investment would be impacted according to the percentage of the VAT. Three other respondents indicated that there would be no impact, but provided no further comment. The variety of responses leads this researcher to believe this population group is not really sure whether or not there will be an impact on their investment. In this regard, the administration manager of one group commented that, "It should be supporting if properly designed" and that perhaps is the best response to describe the way this sector perceives the relationship between VAT implementation and the potential impact it may have on their investment. “If properly designed” is the operative key condition in this assessment.

How would the introduction of VAT affect your company financially?

Because of the wide variety of responses to this question, this researcher found it best to summarise answers and present them in a list form, as follows:

- It will make the location less competitive
- It will increase the financials
- The business profit will be reduced as the price is increasing.
- This essentially depends on government policy – in the VAT has to be added in our product selling price
- Depends on government policy
- It will have a negative impact on product capability, volume of business.
- Will not affect my business financially - no impact (4 respondents made this comment)
- It will not affect the investment drastically
- Yes, costs will go up
- VAT would impact my investment by bringing up my purchasing/bargaining power due to reduced cash availability.

VAT Adoption for RAK and UAE as Perceived by Free Zone Firms

Demographics of the Sample

Of the 100 questionnaires that were sent to service firms and companies, there were 92 respondents, 82 of which fully completed the survey.

Free Zone firms represented the largest response group that was surveyed on its perception of VAT adoption for RAK and UAE. Table 7-5 on the following page provides demographic information on this particular set of respondents. Information includes job position, whether or not a UAE national, knowledge about VAT, experience with VAT requirements, and research of VAT issues that could affect their financial situation.

As indicated in Table 7-5, 92 of those surveyed participated in the survey, but only 82 completed the open-ended questions. It is also important to note that job
summaries have been condensed by grouping like-positions in order to reduce the number of entries listed in the table. While there were many different types of managers for example, all of which have been collapsed into the general category of ‘manager’ for the purposes of this exercise.

Similar to other populations that have been described in this analysis, Free Zone Firms were knowledgeable about VAT (yes = 54 or 59%), but lacked experience with VAT requirements (no = 66 or 73%). Also similar to others, more than half (n = 60 or 66%) had not researched VAT issues affecting themselves or their respective companies. Again, a profile of the average Free Zone firm respondent emerges from the demographic data. This person is a manager who is knowledgeable about VAT but lacks experience with VAT requirements, is not a UAE national and has not researched VAT issues affecting either himself or his company.

The survey of Free Zone firms and companies included the following eight open-ended questions:

1. Should Free Zone Companies remain exempt from taxes including the VAT?

2. If a VAT were imposed on free zone companies at a lower rate than most other countries, would it provide an incentive to foreign companies to pay in the UAE?

3. How would a VAT impact foreign investment?
4. Do you think UAE/RAK has or will have well trained tax administrators and the knowledge, infrastructure, and tax culture to control and collect VAT from all companies with the necessary transparency to prevent manipulation in both public and private sectors?

5. How is the introduction of a VAT likely to impact your plans to continue your present business strategy?

6. Should the VAT differ for nationals and non-nationals?

7. Are you in favour or opposed to VAT? What is the reason for your support/ opposition?

8. How would the introduction of VAT affect your company financially?

The following reflect the responses to these survey questions.
### Table 7-5: Demographics of Free Zone Firms

<table>
<thead>
<tr>
<th>Factor</th>
<th>No.</th>
<th>%</th>
<th>Factor</th>
<th>No.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>UAE National?</strong></td>
<td></td>
<td></td>
<td><strong>Knowledgeable about VAT?</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>2</td>
<td>4.4</td>
<td>Yes</td>
<td>54</td>
<td>58.7%</td>
</tr>
<tr>
<td>No</td>
<td>88</td>
<td>95.6</td>
<td>No</td>
<td>38</td>
<td>41.3%</td>
</tr>
<tr>
<td><strong>Job Positions</strong></td>
<td></td>
<td></td>
<td><strong>Experienced with VAT Requirements?</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managers</td>
<td>29</td>
<td>31.5%</td>
<td>Yes</td>
<td>25</td>
<td>27.5</td>
</tr>
<tr>
<td>Directors</td>
<td>17</td>
<td>18.5%</td>
<td>No</td>
<td>66</td>
<td>72.5</td>
</tr>
</tbody>
</table>
| Accountants                   | 6   | 6.5% | **Research VAT Issues Affecting You or Your Company Situation?**
| CEO-COO                       | 5   | 5.4% | Yes                           | 31  | 34.1% |
| P.R.O.                        | 5   | 5.4% | No                            | 60  | 65.9% |
| Production Planner            | 4   | 4.3% |                               |     |     |
| Owner                         | 4   | 4.3% |                               |     |     |
| Admin Personnel               | 3   | 3.3% |                               |     |     |
| Secretary                     | 2   | 2.2% |                               |     |     |
| Investor                      | 2   | 2.2% |                               |     |     |
| Coordinator                   | 2   | 2.2% |                               |     |     |
| Sales Admin                   | 1   | 1.1% |                               |     |     |
| Logistics Officer             | 1   | 1.1% |                               |     |     |
| Customs Work                  | 1   | 1.1% |                               |     |     |

* Variety of titles condensed to general type.

### Should Free Zone Companies remain exempt from taxes including the VAT?

Only four (4%) Free Zone company respondents indicated that they should not remain exempt from taxes including the VAT, while 74 (80%) thought that they should. The remaining respondents either had no comment or offered...
commentary related to the question which indicated that the details of the arrangements were paramount. One individual said, "It depends in most countries for which product it is imposed on and some products pay VAT, but ultimately claim it back from the relevant governments." One Director commented that "We as a Free Zone company joined and invested in the Free zone because it is Tax/VAT free." This was supported by another respondent who commented that one of the principal attractions with the UAE is the tax free threshold as well as the option of 100% foreign ownership within free zones.

If a VAT were imposed on free zone companies at a lower rate than most other countries, would it provide an incentive to foreign companies to pay in the UAE?

"No," according to 39 (42%) Free Zone Firm respondents. "Yes", according to 21 (23%) respondents. A total of seven participants commented, "maybe" and "not sure." One said it was debatable and that there were many of factors to consider, while another indicated that it would be difficult to survive commercial if such a tax was imposed on free zones. According to one respondent, the tax would not be considered in isolation, and investment decisions would need to be made on the basis of a range of factors including VAT, but also other taxes if applicable as well as rent, etc. One respondent commented that, “By definition Gulf countries attract foreign investments mainly due to the fact that there is no taxation”. Another respondent commented, "No. the reason for mutual success for many companies has been to set up without VAT in their minds". “A lower rate is
against the Free Zone laws”, commented another participant. “If it changes, then it is not a free zone anymore so therefore these companies cannot accept any kind of VAT”.

**How would a VAT impact foreign investment?**

The most commonly used one word response to this question was "negatively." Many respondents thought that a VAT would have a negative impact on foreign investment. One manager commented that if VAT was imposed, investors would prepare to stay in their own country to do business and to earn more profit. Other comments were as follows:

- More taxes always affect investment
- It will reduce the interest in investment and foreign companies will look elsewhere to locate and run business
- They will run away
- With the very tough market conditions continued increasing foreign investment will reduce
- It may affect tourism investment as compared to prevailing tax free status
- VAT will have a discouraging effect on foreign investment
- The attraction of tax free sales will be reduced
- VAT will definitely impact foreign investment as that will be an additional burden on the businesses which are severely affected in UAE now due to enormous competition and limited volumes of business
- Negatively - negative impact (noted 12 times in the commentary)
• VAT would make the business not competitive to survive in today’s market
• I think that the most important advantages for foreign investors is that no taxes are imposed at the free zone so I believe that it should remain as it is.

Do you think UAE/RAK has or will have well trained tax administrators and the knowledge, infrastructure, and tax culture to control and collect VAT from all companies with the necessary transparency to prevent manipulation in both public and private sectors?

Of the total sample, 26 (28%) said “yes” and 21 (23%) said “no”. Seven respondents were not sure. One respondent was quite candid in his negative response. He said," Definitely not. We currently see a lack of training with even customs or other administrative positions and would expect a VAT office to be no different." Another respondent warned that if the UAE government decides to impose VAT, then they will have to rely on foreigners for a good 5 - 10 years until UAE nationals understand the process in depth and are capable of taking care of the system by themselves. Several others support this view. One participant commented, "Most of the staff from the customs are new and need more training and work better together with the companies. They should make a meeting with companies to learn and see what international companies need".

One of the more pertinent comments was made by another manager who said, "If they hire experienced and well qualified personnel for this job then it will be easier to handle these issues. But this is not a right time to adopt taxes as the
market situation is very bad." It would seem that the majority of Free Zone respondents have a very negative opinion of the country's ability to hire and train tax administrators in the knowledge, infrastructure, and tax culture to control and collect VAT from all companies with the necessary transparency as well.

