February 1993

The UK Experience with VAT

Neil Warren

University of New South Wales

Follow this and additional works at: <http://epublications.bond.edu.au/rlj>

Recommended Citation

Warren, Neil (1993) "The UK Experience with VAT," *Revenue Law Journal*: Vol. 3 : Iss. 2 , Article 1.
Available at: <http://epublications.bond.edu.au/rlj/vol3/iss2/1>

This Journal Article is brought to you by the Faculty of Law at ePublications@bond. It has been accepted for inclusion in Revenue Law Journal by an authorized administrator of ePublications@bond. For more information, please contact [Bond University's Repository Coordinator](#).

The UK Experience with VAT

Abstract

This article provides an overview of the background and changes to the Value Added Tax (VAT) introduced into the UK in 1973. The main economic effects of VAT, its distributional impact and the cost of administration and compliance are examined. The article concludes with an assessment of the likely future direction of VAT.

Keywords

VAT, value added tax, consumption tax, United Kingdom

THE UK EXPERIENCE WITH VAT

Dr Neil Warren
Senior Lecturer
School of Economics
University of NSW

This article provides an overview of the background and changes to the Value Added Tax (VAT) introduced into the UK in 1973. The main economic effects of VAT, its distributional impact and the cost of administration and compliance are examined. The article concludes with an assessment of the likely future direction of VAT.

Introduction

The Value Added Tax (VAT) was introduced in the UK in 1973 and now raises around one fifth of all government tax revenue. While introduced initially at a rate of 10% on a base which zero-rated most “essentials” such as food, children’s clothing, water, power and heating fuel, the tax base has remained largely unchanged while the rate now stands at 17.5%. In this paper, we shall provide an overview of the changes to VAT since its introduction nearly two decades ago.

Initial attention will be focused on the reasons for the introduction of VAT and specific developments since its introduction in 1973. The economic effects of the introduction of VAT and subsequent changes to it will then be examined, along with their distributional impact. The important issue of the cost to government of administering VAT and to business when complying with the legislation are then examined. Finally, the implications of fiscal harmonisation within the European Community for the base and rate of the UK VAT are studied along with its implications for the administration of the VAT.

Why a VAT for the UK?

Background to VAT

The major force behind the introduction of a VAT in the UK was the growing support in the late 1960s for the UK to join the European Community (EC). With the Second EC Directive on Value Added Tax

- 1 This directive resulted from the *Neumark Report* which was released in April 1967. It is significant that the Neumark Committee initially advocated a single stage retail sales tax, but due to opposition arising from perceived compliance problems associated with high rates of tax and the existence already of a form of VAT (a multiple stage retail sales tax) in France (who was a strong force in the EC), a VAT was finally advocated for adoption throughout the EC by all member countries by 1 January 1970.

requiring all member countries to adopt a VAT, the UK had no real choice but to implement such a tax before becoming an EC member country.

The importance attached by the EC to a VAT stemmed from the perception that such a tax was a means through which indirect tax systems could be harmonised. Moreover, it was seen as enabling member countries to raise significant revenue via indirect taxes without adding to the costs of exports and without exempting imports from tax carried on domestic products.

The push towards the introduction of a VAT in the UK gained momentum with the election of a Conservative government in June 1970. Not only did its manifesto support joining the EC, it suggested that replacing the Purchase Tax and the Selective Employment Tax (SET) with a VAT should be closely examined. At that time, the Purchase Tax was a wholesale stage tax on the sales of goods between a registered trader and an unregistered customer, and was levied at multiple rates and on a narrow base which excluded many goods and all services.

In contrast, the SET was a per capita tax on all employees, being collected as a flat rate surcharge on social security contributions which were, at that time, levied on a similar basis. The SET paid by employers was then refunded to selected employers, including local authorities and those engaged in manufacturing and farming. No refunds were available to distribution or retailing (unless the business qualified as a manufacturer) or to the service sector. The purpose of the SET was to divert labour from service industries (which did not export) to manufacturing and farming (which did export), not as a means to indirectly tax services (which were exempt under the Purchase Tax).

The demise of the Purchase Tax and SET was assured when the Conservative government released a report² in March 1971 which concluded in favour of these taxes being replaced by a VAT. The VAT was argued for on several grounds:

- Balance of payments effect: The argument was that by replacing the Purchase Tax and SET by a tax which zero-rated exports and taxed imports, the balance of payments would be assisted by removing incidental tax from exports and import competing goods.
- Consumption and production distortion: A flat rate, broad based consumption tax was argued to be less distortionary than a narrow based,³ multiple rate tax. Replacing the Purchase Tax and SET with a single rate VAT was therefore seen to be reducing distortions and

2 Cmnd 4621, *Value Added Tax* (London, HMSO, March 1971).

3 At issue here is not only the goods that are included in the base of the taxes, but also the stage at which the goods are taxed. For example, the Purchase Tax was levied at the wholesale stage while the SET was a tax on labour inputs, primarily in the service sector.

improving economic efficiency. This argument for a VAT was partly weakened by the subsequent exemptions from the VAT base adopted in the UK.

- **Buoyant revenue source:** A broad based VAT offers a government a relatively stable revenue source which has attractions for government budgeting. However, the Conservative government also saw VAT as a tax which had considerable revenue potential. This appealed because it could ultimately provide the basis on which to achieve a long held Conservative objective of introducing a major shift in the mix of taxes (as it did in 1979).
- **Demand management:** A broad based consumption tax offers a better tool for demand management than a Purchase Tax because of its broad base and the inability of consumers to escape paying the tax.
- **Avoidance and evasion:** Under a multiple-stage tax, minimising the traders' tax burden means maximising their input tax and minimising their output tax. However, since one firm's input tax is another's output tax, each trades motives are contrary, and this results in there being a self-policing element in VAT. This aspect becomes particularly important if a high rate VAT is envisaged.
- **Automatic indexation:** A VAT is an ad valorem tax and increases at the same rate as inflation,⁴ with the effect of encouraging more accountable government. In contrast, a personal income tax schedule creates fiscal drag (unless the schedule is annually indexed to the inflation rate) and an excise duty creates negative fiscal drag (where the average tax rate decreases with inflation).

