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The Impact of Public Perceptions on General Consumption Taxes

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The traditional view as regards general consumption taxes is that excluding certain products from the base decreases their natural regressivity. Whilst this view has been consistently questioned over the last forty years, public perceptions are still heavily influenced by it. Drawing insights from the legislative history of the old European VAT system and the newer Australian VAT system, this paper demonstrates how policy debates and changes in VAT rates have been heavily influenced by those public perceptions; and how special interest groups, which would be set to lose out from broad base VATs, are able to use the information asymmetry behind those perceptions to defend their interest in favour of base narrowing, or against base broadening reforms. The paper presents a novel analytical and conceptual framework – informed by tax law, political economy, political science, behavioural science, and regulatory theory – of the likely factors behind the prevalence of those public perceptions. It demonstrates how, in the absence of external pressures, they result in increased use of reduced rates over time, and the consequent narrowing of the tax base. It concludes by presenting a new pathway to shift public perceptions, and to overcome the political resistance to broad based consumption taxes.

I. Introduction

General consumption taxes, like VAT, are commonly regarded as regressive.[1] The traditional response to concerns over this regressivity has been the exclusion of certain products from full taxation, on the presumption that this exclusion will achieve social and distributional aims. The argument is two-fold: first, non-taxation will increase consumption of products with positive externalities, so-called merit goods, such as cultural events, sport events and books; and, second, non-full taxation of essential products, such as food, healthcare and education, will diminish the natural regressivity of consumption taxes. Non-full taxation is achieved primarily through either exemptions or reduced rates, and both methods are widely used within Europe, as well as in many other countries applying a VAT, including Australia.

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[1] Whilst the paper concentrates on VAT, most its conclusions are applicable, *mutatis mutandis*, to other general consumption taxes, such as Retail Sales Tax (RST) applicable in the USA.

Yet, over the last decades, an overwhelming body of legal and economic evidence has built up against the use of multiple VAT rates structures. Applying more than one rate of VAT gives rise to significant legal difficulties, creates economic distortions, and it is at best unclear whether it actually has the social and distributional effects that it aims to achieve. Despite the evidence, however, multiple rates are still widely used worldwide. Therefore, beyond demonstrating that using VAT reduced rates is an inefficient method of achieving social and distributional aims, the question which *should* be asked is why is the allure of applying reduced rates of VAT has proved so hard to resist? Not only why have so many countries opted to apply reduced rates of VAT in the first place, despite the strong evidence against it, but also why does their use not decrease, but rather increase, over time? The aim of this paper is to answer these questions by focussing on the political dynamics that frame the debate and ultimately dictate the outcome.

The role of political economy in determining taxation policy has been increasingly acknowledged as a response to an easily observable gap in traditional tax policy analysis; namely that policy outcomes are often sub-optimal, and thus hard to understand without also appreciating political dynamics.[2] The now sizeable, and growing literature on the political economy of taxation has convincingly confirmed this intuition as regards the determining role of political factors. An empirical study of labour taxation reforms in Europe, for example, has provided evidence that political variables carry more weight in triggering reforms than explanatory economic variables.[3] Yet, despite this growing awareness of the impact of political factors in tax policy, and notwithstanding the relevance of consumption taxes generally – and VAT in particular – very limited work has been done on the political dynamics of their design and reform,[4] from either a public finances or a political science perspective. This paper addresses this research lacuna by presenting a new framework that conceptualises those dynamics in both a design context (Australia), and a reform context (Europe).

Regarded as the birthplace of today's VAT,[5] Europe has in place a so-called traditional VAT, where differentiated rates structures date back to the introduction of the tax itself; a time when evidence regarding the potential negative consequences of applying multiple rates was at best limited. Notwithstanding this initial lack of awareness, difficulties have been evident for some decades, and recent decades have witnessed several attempts to amend European rates structures to reflect this reality. Yet, not only have all attempts that entailed a reduction of rate differentiation, and a broadening

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2 J. Alt, I. Preston and L. Sibieta, "The Political Economy of Tax Policy" in S. Adams et al (eds), *Dimensions of Taxation* (OUP, 2010), Chp 13. See also D. Gamage and D. Shanske, "Tax Cannibalization and Fiscal Federalism in the United States" (2017) *Northwestern University Law Review* 111(2), 295-376.

3 M. Castanheira et al, "On the political economies of tax reforms: survey and empirical assessment" (2012) *International Tax and Public Finance* 19(4), 598-624.

4 On the critical difference between tax policy design and tax policy reform, see M. Feldstein, "On the Theory of Tax Reform" (1976) *Journal of Public Economics* 6, 77-104.

5 For a brief history of the introduction of VAT, see R. de la Feria and R. Krever, "Ending VAT Exemptions: Towards a Post-Modern VAT" in R. de la Feria (ed.), *VAT Exemptions: Consequences and Design Alternatives* (The Hague: Kluwer Law International, 2013), 3-35. See also K. James, *The Rise of the Value-Added Tax* (CUP, 2015).

of the base, been met with significant resistance, but the most recent agreed-upon amendments and proposals to the rates structure purport to increase the level of differentiation, rather than to decrease it. As a result, today more goods and services are subject to reduced rates in Europe, than even as recently as fifteen years ago. Australia, on the other hand, has a much more recent GST, having only been introduced in 2000; and it is one of the countries around the world that is said to apply a *modern* VAT.[6] By the time Australia introduced its system, there was a clear awareness of the legal difficulties and economic distortions caused by multiple rates structures. Mindful of this reality, rates differentiation was not part of the initial Australian GST design. Yet, in a last-minute decision amidst political fears over the impact amongst lower income households of introducing GST, zero-rating was introduced for food,[7] and further narrowing of the base has been a topic of public discussion ever since.

Part Two of this paper presents the case against rate differentiation, by presenting a cost-benefit analysis of its use, focusing upon the legal and economic dynamics of multiple rates structures. Attention will then turn to the design of VAT rates structures. Part Three concentrates on the European and Australian experiences, analysing the historical developments of rates structures, in particular failed attempts to broaden the base, and the tendency for base narrowing. It is argued in Part Four that those experiences demonstrate how political pressures have both stopped the broadening of the EU VAT base, and influenced the initial design of the Australian GST base. It is further argued that those experiences also show that, in the absence of external pressures, those same political economy pressures have determined the narrowing of the tax base, either by an increase in rate differentiation, or the extension of reduced rates to further products. These political economy pressures seem to be primarily motivated by traditional views over the positive impact of reduced rates on decreasing the regressivity of the tax, facilitated by information asymmetry, framing and fairness-centric narratives from special interest groups, in conjunction with various behavioural biases that often present constraints to policy reform. The paper concludes by presenting a pathway to overcome the resistance to both broad based general consumption taxes *ex novo*, and base broadening reforms.