**How is the introduction of a VAT likely to impact your plans to continue your present business strategy?**

A significant number of respondents indicated that, in the event of the introduction of a VAT regime, they will rethink, review, and recalculate their plans to stay in the UAE and RAK tax free zones. Respondents agreed that they would move to another country, change their strategy, or may consider paying the same tax in their home country where laws and regulations are clear. In addition, several commented that they may choose to relocate to alternative tax free low cost areas such as Cyprus. A few respondents even said it would be unlikely that they could continue to stay in business, as it was considered that the extra cost of administration would be just another strain on their already very limited profits and the UAE and RAK should rethink plans to initiate what one respondent described as “this devastating VAT imposition”. At least ten firms would strongly consider closing part and even all of their facilities if such a plan is initiated.

The following are the answers that best express the sentiment of the respondents for this question:

- We would consider other countries for expansion and investment
• Tax will make it more equitable to do business on other country and less attractive to be in UAE

• Northern Emirates have already had to suffer paying an extra 5% duty importing raw materials into Jebel Ali. The introduction of VAT would make us look very seriously at our continuing operation in RAK.

Should the VAT differ for nationals and non-nationals?

A total of 50 (54%) of the sample population of Free Zone Firms believe that the VAT should not differ for nationals and non-nationals. Only 5 (5%) agree that they should differ. It is clear that the majority of respondents do not feel this would be equitable or fair. "No it should not," commented one respondent. "If it did it would send the wrong message as the non-national is having to support the national. This should not change regardless of a person's nationality. It is very different from personal tax issues." Another respondent, a planner, agreed. "How can non-nationals compete if nationals can buy and sell cheaper?" he commented. Others expressed a similar sentiment. "It should be equal for all," "there should be no difference," and "laws and regulations should be the same for all races, religions, and gender" were just three of the supportive comments.

Are you in favour or opposed to VAT? What is the reason for your support/opposition?

There was far more opposition to VAT as compared to being in favour of it. A total of 42 comments were received in opposition. This represented 46% of the Free Zone firm respondents. According to one CEO, "I oppose VAT because it
will not give us business opportunity in this country.” But another respondent said that they are not in opposition of VAT, they would simply like to see the VAT in an appropriate range. One participant indicated support for the proposed VAT, depending on the investment his parent company was willing to invest. Additional costs were the most cited reason for the opposition, followed by removing one of the attractions for expatriates being in the UAE. As one respondent pointed out, "expats form a large part of the working population of this country." Other reasons included the likely additional administrative burden to comply with regulatory requirements, fear of the system being introduced unfairly which may cause the balance of the economy to shift, benefits may vanish, and companies will have no incentive to be there at all. One of the most disgruntled comments was, "VAT is just another way to collect revenue in an already highly inflated market."

**How would the introduction of VAT affect your company financially?**

An interesting comment was submitted by one director and is worthy of note in a summary answer to this question. The participant writes:

“if costs become significant and no tax refund system is in place, it will make competitive edge to business less interest, less business, less employees and less cash in RAK business cycle. Our sales will decrease as we will increase our rates - would put an extra strain on the company in order to be competitive - the profit margin will have to decrease, so either
product price will go up or the work force will be decreased negatively - too much”.

According to the majority of respondents to this question, the introduction of VAT would have a negative effect on company finances by lowering cash flow and slowing growth prospects. Sales would be reduced and margins would shrink. Of interest is the fact that respondents considered that overheads would still remain the same, thereby affecting company finances. Some respondents commented that, in order to regain their financial position, companies would have to drop their business volume, go out of business, decrease their work force, increase their product cost, and/or pass new taxes onto their consumers. In taking any of these “drastic” measures, products will become more expensive, leading to the problem of customer resistance.

In summary the respondents indicated that introduction of VAT would affect all companies financially and in negative terms. In short, this would increase the high cost of operating in the UAE, which several respondents say are already higher than they need to be. The solution in the UK, according to one study subject, is that the company pays the tax, then claims it back if it is not a consumable product. If VAT were introduced in RAK in this way, the perception of its impact and effect may sharply change, and the only way in which companies would be affected would be to pay up front VAT before refunds were returned, which would in turn impact on cash flow.
Emerging Themes and Implementation Issues

It was surprising to this researcher how very similar responses were when public, corporation, service zones, free service firms, and international firm responses were compared to each other. Although the demographics differed, responses to open ended questions were very similar and generally quite negative when discussion came around to implementing a VAT. According to responses in every group except the general public, the overall effect of such implementation on investment in the Emirate of RAK is considered to be very negative. Some businesses indicated that they may pull out. Comments from respondents regarding the perceived impact of a VAT included the need to raise their prices, decrease their work force, drop their business volume, and/or pass the new tax directly on to their consumers. In taking any of these measures, it was generally regarded that products will become more expensive, profits will drop and there is likely to be a problem of customer resistance.

According to the majority of respondents in four of the five sample populations the introduction of a VAT would have a negative effect on company finances by lowering cash flow and slowing growth prospects. Sales would be reduced and margins would shrink. Nevertheless, overhead would still remain the same. In essence, the majority of the populations in the service firms, international firms, corporations, and free zone companies opposed the introduction of a new value added tax. They saw how it could negatively impact their financial situation and reported this on the survey.
The majority of the public, however, did not unanimously perceive the creation and implementation of a VAT tax as a necessarily negative directive. Rather, some perceived the tax as a viable way to improve infrastructure. However, because these individuals are not associated with a company or corporation, they are not necessarily concerned about the potential impact a VAT may have on a company's financial situation. Nor are they likely to be aware that initiating such a tax would possibly affect them indirectly in product cost increases.

A number of respondents believe that recent revenue losses in the oil sector could be offset with the introduction of a VAT with a uniform rate. They also agreed that the decline in customs collection in RAK may well be offset by VAT revenue. However, a clear message that has been received from all sectors is the need for more information. Indeed, a number of the comments are clearly made on an incorrect understanding of how a VAT system would generally operate. In this context it is apparent that it will be important for all sectors to be fully informed, and ideally included in consultations, as the new taxation arrangements are being developed.

Key issues that need to be resolved and communicated to RAK stakeholders include, but are not limited to:

- Proposed exclusions from the scheme. In particular, there was broad concern that the VAT may disadvantage low income earners, and consequently it will be necessary to clarify and communicate any
decisions regarding essential services that will be excluded from the tax arrangements;

- The way in which input credits may be claimed by service providers and producers should also be clarified and communicated. A general concern expressed within all business sectors was the likelihood that overheads would remain constant, while inputs to manufacture or service provision would increase under the new arrangements. The effect of offsetting tax on inputs is therefore an important point that needs to be communicated. In this regard, however, the potential impact of the arrangements on cash flow cannot be ignored. It will therefore be necessary to ensure that highly efficient and streamlined regulatory procedures are introduced in order to minimise the regulatory compliance impact on businesses;

- The concern about potential erosion of competitiveness in the Free Zones is of particular importance in terms of business confidence. Again, there is a need to settle the arrangements for such zones, including zero-rating of exports in a way that minimises any potential erosion of what is currently seen as a principal attraction of the UAE and RAK for business – that is, its status as a low tax jurisdiction;

- Other key decisions that need to be publicised as soon as possible include the Government’s intentions regarding other taxes, particularly customs duties and corporation tax;

- There appears to be little concern among any of the surveyed sectors about the need to tax both UAE nationals and non-nationals on an equal
basis. However, one issue that needs to be addressed in order to minimise the potential adverse impact on tourism is the availability of refunds for tourists, as well as clarification of international travel falling within the zero-rated category of ‘exports’;

- A clear message that was received through the survey was the concern expressed by firms and companies about their lack of confidence in the public sector, in the context of it being capable of effectively and efficiently administering the new scheme. Clearly there is a need for recruitment of personnel with the appropriate knowledge, skills and competencies to professionally carry out their duties. Similarly, there will be a need for the business sector to develop the knowledge, skills and competencies of its workforce in order to ensure compliance with the new arrangements; and

- Finally, the timing of any new arrangements is likely to prove critical, not only in terms of administrative capacity, but also in terms of stakeholder confidence. Stakeholders believe that the recent financial crisis that continues to impact the UAE and RAK will eventually improve. However, they are concerned that economic recovery may be negatively impacted by the poor timing of the introduction of a new taxation regime.