The arguments against a VAT included:

- **Effects on prices and wages:** The price effect of a VAT depends on the structure of the reform package of which it forms part. While the introduction of a VAT could cause a rise in inflation and have a similar impact on wage inflation, this need not be the case as it depends on government macro-economic policy stance and incomes policy.
- **Distributional effects:** Most opposition to the VAT came from its perceived regressivity. This criticism was not addressed by directly compensating those adversely affected by a broad based VAT but by zero-rating food, children's clothing, water, power and heating fuel (as discussed later).
- **Administrative and compliance cost:** While this burden was acknowledged as important, it was recognised that it can be

⁴ An obvious exception is where the base is not comprehensive or the tax is not levied at a single rate. In this case, a change in consumption patterns or different average inflation rates for the differently taxed bases of the tax could result in the tax revenue increasing at a rate different from the average overall inflation rate.

minimised by keeping the number of exemptions and zero-rated goods and services to a minimum.

- Taxpayer resistance: The magnitude of the initial and on-going compliance cost may result in resistance to the VAT, but again much depends on the structure of the VAT and the taxes which it replaces.

The Conservative Government took the view that the benefits of a VAT outweighed the costs and, in March 1972,⁵ released a White Paper in which it was formally outlined that a tax bill would be introduced in 1 April 1973 and that a VAT would supersede the Purchase Tax and the SET. Draft clauses and schedules for the pending finance bill were released for public discussion, with these ultimately becoming Part I of the 1972 Finance Act.

In the period between the announcement (summer 1972) and the introduction of the VAT (spring 1973), considerable preparatory work had to be undertaken. For the government, a whole new bureaucracy had to be formed, with the VAT estimated to require some 8000 tax officials compared to only 2000 under the Purchase Tax. For business, a major education and training program had to be undertaken, particularly since there were only 74,000 taxpayers under the Purchase Tax (in March 1973), compared to the 1.2 million under VAT (in 1974). Not only did these new taxpayers have to be identified, but they also had to install systems which would enable them to comply with the legal requirements of the tax. Taxable parties were in fact only given six months to register and this proved too formidable a task. By start-up date, some 19% of VAT registration forms were still incomplete or incorrect and, in the first year of operation, some 20% of the returns were defective in some way. If anything, the pace of the UK start-up was probably too fast.

Form of introduction in April 1973

With the passage of the Finance Act 1972, the VAT was to be applied to all businesses, unless specifically exempted, and to all goods and services, unless they were specifically identified as attracting special attention. "Supply" was subsequently broadly defined for tax purposes as including all forms of transaction and a "business" was widely defined to include not only any trade or profession but also associations and clubs. All activities of a business were to be treated as one, although larger corporations could register more than one entity.

5 Cmd 4929, *Value Added Tax* (London: HMSO, March 1972).

6 This figure was later recognised as a significant underestimate with 2,000 more officials being appointed so that, while there were some 7,700 staff in 1974, this number had increased to 10,500 by 1975, 11,600 by 1976 and 12,213 by 1977. As we shall later see, part of this escalation was due to changes to the rates and base of the VAT over this period.

7 D Johnston, *A Tax Shall be Charged* (London, HMSO, 1975).

What proved to be a major problem for business was the adoption of a less than comprehensive tax base and non-uniform tax rates.

Rate

While the VAT base was known well before the introduction of the VAT, the rate of VAT to be implemented on 1 April 1973 was only announced in the Budget on 6 March 1973. This delay was driven by a desire to ensure that the reform package being introduced was largely revenue neutral in its first year of operation. The VAT rate scale adopted was for two rates, 0% and 10% (on a tax inclusive basis). The government also introduced a 10% (wholesale stage) Car Tax as a complement to the VAT, primarily due to a concern about the revenue cost of taxing motor vehicle sales with only a 10% VAT.

Base

The base of the VAT was broad compared to the Purchase Tax but still included concessions to different categories of goods and services. In fact, the VAT only taxed 2% more of total consumption expenditure on *goods* than did the Purchase Tax, although it did tax most *services* (directly or indirectly). Based on the premise that all goods and services consumed by the household sector should be taxed, two categories of goods and services received special treatment under the VAT.

First, there were those goods and services bearing no tax burden, termed *zero-rated* goods and services. This meant that any VAT on the inputs into their production was refunded to the producer to ensure that no tax was passed on to the consumer.

Secondly, there were those goods and services which were *exempt*. This meant that the trader was not liable for VAT on any value added, but was also not entitled to a rebate of the VAT on inputs. The goods and services which were exempt and zero rated in 1992 are shown in Table 1 and we now examine how this base differs from that introduced in 1972.

History of VAT

The VAT has now been in force in the UK for nearly two decades. Most of the important changes made to the base and rates of the VAT occurred in the first decade. This was partly due to the fine-tuning of the tax, but mostly due to political considerations. The changes that have been made fall into two categories: those relating to the rate and base of the tax and those to its administration.

TABLE 1
GOODS AND SERVICES EXEMPT AND ZERO-RATED UNDER THE
UK VAT IN 1992

Zero-Rated

- 1 Exports of goods and services
- 2 Food, other than
 - meals out
 - icecream and ice confections, confectionery and chocolate products
 - all drinks other than tea and coffee
 - beverages chargeable with excise duty
 - crisps and prepared nuts
 - prepared pet food
 - food supplied in the course of catering
- 3 Sewerage services and water to house
- 4 Books and newspapers
- 5 Talking books for the blind and handicapped, and radio for the blind
- 6 Fuel and power for domestic and charity use, (but not road fuel)
- 7 Construction of dwellings
- 8 Supply, repair and maintenance of ships and aircraft (not small or pleasure craft)
- 10 Caravans and houseboats which can provide permanent habitation
- 11 Certain supplies of gold
- 12 Bank notes
- 13 Drugs, medicines and appliances supplied on prescription and aids for the handicapped
- 14 Supplies by charities of donated goods
- 15 Young children's clothing and footwear, protective boots and helmets