II. VAT Base: Traditional vs Modern View

Despite the widespread perception of VAT as a naturally regressive tax, the question is not as straightforward as it initially appears, and it is far from settled. Although questions have been raised concerning the possible bias over the measurement of VAT regressivity generally,[8] the main source of contention relates to how regressivity is assessed. Namely whether it should be assessed relative to

[6] The expression 'modern VAT' to classify the new, improved VAT model, first introduced in New Zealand in the 1980s, as opposed to the 'traditional VAT' used in Europe, appears to have been coined by L. Ebrill, et al, *The Modern VAT* (International Monetary Fund 2001).
[7] Chapter 1, Further Supplementary Explanatory Memorandum (Senate) A New Tax System Goods and Services Tax Bill 1999 and amendments in subdivision 38AA.
[8] F. Gastaldi et al, "Regressivity-Reducing VAT Reforms" (2017) *International Journal of Microsimulation* 10(1), 39-72.

current income, or to current consumption.[9] VAT is particularly regressive if regressivity is assessed relative to income, but much less so when it is assessed relative to consumption, which is regarded as a better indicator of lifetime welfare;[10] in 2014, an OECD report looking at twenty of its members, concluded that VAT systems were either proportional or slightly progressive when measure as a percentage of expenditure.[11]

It is undoubtedly true that to the extent that all income is consumed, VAT is equivalent to a flat-rate, proportional, tax, rather than a regressive one, and this will indeed be the case for those at the lower end of the income distribution. To the extent, however, that not all income is consumed and savings come into play, regressivity becomes a concern. Of course, it can be argued – and it often is – that savings are mere deferred consumption.[12] Yet, that argument does not fully convince, for two reasons. The first is that, whilst savings can indeed be seen to some extent as deferred consumption, they are much more than that, such as further income generators; until consumption takes place, individuals will extract significant benefits from their savings holding. The second, and perhaps more important reason is that, the higher the savings, the more deferred in time the consumption will potentially be, and *ad extremis* it can be passed on inter-generationally to a time when consumption is no longer taxed. It is therefore more realistic to argue that whilst VAT is a proportional tax for the lowest income deciles, where all income is spent on consumption, it becomes regressive once part of that income is saved. Consequently, the higher the percentage of income saved, the more regressive the tax will be. The question is then, how to address this regressivity.[13]

Reduced rates are one of two methods traditionally used to address vertical equity concerns – either to diminish the regressivity of VAT, or to increase consumption of perceived merit goods – the other being exemptions. Whilst the reasons for the use of reduced rates in older VATs are rather more prosaic,[14] early literature on optimal consumption taxation does provide backing for the use of differentiated rates.[15] Yet, the reduced rates in existing VATs do not follow the inverse elasticity rule suggested in early optimal taxation theory: firstly because, in practice, the information on consumers' behaviour needed to operate a differential tax regime that improves, rather than worsens, economic welfare is so

[9] R. de Mooij and M. Keen, "Fiscal Devolution and Fiscal Consolidation: The VAT in Troubled Times" in A. Alesina and F. Giavazzi (eds.), *Fiscal Policy after the Crisis* (University of Chicago Press, 2013), 443–485.
[10] E. Caspersen and G. Metcalf, "Is a Value Added Tax Regressive? Annual Versus Lifetime Incidence Measures" (1994) *National tax Journal* 47(4), 731-746. See also N. Warren, A. Harding and R. Lloyd, "GST and the changing incidence of Australian taxes: 1994-95 to 2001-02" (2005) *eJournal of Tax Research* 3(1), 114-145; G.N. Carlson and M.K. Patrick, "Addressing the Regressivity of a Value-Added Tax" (1989) *National Tax Journal* 42(3), 339-351; and S. Cnossen, "The Value-added Tax: Key to a Better Tax Mix" (1989) *Australian Tax Forum* 6(3), 265-281.
[11] OECD, *The Distributional Effects of Consumption Taxes in OECD Countries* (Paris: OECD Publishing, 2014).
[12] A. Thomas, "Reassessing the Regressivity of the VAT" (2020) *OECD Taxation Working Papers* 49.
[13] Assuming it should be; some argued that progressivity concerns should not be concentrated in one single tax, see A. Auerbach, "Public finance in practice and theory" (2010) *CESifo Economic Studies* 56(1), 1-20.
[14] As discussed in R. de la Feria and R. Krever, n. 5 above.
[15] F.P. Ramsey, "A Contribution to the Theory of Taxation" (1927) *Economic Journal* 37, 47-61; W.J. Carlett and D.C. Hague, "Complementarity and the Excess Burden of Taxation" (1953) *Review of Economic Studies* 21, 21-30; and A. Sandmo, "A Reinterpretation of Elasticity Formulae in Optimum Tax Theory" (1987) *Economica* 54(213), 89-96.

extensive as to make such regimes impractical;[16] and secondly, the traditional use of reduced rates by VAT systems to reduce the regressively of the tax, tends to result in precisely the opposite result to that suggested under that rule, namely the higher taxation of highly inelastic products, such as food and utilities. There is therefore limited literature support, in optimal taxation theory or otherwise,[17] for the use of differentiated rates as applied in older VATs, such as the European ones. This is because, not only is there now extensive evidence that reduced rates carry significant costs beyond the obvious loss of revenue, but there are also significant doubts as to their potential benefits, namely whether applying reduced rates truly achieves social and distributional aims.

VAT Incidence and Distributional Impact

As a pre-condition for reduced rates to achieve the sought after distributional and social aims, the decrease in the tax rate must be passed on to consumers, in the form of price reductions. Theoretically, this should indeed be the case: in a perfectly competitive market, it is assumed that a decrease in taxes should result in a decrease in prices. Indeed, in policy circles it is almost universally assumed that indirect tax changes are fully and exactly passed through to consumer prices.[18] Markets, however, are often not perfectly competitive, and theory makes clear that pass-through may be less than complete (under-shifting), or more than complete (over-shifting).[19] For a long time, economic literature provided sound theoretical insights into the efficiency of consumption taxes, but the empirical work was not as widely developed.[20] For the last decade, however, there has been a wealth of studies on the incidence of VAT. Whilst these studies do not reach fully uniform results, and show instead varying degrees of pass-through to consumer prices, clear patterns have emerged that cast doubts, in policy circles, over the full pass-through assumption.[21]

One of the first, and most significant, studies was the so-called "labour-intensive services experiment". Carried out across several European countries, and across a range of industries – from hairdressing to cleaning – the aim of the study, implemented in 1999, was to test the impact of the introduction of reduced rates of VAT on job creation. In 2003, a report from the European Commission confirmed that the impact of the new reduced rates on prices of labour-intensive services was minimal: when conducting price surveys, Member States found that reduced rates of VAT were reflected in consumer prices only partially or not at all, and that at least part of the VAT reduction was used to increase the

[16] OECD, "Choosing a Broad Base-Low Rate Approach to Taxation" (2010) *OECD Tax Policy Studies* 19.
[17] P.B. Sorensen, "The Theory of Optimal Taxation: What is the policy relevance?" (2007) *International Tax and Public Finance* 14, 383-406; and H.J. Kleven, "Optimum Taxation and the Allocation of Time" (2004) *Journal of Public Economics* 88, 545-557.
[18] R. Bird and P.P. Gendron, *The VAT in Developing and Transitional Countries* (Cambridge: Cambridge University Press, 2007).
[19] D. Benedek *et al*, "Varieties of VAT Pass Through" (2019) *International Tax and Public Finance* 26.
[20] T. Kosonan, "More and Cheaper Haircuts After VAT Cut? On the Efficiency and Incidence of Service Sector Consumption Taxes" (2015) *Journal of Public Economics* 131, 87-100.
[21] For a review of the latest literature see T. Buettner and B. Madharova, "Unit Sales and Price Effects of Pre-Announced Consumption Tax Reforms: Micro-Level Evidence from European VAT", 2020, *mimeo*.

