How Could We Improve the Federal Tax System?

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

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

A. For a "zero-rated good," the government doesn't tax its sale but allows credits for the value-added tax 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 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 34 Organisation for Economic Co-operation and Development countries with a VAT in 2016, 18 "zero rated" certain goods and all but Chile and Japan had at least one reduced VAT rate.

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Further Reading

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