Value Added Tax

Value-added tax (VAT), also known as a goods and services tax (GST) in some countries, is a form of tax that is assessed incrementally. It is levied on the actual transaction value of a product or service at each stage of production, distribution or sale to the end consumer.

VAT essentially compensates for the shared service and infrastructure provided in a certain locality by a state and funded by its taxpayers that were used in the creation of the said product and service.

Overview of Value Added Tax

The amount of VAT is decided by the end-market price. Its main purpose is to tax only the value added by a business on top of the services and goods it can purchase from the market

At each stage of production, the product gets successively more valuable at each stage (e.g. chocolate bars starting off as cocoa beans). When an end consumer makes a purchase, they are not only paying for the VAT of the entire product at hand (e.g., a cup of coffee) but for the entire process of production (e.g., the purchase of the cocoa beans, transportation, processing etc.), since VAT is always included in the prices.

The value-added effect is achieved by prohibiting end-consumers from recovering VAT on purchases but permitting businesses to do so. The VAT collected by the state is computed as the difference between the VAT of sales earnings and the VAT of those goods and services upon which the product depends. The difference is the tax due to the value-added by the business. In this way, the total tax levied at each stage in the economic chain of supply is a constant fraction.

How is Value Added Tax different from Income Tax

The VAT is similar to the income tax as it is based on the value of a product or service at each stage of production. However, there are some important differences.

1. A VAT is usually collected by the end retailer. Therefore, even though is incurred at every stage of production and distribution.

2. A VAT is usually a flat tax

3. For VAT purposes, an importer is assumed to have contributed 100% of the value of a product imported from outside of the VAT zone. The importer incurs VAT on the entire

value of the product, and this cannot be refunded, even if the foreign manufacturer paid other forms of income tax.

Limitations of VAT

A VAT, like most taxes, distorts what would have happened without it. Because the price for someone rises, the number of goods traded decreases. Correspondingly, some people are worse off by more than the government is made better off by tax income. That is, more is lost due to supply and demand shifts than is gained in tax. This is known as a deadweight loss. If the income lost by the economy is greater than the government's income; the tax is inefficient. VAT and a non-VAT have the same implications on the microeconomic model.

The entire amount of the government's income (the tax revenue) may not be a deadweight drag, if the tax revenue is used for productive spending or has positive externalities – in other words, governments may do more than simply consume the tax income. While distortions occur, consumption taxes like VAT are often considered superior because they distort incentives to invest, save and work less than most other types of taxation – in other words, a VAT discourages consumption rather than production.