margins of service providers; where the VAT reduction had been passed on to the consumer, Member States found that this was only a temporary measure and prices would subsequently increase.[22] Overall, the study concluded that, partially due to the lack of effect on prices, the aims of the experiment, namely to increase employment and to combat informality, had not been achieved.[23]

Around the same time, a second experiment to assess the impact of reduced rates on prices took place in Ireland. In 2001, struggling to contain high inflation, the Irish Government reduced the rate of VAT from 21% to 20%. In a speech, the Finance Minister stated that the government expected to see "the VAT reduction passed on to the consumer and not absorbed in higher retail margins". In 2002, the Irish government decided to raise the rate of VAT back from 20% to 21%, after the Government concluded that the lower rate of VAT had not been passed on to consumers.[24]

Changes in European domestic VAT rates structures in the last decade have also opened up opportunities for empirical studies on the price incidence of the tax,[25] and there is now a significant body of literature exploring the topic, displaying clear trends and response patterns. The main take-away is in line with the results of the labour-intensive services and the Irish experiments: there is near unanimity in finding less than full pass through on prices. Prices tend not to reflect changes in VAT rates – or at least, not fully. The response to VAT changes is, however, heterogeneous, and depends on not only the type of change, but the product type and firms' characteristics. Changes in the level of standard rates are more likely to be passed on to consumers, than changes in the level of reduced rates or base narrowing reclassification measures;[26] wide-ranging changes that affect a small consumption share are less likely to be passed on to consumers, than changes that affect around half of the consumption share;[27] and, as opposed to what tax incidence theory indicates, the response to rate changes is asymmetric, and increases are more likely to be passed on than are decreases.[28] Larger firms are also more likely to pass on rate reductions on prices than smaller firms;[29] reductions for products in more

[22] See *Experimental application of a reduced rate of VAT to certain labour-intensive services*, Report from the Commission to the Council and to the European Parliament, COM(2003) 309 final, 2 June 2003; and *Evaluation report on the experimental application of a reduced rate of VAT to certain labour-intensive services*, Commission Staff Working Paper, SEC(2003) 622, 2 June 2003. For a detailed analysis of the "labour-intensive services experiment" see point 3.2 below.

[23] SEC(2003) 622, 2 June 2003, n. 23 above, at 28.

[24] Ibid, at 26.

[25] On the changes in European domestic VAT rates since 2018, see R. de la Feria, "Blueprint for Reform of VAT Rates in Europe" (2015) *Intertax* 43(2), 154-171.

[26] D. Benedek *et al*, n. 20 above.

[27] Ibid.

[28] Y. Benzorty *et al*, "What Goes Up May Not Come Down: Asymmetric Incidence of Value-Added Taxes" (2018) *NBER Working Paper* 23849. See also R. Batista Politi and E. Mattos, "*Ad Valorem* Tax Incidence and After-Tax Price Adjustments: Evidence from Brazilian Basic Basket of Food" (2011) *Canadian Journal of Economics* 44(4), 1438-1470.

[29] T. Kosonan, n. 21 above; and J. Harju *et al*, "Firm types, price-setting strategies, and consumption-tax incidence" (2018) *Journal of Public Economics* 165, 48-72.

competitive markets are more likely to be passed on than those where there is imperfect competition;[30] reductions are more likely to be passed on as regards products where the market salience of the tax is higher;[31] and firms operating in sectors with low profit margins are less likely to pass on VAT decreases, than are firms operating in sectors with high profit margins.[32]

How to explain these results? The most typical explanation for the lack of full pass-through of VAT changes on consumer prices is that it results from inelastic supply and demand or imperfect market competition.[33] Another possible explanation for the lack of effect on prices, particularly in the context of temporary changes such as the labour-intensive services experiment, is the assumption of fixed costs for changing prices.[34] Cognitive biases may, however, also play a role. Anchoring, whereby an individual depends on an initial piece of information to make subsequent judgments, may help explain the lack of pass-through if consumers make purchasing decisions on the basis of the pre-VAT reduction price (anchor). The low market salience of indirect taxes, resulting in consumers not always fully factoring in the price effects of general consumption taxes or excise duties in their purchasing decisions, seems to also contribute to the lack of pass-through.[35]

Whilst all these explanations can certainly help to partly explain the results, they do not do so fully – in particular, they do not explain the heterogeneous response of firms, depending on size or business structure, or the different pass-through rates depending on share of consumption affected by the reform. Regardless of the reason – or most likely reasons – for the lack of pass-through of VAT changes on consumer prices, we now know that consumers tend not to receive the benefit of reduced rates of VAT. This begs the further question of who does tend to benefit from this reduction in rates. Until recently there was limited concrete evidence on the main beneficiaries of reduced rates, although employees and a possible positive effect on (low-skill) employment had already been discarded;[36] a recent study, however, confirms the intuition that retailers – not consumers, employees or suppliers – are the primary beneficiaries of VAT reductions.[37]

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[30] C. Carbonnier, "Who pays sales taxes? Evidence from French VAT reforms, 1987–1999" (2007) *Journal of Public Economics* 91, 1219-1229.

[31] F. Montag, A. Sagimuldina and M. Schnitzer, "Are Temporary Value-Added Tax reductions passed on to consumers? Evidence from Germany's Stimulus" (2020) *arXiv:2008.08511v1*, 19 August. On the distinction between market and political salience, further discussed in Section V below, see D. Gamage and D. Shanske, "Three Essays on Tax Salience: Market Salience and Political Salience" (2011) *Tax Law Review* 65, 23-97.

[32] Y. Benzorty *et al*, n. 29 above.

[33] D. Fullerton and G.E. Metcalf, "Tax Incidence" (2002) *Handbook of Public Economics* 26, 1787-1872; T. Kosonan, n. 21 above; and S. Delipalla and M. Keen, "The comparison between *ad valorem* and specific taxation under imperfect competition" (1992) *Journal of Public Economics* 49, 351-367.

[34] M Golosov and R.E. Lucas, "Menu Costs and Phillips Curves" (2007) *Journal of Political Economy* 115(2), 171-199.

[35] R. Chetty et al, "Salience and Taxation: Theory and Evidence" (2009) *American Economic Review* 99, 1145; and *a contrario*, F. Montag, A. Sagimuldina and M. Schnitzer, n. 31 above.

[36] T. Kosonan, n. 21 above.

[37] Y. Benzarti and D. Carloni, "Who Really Benefits from Consumption Tax Cuts? Evidence from a Large VAT Reform in France" (2019) *American Economic Journal: Economic Policy* 11(1), 38-63.