In terms of implementation, commercial entities will inevitably incur compliance costs, that is, time and expenses to comply with VAT regulations, including records, tax planning, report filing, tax collection and remittance (KPMG, 2008). In addition, firms will need to allocate time and resources to fully understand the new arrangements, including their rights and responsibilities as taxpayers. At the
same time, businesses will need to create or modify their IT system to address invoicing, record-keeping, and reporting regulations. While some sectors will need to address certain compliance risks, such as misclassification, exporters will also need to mitigate risk associated with inadequate documentation for zero rating during the early stages of implementation. This could result in the denial of refund of input VAT. Importing firms could also make errors on import declaration forms that result in delays in releasing goods at the border. As noted previously, forms and procedures need to be uniform throughout the Emirates for optimal results and to increase the degree of certainty and clarity for the private sector.

As noted by KPMG (2010), however, the private sector will need to take a number of proactive steps as it faces the likely introduction of a VAT. In this context he comments:

“For businesses preparing for the introduction of VAT, the primary focus in adapting to this morphing tax landscape should be on buffering against the risks while identifying opportunities to create value. Effectively dealing with indirect tax can boost the bottom line of a business by enhancing cash flow, reducing the amount of unrecovered VAT and cutting the costs of bureaucracy. Forward thinking businesses can become key influencers of a workable VAT system by influencing change in a coordinated fashion, analysing market impacts, future-proofing contracts for VAT changes and preparing for inevitable audits” (p. 13).
Implementation issues will also be faced by the Administration. VAT is a relatively complex system to administer, and relies on thorough auditing and enforcement. Evasion continues to be an issue in most VAT regimes. Rate differentiation and exemptions can result in distortions and add to the system’s complexity.

It is necessary to involve government agencies, businesses, and trade groups when transitioning to and implementing the VAT. However, for the sake of efficiency and simplicity it is preferable to have as few government agencies involved in the final administration of the VAT as possible. In actuality, it is seldom possible to create a separate VAT department because the tax will inevitably impact other areas of government and the economy (KPMG, 2008).

Finally, for the VAT to be effective it is necessary to have a plan to educate staff and taxpayers. This is especially important in the UAE because the Emirates do not have a taxpaying tradition. The implementation of a VAT in other nations indicates that considerable investment in training and education significantly reduces noncompliance by taxpayers and reduces the risk of mistakes by staff administering the levy (KPMG, 2008). In this regard, the IMF (2005) has also commented that, when considering the introduction of any new taxation arrangements, efforts should be made to strengthen the institutional capacity of tax administration.

Consequently, with regard to implementation, the following are seen to be the priority issues:
1. Government clarification of its taxation strategy, including key elements of the new arrangements such as rates, exemptions, zero-rating, impact on other taxes, and other high level matters;

2. Communication of the new arrangements to the public and business community, including consultation on issues of implementation wherever possible. This may include details of the proposed regulatory compliance program and the rights and responsibilities of taxpayers;

3. Establishment of a government authority with a well trained, professional workforce with the necessary knowledge, skills and competencies to effectively and efficiently administer the new arrangements; and

4. Development and delivery of public and industry information campaigns and education programs to ensure that taxpayers are fully aware of their rights and responsibilities, and the likely impact the tax will have on them.

The Research Questions

At this point, it is possible to answer the remainder of the research questions based on the analysis of the survey responses and research findings. In the previous chapter research questions 1, 2, 3 and 5 were addressed. Here, research questions 4 and 6 are addressed.

Research Question 4: What are the basic compliance requirements of a VAT regime, and how would such a regime impact business sectors in RAK?
Compliance requirements differ widely among VAT regimes and have been described in detail in earlier chapters as well as in the survey responses of the administrators in Australia, the UK, Germany, and South Africa. Uniform standards, effective requirements to file accounts to international standards, efficient auditing, and an effective IT system are all considered to be basic requirements for compliance management. However, the majority of respondents in each trade sector surveyed view the tax negatively. The research literature suggests that many firms find the requirements burdensome and costly to administer and pass the costs on to consumers. Non-compliance and fraud are also rampant when a system is perceived as unfair. In this context it is important to ensure that the scheme is widely understood, and that the associated regulatory requirements are simple, clear and predictable. At this point, the precise nature of the compliance requirements are not known, as this will emerge following the policy decisions yet to be made by the UAE Government, as discussed in the previous chapter. However, the basic regulatory compliance requirements will include the need to keep proper records, to make those records available for inspection by the administrators, to undertake tax planning, to report taxable transactions and related business activities to the government authorities, to collect and pay the VAT where required, and to remit tax collected to the Government.

While it will be important to ensure that the new regime provides a greater degree of efficiency than existing regimes, commentators find that improved efficiency accompanying the implementation of a VAT system is difficult to
assess directly. The conventional method is problematic because there are too
many errors associated with measurement. According to Ebrill et al. (2002), the
correct standard should be entire consumption, not GDP. Aizenman and Jinjarak
(2008) found the collection efficiency of a VAT is also dependent upon key
structural and political economy variables, and if there is political instability in the
region, tax efficiency is diminished because fewer resources are available for
enforcement. Also, the demographics of the country in which the VAT is
introduced will impact on the tax efficiency. However, ultimately the private
sector’s perception of the new tax arrangements will be based on their
experience in meeting the regulatory requirements. As such, it will be important
to minimise the regulatory burden on the various sectors by providing as efficient
a system as possible. The use of an effective IT system to manage the new
taxation arrangements at a national level will also provide the business sectors
with a more efficient method of meeting their tax obligations.

**Research Question 6: What will be the likely effect of implementing the
VAT on the public sector and the social economy of the Emirate of RAK?**

The tax is by its nature regressive and can have a negative effect on the poor
and disadvantaged. But this effect can be offset by exemptions, such as those
relating to basic necessities. The revenue sharing method can also ensure that
poorer regions receive needed money for social welfare and infrastructure
requirements even if VAT revenue is not as high from those areas as from
others.
Initially, establishing the infrastructure, building on present infrastructure, recruiting and training administrative personnel, developing and implementing auditing and IT functions will be costly and time consuming for the public sector/government. Educating the public, educating enterprises affected by the tax, and registering such enterprises will also be costly and time consuming. However, once all of this has been accomplished and well trained, professional administrators are in place, in is considered that the VAT regime will be capable of functioning quite efficiently as seen in many of the countries discussed in this research study.

**Summary and Conclusion**

Chapter 6 presented and analysed the data collected through of a total of five stakeholder groups that were sampled in the second part of the analysis for their views on VAT adoption for RAK and UAE. These groups included the Public, Corporations, Service Firms, International Firms, and Free Zone Firms. For each of these groups, the demographics of the sample were described in table and text form and answers to survey questions dealing specifically with each of the respective groups were presented and analysed. The two remaining research questions were also addressed, which related to the basic compliance requirements of a VAT regime and how such a regime may impact business sectors in RAK, and the likely effect of implementing the VAT on the public sector and the social economy of the Emirate of RAK.
A key conclusion reached is the need to carefully address issues of implementation, with a number of areas being identified as a priority in this regard. These include the need for the Government to clarify its taxation strategy, including key elements of the new arrangements and the need to communicate the new arrangements to the public and business community. Other identified priority areas include the need to establish a government authority with a well trained, professional workforce to administer the new arrangements and the development and delivery of public and industry information campaigns and education programs to ensure that taxpayers are fully aware of their rights and responsibilities.

Chapter 8 concludes this study with a discussion of conclusions and recommendations based on the findings of the research.
CHAPTER 8: CONCLUSIONS

The aim of this study is to identify the likely impact of the proposed VAT arrangements on the UAE as a whole, and, Ras Al Khaimah Emirate specifically. To accomplish this objective, the researcher analysed both qualitative and quantitative data and evaluated the potential economic impact of a VAT regime on the public and private sector of the Federation. The direct and indirect effects of implementing the proposed VAT scheme on RAK were examined. The validity and viability of the proposed VAT scheme, including the associated revenue sharing arrangements, and the potential it holds for the future financial landscape of RAK was assessed. To understand these potentialities, the issues surrounding the implementation of VAT regimes in other economies were examined. Finally, the most appropriate VAT policy options for RAK in the context of a federal (UAE) revenue sharing system were identified.

Of the four countries with a VAT that were studied in detail, the most successful model was Australia where the federally administered VAT was designed to provide the states with a continuing source of revenue (Searle, 2010). This approach is considered to be particularly pertinent to the adoption of a VAT in the UAE, which is also seeking to establish an alternative long term, sustainable and predictable source of revenue rather than continue to rely on oil and gas. In response to issues of Vertical Financial Integration (VFI), Australia has developed a system of taxation that tries to obtain the greatest degree of horizontal fiscal equalization (HFE) of any democratic federation (McLean, 2002,
2004). This approach creates an ideal model for fair treatment of all states in a federation regardless of unequal own revenue or lack of natural resources, etc. In addition, Australia’s closed system enables HFE without altering general public sector outcomes (Searle, 2007). The use of a nonpartisan agency of administration is also a benefit of the Australian system. In addition, unlike other nations with a VAT, in Australia all activities of public and non-profit organizations are subject to the levy, resulting in simplicity and less economic distortion (Gendron, 2005). Finally, the VAT is extremely successful in raising tax revenues (Dollery, 2010), as it is in the other nations as well.

