

51.2 An exercise on the effects of VAT

Explain the effect of VAT on the profit of a business, and on its cash flow.

Response

Profit: in principle, VAT is borne by consumers, with business firms merely acting as collecting agents for the tax. VAT should not, therefore, affect the profit of a firm, except insofar as any tax on goods or services will tend to reduce demand.

Cash flow: a firm trading at a profit, with the value of its outputs greater than the value of its inputs, will collect output VAT from its customers with a greater value than the input VAT it pays to its suppliers. This would appear to give the firm a cash flow advantage, meaning that the firm holds the extra cash at its disposal until the time of quarterly accounting.

However, the cash flow effect is complicated by the fact that inputs (and input VAT) must usually be paid for before the firm is in a position to collect any cash from the sale of its outputs.