Exempt

- 1 Rent and land
- 2 Insurance by authorised insurers
- 3 Postal services provided by the Post Office
- 4 Betting, gaming and lotteries
- 5 Finance (transactions in money and securities)
- 6 Education - public and non-profit
- 7 Most health and welfare services
- 8 Fundraising events held by charities
- 9 Burial and cremation
- 10 Trade unions and professional bodies
- 11 Some sports competitions
- 12 Disposal of works of art exempted from capital gains taxation

Changes to the rate and base of VAT

Table 2 highlights the major changes to the UK VAT since 1973. The reasons for these changes become clear when one recognises the environment in which they were implemented. While a Conservative government introduced the VAT in April 1973, a Labour government was elected in 1974 and governed until 1979. The introduction of the 8% category in July 1974 was aimed at reducing the inflation rate at a time of wage indexation. The November 1974 25% tax on petrol was designed to reduce the consumption of petroleum product further than the reduction in consumption already caused by the OPEC oil price rise. The April 1975 extension of the 25% VAT category (detailed in Table 3) to "luxuries" was

designed by the Labour government to shift more of the VAT burden onto the higher income groups. What resulted instead were many problems for the electrical industry and numerous administrative problems and absurdities. Prest⁸ cites the example of repairs to a light switch by an electrician. The VAT on his services would have in this case been charged at the lowest rate, but if, while visiting, he replaced the plug on an iron, this would imply the higher rate of tax on his services. Prest⁹ notes that some 1000 extra VAT officials were required to administer such complexities.

TABLE 2
MAJOR REFORMS TO THE BASE AND RATE OF THE UK VAT

1973	10% VAT introduced (April)
1974	VAT base extended to include vehicle fuels and certain categories of exempt food and drink (including confectionery, icecream, soft drinks and potato crisps) (April); VAT rate reduced to 8% (July); and VAT on gasoline raised to 25% (November)
1975	25% VAT extended to a range of 'non-necessities'
1976	25% VAT reduced to 12.5%
1978	All imported services taxable ¹⁰ and VAT tax relief on bad debts
1979	Standard and higher rate replaced by a single 15% rate (accompanied by substantial personal income tax changes)
1980	Nil
1988	Minor changes to extend the base of VAT
1989	VAT levied on: <ul style="list-style-type: none"> • commercial buildings • fuel, power, water and sewerage services to industry • news services; and • protective boots and helmets supplied by employers
1990	Minor changes to the VAT base, involving 'self supply' goods
1991	VAT rate increased to 17.5% in return for a £140 cut in the Poll Tax

The adverse employment effects of taxing some higher rate activities saw the government attempt to clearly delineate between the higher and lower tax rate categories. When this failed, the higher rate was reduced to 12.5% in April 1976. Despite the reduction in the difference between the two positive rates, major administrative problems remained and it was mainly this factor which led to the two positive rates being amalgamated in June 1979 by a

8 Prest, *VAT: The Experience of the United Kingdom* (1982, American Enterprise Institute for Public Policy Research) 31.

9 Ibid at 30.

Conservative government which also raised the standard rate to 15% in return for income tax cuts.

The changes to the base and rate of the VAT since 1979 have been less dramatic than those prior to 1979, mainly due to a Conservative government remaining in power throughout this period. In the early 1980s, minor changes were made to the base of the VAT, in an attempt to streamline the operation of the VAT and to conform to EC directives. Further modest changes were made in 1984 and 1985. A distinction was drawn between food for home consumption (zero-rated) and food which was taxable. Previously, takeaway food (eg pizzas) was zero-rated. Changes were made in 1984 so that food bought for consumption off the premises is taxed if, and only if, it is intended to be served at a temperature higher than the ambient temperature and is actually so served.¹⁰ Another change was to remove the distinction between repairs and maintenance to a home (which was taxable) and alterations and additions (which were zero-rated). Both were made taxable.

TABLE 3
GOODS AND SERVICES SUBJECT TO HIGHER RATE BETWEEN
1 MAY 1975 AND 18 JUNE 1979

Electrical domestic appliances (but not stoves and heaters); radios and television sets; pleasure boats and light aircraft; touring trailers, photographic equipment and binoculars; furs; jewellery; goldsmiths and silversmiths' wares; gasoline

Electrical domestic appliances (but not stoves and heaters); radios and television sets; pleasure boats and light aircraft; touring trailers, photographic equipment and binoculars; furs; jewellery; goldsmiths and silversmiths' wares; gasoline

Table 4 illustrates the proportion of the final consumption expenditure of households which was taxable under the different classifications of goods and services in 1985. Just over half of household consumption was taxed at the standard rate of VAT with nearly 30% of expenditure zero-rated, the largest zero-rated component being food (17.6%).

The major factor motivating most recent changes to the VAT base has not been a simple desire to expand the base but to bring UK practice into line with EC Directives. In 1989, the Government was forced to respond to a challenge to the validity of the zero-rating of construction from the European Court of Justice. This led to substantive changes to the treatment of commercial buildings, which were subsequently made taxable at the

10 Davies and Kay, "Extending the VAT base: problems and possibilities" (1985) 6 *Fiscal Studies* 3.

standard rate.¹¹ Other changes included the taxation of fuel, power, water and sewerage services to industry (previously zero-rated); news services (previously zero-rated); and protective boots and helmets supplied by employers. In 1990, minor changes were made to the base with the incorporation of "self supply" goods.

TABLE 4
HOUSEHOLD SPENDING AND VAT

	Percent of Consumer Spending
Zero-rated items	29.6
Food	17.8
Fuel, light, power	6.5
Children's clothing	1.9
Books and newspapers	1.6
Public transport	1.8
Exempt items	3.4
Housing	11.1
Standard rated items	55.9
Food (icecream, meals out etc)	4.6
Adult clothing	6.4
Alcohol and tobacco	4.8
Durable goods	7.6
Other	32.5
Total	100.0
Source: Davis and Kay (1985) p 2	

In 1991, the first change in the VAT rate since 1979 was introduced as part of a program to reform the taxation of property. Originally, local governments in the UK collected most of their revenue from local property taxes. When these were replaced by a Poll Tax, public opposition was enormous. Moreover, the Poll Tax had been subject to considerable evasion, as people failed to register on the Electoral Rolls when they moved to new areas.¹² This placed a large administrative burden on local governments as they attempted to keep up-to-date Poll Tax registers.