However, the Australian system has a number of complications that might make it difficult to implement in the UAE and/or RAK. As a result, the New Zealand VAT scheme probably offers a better model for the UAE and especially RAK because of its simplicity. When the rules and policy are simpler, implementation is easier and compliance is greater. Having two rates (exempt and non-exempt) is significantly easier to implement than a regular rate, 5% reduced rate, exempt policy, and zero-based rate. Indeed, the simpler the system, the more efficient and viable it will be for the Emirates.

According to Emirates News (2012), the UAE currently has one of the fastest growing economies in the world. The Ministry of Finance and Industry reported that the nominal GDP rose by 20.8% in 2012 to $360 billion, compared with $298 billion in 2011. Consequently, a VAT scheme is likely to provide the UAE and RAK with a substantial revenue base (see Figure 8-1).
Based on the findings of the study, the researcher has been able to address the six research questions, as follows.

**What economic and political policies should support the principles of implementing a VAT regime?**

It is evident from the research findings that a number of key economic and political policies need to be developed and agreed to by all members of the UAE regarding VAT type, applicable rates, exemptions, zero-rating, central or local administration, methods of collection, treatment of other taxes, financing of administration and collection, and, perhaps most importantly, revenue sharing. Introducing a relatively complex tax such as the VAT to a federation with little or
no experience with a modern system of taxation could encompass a major change in administrative processes (Deloitte, 2008) and raise new political issues regarding revenue sharing. However, in terms of administration, the current structure that has been established to administer customs tariffs and collect various fees should serve as a base upon which to build new structural arrangements.

**What are the potential advantages and disadvantages of adopting a VAT regime for RAK?**

In essence, the basic advantage for RAK is an opportunity to move away from its current reliance on revenue from customs tariffs and other fees and charges, by providing both the UAE and RAK with a long term, sustainable and predictable broad-based source of tax revenue. The disadvantages include risks of unfair taxation of the poor and disadvantaged since the VAT is generally regarded as a regressive tax, excessive administrative burdens on the government and on businesses, loss of business and investment, inflation, and fraud. Implementing an efficient structure with trained personnel and education of the public and commercial entities will be costly and time consuming. On the other hand, if implemented judiciously and in phases, it is considered that the new taxation regime can be understood and accepted by the public and commercial entities and professionally administered by the authorities, raising needed revenue effectively and efficiently.
What VAT models around the globe have been successfully implemented in selected countries?

Based on the findings of the current research, it is considered that Australia and New Zealand have both implemented efficient models. New Zealand is favoured due to its simplicity and perceived fairness. It consists of a single rate that is applied uniformly to most goods and services, it has very few exceptions and a zero rating for exports. In this regard, requirements are simple and clear and administration and compliance is less costly.

What are the basic compliance requirements of a VAT regime, and how would such a regime impact business sectors in RAK?

Compliance requirements differ widely among VAT regimes and have been described in detail in this study. Uniform standards, effective requirements to file accounts to international standards, efficient auditing, and an effective IT system are all considered to be basic requirements for compliance management. However, the majority of respondents in each trade sector surveyed view the tax negatively. The research literature suggests that many firms find the requirements burdensome and costly to administer and pass the costs on to consumers. Non-compliance and fraud are also rampant when a system is perceived as unfair. In this context it is important to ensure that the scheme is widely understood, and that the associated regulatory requirements are simple, clear and predictable.
At this point, the precise nature of the compliance requirements are not known, as this will emerge following the policy decisions yet to be made by the UAE Government, as discussed in the previous chapter. However, the basic regulatory compliance requirements will include the need to keep proper records, to make those records available for inspection by the administrators, to undertake tax planning, to report taxable transactions and related business activities to the government authorities, to collect and pay the VAT where required, and to remit tax collected to the Government.

Ultimately, the private sector’s perception of the new tax arrangements will be based on their experience in meeting the regulatory requirements. As such, it will be important to minimise the regulatory burden on the various sectors by providing as efficient a system as possible. The use of an effective IT system to manage the new taxation arrangements at a national level will also provide the business sectors with a more efficient method of meeting their tax obligations.

What is the optimal revenue-sharing method for RAK?

The following options are proposed based on the research findings:

**Option 1:** All VAT revenue to remain in the Federal Government account, to be earmarked for expenditure on national infrastructure and other Federal Government expenses that would benefit all the Emirates;
**Option 2**: 30 per cent of the tax revenue to remain in the Federal Government account, with the remaining 70% to be shared among the Emirates according to an agreed formula; and

**Option 3**: The tax revenue is to be shared as per the percentage of the Emirate representation in the federal parliament, which reflects size of the Emirate in terms of population count.

The preferred option is Option 2, which will not only provide the Federal Government with its own discretionary funding, but also provide the Emirates with their individual budgetary requirements. For RAK, a fair and clear system of revenue sharing is extremely important and a system which properly recognises the geographic location where the revenue is generated is considered to be the most practical. In this context, the research findings indicate that one aspect of the revenue sharing models that is likely to prove critical to the effective operation of a VAT system is the way in which the revenue distribution formula is constructed and agreed.

**What will be the likely effect of implementing the VAT on the public sector and the social economy of the Emirate of RAK?**

The VAT is by its nature regressive and can have a negative effect on the poor and disadvantaged. However, it is proposed that this effect be offset by exemptions, such as those relating to basic necessities. The revenue sharing method can also ensure that poorer regions receive needed money for social
welfare and infrastructure requirements even if VAT revenue is not as high from those areas as from others.

Initially, establishing the infrastructure, building on present infrastructure, recruiting and training administrative personnel, developing and implementing auditing and IT functions will be costly and time consuming for the public sector/government. Educating the public, educating enterprises affected by the tax, and registering such enterprises will also be costly and time consuming. However, once all of this has been accomplished and well trained, professional administrators are in place, it is considered that the VAT regime will be capable of functioning quite efficiently as seen in many of the countries discussed in this research study.

A key issue to address to ensure effective implementation is the hiring and training of knowledgeable personnel to administer the program. Without experienced and knowledgeable personnel, the system will quickly fail or be subjected to high levels of fraud. Moreover, adequate infrastructure, auditing at international standards and state of the art IT functions will be necessary. Finally, educating the public, educating enterprises affected by the tax, and registering such enterprises is critical.

With regard to implementation of the new taxation arrangements, the research has identified a number of priority issues. First, there is need for Government clarification of its taxation strategy, including key elements of the new arrangements such as rates, exemptions, zero-rating, impact on other taxes, and
other high level matters. Second, communication of the new arrangements to the public and business community, including consultation on issues of implementation wherever possible is of particular importance. This may include details of the proposed regulatory compliance program and the rights and responsibilities of taxpayers. Third, it will be necessary to establish a government authority with a well-trained, professional workforce with the necessary knowledge, skills and competencies to effectively and efficiently administer the new arrangements. Finally, there is a need to develop and deliver public and industry information campaigns and education programs to ensure that taxpayers are fully aware of their rights and responsibilities, and the likely impact the tax will have on them.

Initially, the above steps to implementation will be costly and time consuming. Enforcing compliance, preventing fraud and tax avoidance will also prove to be costly. However, these are seen as necessary steps, as the research indicates that substantial portions of corporations, service firms, international firms, and Free Zone firms are likely to react negatively to the new tax, although a larger sample size may be necessary to adequately represent some of these groups. Regardless, gradual implementation is considered to be necessary in order to educate and obtain compliance from these groups. Initially, some foreign investment might be lost. But experience in Australia and New Zealand as well as other countries suggest that eventually the public and enterprises become accustomed to the tax and compliance quickly reaches satisfactory levels, recognizing of course that fraud remains significant in many nations.
APPENDICES

APPENDIX A: INTERVIEWS OF VAT ADMINISTRATORS

4 Country Interviews about VAT and Revenue Sharing Systems
(Germany, UK, Australia, South Africa)

Revenue Sharing, the VAT System and Ways it Impacts Your Country

Interviews were based on the following broad questions.