The above studies cast doubts on whether reduced rates of VAT will be passed through to consumers. Yet, even assuming that, given the heterogeneity of the response to VAT reductions, reduced rates will indeed affect prices, there are still no guarantees of attaining the envisaged distributional and social aims. Economic literature has been consistently sceptical of the suitability of differentiated VAT rates to achieve distributional aims.[38] Such aims are generally regarded as better addressed under an efficient, and welfare enhancing,[39] single rate system, with the yield then used to compensate lower-income households, either through welfare transfers, or progressive income taxes.[40] Only when there are no other means of compensating lower-income households, due to poor targeting capacity – as in the case of some developing countries– has an efficiency argument been made to justify the use of reduced rates of VAT.[41] This is partly because the most significant beneficiaries of the tax expenditure that result from the application of reduced rates of VAT are not lower-income households, but higher-income households.

Given the regressive nature of VAT, at least at the higher-income deciles, it seems intuitive that applying lower rates of VAT will protect low-income households and limit the regressivity of the tax. Yet analysis of consumption patterns, and distribution of VAT payments by income decile or quantile, seems to indicate that it is often the opposite: since consumption, even of essential items, is overwhelmingly by the highest income households, when there is a VAT reduction – assuming this reduction is passed-through – it is those households that primarily benefit from VAT decreases.[42] A recent empirical study found that in Ghana, the average estimated benefit received by the lowest consumption decile by the application of VAT reduced rates and exemptions was $16 per capita, compared to $190 per capita at

[38] Although there is some support in optimal tax theory for their application when it impacts on household production, see H. Kleven, W. Richter, and P.B. Soerensen, "Optimal taxation with household production" (2000) *Oxford Economic Papers* 52(3), 584-594.

[39] Even under imperfect competition conditions, see B. Bye et al, "Welfare effects of VAT reforms: a general equilibrium analysis" (2012) *International Tax and Public Finance* 19(1), 368-392.

[40] A. Atkinson and J. Stiglitz, "The structure of indirect taxation and economic efficiency" (1972) *Journal of Public Economics* 1, 97-119; A. Deaton and N. Stern, "Optimally Uniform Commodity Taxes, Rate Differences and Lum-sum Grants" (1986) Economic Letters 20, 2634; I. Crawford, M. Keen and S. Smith "Value-Added Tax and Excises", in J Mirrlees et al (eds.), *Dimensions of Tax Design: the Mirrlees Review*, (Oxford University Press, 2011); C.L. Ballard and J.B. Shoven, "The Value-Added-Tax: The efficiency cost of achieving progressivity by using exemptions" in M.J. Boskin (ed.), *Modern Development in Public Finance: Essays in Honor of Arnold Harberger* (Oxford, B. Backwell, 1987), 109-129; and E.H. Davis and J.A. Kay "Extending the VAT base: problems and possibilities" (1985) *Fiscal Studies*, 6(1), 1-16.

[41] M. Keen, "Targeting, Cascading, and Indirect Tax Design" (2013) *IMF Working Paper*s WP/13/57; R. Bird and P.P. Gendron, n. 19 above; M. van Oordt, "Zero-Rating vs Cash Transfers under the VAT" (2018) *Fiscal Studies* 39(2), 1-27; and C. Heady and S. Smith, "Tax and Benefit Reform in Central and Eastern Europe" in D. Newbery (ed), *Tax and Benefit Reform in Central and Eastern Europe* (London, Centre for Economic and Policy Research, 1995).

[42] This issue is further developed in R. de la Feria and A. Swistak, "The Progressive VAT", forthcoming. See also A. Bozio et al, *Fiscalite et redistribution en France: 1997-2012* (Institute des Politiques Publiques, 2012); and N. Ruiz and A. Tronnay, "Le caractere regressif des taxes indirectes: les enseignements d'un modele de microsimulation" (2008) *Economie et Statistique* 413, 21-46.

the top end of the distribution.[43] The picture is even worse when high levels of informality are taken into account: a recent study found that the presence of large informal sectors in developing countries has a significant impact upon the distributional impact of general consumption taxes.[44] The large negative relationship between informal consumption shares – or from small businesses below the VAT registration threshold – and households' total expenditure means that applying reduced rates or exemptions will primarily affect either higher income households, whose consumption is concentrated in the formal sector, or larger businesses.

In practice therefore, reduced rates of VAT, to the extent that they are passed through in lower prices, effectively subsidise the consumption of the households at the higher levels of the income distribution. This in turn means that, contrary to intuition, reduced rates of VAT, as with any other exclusions from the base, do not necessarily reduce the regressivity of the tax,[45] but can on the contrary, increase it.[46] This will be particularly the case where reduced rates of VAT apply to services where there is a choice between private and public services, as is often the case with medical services or education – as principally high-income households tend to opt for private services – or where they apply to meritorious items, such as books or cultural events – as principally high-income households consume these products.[47]

Revenue Costs and Spillover Effects

In addition to questions over the effectiveness of applying reduced rates of VAT in order to pursue distributional and social aims, consideration must also be given to the equity and efficiency costs of introducing such rates. In this regard, the most significant element to consider is undoubtedly the size of the tax expenditure associated with these exclusions from the base. There are also, however, significant spillover effects that result from the application of multiple rates, namely interpretative and qualification problems, loss of neutrality and distortions to competition, opportunities for tax planning and avoidance, and increased compliance and administrative costs.

The tax expenditures – defined as reductions in tax liability compared to the benchmark –[48] resulting from the use of reduced rates of VAT are likely to be extremely significant. Whilst it is not always easy to determine the exact size level of this tax expenditure,[49] c-efficiency levels do provide some indication: in

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[43] T. Harris et al, "Redistribution via VAT and cash-transfers: an assessment in four low and middle income countries" (2018) *IFS Working Paper* W18/11. See also S. Boeters et al, "Economic effects of VAT reforms in Germany" (2010) *Applied Economics* 42(17), 2165-2182.
[44] P Bachas et al, "Consumption Taxes, Redistribution and Informality" (2020) *IFS Working Paper* W20/14.
[45] Although they can, particularly in high-income countries, see A. Thomas, n. 12 above.
[46] T. Harris et al, n. 44above.
[47] R. de la Feria and A. Swistak, n. 43 above.
[48] C. Heady, "Tax Expenditures: Definitional and Policy Issues" in L. Phillips *et al* (ed), *Tax Expenditures: State of the Art* (CTF, 2011). On reduced rates of VAT as tax expenditures, see P.P Gendron, "Canada's GST at 21: a tax expenditure view of reform" (2012) *World Journal of VAT/GST Law* 1(2), 125-148; and Y. Zu, "Reforming VAT Concessions: A Tax Expenditure Analysis" (2017) *British Tax Review* 4, 418-437.
[49] Y. Zu, n. 49 above.

developed countries low c-efficiency tends to be attributable primarily to the VAT policy gap – i.e. revenue loss due to exclusions from the base – rather than the compliance gap, as tends to be the case in developing countries.[50] It is therefore suggestive of the scale of the tax expenditure involved that European countries' VAT systems tend to rank below the OECD c-efficiency average, which stands at 52.9, and Australia scores just above the average with 53 points, whilst New Zealand, which amongst other broad-base features applies one single VAT rate, ranks at above 90 points.[51] Similarly, the VAT Revenue Ratio (VRR), which also measures the effectiveness with which taxes are collected, also suggests that most VATs have significant tax expenditures, with between half and one third of potential revenues lost due to exclusions from the base.[52] These results are in line with a recent calculation of the tax expenditure associated with exclusions from the VAT base in low and middle-income countries, which found that between 22% and 55% of potential VAT revenue was foregone as a result of those exclusions.[53]

