What is the difference between zero rating and exempting a good in the VAT?

For a "zero-rated good," the government doesn't tax its sale, but allows credits for the value-added tax (VAT) paid on inputs. If a good or business is "exempt," the government doesn't tax the sale of the good, but producers cannot claim a credit for the VAT they pay on inputs to produce it.

ZERO RATING

Almost all countries apply preferential rates to some goods and services, making them either "zero rated" or "exempt." For a "zero-rated good," the government doesn't tax its retail sale, but allows credits for the value-added tax (VAT) paid on inputs. This reduces the price of a good. Governments commonly use zero-rated goods to lower the tax burden on low-income households by zero-rating essential goods, such as food and utilities or prescription drugs.

EXEMPTING

If, by contrast, a good or business is "exempt," the government doesn't tax the sale of the good, but producers cannot claim a credit for the VAT they pay on inputs to produce it. Because exempting breaks the VAT's chain of credits on input purchases, it can sometimes raise prices and revenues. Hence, governments generally only use exemptions when value-added is hard to define, such as with financial and insurance services.

IN PRACTICE

Of the 33 OECD countries with a VAT in 2015, 18 "zero rated" certain goods and 24 applied at least one nonzero reduced rate to a subsector of goods.

FURTHER READING

Gale, William, and Benjamin H. Harris. 2011. "A VAT for the United States: Part of the Solution." In *The VAT Reader* (64–82). Falls Church, VA: Tax Analysts.

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