1. How is revenue shared within your country?
2. What are the problems facing revenue sharing in your country?
3. What are the ways used in your country for taxing and refund?
4. What items are taxed in your country and which are exempted?
5. What is the process of refund?
6. In your country, are there any restrictions on the states (countries, districts) on how to use the tax money?
7. In your country, is there any percentage for the federal government?
8. From your experience, what would you recommended for the best sharing system?
9. Do your support your country's revenue sharing or VAT system? Yes No
   If no, why not?
10. Does your revenue sharing system unfairly impact low-income individuals, increasing unequal distribution of incomes and expenses?
11. Should exemptions or zero-rating be provided for necessities, such as food, education, and healthcare, as is done in other countries with VATs?
12. Does a VAT system discourage foreign investment and tourism?
13. In your revenue sharing system, should certain services be exempted, such as independent contractors of business services, financial services and/or medical services?
APPENDIX B: SURVEY OF THE PUBLIC

Section 1: Demographic and General Information

1. My job position is (please identify): _____________________________

2. Gender (circle one): Male Female

3. Current Age (circle one): 21-29 30-39 40-49 50-59 60+

4. Are you a UAE national? Yes No

5. Are you knowledgeable about Value Added Tax (VAT)? Yes No

6. Have you had experience with VAT requirements? Yes No

7. Have you researched VAT issues that could affect your financial situation? Yes No

Section 2: Questions Regarding the Impact of Adopting a VAT in RAK and UAE

1. Do you support or oppose the introduction of a Value Added Tax (VAT) in Ras-Al-Khaimah (RAK) and the UAE? What is the reason for your support/opposition?

2. Do you think that the VAT will unfairly impact low-income individuals?

3. Should exemptions or zero-rating be provided for necessities, such as food, education, and healthcare, as is done in other countries with VATs?

4. Do you think that the decline in customs collection in RAK is likely to be offset by the revenue from the VAT?

5. Do you think that a VAT will impact Emirates unequally – e.g. those that are not major petroleum producers, like RAK?

THANK YOU FOR YOUR COOPERATION
APPENDIX C: SURVEY OF FREE ZONE FIRMS

Section 1: Demographic and General Information

1. My job position is (please identify):

2. Are you a UAE national?    Yes    No

3. Is your company knowledgeable about Value Added Tax (VAT) requirements in the country/countries in which you do business?
   Yes    No

4. Has your company had experience with VAT requirements?
   Yes    No

5. Has your company researched VAT issues that could affect an individual or a company's financial situation or operations?
   Yes    No

Section 2: Questions Regarding the Impact of Adopting a VAT in RAK and UAE

1. Should free zone companies remain exempt from taxes, including the VAT?

2. If a VAT were imposed on free zone companies at a lower rate than most other countries, would it provide an incentive to foreign companies to pay in the UAE?

3. How would a VAT impact foreign investment?

4. Do you think the UAE/RAK has or will have well trained tax administrators and the knowledge, infrastructure, and tax culture to control and collect VAT from all companies with the necessary transparency to prevent manipulation in both public and private sectors?

5. How is the introduction of a VAT likely to impact your plans to continue your present business strategy?

THANK YOU FOR YOUR COOPERATION
APPENDIX D: SURVEY OF CORPORATIONS

Section 1: Demographic and General Information

1. My job position is (please identify):

2. Are you a UAE national?  Yes  No

3. Is your company knowledgeable about Value Added Tax (VAT) requirements in the country/countries in which you do business?
   Yes  No

4. Has your company had experience with VAT requirements?
   Yes  No

5. Has your company researched VAT issues that could affect an individual or a company’s financial situation or operations?
   Yes  No

Section 2: Questions Regarding the Impact of Adopting a VAT in RAK and UAE

1. How would the introduction of a VAT affect your company financially?

2. Would the compliance burden be relatively hard or easy for your corporation?

3. Would a VAT hinder economic recovery?

4. Should the UAE retain its current corporate tax rate? Should the same be true for RAK?

5. Do you support or oppose the introduction of a VAT? What is the reason for your support/opposition?

THANK YOU FOR YOUR COOPERATION
APPENDIX E: SURVEY OF INTERNATIONAL FIRMS

Section 1: Demographic and General Information

1. My job position is (please identify):

2. Are you a UAE national?  Yes  No

3. Is your company knowledgeable about Value Added Tax (VAT) requirements in the country/countries in which you do business?
   Yes  No

4. Has your company had experience with VAT requirements?
   Yes  No

5. Has your company researched VAT issues that could affect an individual or a company’s financial situation or operations?
   Yes  No

Section 2: Questions Regarding the Impact of Adopting a VAT in RAK and UAE

1. Should the VAT replace customs tariffs?

2. Will a VAT discourage foreign investment?

3. Will you conduct business elsewhere if a VAT is implemented?

4. Will a VAT discourage tourism?

5. Should the VAT differ for nationals and non-nationals?

THANK YOU FOR YOUR COOPERATION
APPENDIX F: SURVEY OF SERVICE FIRMS

Section 1: Demographic and General Information

1. My job position is (please identify):

2. Gender (circle one): Male Female

3. Current Age (circle one): 21-29 30-39 40-49 50-59 60+

4. Are you a UAE national? Yes No

5. Are you knowledgeable about VAT needs and requirements in the country in which you do business?
   Yes No

6. Have you as a public citizen or your company had experience with Value Added Tax (VAT) requirements?
   Yes No

7. Have you as a public citizen or your company researched VAT issues that could affect an individual or a company’s financial situation or operations?
   Yes No

Section 2: Questions Regarding the Impact of Adopting a VAT in RAK and UAE

1. How would a 5 per cent VAT impact your service company?

2. Would sales and profits be negatively impacted?

3. Should certain services be exempted, such as independent contractors of business services, financial services and/or medical services?

4. Are you in favor of or opposed to a VAT? What is the reason for your support/opposition?

5. Will the VAT enable the UAE to diversify away from its reliance on oil?

THANK YOU FOR YOUR COOPERATION
APPENDIX G: COVERING LETTER FOR RAK SURVEYS

Dear Sir/Madam

May I please introduce myself, I am Mohammed Al Mehrez Director General (DG) of the Ras Al Khaimah Customs department and I am currently studying for a PHD in Government Management.

I am writing to you as a PHD student and not in my official capacity as DG of the Customs department. My studies must include the presentation of a Thesis on a customs related topic which in my case is, the “Effect of the introduction of Value Added Tax (VAT) in Ras Al Khaimah and the UAE”. I wish to be clear with you that my research is an academic case study, and I am only evaluating the theory of the topic. The information I am requesting for my questionnaire is no way represents a policy of either the governments of UAE, or Ras Al Khaimah.

To assist me with my Thesis, I would very much like to compile views, opinions and feedback from local companies (Free Zone, Industrial, Local Market) and the public on the potential positive and negative impact on business’s and general economic trading within the UAE, of this theoretical proposition. For this purpose I enclose a questionnaire/survey which I respectfully request you kindly consider completing and return back to me, for my analysis and incorporation within my final submission to the university.

Thank you for taking the time to consider my request and I look forward to receiving your reply.

Yours faithfully
APPENDIX H: AUSTRALIAN COMPLIANCE CASE STUDY

ATO: Cash Economy Project Evaluation with Specific Reference to Impacts on VAT/ GST Revenue and Compliance

This case study outlines the ATO’s risk treatment strategy for its cash economy project presented against the background of its formal four phase risk treatment evaluation methodology:

Phase 1: Articulation of the compliance risks involved

1) What is the compliance risk to be addressed?

The ATO adopts a compliance approach that changes behaviour, ensures that voluntary compliance is sustained, and which is recognised by the community as a credible response to non-compliance. For this project, the key risks were identified as:

- Continued community acceptance of participation in the cash economy encourages non-compliant behaviour;
- The community may perceive the ATO as unable to detect and respond to non-compliance in the cash economy;
- Visible non-compliance will erode the integrity of the tax system.

2) Who’s involved? What are the behaviours and drivers associated with the risk?

The primary form of non-compliance is failure to declare cash income. Registered participants may also fail to file returns or file on time, fail to accurately report transactions and may not pay on time. Often cash economy participants are poor record-keepers. They may also be non-compliant with other regulatory obligations.

This behaviour often results from a desire to minimise tax obligations coupled with a perception that there is only a small chance that non-compliance will be detected. Behaviour may be driven by low margins and the need to remain competitive. It is often evident in transactions between businesses and consumers, as consumers seek price discounts. In some instances business operators do not fully understand their tax obligations and may perceive the system to be too difficult or costly to comply with. They are often more focused on the operating side of their business.

Consumers may demand discounts for cash payments and make no connection with tax compliance considerations as they have no obligations in this situation. They may perceive little risk for themselves other than having no evidence of payment if the goods or services are not of an expected standard. Many people are also prepared to pay cash for priority access to tradespersons in periods of high demand.

Behaviour is often driven by the perception that everyone benefits from the cash economy and by a failure to recognise the broader impacts in terms of the Government’s ability to provide a proper level of services to the Australian community.