In response, the Conservative government cut some £140 pa from the Poll Tax in April 1991, funding this by increasing VAT to 17.5% and

-
- 11 Bennet, "The new VAT on Construction of Commercial Property" (1991) 12 Fiscal Studies 78.
- 12 The local governments extensively use electoral rolls to check on residents in their local area. However, many people entering an area do not register on the electoral rolls and many established residents have removed themselves from the electoral roll. In some areas, this has effectively disenfranchised a large sector of the population.

initiating a new system of collecting taxation at the local government level¹³ to replace the remainder of the Poll Tax. The subsequent abolition of the Poll Tax has not resulted in any further changes in the VAT rate.

Administrative changes and legal challenges

The administration of the UK VAT is the responsibility of HM Customs and Excise Department. When VAT was introduced, a mass of information was released to traders through a large range of pamphlets. To minimise the scope for avoidance and evasion, the "invoice method" of administering VAT was introduced in which a distinction was drawn between input and output tax. The output tax on a good would be calculated by valuing the good exclusive of VAT on inputs but including any other taxes (such as excise duties). The VAT liability of the business would then be the difference between the output tax and the tax paid on inputs. Liability would arise when the services were provided or the goods shipped. In the case of a business selling zero-rated goods (such as exporters and sellers of food), a VAT refund would be claimed for the VAT on inputs.

VAT administration is built on the self-assessment principle, with no specific accounting procedures being required for compliance with VAT, although advice is available. For the majority of traders, VAT administration requires VAT accounting on a quarterly basis, with the tax payable within a month of the quarterly date. Lodgement dates are staggered amongst businesses and can be tailored to the financial or accounting year of the business. In effect, this means that businesses paying VAT each quarter receive a permanent interest free loan, the magnitude of which depends on the VAT rates – this acting to improve the trader's cash-flow. For those selling zero-rated goods, however, this is not the case for they are providing an interest free loan to the government. As a consequence, traders of zero-rated goods are allowed to lodge returns monthly and will normally receive a refund within seven days of lodgement.

Problems arise in the administration of VAT in several areas:

- Traders who carry on both exempt and taxable activities: An apportionment system was devised to cope with cases of this sort. A similar procedure was used when a trader's goods are used for private use (such as a telephone).
- An exempt trader who provides himself with a taxable item: The supplies are taxable – an example being an insurance company providing its own stationery.
- Quasi-traders such as government authorities or charities, who provide taxable goods and services. These traders are liable for VAT on those services.

13 Hills and Sutherland, *Banding, tilting, gearing, gaining and losing* (1991).

In an attempt to make administration simpler for many traders, a range of specially simplified schemes operate for the calculation of VAT liability. This enables traders to adopt longer accounting periods and, in some cases, methods of administration akin to the "accounts" method, where purchases and sales are identified according to tax category. From this information, VAT liability is determined.

The 1972 Finance Act, under which VAT was enacted, left many of the detailed points and provisions to explanation and regulation by Treasury Order. The VAT infrastructure was centred on a devolution to Local Vat Offices (LVO) of all enquiries and complaints, with all registrations and VAT returns being made to a central office. Enforcement was strong and backed up by field visits from an inspectorate, which sought to see one-third of all registered traders each year.

A special appeals system was instituted, with VAT Tribunals sitting in various regions. The objective was to prevent recourse to the courts (which was costly and could clog the courts with unnecessarily detailed VAT issues). Taxpayers could, nonetheless, appeal tribunal decisions.

In recent years, the level of penalties has been increased. Audits are more rigorous and penalties more onerous. The problem for the Government was that "reasonable excuse" appeals have recently accounted for some 50% of tribunal decisions.¹⁴ In response, on 1 January 1990, a new system of penalties relating to serious misdeclarations and default interest came into force. This has focussed considerable attention on the legitimacy or otherwise of possible excuses for late returns, but appears designed to minimise litigation and improve compliance.

Economic effects of VAT

The introduction of a VAT is invariably accompanied by many economic arguments for and against the introduction of the tax. These arguments involve both micro-economic and macro-economic considerations. In this section, we shall briefly examine these factors as they were discussed at the time of the introduction of VAT in the UK and the outcome subsequent to the introduction of a VAT.

Micro-economic considerations

- *Economic neutrality*

The 1973 tax reforms were seen as potentially more neutral in their effect on production and consumption than the Purchase Tax and SET. Since economic welfare is reduced when consumer preference or producer economic behaviour is distorted, tax systems which are neutral in their economic impact will improve economic (or allocative) efficiency and

14 See Dencher S, "Late Returns: Excuses Excuses" (March 1990) *Accountancy* 94-95.

therefore the level of production and economic welfare from a given level of resources.

This effect in the UK was not considered significant, although the VAT did have a broader base than the Purchase Tax and SET. It should be remembered, though, that, while the UK VAT might have a broader base than the purchase tax, it still also has many goods and services either exempted or zero-rated. Equally, while the Purchase Tax had a differentiated rate structure, so too does the VAT.

The reality is that the 1973 VAT reforms in the UK probably had only an infra-marginal impact on overall economic efficiency and output.

- *Moving to consumption based taxes*

VAT reforms are often introduced with accompanying personal income tax changes. This was not the case with the 1973 VAT reforms, although, as we noted previously, this was one of the underlying objectives of the original VAT reforms and came to fruition in 1979.

It is often argued that a major advantage of consumption taxes is that they do not distort the decision to save or invest or work or take leisure. Various countries have consequently introduced tax mix changes, but the benefits from such changes, particularly in the UK, have not really been ascertained. The primary difficulty is that the tax reforms introduced have been largely revenue neutral so that any effects on a household are, at best, only marginal.

Macro-economic considerations

Prices

The impact of the introduction of the 10% VAT replacing the Purchase Tax and SET in April 1973 was estimated by the UK National Institute for Economic and Social Research (NIESR) to increase inflation by between 0.5% and 2.5%. In practice, by August 1973, prices had risen 2.5% and, by December 1973, by 8%. The difficulty is that the impact of VAT on prices cannot be easily distinguished from the underlying inflation rate. Moreover, the monetary policy and incomes policy stance of government during the reform phase can affect the economic outcome. A study of the UK and other countries by Tait¹⁵ concluded that the 1973 VAT based revenue-neutral tax reforms had little effect on prices.