The high levels of tax expenditures associated with reduced rates of VAT are all the more significant, because the foregone revenue has the potential to affect mostly those in lower-income households, as by nature of consumption patterns, those are the ones who mostly benefit from public expenditure – whether welfare benefits or others such as education or healthcare services. In the UK, for example, the distributional impact of eliminating reduced rates of VAT, whilst increasing the range of social benefits, was found to benefit mostly the three lowest-income deciles.[54] Similarly, a study focusing on four low and middle-income countries found that, despite being completely untargeted, a Universal Basic Income (UBI) funded by the revenue gains from a broader VAT base would create large net gains for poor income households and reduce inequality and poverty, even if only 75% of additional VAT revenue was disbursed as UBI payments.[55]

Beyond the revenue costs, the use of multiple VAT rates also carries significant spillover effects, not least qualification and interpretation problems. In Europe, these difficulties can be illustrated with a few examples. In *Belgium*, a cycle repair of a puncture is subject to a lower rate than the inner tube used for the repair, because of the labour component. In *Portugal*, fresh fish is subject to a 5% rate; if it is cooked prior to being frozen, it is subject to a 19% rate; and if it forms part of a ready meal to be taken away or consumed on the spot, it is taxed at a 12% rate. In the *United Kingdom*, raw and unprocessed nuts are zero-rated, and so are roasted and salted nuts still in their shells; fruit and nut mix can be zero-

[50] M. Keen, "The Anatomy of the VAT" (2013) *National Tax Journal* 66(2), 423-446.
[51] D. Snell, "GST – Revenue and Business Risk", in R. Krever and D. White (Eds.), *GST in Retrospect and Prospect* (Wellington: Thomson Brookers, 2007), 423-430, at 426.
[52] OECD, n. 17 above, at 59-61.
[53] T. Harris *et al*, n. 44 above. Tax expenditure studies in France, Italy and Germany show equally large numbers, see B. Egert, "The Efficiency and Equity of the Tax and Transfer System in France" (2013) *CESifo Working Paper* 4210; J. Tyson, "Reforming Tax Expenditures in Italy: What, Why and How?" (2014) *IMF Working Paper* WP/14/6; and M. Thoene, "18 Billion At One Blow – Evaluating Germany's Twenty Biggest Tax Expenditures" (2012) *Fifo Discussion Papers* 12-4.
[54] R. de Mooij and M. Keen, n. 10 above.
[55] T. Harris *et al*, n. 44 above.

rated if the weight of the roasted nuts is less than a quarter of the whole; however, if nuts are shelled and roasted or salted, or if they have been coated with chocolate or yoghurt, the standard rate applies.

In *Australia*, an overwhelming level of detail is needed to determine the scope of application of the zero rate of VAT applicable to “food for human consumption” and “beverages”.[56] Thus many similar examples to the European ones are evident: uncooked chicken or chicken meat purchased in a supermarket is GST-free, whereas a cooked (so-called “BBQ”) chicken is subject to GST,[57] and fresh bread is not subject to VAT, unless it has a sweet filling or coating, or is sold in combination, such as sausage and onion on a slice of bread. In 2011, it took a Full Bench of the Federal Court, and no doubt many thousands of dollars, to determine whether mini ciabatte styled as “Italian flat bread” were to be treated as GST-free bread or as taxable cracker biscuits.[58]

Also symptomatic of these definitional and interpretative difficulties are the high levels of litigation concerning the application of reduced rates of VAT. Within the EU, there is a growing number of cases on whether reduced rates of VAT should be applicable to specific – often new - products.[59] Amongst the most recent, and illustrative, cases are those concerning the treatment of non-physical books. At stake in these cases has been the interpretation of the word ‘books’, and whether the provision within the EU VAT Directive which allows ‘books’ to be subject to a reduced rate of VAT should be extended to similar products which did not exist at the time the Directive was approved, namely audio books, and e-books. In the first of this group of cases concerning non-physical books, namely audio books, the (3rd Chamber of the) Court of Justice of the European Union (CJEU) left the decision to the national court on whether applying a VAT reduced rate to hardcopy books, but not to audio books, violated the principle of fiscal neutrality.[60] Yet, barely six months later, in two other decisions on the same theme, the (4th Chamber of the) Court ruled that the supply of electronic books cannot fall within the scope of the rules reduced VAT rates.[61] These initial cases have been followed by others, and the matter was only settled with the approval of new (amending) legislation.[62]

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[56] S 38-3 and 38-4 *A New Tax System (Goods and Services Tax) Act 1999* and especially Schedule 1 “Food that is not GST-free” and Schedule 2 “Beverages that are GST-free”.
[57] See *A New Tax System (Goods and Services Tax) Act 1999* Schedule 1 - Food that is not GST-free, Item 6.
[58] *Lansell House Pty Ltd v FCT* [2011] FCAFC 6.
[59] For a comprehensive analysis of this jurisprudence see R. de la Feria, “EU VAT Principles as Interpretative Aids to EU VAT Rules: The Inherent Paradox” in M. Lang et al (ed.), *Recent VAT Case Law of the CJEU* (Vienna: Linde, 2016).
[60] Case C-219/13, *K Oy*, ECLI:EU:C:2014:2207.
[61] Cases C-479/13, *Commission v France*, ECLI:EU:C:2015:141; and C-502/13, *Commission v Luxembourg*, ECLI:EU:C:2015:143.
[62] Council Directive (EU) 2018/1713 of 6 November 2018 amending Directive 2006/112/EC as regards rates of value added tax applied to books, newspapers and periodicals, OJ L 286, 14/11/2018, 20–21. For a review of the so-called e-books cases see F. Cannas, “Reduced Rates and the Digital Economy” (2017) *EC Tax Review* 2, 96-108.

National courts have struggled with similar difficulties, and in this regard, whilst other countries have also experienced a high volume of cases,[63] litigation levels in the United Kingdom are particularly telling.[64] One of the most (in)famous cases was *Jaffa Cakes*.[65] Jaffa Cakes are a food product comprised of three layers: a sponge cake base, a layer of solidified orange flavoured jam, and a chocolate cover. For several years McVities, the producers of Jaffa Cakes, treated them as cakes, which – for historical reasons that are not fully clear, but appear to be related to their sale in traditional bakery shops – are subject to a zero rate of VAT in the United Kingdom. In 1991, however, this classification was challenged by HMRC, in particular on the basis that Jaffa Cakes are the same size and shape as biscuits, which under UK VAT law are subject to a standard rate on the basis of having been regarded by the legislator at the time of the law's entry into force as non-essential food products. The case was brought before the VAT Tribunal, with a central question: what criteria should be used to class something as a cake, rather than a biscuit? Ultimately, the court concluded that Jaffa Cakes where indeed cakes, rather than biscuits, and should therefore be zero rated.[66] The decision had a massive impact in the food industry in the UK. Not only did it give raise to significant and ever more complex follow-up litigation,[67] but the criterion established by the court in that case – based on the consistency of the product once it becomes stale – remains to the present day the one applicable to distinguish zero-rated cakes (which harden when stale) from standard-rated biscuits (which soften when stale). Many other everyday food products have been the subject of court cases in the UK to determine their VAT treatment, such as M&S teacakes, or Pringles.[68]

In addition to qualification and interpretative problems, multiple rates' systems give rise to planning, avoidance, and fraud opportunities; generally, the greater the number of VAT rates, the lower the degree of compliance.[69] Indeed, litigation indicates that VAT avoidance is often linked to exclusions from the base: of all the VAT avoidance cases decided by the CJEU in the last 20 years, for example, only two did not concern either reduced rates, or exemptions.[70] A paradigmatic example of the opportunities created by the application of reduced rates is the existing, and ongoing, litigation regarding

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[63] M. Kukawska and M. Machinski, "Polish landscape in the area of VAT rates for foodstuffs from the perspective of the neutrality principle" (2014) *World Journal of VAT/GST Law* 3(3), 201-209.