The community is often reluctant to report cash economy participants and may accept such participation to a point. However, the community does not accept blatant non-compliance or
conspicuously-wealthy lifestyles funded by undeclared cash. Nor does it accept under-reporting of income in order to receive social security benefits or avoid child support payments.

**Phase 2: Definition of the outcomes sought and the strategies to achieve them**

The outcomes identified as being sought from this initiative were as follows:

- The ATO demonstrates its ability to detect and respond to the cash economy;
- Voluntary compliance by participating taxpayers is sustained;
- Appropriate community education reduces tolerance of participation in the cash economy;
- The community maintains its confidence in the integrity and fairness of the tax system.

An integrated package of strategies was developed, including the following elements:

- **Enforcement:** Identifying those who present a higher level of risk, by making increased use of the ATO’s ability to cross-match third party and other data to identify likely non-compliance. A differentiated approach that escalated depending on the taxpayer’s attitude to non-compliance was adopted and the strategies deployed ranged from letter campaigns suggesting voluntary disclosure, reviews, desk-based and comprehensive audits, administrative penalties and prosecution referrals.

- **Influence and leverage:** Entailed initiating less costly and leveraged activities that over time should encourage greater voluntary disclosure from participants large in number but relatively low in terms of revenue.

- **Communication:** Use of a variety of channels to educate and inform the community on: 1) the ATO’s ability to detect and respond to non-compliance; 2) the assistance it provides; 3) its collaboration with representatives of high risk industries and the tax profession (e.g. using joint press releases); 4) inherent risks posed to consumers by cash jobs; and 5) the cost to the community of non-compliance.

- **Education:** Entailed a range of educational activities including letters, calculators, industry benchmarks, seminars and advisory visits, used either individually or as part of the ATO’s Small Business Assistance Program.

- **Engagement:** Engaged of key stakeholders, including tax profession and industry representatives by working collaboratively to improve the ATO’s understanding of the cash economy, developing industry benchmarks and related assistance products, and co-designing appropriate responses and building on going working relationships.

**Phase 3: Design of indicators (to gauge effectiveness of the risk treatment strategy)**

1) **What indicators will we use?**

A broad range of indicators were identified to gauge the effectiveness of the risk treatment strategy:

1) changes to indicators of tax performance at the individual and industry level;

2) changes to rates of filing performance for business activity statements;

3) payment of outstanding liabilities by participants in the cash economy;

4) trend in the number of reports received on the tax evasion hotline;
5) responses to various perceptions surveys involving key stakeholders;
6) frequency and tone of media comment relating to the cash economy;
7) levels of industry —engagement in the management of the cash economy; and
8) levels of compliance by cash economy participants with other obligations (e.g. welfare).

Phase 4: Determining the extent of improved effectiveness achieved

1) Have we been effective in achieving our desired outcomes? How do we know?

Focussed attention to assessing the impacts of the strategy revealed indications of increased voluntary compliance, demonstrated through reporting of cash transactions, return filing and payment obligations by those operating in the cash economy. Specifically:

- **Return filing:** Success is evident from an increase in the number of activity statements overall and filed on time. On time filing of quarterly activity statements increased by 12% after the ATO data matched information from shopping centre operators.

- **Correct reporting:** Success is evident from increases from increases in the trend, relative to other industries, of amounts reported by those in the targeted industries. Observations of the restaurant and café industries and the building industry (sub-trades) showed:
  - Increased GST (VAT) reported for businesses audited in 2006-7. While the year’s average for quarterly GST liabilities for all industries increased by 9.5% and 9.7% in the June and September quarters respectively, taxpayers subject to intervention recorded up to a 60% increase in average net GST (VAT) in the June quarter.
  - Average net GST (VAT) in the June 2007 quarter increased by 25% by taxpayers found to be compliant as a result of the ATO’s interventions, suggesting that its audit activities had some indirect effect by increased the GST reported, even by taxpayers found to be compliant.

- **Community tolerance:** Community reports concerning alleged cash economy activity to the ATO’s tax evasion hotline increased by 74.2% in 2007-08, over the number in 2005-06, reflecting declining community tolerance of cash economy activity.

- **Community confidence and engagement:** Evidence of increasing confidence and engagement from community sectors (e.g. positive coverage of ATO’s activities in professional media, improved business perceptions survey results, and increased collaboration with trade associations).

2) Where to from here?

Building on these outcomes and the experience gained, activities for 2008-09 will see development of the help and education activities that provide opportunities for self-correction and voluntary disclosure. However, the importance of maintaining a visible audit presence will remain and the emphasis on improved risk detection will be aided by further expansion of data matching capabilities, with some attention given to identifying situations of conspicuous consumption that are not matched by taxpayers’ reported incomes.

Measuring the key elements of our response over the longer term will give us a better indication of whether changes in compliance behaviour have been sustained. Intelligence from the ongoing
evaluation will help shape our strategies. For example, we expect to see an increase in the number of reports of tax evasion to our hotline as community gains confidence in how we use this information, our systems will monitor and record the volume and nature of accesses to specific website products, and there will be an expansion of data matching, providing us with better risk detection tools, especially in relation to taxpayers whose lifestyle appears out of step with their reported incomes.

APPENDIX I: UK VAT TAX GAP METHODOLOGY

HMRC’s VAT Tax Gap Methodology

Estimating VAT Losses
This estimate of losses from the VAT system excludes losses through illicit activity in spirits and tobacco goods, as these are covered by the HMRC’s published excise duty gaps.

Methodology
1) The methodology for calculating the VAT gap was first published in November 2002.

Principle
2) The total level of VAT losses can be estimated using a top-down approach by comparing the net theoretical tax liabilities with actual VAT receipts. The difference between these amounts is known as the VAT gap.

\[
\text{VAT gap} = \text{Net Theoretical Tax Liabilities} - \text{Actual VAT Receipts}
\]

3) The approach employs a gap analysis (as at 2.1 above), which involves:
   • assessing the total amount of expenditure in the economy that is theoretically liable for VAT;
   • estimating the tax liability on that expenditure based on commodity breakdowns of the expenditure data;
   • estimating the value of tax on the VAT-able expenditure, to derive the gross VTTL;
   • subtracting any legitimate refunds (deductions), occurring through schemes and reliefs, to arrive at the net VTTL;
   • subtracting actual VAT receipts from the net VTTL; and
   • assuming that the residual element, the gap, is the total VAT loss due to any cause.

General Calculation Methodology
4) VTTL is the theoretical amount of VAT that would be collected in the absence of any losses. It is calculated by multiplying appropriate categories of expenditure liable to VAT in the economy by their VAT rate and allowing for other relevant rules determining tax liability.

5) The expenditure series used in the calculation are mainly constituents of National Accounts macroeconomic aggregates. All National Accounts data used to construct VTTL estimates are consistent with the latest Office for National Statistics (ONS) Blue Book.

6) A number of streams of expenditure contribute to the tax base, with most VAT deriving from consumers’ expenditure. The main expenditure categories that comprehensively cover VAT liabilities are:
   • household spending and non-profit institutions serving households’ final consumption expenditure;
   • central government current and capital expenditure;
   • exempt sector intermediate consumption and other input tax blocks; and
   • Developments in VAT Compliance Management in Selected Countries
   • housing expenditures - certain household and corporate capital expenditure which incurs non-refundable VAT.
**Input Tax Adjustments**

7) Net VAT liability is the difference between VAT due on taxable supplies made by registrable traders (‘output tax’), and that recoverable by traders on supplies made to them (‘input tax’).

8) VAT liability for the relevant categories can be estimated directly from National Accounts data, with one exception - the exempt sector. Businesses making outputs that are exempt from VAT are generally not permitted to reclaim the VAT on inputs associated with their exempt outputs. In order to make an adjustment for this irrecoverable input tax, a separate HMRC survey is used to ascertain the proportion of purchases on which VAT cannot be reclaimed.

9) A further adjustment is made for expenditure by businesses legitimately not registered for VAT and, as such, the VAT is not recoverable as input tax. This adjustment uses a combination of ONS data and HMRC information on the distribution of business turnover below the VAT threshold to estimate relevant expenditure.

10) Finally, third party data sources are used in conjunction with National Accounts data to inform estimates of business expenditure on cars and entertainment, on which VAT is due.

11) Because the calculation of non-recoverable input tax is complex, the level of uncertainty around input tax adjustments is larger than for the other elements.

**Deductions**

12) The sum of the VAT liability arising from each of the expenditure categories listed in paragraph 6 gives an estimate of the gross VTTL in each year. However, there are a number of legitimate reasons why part of this theoretical VAT is not actually collected. These can be grouped into two broad categories:

- VAT refunds; and
- expenditure at traders legitimately not registered for VAT.