A similar observation can be made for the VAT changes in 1979 where the impact on prices was estimated to be 3.5%. In the six months to June 1979, prices rose 11.4%, but, in the twelve months to June 1980, prices rose

15 Tait, "The Value Added Tax: Revenue inflation and the foreign trade balance", in Gillis, Shoup and Sicut, *Value Added Taxation in Developing Countries* (World Bank 1990).

20.8%. It is difficult again to determine just what effect the VAT changes had on the underlying rate of change in the Consumer Price Index.

Balance of payments

One area where significant benefits were mooted from the introduction of a VAT was on the balance of payments. However, the benefits from the 1973 tax reforms were marginal. The NIESR at the time estimated these changes resulted in a 0.25% improvement in the volume of exports with no significant change in the level of imports. The removal of the Purchase Tax on the input to exports was therefore seen as negligible.

Investment

The benefits of a VAT to investment arise through the encouragement such a tax may provide for increased savings by being offset against income tax reforms. This situation did not arise with the 1973 tax reforms and was relatively minor in 1979, since the increase in VAT was largely offset by a decrease in personal income taxation.

Distributional impact of VAT

The distributional impact of any tax is highly controversial. This was especially the case with the introduction of VAT in the UK in 1973. It was just this factor which resulted in food, heating and children's clothing being zero-rated. However, while such a special treatment of selected goods may have political advantages, it results in three clear inefficiencies.

First, such concessionary treatment increases administration and compliance costs, as we detailed earlier. Secondly, it acts to distort the allocation of consumer resources between different types of consumption goods and services (also raised earlier). Thirdly, and most importantly, it is an inefficient method of compensating those adversely affected by the introduction of a broad based consumption tax.

Kay and Davies¹⁶ illustrate just this fact. They show that by extending the base of the UK VAT to include those commodities currently zero-rated, the lower income groups could be relatively easily compensated through the social welfare system (and personal income tax) for the adverse effects on them of the changes. This is because zero-rating benefits all income groups and not just those on lower incomes. Consequently, the revenue raised from extending the VAT base can be used to (over) compensate those in the lower income groups.

The UK government has not been receptive to the idea of broadening the VAT base to include zero-rated goods and services even though, as we

16 Above n 11.

have shown in Table 3, the base could be substantially expanded by their inclusion. The distributional impact of the current VAT is shown in Charts 1 and 2 for 1985 and 1991 respectively. Some care should be taken in interpreting these charts because of their different method of estimation.

Chart 1 is compiled by the government Central Statistical Office and includes all the direct and indirect effects of the VAT. That is, it allocates to households not only the VAT directly identified on their consumption goods but also that which flows through to them indirectly as a result of some industries being exempt and therefore input taxed. The results indicate that VAT is an increasing proportion of household consumption and, in this context, the tax is progressive.¹⁷ However, this is really not surprising since the goods which are zero-rated are of greatest benefit to the lowest income groups (after all, the rich can only consume so much food).

If we argued that what should concern us is not actual consumption but a household's ability-to-pay taxes, then gross income may be a more appropriate measure of the distributional impact of a tax. Chart 1 also illustrates the results when households are ranked into deciles according to their gross income and VAT is illustrated as a percentage of gross income. A quite different picture emerges with VAT being regressive for most income groups, despite the zero-rating of food. Without doubt though, the VAT is less regressive than it would be if those goods which are zero-rated were taxed.

Some argue that a more appropriate indication of the regressivity of VAT is obtained not from examining its distributional impact relative to a household's gross income but relative to their disposable income (gross income less personal income taxes). This, it is argued, reflects the resources that a household actually has available to it to consume (even though it might decide to consume some in the future, in which case it saved). Chart 2 illustrates the distributional impact of the 17.5% VAT in 1991 after the increase from 15% in April 1991 (but excludes the VAT indirectly incurred by consumers on their purchases). The VAT is shown in this case to be broadly progressive, but slightly regressive at the very top of the net income distribution. Again, what we are seeing reflected is food and heating being a large proportion of the net income of the poor, the middle income groups spending a larger proportion on VATable goods while the higher income groups have a high level of saving.

Overall, the UK VAT is not particularly regressive and therefore has not been the cause of much adverse community debate. However, as we noted earlier, a broader based VAT could be just as, if not more, equitable if it were linked to social welfare and personal income tax compensation.

17 The concept of progressivity is widely used and, unfortunately, also abused through a failure to explicitly define the concept under consideration. Here we shall define a tax as progressive against some base (such as consumption, gross income or net income) if the tax is an increasing proportion of the base as the base increases.

VAT administration and compliance costs

The private sector attitude to the introduction of the VAT was typical of the response to any new form of tax, particularly one which generally applied to all retailers. While some of the criticism was centred on what should and should not be in the tax base, much of the discussion was defused by the zero-rating of food and children's clothing. The main debate instead focussed on the need for simplified administration and the problems of small businesses. As a consequence, compliance cost to businesses was a major issue associated with the introduction of a VAT.

The cost of operating any tax stems largely from the form in which it is introduced. In the case of the UK VAT, most initial complications arose from a too speedy introduction of VAT and the adoption of two rates (0% and 10%) and several exemptions. Compounding this was the introduction in 1974, and expansion in 1975, of a second positive tax rate. This, as we noted above, caused problems for VAT administration for both government and businesses.

Government administrative burden

Administration cost

The form in which the VAT was introduced in 1973 resulted in several problems for HM Customs and Excise. Firstly, they severely underestimated the manpower required to administer the VAT, initially having some 7,700 tax officials in 1974, but rapidly increasing this to 10,500 in 1975, 11,600 in 1976 and 12,213 by 1977.¹⁸

A second problem was that, in the first year of VAT, some 20% of returns were defective in some way, causing considerable administrative problems and requiring VAT field officers to act as VAT advisers. In particular, VAT officers would try to visit each new business as it registered for VAT, to ensure that traders knew their obligations and had records and systems that were adequate.

