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UPDATE on COVID-19

The Belt and Road Initiative Tax Administration Cooperation Mechanism

EDITOR'S NOTE:

At this critical moment in the world's fight against the COVID-19, the Special Edition of the BRITACOM Update on COVID-19 is issued, aiming to provide a platform for BRITACOM Council Members, Observers and other stakeholders to exchange views and share experience in responding to the outbreak. Issue 20 is an article of actions and measures provided by the International Tax and Investment Center to mitigate the negative impact of COVID-19. Later we will share more experience of tax administrations from countries and regions and views of international organizations and tax experts with you. If you would like to make contributions to the Special Edition, please contact us via email secretariat@britacom.org or britacom@163.com.

Restarting the Growth Engine: Tax Policy After the Pandemic

Abstract: Economic recovery from the Covid-19 pandemic will require adroit tax policy in both developed and developing countries. David Hunt and Daniel Witt of the International Tax and Investment Center explain how a value-added tax policy can bring in much-needed revenue to governments facing falling revenue with increased spending on public health and stimulus measures. Addressing VAT may be politically challenging, but the fiscal situation demands it. Relatively small and simple policy changes can help taxpayers, businesses and governments alike, offering the upside of increased revenue with a low risk of any downside; often, 80% or more of revenue comes from the largest 10% of taxpaying firms.

Zambia's recent default on its U.S. dollar bonds, which the government blamed on the pandemic, highlights how many governments, already starved for revenue, today face unprecedented challenges: sharply falling revenue with skyrocketing spending, particularly on public health and stimulus measures, leaving little "fiscal space" for policymakers. Global output has declined in both goods and services, with an estimated contraction of 4.9% for 2020. Yet governments need revenue to serve the public. How can this cycle be broken?

As governments move to develop plans for full recovery, we believe growth-friendly tax policy should stand at the heart of their efforts. Addressing constraints on fiscal space will require adroit tax policy in both developing and developed countries to generate revenue and foster growth, as well as support small and medium enterprise (SMEs).

SMEs remain the backbone of many developing world economies and a key to restoring growth, as these businesses were often hit hard by pandemic-related shutdowns. Even though they often account for less than 20% of tax revenues, SMEs support the larger economy as both customers and suppliers, fueling economic growth and employment. As the key to recovery for SMEs is cash flow, this should guide fiscal policy to promote employment. Deferring tax payments, flexible payments, and waiving penalties for the hardest hit sectors lowers short-term revenues but rebuilds employment.

Many governments have already taken bold steps in administrative relief and reforming tax administration, which are low-hanging fruit to spur recovery and convenience for taxpayers. E-invoicing, better service, and electronic customs schemes approved by the World Customs Organization are a strong response when many businesses are working remotely. More efficient enforcement of existing legislation in transfer pricing and the effective use of withholding mechanisms can bring in much-needed revenue rapidly.

Value-added tax (VAT) is one tool governments can use in these efforts. This is an important source of revenue to 160 countries, but it has been hit hard as consumption declined precipitously. However, tackling VAT now may be the best way to increase revenue without unduly hampering recovery, as it is less distorting and hence less likely to discourage investment and growth, even among SMEs. For many low and middle-income countries, a well-functioning VAT is an essential component of both their recovery and their future prospects.

To make VAT better, fairer, and simpler than it is now, focus on the “policy gap” (exemptions) and the “compliance gap” (nonpayment). In Latin America, the average combined “VAT gap” is 43% of revenue; in Africa, it is 37% (South Africa stands out with a compliance gap of under 10%, less than half that in the EU). Many countries can improve compliance to boost revenue. For SMEs, VAT should be simplified by introducing an appropriately high threshold and simplifying registration and filing, and presumptive taxes for smaller businesses should be considered as an alternative to the cumbersome VAT system.

Addressing VAT may be politically challenging, but the fiscal situation demands it. Relatively small and simple policy changes can help taxpayers, SMEs, and governments alike, offering the likely upside of increased revenue with a low risk of any downside; often, 80% or more of revenue comes from the largest 10% of taxpaying firms.

Time is of the essence in these responses. Governments must take action clearly so that taxpayers and SMEs know what applies to them. No single response will apply to all countries; governments must find the balance between economic stimulus and revenue demands.

Getting that balance right will take finesse and, of course, progress in fighting COVID-19. Even as economic growth rebounds, the fiscal effects will likely last longer than the pandemic itself. But governments should remember that growth will itself provide more of the revenue they need to address the Sustainable Development Goals, in partnership with business. Although the world does not know how long the pandemic will last, governments should take action now to reset their tax systems to aid both economic recovery and increase revenue.

Author Information

David Hunt served in the Cabinets of Margaret Thatcher and John Major. He is currently Chairman of the Financial Services Division at DAC Beachcroft LLP and Co-Chairman of the International Tax and Investment Center. Daniel Witt is the Founder and President of the International Tax and Investment Center.

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