[64] G. Morse, '*Proctor & Gamble UK v HMRC (Pringles Two)* – a very peculiar UK practice – the characterisation of food products for zero-rating' (2009) *British Tax Review* 1, 59–67; and I. Roxan 'Interpreting exceptional VAT legislation: or, are there principles in Pringles?' (2010) *British Tax Review* 6, 699–716.

[65] *United Biscuits (UK) Ltd v The Commissioners of Customs and Excise*, LON/91/160.

[66] The court ruling has become one of the most famous tax cases in the UK outside tax law circles, even becoming the subject of a short documentary in 2006 entitled "Half Cake Half Biscuit", see "The Great Jaffa Cake Debate, Food: Identity Crisis", *The Sunday Herald*, 26 March 2006.

[67] M. Devereux and R. de la Feria, "VAT – Unjust Enrichment" (2008) *Tax Journal*, 12 May, 13-15.

[68] *Procter&Gamble UK v HMRC*, [2008] STC 2650. See G. Morse "*Procter & Gamble UK v HMRC (Pringles Two)*: A very peculiar UK practice - The categorisation of food products for zero-rating" (2009) *British Tax Review* 1, 59-66.

[69] A. Agha and J. Haughton, "Designing VAT Systems: Some Efficiency Considerations" (1996) *Review of Economics and Statistics* 78(2), 303-308. See also T. Buettner and K. Erbe, "Revenue and welfare effects of financial sector VAT exemption" (2014) *International Tax and Public Finance* 21(6), 1028-1050.

[70] Cases C-452/03, *RAL (Channel Islands) and Others*, ECLI:EU:C:2005:289; and C‑419/14, *WebMindLicenses*, ECLI:EU:C:2015:832.

composite supplies. The debate has two inter-related dimensions: the first concerns a qualification problem, namely how to treat a single supply of products some of which are subject to reduced rates, whilst others are subject to standard rates;[71] the second, however, is how and when should a supply with various components be regarded as single, and when should it be regarded as composite, and it is in this context that planning and avoidance can come into play, with either artificial merger, or artificial division of supplies.[72] In addition, certain types of VAT fraud are also linked to exclusions from the base, and would not be possible without those exclusions, such as misclassification of supplies,[73] or certain claims for non-refundable input VAT.[74]

The compliance and administrative costs of the above are clear. The difficulty establishing the VAT rate applicable to a determined supply, amplifies companies' compliance costs. In many cases, as acknowledged by the European Commission, the resort to external tax expert advice is unavoidable, creating significant additional financial burdens,[75] which for SMEs will often be onerous. Similarly as regards administrative costs: both classification and interpretative difficulties, and combating avoidance and fraud are an unnecessary imposition. Combating aggressive planning also gives rise to extremely significant administrative costs, as demonstrated by the levels of litigation.

The case in support of differentiated rates of VAT, particularly as a method of reducing the regressivity of the tax or encouraging the consumption of meritorious products, is extremely weak. There is limited evidence that tax savings are passed on to customers, on the contrary, they tend to be absorbed primarily by retailers; even where they are passed on to customers, reduced rates tend to benefit overwhelmingly the richest households, as a result of global consumption patterns across the income distribution – in some cases resulting in increased regressivity. The costs of multiple rate systems, on the other hand, are extremely high. The revenue costs are very significant, which is particularly concerning, as public expenditure – either where it takes the form of welfare benefits or of public services – tends to most benefit the poorest income households, and the spill over effects are both

[71] Case C-251/05, *Talacre Beach Caravan Sales*, [2006] ECR I-6269. See also G. Morse, "Restricting the composite approach in VAT: primacy of zero-rating and other categorising legislation: *Talacre Beach Caravan Sales Ltd v CEC*" (2007) *British Tax Review* 1, 17.

[72] T. Boulangé and L. Van der Noot, "The CJEU Confirms that Composite Services Cannot be Artificially Split in order to Benefit from a Reduced VAT Rate" (2018) *Intertax* 46/5, 450-452; G. Morse, "Separate or Composite Supplies for VAT: Assessing the Level of Generality: *Dr. Beynon and Partners v Customs & Excise Commissioners*" (2005) *British Tax Review* 2, 190-196; G. Morse, "Identifying Supplies. Further Reflections on Third Party and Multiple Supplies: *Debenhams Retail plc v CEC* and *College of Estate Management v CEC*" (2006) *British Tax Review* 1, 54-63; and D. Ladds and M. Chowdry, "*Debenhams Retail plc v Commissioners of Customs and Excise*" (2004) *British Tax Review* 1, 26-36.

[73] A. Hopland and R. Ullmann "Pushing the wrong buttons: VAT evasion by misclassification of meal consumption type" (2019) *European Accounting Review*, 1-23.

[74] This point is further developed in R. de la Feria and A. Schoeman, "Addressing VAT Fraud in Developing Countries: The Tax Policy-Administration Symbiosis" (2019) *Intertax* 47/11, 950-967.

[75] *Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax*, COM(2003) 397 final, 23 July 2003, at paragraph 42. As G. de Witt rightly points out "a complicated VAT system is good for lawyers and other advisers, but is bad for business", in "The European VAT Experience" (1995) *Tax Notes International* 10(2), 49-54, at 49.

varied and large. The case in favour of approving, or moving to, a single-rate VAT system, or at least broadening the VAT base, is therefore overwhelming. Yet, both in Europe and in Australia the opposite has happened: not only has broadening the base proved impossible, but the tendency has been instead to narrow the base further.