The problem for many businesses was the mass of educational information coming out of HM Customs and Excise, which many could simply not comprehend. For example, by February 1977 there were over 600 pages of official VAT literature which was viewed by businesses as too wordy, legalistic and repetitive. In response, VAT forms were considerably simplified in 1978.

A third problem for HM Customs and Excise was delays in tax payments and straight out evasion and underpayment, especially by smaller businesses, as most of these businesses paid minimal VAT. In fact, at this time, some 3000 traders paid two thirds of the VAT revenue and many of

¹⁸ Figures are for the year ending 31 March.

these were non-retailers. Furthermore, some 200,000 paid only £10m.¹⁹ In response, the government raised the VAT registration threshold significantly in 1977 and 1978 in an attempt to reduce the number of registered traders, but only 20% of those eligible to deregister did so. This appeared to be due to two factors – a desire by some traders to conceal the (low) size of their turnover, but more importantly, because many of these firms were negative tax-payers (trading in zero-rated goods). For the latter group, it would be unreasonable for them to deregister or for the government to force them to deregister.

The official cost of compliance with the VAT legislation for selected years is shown in Tables 5 and 6.

TABLE 5 ADMINISTRATION AND COMPLIANCE COST OF VAT						
Year	No of Taxpayers (million)	Value Added Tax		Government Administration Cost (£m)	Compliance Cost for Business	
		Rates (%)	Revenue (£m)		Gross (£m)	Net (£m)
1977-78	1.274	0.8,12.5	4.2	86	392	319
1986-87	1.506	0.15	21.4	220	791	na
Sources: Sandford (1990, p 104)						

TABLE 6 ADMINISTRATION AND COMPLIANCE COST OF VAT				
	Government Administration Cost	Business Compliance Cost		Ratio of Administration Cost to Gross Compliance Cost
		Gross	Net	
1977-78	2.03%	9.3%	7.6%	1:4.6
1986-87	1.02%	3.7%	na	1:3.6
Hypothetical Cases: 1987 Case A: 17.5% Standard Rate	.87%	3.2%	-	-
Case B: 17.5% Standard Rate and no zero-rating (30% saving; Prest (1982) p 36)	.61%	2.2%	-	-
Sources: Sandford (1990, p 104) and own calculations				

19 Cmd 7415, HM Customs and Excise, *Review of VAT* (London, HMSO, December 1978).

For the UK government, the problem of evasion and avoidance has been greatest amongst VAT traders who are self-employed and small businesses. This appears in part due to these businesses' inability to cope with or understand their obligations, if only because these parties devote too little time and effort to understanding them. The problem for VAT administrators is that the cost of administering VAT may be considerably higher if the current level of evasion is considered unacceptable. Moreover, any increase in tax revenue that may result from reduced evasion may be totally consumed by increased administrative costs (and business compliance costs).

Linkage between VAT and income taxation

One area where VAT has proven a boon in some countries is in personal income tax enforcement. In most OECD countries with VAT, the VAT and income tax are administered by the same tax department and the same tax inspector deals with the VAT and income tax audit for each business. This is not the case in the UK where the VAT is administered by HM Customs and Excise and the income tax by the Inland Revenue. There is also no possibility of joint audits, although there is a possibility for some exchange of information between the different departments. Moreover, in the UK each tax department does not systematically inform the other when it is about to undertake a field audit, though in some cases the results of the audit are communicated (but only at the central level).

Appeals process

Another important area for concern for government was the possibility of litigation arising out of disputes with VAT traders. While the general structure of VAT has remained basically unchanged since its inception, there have been numerous disputes which have required resolution. The resolution mechanism introduced was a three stage process, not dissimilar from that in other countries with VAT.

The first level of appeal is to the tax authorities. The decision here can be appealed to a VAT Tribunal. The objective of these tribunals is to give businesses an appeal process which is simple, cost effective and results in a quick decision being given. More complicated cases requiring more time can then be left to the courts. Appeals from the Tribunal findings can be resolved here. Cases which are likely to establish important precedents can proceed directly to the courts.

The broad range of issues open for dispute can be highlighted by an examination of a series of articles by Stanley Dencher.²⁰ There are four main areas of disputation and we shall examine each briefly.

The first area of disputation is the definition of a *taxable person*. Before a person qualifies as taxable, they must make taxable supplies and such activities must be in the course of, or in furtherance of, a business; the business must be carried on by them and turnover must exceed registration limits. Of particular concern for many small businesses is the VAT registration and deregistration rules as their turnover goes above and below the VAT threshold and their liability for VAT in each case.

For example, a trader is required to register at any time they believe that the value of taxable supplies in the next 30 days will exceed £36,600, or at the end of any month if the value of taxable supplies in the past 12 months then ending has exceeded £36,600. If a trader does not register when required, he or she is liable for the VAT on taxable supplies from the proper registration date. However, a person who initially appears liable to register need not if they can show that, in the next 12 months, taxable supplies will not exceed £35,100. A currently registered trader can deregister also if, in the year from the application to deregister, their taxable supplies are not expected to exceed £35,100.

For small traders near this threshold, it probably implies that they have no alternative but to register to avoid the penalties and administrative problems that may arise from becoming entwined in the deregistration process.

A second area of disputation is the definition of *business*. Disputes arise here from classifications of certain categories of goods and services as exempt or zero-rated. For example, a zero-rated business (eg, an educational institution) may carry out programs (such as training programs) which are comparable to those provided by taxable businesses. A point of contention was whether the pursuit of gain was a prerequisite for the existence of a commercial purpose. It was decided that activity which was comparable to that of other business which was taxed implied a taxable activity by the zero-rated business.

The third area of attention was the definition of supply. This area was the subject initially of numerous disputes, because a distinction was drawn between building alterations (zero-rated) and repairs and maintenance (taxable). This problem was overcome in 1984 when building alterations became taxable. The majority of problems in this area arise therefore from difficulties in classifying the activities of a business. For example, a club or association is an exempt activity, but if its membership releases a magazine which is zero-rated should that part of the club's activities which goes on

20 Dencher, "A Question of VAT" (September 1989) *Accountancy Journal* UK 92-93; "Sweet Reason and the VAT Inspector" at 80-82, January 1990; "Late Returns: Excuses Excuses" at 94-95, March 1990; "Defences Against the VAT's Blunt Instrument" at 80-81, December 1991.

financing the magazine be zero-rated? It was concluded that while the magazine was zero-rated, the crucial test was whether it is appropriate for the association to charge a separate fee for the magazine.

