

# NATURE AND APPLICATION OF VAT

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## I. FINANCE AND VAT

VAT is an abbreviation of valued added tax which was first applied in France in 1954. It is a kind of indirect tax. Indirect tax is a tax that is not paid by the taxpayer to the government, but is collected by suppliers, shopkeepers, stores. It includes consumption tax, excise tax, tariffs, turnover tax, sales tax and VAT.

European financial analysts argue that the indirect tax is a kind of tax in which the taxpayer and the taxable person are different persons while in direct tax the taxable person is just the tax payer (S.Mill and Paul Leroy Beaulieu). According to Stourm, the indirect tax does not target at assets and ownership but at special events: a contract or a consumption behavior. In other words, if the direct tax is imposed on capital and profits while the indirect tax on distribution, production and consumption.

VAT is a form of general sales tax, charged as a percentage of the selling price of an article or commodity. It is added to the invoice as output tax at each stage of production and distribution, from manufacturers to wholesaler and to retailer. At each stage, the taxable person must account to the government for the output tax but is allowed to set against it the input tax, i.e. tax charged to him by his suppliers. For example, the VAT is levied on iron nail with a rate of 10% for each distribution stage as follows:

Stage 1: The miner exploits iron deposits and sells them to the metallurgy plant. We suppose he does not spend his money buying production equipment, and hiring workers; and does not incur other costs. We note only the iron deposit which has no value when it remains underground. When the miner sells it to the metallurgy plant for



VND100; the added value of the iron deposit increases from VND0 to VND100. The plant will pay an VAT tax of VND10 to the miner so that he pays this amount to the tax agency.

- Stage 2: The plant casts the deposit into sheet steel and sell its products to a consumer goods manufacturer for VND150. The manufacturer pays to the plant an VAT of VND15, but it really pays VND5 because the plant has paid VND10 to the miner when buying the iron deposit.

- Stage 3: The manufacturer makes finished products such as steel iron, scissors, pliers and sell them to the retailers for VND300 including VAT tax of VND30 but the retailer really pays VND15 because the rest has been paid in early stage.

- Stage 4: The retailer sells finished products (nails, pliers, scissors) to consumers for VND500 including an VAT of VND50. Then, the consumer is indirectly charged

a tax of VND50 and the retailer pays to the government VND20 and VND30 is the deduction of the tax they have paid to the manufacturer.

The above example indicates each stage of production and distribution generates an amount of VAT indirectly paid to the government. We also see the process in which the tax agency collects a full tax of VND50, equal to 10% of the product value sold to the user.

This is a simple example of VAT. In fact it is much more sophisticated. In this example, we

suppose the miner incurs no costs to exploit iron deposit, so that the selling price of the iron deposit is the whole value added and taxable. In reality, the miner buys equipment and hires workers and pays a tax of VND6 so that he pays only VND4.

Our country has applied VAT since Jan 1, 1999 to replace sales tax as France, Sweden, the Netherlands and Germany. These countries considered the old tax as a multiple tax which has many defects and should be changed into VAT. As a result, what are advantages and disadvantages of VAT ?

## II. ADVANTAGES AND DEFECTS OF VAT

First, it helps avoid multiple taxation and biased tax reduction in sales tax. Multiple taxation has increased product prices in each stage before the product reaches the end-users which are subject to unfair taxation. The VAT overcomes these shortcomings because it is

deducted all taxes paid in early stages. In the end the multiple taxation is abolished.

Second, each firm feels assured when paying VAT and wants to have enough invoices for tax deduction rather than find every way to avoid tax.

Third, VAT increases the revenues for the State budget if the technical conditions are fully met such as adequate accounting books, updated information; output tax rates should be higher than input ones or there is only tax rate for each item, service with a view to preventing tax redemption which may cause a great burden to the tax authorities; professional staff must be qualified; and the basic condition is that VAT must be imposed on most of goods and services in local

## ASPECTS OF VAT

American legislators used to call VAT "a European pretty girl" because it is an indirect tax and when the Congress votes for adoption of indirect tax, it rarely faces firms' opposition because their pockets are not hit. In contrast, when passing a direct tax, the Congress often faces complaints of many social strata.

Over 35 years ago, the British Richardson Committee made a report on the application of VAT to French firms and concluded this tax was not so heavy as English purchase tax. They said: "If a firm must pay a tax of 100 unit up on their products, they will feel easy when paying 80 to their suppliers and only 20 to the government". However,

because it greatly affects the public life and spending or the market supply and demand. It also has impacts on the government revenues.

In economic aspect, there are debates about the VAT effects on economic development. Does VAT lead to price hikes, declining purchasing power and imbalance between supply and demand? Is it useful for the country's trade balance when it is imposed on imports and not on exports. Many argue that VAT will boost the economic growth when the stage of investment in production is free of tax.

There are still many problems for policymakers, economists and public financial analysts in case of VAT application, forcing them to find the nature and common variables in the studies of indirect tax, the



trade transaction.

Nevertheless, VAT has also defects. Developing countries learn from European countries only how to apply this tax but they ignore the scientific and legal background and the nature of VAT. Therefore, they face unsuccessful results, sometimes this causes a financial burden to the national budget. Some tax officers feel tired when collecting VAT, so they want to maintain the old tax system and procedures, especially in the process of considering tax relief. As a result, these advantages and shortcomings are typically paid attention to by many countries' legislators and executors with the aim to understand the foundation of VAT in terms of science, legislation, and theory.

## III. LEGISLATIVE AND ECONOMIC

this committee warned it was impossible to replace the purchase tax with VAT because they saw an increase in costs when hiring many workers as tax collectors. This situation is the same in many less developed countries where there are millions of small- and medium-size economic units without accounting books or with poor accounting.

For American economists, the cheapness of collection is an excellent test of operating efficiency of a tax administrative body. If a considerable percentage of every dollar of a given kind of tax is absorbed by the cost of collecting it, there may well be reasonable doubt concerning the wisdom of continuing that form of taxation.

Regarding VAT, the legislative principles should be much stricter

VAT collection is then much more efficient. This explains why the U.K. and the U.S. had to make studies of VAT over a quarter of century and China has just applied this tax in production and retail trade only.■

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