III. VAT Rates: Reform vs Design

Within Europe, the use of reduced rates dates back to the introduction of VAT itself in 1967.[76] Although evidence regarding potential negative consequences of applying multiple rates may have been unavailable at that time,[77] difficulties soon became apparent. Accordingly, since the late 1980s, there have been several attempts to amend European rates rules, under the political guidance and legislative initiative of the European Commission. Yet, there has been unwavering resistance by EU Member States to any proposed amendments that might lead to a broadening of the VAT base. On the contrary, the most recent agreed upon amendments to the rates rules have narrowed the VAT base, with more goods and services being subject to reduced rates in Europe today than even as recently as fifteen years ago. Despite the impact of the financial crisis on the use of reduced rates of VAT, by 2011 the share of reduced rate goods and services was still on average 26%, ranging from a few percentage points in Bulgaria, Denmark and Romania, to more than 40% of total consumption in Greece, Poland, Portugal, and Spain.[78]

Failed Efforts to Broaden the EU VAT Base

The system put in place under the First and Second VAT Directives established only a basic framework, leaving full autonomy to Member States insofar as rates were concerned. Reportedly for political and practical reasons, Member States used that freedom to largely mimic the multiple rates structures applied under their previous turnover taxes.[79] With the approval of the Sixth VAT Directive in 1977, there was a significant increase in the level of detail regarding the tax base, and a decrease in the level of freedom granted to Member States.[80] Yet, despite the progress achieved in some areas of the system, as regards other areas such as the rates structure, reportedly the EC Council of Ministers found

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[76] The overview provided in the initial pages of this section is largely a summary of the analysis provided in R. de la Feria, n. 26 above.
[77] As discussed in R. de la Feria and R. Krever, n. 5 above.
[78] F. Borselli *et al*, "Patterns of Reduced VAT Rates in the European Union" (2012) *International VAT Monitor* 1, 13-21.
[79] R. de la Feria and R. Krever, n. 5 above. See also S. Cnossen, 'What Rate Structure for a Value-Added Tax?' (1982) *National Tax Journal* 35(2), 205–214, at 209; and V. Lenoir, 'April 1954–April 2004 – VAT Exemptions: The Original Misunderstanding' (2004) *European Taxation* 10, 456−459, at 456−457.
[80] Sixth Council Directive 77/388/EEC of 12 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, OJ L 145, 13/06/1977, 1.

it impossible to reach agreement, and consequently further harmonisation was postponed to a later date.[81]

In 1987 the European Commission put forward a proposal for a new VAT rate structure.[82] This new structure was based on three basic principles: implementation of a dual-rate system, as opposed to a multiple-rate system; use of reduced rates limited to six categories of goods and services; and repeal of all temporary derogations, allowing Member States to apply reduced rates, where those rates had been in place before 1976.[83] The proposal was widely regarded as too ambitious,[84] and by 1989, the Commission recognised that certain aspects were curtailing the possibility of reaching agreement. In 1991, the Council finally reached agreement on the essential characteristics of a new VAT rate structure,[85] which as demonstrated in Table 1, not only differed significantly from the Commission's original 1987 proposal, but also differed from the alternative rates structure proposed by the Commission in 1989. The new VAT rate structure, which would apply from 1993 onwards, was largely a product of political compromises. The price for reaching agreement was not only extremely complex system, but filled with exceptions and derogations.

Table 1: VAT Rates Proposals 1987-1992

COMMISSION'S 1987 PROPOSAL	COMMISSION'S 1989 ALTERNATIVE PROPOSAL	APPROXIMATION OF VAT RATES DIRECTIVE
Two-rate system (standard rate and reduced rate)	**Two-rate system** (standard rate and reduced rate)	**Five-rate system** (standard rate, three reduced rates and zero-rate)
Standard rate band (14% to 20%)	**Standard rate minimum**	**Standard rate minimum** (15%)
Reduced rate band (4% to 9%)	**Reduced rate band** (4% to 9%)	**Reduced rates minimum** (5%) in theory; in practice no minimum applies

[81] European Commission, *First Report from the Commission to the Council on the application of the common system of value added tax, submitted in accordance with Article 34 of the Sixth Council Directive (77/388/EEC of 17 May 1977)*, COM(83) 426 final, 14 September 1983, at 5.

[82] European Commission, *Proposal for a Council Directive completing the common system of value added tax and amending Directive 77/388/EEC – Approximation of VAT rates*, COM(87) 321 final/2, 21 August 1987. For details on the context of this proposal, see R. de la Feria, *The EU VAT System and the Internal Market* (Amsterdam: IBFD, 2009), at 57 et seq.

[83] European Commission, *Completion of the Internal Market: approximation of indirect tax structures and harmonisation of indirect tax structure*, Global Communication from the Commission, COM(87) 320 final, 5 August 1987.

[84] A.J. Easson, "The Elimination of Fiscal Frontiers", in R. Bieber *et al* (eds.), *1992: One European Market? A Critical Analysis of the Commission's Internal Market Strategy* (Baden-Baden: Nomos Verlagsgesellshaft, 1988), 241-260, at 260.

[85] Council Directive 92/77/EEC of 19 October 1992, OJ L 316, 31/10/1992, 1, known as the "Approximation of VAT Rates Directive".

6 items that may be subject to reduced rate	**6 items** that may be subject to reduced rate	**22 items** that may be subject to reduced rates
Compulsory nature of list of goods / services subject to reduced rate	**Compulsory nature** of list of goods / services subject to reduced rate	**Optional nature** of list of goods / services subject to reduced rate
Abolition of zero-rating	**Maintenance of zero-rating** for a limited range of products	**Maintenance of zero-rating**

Whilst temporary measures on VAT rates described above were supposed to be in place for a period of only four years after 1993, the Commission was unable to fulfil this time plan and it was not until the summer of 1996 that a work programme was presented for the adoption of the new VAT rules regarding the base.[86] Ultimately, this new attempt was also doomed to fail. The first setback came very soon after the presentation of the 1996 programme, as Member States failed to reach total agreement on the already tabled proposal regarding the establishment of a fixed band for standard rates of VAT. Although the proposal was eventually approved, the final text contained no reference to the maximum level of standard rate.[87] Unknown at the time, this was to be the last significant EU attempt to broaden the VAT base.

Over the years, it was always clear that Member States' resistance to VAT broadening measures was inextricably linked to political constraints. One of the most paradigmatic examples of these constraints, which has acquired near mythical status within European circles, is the Irish Budget of 1982. In 1981, faced with a struggling Irish economy, the then Irish Minister for Finance, presented a range of tax reform measures aimed at dealing with the fiscal deficit. The measures included various VAT base-broadening measures, which would result in the application of the standard rate of VAT to several products that until then had been subject to zero-rate, such as children's shoes. Although the Budget included pay-back to lower-income families, so as to limit the potential regressive impact of the measure, the measures immediately became the target of strong controversy. Emotional political discussions were held on prime-time national TV, focussing primarily on the effect of the rate change on lower-income families.[88] Dependent on independent members of the Irish parliament to get the Budget passed, the coalition government of the time failed to get his Budget. The defeat of the Government over the Budget made a general election unavoidable,[89] giving victory to the main opposition party.[90] Although the Irish General Election of 1982 was said to be brought about by "a unique set of

[86] European Commission, *A common system of VAT – A programme for the Single Market*, COM(96) 328 final, 22 July 1996.
[87] Council Directive 96/95/EC of 20 December 1996, OJ L 338, 28/12/1996, 89.
[88] See *Today Tonight – Budget 1982*, Broadcasted on RTE Television on 27 January 1982, available at: https://www.rte.ie/archives/
[89] See *Election'82*, Broadcasted on RTE Radio on 27 January 1982, available at: https://www.rte.ie/archives/
[90] See *Today Tonight*, Broadcasted on RTE Television on 16 February 1982, available at: https://www.rte.ie/archives/

circumstances”,[91] the popular view, which has survived the test of time, was that the Government’s fall was largely attributable to the VAT base-broadening changes, and particularly the imposition of a standard rate of VAT on children shoes.[92]