The fourth area of appeal is in relation to "reasonable excuses" for late or erroneous returns. In recent years, this category has accounted for over half of the Tribunal's decisions.

The review in Dencher²¹ highlights the many cases which come before the Tribunals and the courts. This has been exacerbated in the past decade by increases in the VAT rate, which have provided business with a greater incentive for them "to get it right" and for the authorities to "ensure that they get it right".

Nevertheless, even when the VAT rates were low, before 1979, many cases went before Tribunals. For example, in 1977-78, there were 881 appeals to Tribunals, of which 474 were withdrawn, 198 heard and 48 resolved in favour of the taxpayer.

What has been highlighted by the discussion above is the importance of the mechanism by which the VAT is operated rather than the design of the tax. A broadening of the VAT base would help to overcome some of these problems, but since health, education, welfare and financial services are typically either zero-rated or exempt, such problems are likely to remain and be the source of ongoing litigation.

Business compliance cost

The cost of VAT compliance for UK business is shown in Table 6. Sandford²² examines the source of changes in compliance cost between 1977-78 and 1986-87 and concludes that the gross compliance cost of VAT has been reduced over this period. While the VAT gross compliance cost rose 102%, after allowing for an 18% increase in VAT-registered traders, the average compliance costs in effect only rose 71%. This occurred at a time when wages rose 162% and prices 109%. As a result, the real (price inflation adjusted) cost of compliance fell one third. This picture is also reflected by the fall in the ratio of administrative to compliance costs. This was helped by the number of VAT officials rising only 4.6% between 1977-1978 and 1986-1987, despite VAT-registered traders increasing 18%.

The change in the compliance costs for traders is due to several factors:

- increased computerisation, especially by small firms;
- the abolition of the higher tax rate in 1979 (saving 8%, according to Sandford);²³

21 Above nn 10 and 14.

22 Sandford, *VAT-UK Experience: Lessons for Australia* (ANU 1986).

23 Ibid at 104.

- changes in the tax treatment of buildings in 1984, which helped reduce compliance costs for the building industry; and
- the simplification of VAT for small traders, in particular a higher registration threshold, new simplified booklets and the introduction of a single sheet VAT form, which can now be electronically lodged.

One major difference over the period noted by Sandford²⁴ was the increased use of professional advisers, particularly accountants. The cost of these advisers to businesses rose from 5.1% of gross compliance costs in 1977-1978 to 17.2% in 1986-1987. This trend is evident in Table 7 which also confirms a decline in the general use of official sources of information. The growth in use of non-official VAT advisers appears to be due to four main factors.

First, the increases in the rate of VAT over the period highlighted the stake business had in getting their VAT right. This came about from a growing awareness that, despite attempts to simplify VAT, it remained a complicated tax. Recognising that they could save their clients money (and make some for themselves), accountants developed teams specialising in this area.

A second factor contributing to greater use of non-official sources of information on VAT was the introduction of a penalty system for incorrect VAT payments and late lodgements designed to frighten traders into taking greater care.

A third factor was the implication of EC decisions and proposals for VAT, particularly for firms trading across borders in Europe.

A fourth contributor was changes in HM Customs and Excise, who were pushing traders towards accountants. Previously, a newly registered business would receive a visit from VAT inspectors to help educate the trader. With tight schedules and financial targets, inspectors stopped visiting traders upon registration and, when they did visit, spent little time helping them and tended to impose an assessment on the traders for any errors and omissions and leave the trader to solve their own problem.

While all these factors have acted to increase traders' compliance costs, some of these costs have been offset by others, such as the adoption of a single positive rate. In relation to compliance cost changes since 1986-87, Sandford notes that, in all probability, compliance costs have increased because of new rules introduced on commercial buildings and land in 1989, and new accounting rules and penalties in January 1990.

Table 6 also presents hypothetical estimates of the possible compliance cost for firms in 1986-1987 assuming the 15% VAT rate was raised to

24 Ibid.

17.5% as it was in 1991.²⁵ This clearly reduces the ratio of administrative and compliance costs to VAT revenue. Also presented are estimates of the benefit of abolishing zero-rating. The sensitivity of compliance costs to the VAT rate and the base of the tax is clear. An additional factor compounding compliance and administrative costs is that many small traders are registered simply because they trade in zero-rated items (such as food). Since these traders are allowed to lodge monthly returns (instead of three-month returns) in order to receive a refund of VAT on their inputs, they incur substantial compliance costs but yield no VAT revenue. For the VAT administrators, this group of traders requires considerable vigilance to ensure that refund requests are justified. The result is that small traders' compliance cost to turnover is more than 30 times those of the largest traders.

TABLE 7
SOURCE OF UK VAT ADVICE

	Users (% of sample)		Finding helpful (% of users)	
	1977-78	1986-87	1977-78	1986-87
Official VAT booklets	76	55	64	63
Visits by VAT officers	71	60	82	82
Local VAT office	48	41	80	78
Accountant	46	60	86	88

Source: Sandford (1990, p 104)

It should be stressed that, while traders do incur costs in complying with VAT regulations, there are two major benefits which can accrue from having to administer the tax. First, a *cash flow* benefit can arise from traders access to the VAT paid by customers during the normal three month VAT accounting period but which is not due to the VAT office until one month after the end of that period. Sandford²⁶ found that, for the larger businesses, this benefit exceeded their compliance costs and so they had negative compliance costs.

The second benefit for traders is the *managerial benefit*. These benefits included better and more complete accounts, better stock control, fewer bad debts and benefits from preparing more of their own accounts. This subsequently provided traders with much better information and enabled them to improve their decisionmaking, particularly in the case of small traders.²⁷

25 In making these estimates, it is assumed that, while the revenue from the VAT increases in proportion to the increase in the tax rate, the administration and compliance costs do not change.