13) VAT refunds are made primarily to government departments, NHS Trusts and regional health authorities for specified contracted out services acquired for non-business purposes. A number of other categories of expenditure cannot be separately identified in the overall VTTL calculation, for which VAT can be refunded. The value of these refunds is taken directly from audited HMRC accounts data.

14) Traders who trade below the VAT threshold can legitimately exclude VAT on their sales. Expenditure on the output of these businesses will have been picked up in the theoretical liability. To adjust for this an estimate of relevant expenditure is made using a combination of ONS data and HMRC information on the distribution of business turnover below the VAT threshold.

**Methodology Changes**

15) The detailed calculations used to construct the estimated VTTL are continuously reviewed to identify improvements to the methodology.

16) The proportion of household expenditure on ex-business cars in second-hand car sales is now taken directly from data used to estimate the amount of input tax blocked on expenditure.
on cars by businesses, which is derived from ONS National Accounts data. This replaces an adjustment previously taken from the Own Resources Account, prepared by HMRC for the Developments in VAT Compliance Management in Selected Countries European Commission. This change ensures consistency in the data being used throughout the VTTL calculations.

17) The VTTL is now adjusted to reflect refunds of VAT made to the Isle of Man, under their agreement with the UK authorities to simplify tax collection procedures for businesses.

**Summary of VTTL**

18) Estimates of the contribution to the VTTL of each relevant expenditure component are given in Table 1. Note that the household element excludes expenditure on purchases of illicit alcohol and tobacco. The revenue losses associated with such purchases are considered in the excise illicit market share estimates and to measure them here would constitute double counting.

Table 1: Expenditure components of VTTL (£bn)

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<tr>
<td>Household</td>
<td>56.6</td>
<td>59.4</td>
<td>62.4</td>
<td>64.5</td>
<td>66.9</td>
<td>69.9</td>
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<tr>
<td>Exempt</td>
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<td>12.7</td>
<td>12.8</td>
<td>13.8</td>
<td>14.5</td>
<td>15.4</td>
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<td>Housing</td>
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<td>4.0</td>
<td>4.1</td>
<td>4.3</td>
<td>4.7</td>
</tr>
<tr>
<td>Gross VTTL</td>
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<td>84.3</td>
<td>88.4</td>
<td>92.5</td>
<td>96.6</td>
<td>101.4</td>
</tr>
<tr>
<td>Deductions</td>
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<td>6.0</td>
<td>6.5</td>
<td>7.1</td>
<td>7.6</td>
<td>8.8</td>
</tr>
<tr>
<td>Net VTTL</td>
<td>75.2</td>
<td>78.3</td>
<td>81.9</td>
<td>85.4</td>
<td>89.0</td>
<td>92.6</td>
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APPENDIX J: UAE CUSTOMS REVENUE DISTRIBUTION

The United Arab Emirates Study Paper On Distribution Mechanism of Customs Revenue Within The GCC Customs Union

CONTENTS

1. Introduction

2. Alternatives put forth by the GCC countries.
   2.1 First Alternative: Collecting 100% of the customs revenue for a common fund.
   2.2 Second Alternative: Collecting 95% of the customs revenue for the first point of entry, and depositing 5% for the common fund.
   2.3 The Mechanism of Final Destination and developing it.

3. Observations and proposals by the United Arab Emirates.

1. INTRODUCTION

- With reference to the Supreme Council's resolution on its 32nd session (December, 2011 – Riyadh) concerning the establishment of an authority for the GCC Customs Union due to commence on 1st June 2012, and authorising The Committee of Financial and Economic Cooperation to approve its internal statutory.

- The tasks of the Authority incorporated the completion of studying the distribution mechanism of customs revenue, including the continuation of Final Destination mechanism, or distribution of 100% customs revenue. The proportions are to be agreed according to the net physical imports standard which will be calculated according to a moving average of a three-year period. The moving average is to be annually revised by omitting one year and adding another.

- By the virtue of the Supreme Council's resolution, and pursuant to the discussions conducted at the first meeting of the team which was formed by the Customs Union Authority to consider the distribution mechanism of customs revenue, the UAE has prepared this study to evaluate the raised alternatives and
to compare the positives and negatives related to each of such mechanisms. The study also aimed at reaching an agreement about the mechanism and guiding the work of the assigned team to set and finalise the required detailed procedures by the Committee of Financial and Economic Cooperation within the allocated period.

2. ALTERNATIVES PUT FORTH BY THE GCC COUNTRIES

- Pursuant to the studies prepared by the General Secretariat and consultants in addition to proposals by the GCC countries, the following alternatives were discussed by the committees of the GCC Customs Union:
  
  1- Collecting 100% of the customs revenue for a common fund and distributing it amongst the GCC countries in accordance with the agreed distribution proportions according to the net physical imports standard which will be calculated according to a moving average of a three-year period and which will be annually revised by omitting one year and adding another.

  2- Collecting 95% for the First Point of Entry and depositing 5% for the common fund which will be distributed according to the agreed proportions.

  3- Retaining and developing the Final Destination mechanism in order to facilitate commodities movement without customs obstructions.

- The following provides a summary of the positives and negatives of these alternatives:

2.1 DEPOSITING THE ENTIRE CUSTOMS REVENUE (100%) IN A COMMON FUND

Observations on this mechanism:

- The Set-off (clearing) data during the previous years since the establishment of the GCC Customs Union in 2003 shows that the percentage of Set-off (clearing) sums within the Final Destination mechanism did not exceeds 4% of the total customs revenues of the GCC Countries. Therefore, it is not logic to transfer the entire customs revenue (100%) to a common fund.

- This mechanism does not reflect the real comparative importance of intra-regional trade between the Council countries.

- The unavailability of data and statistics required for executing the mechanism or commencing it within the timeframe specified by Financial and Economic Cooperation Committee.
Transferring the entire customs revenues to the common fund will negatively affect the GCC countries cash flows of which customs revenue represents a high percentage of their general budget with regard to the period relating to transferring customs revenue sums between the countries and the fund.

Increase of administrative cost relating to the audit and control operations required for implementing the mechanism by both internal and external control authorities, in addition to the shared systems required for such implementation.

The mechanism is considered unfair as it relies on history data instead of actual figures that reflect customs imports of the GCC countries.

Therefore, the United Arab Emirates has reservations about this alternative.

2.2 COLLECTING 95% FOR THE FIRST POINT OF ENTRY AND DEPOSITING 5% AT THE COMMON FUND

Observations on this mechanism:

1. Transferring 5% of the revenue to a common fund complies with the Set-off statistical ratios for the previous years.

2. The percentages referred to within the heading reflect the actual ratios of intra-regional trade between the GCC Countries.

3. Keeping 95% of the total customs revenue at the First Point of Entry will not affect the cash flows of customs revenue within the GCC countries.

4. Lower administrative cost associated with the cost of control, audit and shared systems.

5. No agreement on distribution proportions of the common revenue has been reached yet. And for such proportions to be fair, one of the following alternatives could be considered:

   a. Distributing proportions should be in accordance with the net physical imports standard which will be calculated according to a moving average of a three-year period and which will be annually revised by omitting one year and adding another.

   b. Distribution of proportions should be in accordance with the Set-off distribution ratios form the previous years. Any other fair proportions can be considered by the team.
6. Transparency and clarity of implementation. That would lead to control the procedures of fairly distributing customs revenue.

The United Arab Emirates suggests that an agreement should be reached regarding this alternative as it complies with the history data of the intra-regional trade, in addition to the possibility of reaching an agreement about a fair distribution of common revenue proportions.

2.3 RETAINING AND DEVELOPING FINAL DESTINATION MECHANISM

Observation on this mechanism:

1. The Final Destination Mechanism is considered the fairest mechanism for distributing customs revenue as it represents the actual revenues of the GCC countries.
2. Transparency and clarity of distributing customs revenue sums amongst the GCC Countries, in addition to the lower administrative costs required for control and audit.
3. This mechanism does not affect the cash flows of customs revenues.
4. From the previous experiment of implementing the mechanism, the following negatives emerged:
   - The required procedures at the intra-regional ports for checking documents.
   - Longer period needed for conducting the matching procedures.
   - Delay of transferring Set-off amounts.
5. Reasons behind the negatives relating to this mechanism refer to reliance on manual matching processes and the unavailability of an automated system or a shared database between the GCC countries.

The United Arab Emirates suggests that the Final Destination Mechanism should be approved if the GCC countries could not reach an agreement on how the proportions of customs revenue will be distributed. Consequently, the revenue distribution team will be charged with setting specifications for the shared systems and the procedures that may reduce the number of checking processes at the intra-regional ports.