26 Ibid at 253.

27 See Sandford, *ibid* at 253.

Future direction of the UK VAT

The discussion above has served to highlight the major characteristics and problems with the UK VAT. The debate over the future of VAT in the UK is now fundamentally linked to the EC Sixth Directive on VAT.²⁸ This sets out a clear program for the staged introduction of the fiscal conditions permitting internal markets to function. In relation to VAT, this involves a harmonisation of the base and rates of VAT. Already, significant progress has been made towards the adoption of a common VAT base, but this leaves two main areas of contention: the rate structure and method of administration across EC members' frontiers.

The number of VAT rates is a source of some disputation in the drive for harmonisation. The European Commission has accepted that a single rate VAT would be in conflict with the structure of VAT in most EC countries.²⁹ Consequently, they have accepted that a multi-rate VAT should be adopted and, in particular, a two-rate system. For the UK, this implies that all those commodities in Table 4, except exports, will have to be taxed at the reduced VAT rate. The EC has concluded that the standard VAT rate should be set between 14% and 20% and the reduced rate set between 4% and 9%.³⁰

The release of the Sixth Directive caused some dissent amongst EC members³¹ and resulted in the harmonisation of VAT rates being made more flexible. Now the reduced rate, while still set in the 4% to 9% band, includes an exception to accommodate the UK's zero-rate, and the standard rate band now has 15% as its minimum rate but has no maximum.

The second important harmonisation issue arises from the adoption of a single European market and the abolition of intra-EC frontiers and customs controls. This action would effectively call for a change in the way that VAT is administered. Currently, EC Members administer VAT on cross border commodity flows using the destinations principle. Here, tax paid on the good is decided by the country of destination and this results in exports being zero-rated and imports being taxed. With no trade frontiers and customs controls, the only operational alternative is to adopt the origins principle. In this case, commodities flowing across EC member country borders will carry with them a credit for the tax levied in the country of origin.

28 "Completion of the Internal Market: Approximation of Indirect Tax Rates and Harmonisation of Indirect Tax Rates and Harmonisation of Indirect Tax Structure", Global Communication from the Commission (COM(87)320 Final/2 Bruxelles) 26 August 1987. See also OECD, *Taxing Consumption* (1985) 275-278.

29 This is because only Denmark and the UK have one positive rate, although the UK does have a zero-rate also. In contrast, some countries such as Belgium have six rates, and France, Ireland, and Greece have five.

30 The Commission actually concluded that the reduced rate should be set in the lower half of the 4-9% band.

31 See A Reid, "Tax Harmonisation - A Recipe for Chaos" (July 1989) *Accountancy* 23-24.

Adopting the origins principle³² has major ramifications for the EC. Under the destinations principle, VAT on traded goods ends up in the hands of the importing country. With the origins principle, this VAT will end up in the hands of exporting countries. This implies a transfer of tax revenue from importing to exporting countries within the EC. In response to such a redistribution, the EC has proposed a clearing system, so that transfers of VAT would occur between government VAT offices to ensure the same outcome as under the destinations principle. The difficulty, which the EC acknowledges, is administering such a system efficiently, with the minimum of fraud and tax evasion, whilst minimising administrative and compliance costs.

Fiscal harmonisation in the EC is, however, still some way off, despite the harmonisation of markets. In the interim, complexities will arise, especially with the administration of VAT across EC frontiers. For the UK, the future will probably not result in any major changes to the VAT base, although there is still a possibility that a low rate VAT may replace the current zero-rate. However, it would probably be a brave British politician who advocated this strategy.

Bibliography

- Aaron A (ed), *VAT: Experiences of some European Countries* (Kluwer Law and Taxation Publishers, Netherlands).
- Aaron A (ed), *VAT: Lessons from Europe* (Brookings Institution, Washington).
- Bennet R J, "The new VAT on Construction of Commercial Property: The Fallout on Urban Regeneration" (1991) 12 *Fiscal Studies* 78-87.
- Dilnot A, Johnson P and Stark G, "Tax Policy and the 1991 Budget" (1991) 12 *Fiscal Studies* 23-33.
- Hills J and Sutherland H, "Banding, Tilting & Gearing, Gaining and Losing: An Anatomy of the Proposed Council Tax" (1991, London School of Economics, London).
- HM Customs and Excise, VAT: General Guide*, Notice No 700.
- Davies E and Kay J A, "Extending the VAT base: problems and possibilities" (1985) 6(1) *Fiscal Studies* 1-16.
- Kay J A and Warren N A, "Effective Rates of VAT" (1980, Working Paper, Institute for Fiscal Studies, London).
- Lee C and Pashardes P, *Who Pays Indirect Taxes?* IFS Report Series No 12 (1988, Institute for Fiscal Studies, London).
- Neumark Report, "Report of the Fiscal and Financial Committee" in The Bureau of Fiscal Documentation, *The EEC Report on Tax Harmonisation* (1963).
- NIESR, "The Home Economy" (1972) 60 National Institute of Economic and Social Research Review 17-20.
- OECD, *Taxing Consumption* (1985, Paris).
- Pechman J A, *World Tax Reform: A Progress Report* (Brookings Institution, Washington).

32 A payroll tax, for example, can also be viewed as an origins principle tax, as can any tax which is not refunded upon the export of the goods.

- Prest A R, *VAT: The Experience of the United Kingdom* (1982, American Enterprise Institute for Public Policy Research, Washington).
- Sandford C T, "VAT: UK Experience" in J G Head, *Changing the Tax Mix* (1986, Australian Tax Research Foundation, Sydney) 247-258.
- Sandford C T, *VAT – UK Experience: Lessons for Australia* (1986, Centre for Research on Federal Financial Relations, ANU, Canberra). Sandford C T, Godwin R, Hardwick P J W and Butterworth M I, *Costs and Benefits of VAT* (1981, Heinemann, UK).
- Tait A A, "The Valued Added Tax: Revenue Inflation and the Foreign Trade Balance" in Gillis M, Shoup C S and Sicat G, *Value Added Taxation in Developing Countries* (1990, World Bank, Washington DC).
- Warren N A, *A Goods and Services Tax for Australia*, Research Report 11 (1990, Australian Tax Research Foundation, Sydney).