3 OBSERVATIONS AND PROPOSALS BY THE UNITED ARAB EMIRATES:
Proceeding from the United Arab Emirates’ keenness to support the march of the GCC Customs Union and in order to reach an agreement about the distribution mechanism of customs revenue within the timeframe allocated for the Authority to complete working on this subject, the United Arab Emirates suggests that:

- The GCC Countries may agree on one of the following two alternatives:

  1- Collecting 95% for the First Point of Entry and depositing 5% for the common fund which will be distributed in accordance with the agreed proportions.

  2- Retaining the Final Destination Mechanism, and developing such mechanism to facilitate the movement of commodities without customs obstructions.

- Directing the efforts of the team towards setting the procedures and following up the application of the shared IT systems required for implementing the mechanism that will be approved.
APPENDIX K: ARABIC DOCUMENTATION ON REVENUE DISTRIBUTION
ورقة دولة الإمارات العربية المتحدة
 حول
 آلية توزيع الحصيلة الجمركية
 في الاتحاد الجمركي بدول المجلس
المحتويات

1. مقدمة

2. البدائل المطروحة من قبل الدول
   2.1- البديل الأول: تحصيل كامل الحصيلة الجمركية (100%) في صندوق مشترك
   2.2- البديل الثاني: تحصيل 95% لنقطة الدخول الأولى و إيداع 5% للصندوق المشترك
   2.3- آليّة المقصد النهائي وتطويرها

3. مبادرات ومقترحات دولة الإمارات العربية المتحدة
بالإضافة إلى قرار المجلس الأعلى في دورته الثانية والثلاثين (ديسمبر 2011 – الرياض)، بشأن إنشاء هيئة الاتحاد الجمركي، تبدأ أعمالها في الأول من يونيو 2012، وتتكون لجنة التعاون المالي والاقتصادي بقرار تنظيمها الداخلي.

تتضمن مهام الهيئة استكمال دراسة آلية توزيع الخصومة الجمركية، بما في ذلك استمرار آلية المقصد النهائي، أو توزيع كامل الخسارة الجمركية (100%)، بحيث يتم الاتفاق على توزيع النسب وفقاً لمعيار صافي الودائع الفعلية ويجدد ذلك وفقاً للمتوسط المتحرك لثلاث سنوات ويعيد المتوسط المتحرك سنوياً، بحذف سنة إضافية سنة.

تنتهي قرار المجلس الأعلى وبناءً على المناقشات التي تمت في الاجتماع الأول للفريق المطلوب من قبل هيئة الاتحاد الجمركي لدراسة آلية توزيع الخسارة الجمركية، أعدت دائرة الإيرادات الجمركية المحددة هذه الدراسة لتقييم البدائل المحتملة ومقارنة الإجراءات والمليات المتوقعة، وبدأ تكوين الفريق لوضع وإجراء الإجراءات التفصيلية خلال الفترة المحددة من قبل لجنة التعاون المالي والاقتصادي.
بناءً على الدراسات المعدة من قبل الأمانة والاستشاريين ومقترحات الدول، تم مبادلة البنداء التالية في لجان الاتحاد الجمركي:

1- تحصيل كامل الحصيلة الجمركية (100%) في صندوق مشترك وتوزيع الحصيلة بين الدول حسب ما يتم الاتفاق عليه في توزيع النسب وفقاً لمعايير صافي الودائع الفعلية وحسب ذلك وفقاً للمتوسط المتحرك لثلاث سنوات ويعدل المتوسط المتحرك سنوياً، بحلف سنة إضافية سنة.
2- تحصيل 95% لنقطة الدخل الأولي و إيداع 5% للصندوق المشترك ليوزع حسب النسب التي يتم الاتفاق عليها.
3- الإبقاء على آلية المقصد الحاليه وتطويرها لما يسهل انتقال السلع دون عواقب جمركية.

فيما يلي موجز للايجابيات وسلبيات البنداء:
الملاحظات على الآليّة:

- تبين بيانات المقاصة خلال السنوات الماضية منذ إنشاء الاتحاد الجمركي عام 2003 أن نسبة سلّام المقاصة في آليّة المقصد النهائي لم تتجاوز 4% من إجمالي الإيرادات الجمركية للدول. لذلك فإنه ليس من المنطقي تحويل كامل الحصيلة لصندوق مشترك بنسبة 100%.
- لا يمكن لهذه الآليّة الأهمية الحقيقية للتجارة الثنائية بين دول المجال.

- عدم تزويج البيانات والإحصائيات المطلوبة لتغذية الآليّة والبدء حسب المجموع المحدد من قبل لجنة التعاون المالي والاقتصادي.
- إن تحويل كامل الإيرادات الجمركية للصندوق المشترك سوف يؤثر سلباً على التدفقات النقدية للدول التي تمثل الحصيلة الجمركية نسبة عالية من ميزانياتها العامة للدولة الزمنية المرتبطة بتحويل المبالغ بين الدول والصندوق.
- ارتفاع الكلفة الإدارية المرتبطة بعمليات التدفق والرقابة المطلوبة لتنفيذ الآليّة من قبل هيئة رقابية داخليّة وخارجية وكذلك الأنظمة المشتركة المطلوبة لتنفيذها.
- تعتبر هذه الآليّة غير عمليّة لأنها تعتمد على البيانات التاريخية وليس الأرقام الفعلية التي تكمن الورادات الجمركية للدول.

لذلك فإن دول الإمارات تتفق على هذا البدل.
الملاحظات على الآليّة:

1. تحويل نسبة 5% من القيمة إلى الصندوق المشترك يتواكب مع نسبة إصدارات المشتقات للسنتين الماضيتين.
2. تمكن نسبة حجم التجارة الثنائية للدول.
3. الاحتفاظ بنسبة 95% من إجمالي الإيرادات الجمركية في البلدان الأولي ليدور على القيمة النقدية للإيرادات الجمركية في الدول.
4. اختصار الككلة الإدارية المرتبطة بتكاليف الرقابة والتفتيش والتنظيم المشترك.
5. يتم تضفي على نسبة توزيع الحصة المشترك، ولكن تكون النسبة عادلة إذا يمكن النظر في هذه البخفي.
6. توزيع المبلغ:
   - توزيع النسب وفقاً لمعايير صافي القيمة المالية ويجب ذلك وفقاً للمتوسط المتحرك لثلاث سنوات.
   - يمكن تحديد سرعة إعادة التوزيع للمتوسط المتحرك سنوياً، بحذف سمة إعادة سنة.
   - توزيع النسب حسب معدلات توزيع الصناعات للسنتين السابقة.
6. يمكن دراسة أي نسب عادلة أخرى من قبل الفريق.

تقترب دولة الإمارات العربية من هذا الباب لتوافقه مع البيانات التاريخية للتجارة الثنائية وإمكانية النمو للاقتاق على نسبة عادلة للتسليط الحصة المشتركة.
الملاحظات على الآلية:
1. ضمان آلية المقصد النهائي الآلية العادلة لتسريع المهمة المطلوبة لدوام الاتصال المحتملة للأعمال.
2. الضمان والضمان في توزيع المبلغ بين الدوام والضمان التكاليف الإدارية الخاصة بالتفاوض والتفاوض.
3. لا تزود على التفاصيل التقنية للإجراءات المحتملة.
4. من وضع الجريمة السابقة تنفيذ الآلية يلزم السلبيات الآلية:
   • الإجراءات المطلوبة في المناقشات المتعلقة بالتفاوض.
   • مدة إجراءات المطلوبة.
   • نادر تحويل المفاق الخاص بالتفاوض.
5. تراجع أسباب السلبيات المربحة بالآلية إلى الاعتماد على عمليات المطلبة بشكل يدوي وعدم توفر نظام آلي.
وقاعدة بيانات مشتركة بين الدول.

تقدم دولة الإمارات العربية المتحدة على حان تعزيز المبادئ على تسوية الالتفاق المبادئ، اعتماد آلية المقصد النهائي وتخفيف فرق توزيع المهمة بوضع مواقف القوى المشتركة والإجراءات التي تقلل عمليات التدقيق في المناقشات المبادئ.
انطلاقاً من حرص دولة الإمارات على دعم مسيرة الاتحاد الجمركي، والتوصل إلى اتفاق حول آلية توزيع الحصص الجمركية وذلك ضمن الحيز الزمني الموضوع لعمل الهيئة تقترب:

اتفاق الدول على أحد البديلين:

1- تحصيل 95% لنقطة الدخول الأولى و إيداع 5% للصندوق المشترك ليوزع حسب النسب التي يتم الاتفاق عليها.

2- الإبقاء على آلية المقصد النهائي وتطويرها لتسهيل انتقال السلع دون عواقب جمركية.

توجه جهود الفريق نحو وضع الإجراءات ومتتابعة تطبيق نظم المعلومات المشتركة المطلوبة لتنفيذ الآلية التي يتم اعتمادها.
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