Narrowing the EU VAT Base

Since the approval of the Approximation of VAT Rates Directive, VAT rates, far from converging as might have been expected,[93] can diverge much more than under the legal framework set up in 1992. As reported by the European Commission in 2001, despite its tentative efforts to increase convergence, “when current rates are compared with those applicable in 1997, it is apparent that rates continue to vary considerably”.[94] The first post-1992 narrowing of the Europe VAT base started in 1999, in the context of the so-called labour-intensive services experiment. The experiment allowed the application of reduced rates to certain labour-intensive services, such as hairdressing and window cleaning, with the aim of testing its impact on job creation and the combat informality.[95] Initially intended to last for three years, the experiment was consecutively extended,[96] until it became permanent. In 2008, the European Commission put forward a new legislative proposal, which had two objectives, both allowing for narrowing of the VAT base: to make the possibility of applying reduced rates to certain labour-intensive services permanent, and to allow Member States the freedom to apply reduced rates to “locally supplied services”, such as restaurant services.[97] The proposal was approved not long after its presentation.[98]

Concurrent attempts by the European Commission during the same period to limit overall differentiation failed miserably. In 2003, the Commission presented a proposal with a view to “review and rationalise the use of reduced rates”.[99] After years of discussions at the Council,[100] the proposal was finally

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[91] See *Today Tonight*, Broadcasted on RTE Television on 16 February 1982, available at: https://www.rte.ie/archives/

[92] Something denied by the then Taoiseach (Head of Government) Garret Fitzgerald, see “How the myth over VAT on children’s footwear still endures” *The Irish Times*, 9 September 2000.

[93] This was in fact the European Parliament’s opinion, see *Options for a definitive VAT system*, Working Paper, Economic Affairs Series, E 5, October 1995, at 87. See also P. Guieu and C. Bonnet, “Completion of the Internal Market and Indirect Taxation” (1987) *Journal of Common Market Studies* XXV(3), 209-222, at 215.

[94] *Report from the Commission on reduced VAT rates drawn up in accordance with Article 12(4) of the Sixth Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment*, COM(2001) 599 final, 22 October 2001, at para 19.

[95] Council Directive 1999/85/EC of 22 October 1999, OJ L277, 28/10/1999, 34.

[96] Council Directive 2002/92/EC of 2 December 2002, OJ L 331, 07/12/2002, p. 27; Council Directive 2006/18/EC of 14 February 2007, OJ L345, 28/12/2005, 19-20; Council Directive 2004/15/EC of 10 February 2004, OJ L52, 21/02/2004, 61.

[97] *Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax*, COM(2008) 428 final, 7 July 2008, at 2. This was the sixth formal proposal by the Commission exclusively on VAT rates (excluding informal suggestions).

[98] Council Directive 2009/47/EC of 5 May 2009, OJ L116, 09/05/2009, 18-20.

[99] *Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax*, COM(2003) 397 final, 23 July 2003.

[100] The Council initiated its formal discussions in 2003, see *Preparation of Eurogroup and Council of Economics and Finance Ministers, Luxembourg, 6-7 October 2003*, MEMO/03/191, 06/10/2003). However, the Council’s

approved in 2006 but at significant cost: the emphasis was no longer on rationalisation of reduced rates, or broadening of the base, but rather on the extension of the temporary rates provisions within the VAT Directive, as well as on the extension of the list of products to which reduced rates may apply. A legislative proposal that had intended to broaden the VAT had resulted in final legislation that had exactly the opposite effect of narrowing it.

By 2008, the level of VAT base erosion in Europe was therefore extensive. The financial and economic crisis of 2008/2009, however, provided Member States with an opportunity to – for a while at least – approach rate differentiation differently. Confronted with high budget deficits and limited (or negative) economic growth, whilst at the same time deprived of the possibility of currency devaluation and bound to a common interest rate, Member States turned to VAT. In line with research that indicates that tax reforms occur more frequently in periods of economic recession, and that VAT increases are amongst the most frequent measures,[101] between 2008 and 2014, a staggering twenty-three out of the twenty-eight EU countries changed their VAT rate structures during this period. At the same time, only nine EU Member States broadened the base – and in only a few cases substantially so.[102] Interestingly, the few Member States where wider broadening measures were introduced were those, like Portugal and Greece, where a bailout had been agreed with the so-called *troika* – a group composed of the IMF, the European Commission, and the European Central Bank – and thus where VAT base-broadening measures were part of wider reforms agreed in the context of the bail-out agreements.[103]

Clearly keen to harness the political momentum,[104] the European Commission launched a public consultation in 2012 on the review of the EU legislation on VAT reduced rates.[105] Whilst the response to the consultation was not widely representative, most respondents were opposed to the abolition of the reduced rates and/or advocated for their extension.[106] Soon after, the European Commission announced what can only be characterized as a monumental U-turn on VAT rates policy, by presenting a legislative proposal that would effectively opening the door to further narrowing of Member States'

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initial discussions indicated that reaching Member States' agreement regarding this proposal might be difficult and lengthy (see *2530th Council Meeting – Economic and Financial Affairs – Luxembourg, 7 October 2003*, C/03/274, Pres/03/274, 07/10/2003 and *Results of the Council of Economics and Finance Ministers, 25th November 2003 – financial services and taxation*, MEMO/03/241, 26/11/2003). During 2005 a substantial push was given to this proposal, leading to its final approval in 2006, see *Results of Council of Economic and Finance Ministers, Brussels, 6-7 December 2004*, MEMO/04/289, 08/12/2004, and *Results of the 2688*th *ECOFIN Meeting*, Press Release 13678/05, Brussels, 8 November 2005, 21.

101 D. Amaglobeli et al, "Tax Policy Measures in Advanced and Emerging Economies: A Novel Database" (2018) *IMF Working Papers* WP/18/110.

102 Details on these changes are provided in R. de la Feria, n. 26 above.

103 A. Krajewska, "Fiscal Policy in the EU Countries Most Affected by the Crisis: Greece, Ireland, Portugal, and Spain" (2014) *Comparative Economic Research* 17(3), 5-27, at 13-25. As regards Portugal, see also R. de la Feria, n. 26 above.

104 R. de la Feria, 'The 2011 Communication on the Future of VAT: Harnessing the economic crisis for EU VAT reform' (2012) *British Tax Review* 2, 119–133.

105 European Commission, *Review of existing legislation on VAT reduced rates*, Consultation Paper, TAXUD/C1, October 2012.

106 European Commission, *Review of Existing Legislation on VAT Reduced Rates, Summary Report of the Outcome of the Public Consultation* (8 Oct. 2012–4 Jan. 2013), taxud.c.1. (2013) 708070, 12 Apr. 2013.

VAT bases.[107] The reasons for such a surprising announcement were not immediately apparent, and there are numerous potential triggers.[108] However, the political context of this U-turn is particularly significant.[109]

As the effects of the financial crisis wore off various base narrowing pressures mounted. First, some Member States started reversing the base broadening measures that had been adopted in the period between 2009 and 2014.[110] Second, pressure intensified from other Member States to obtain derogations from EU rates rules, which would allow them to apply reduced rates of VAT to specific products. Finally, and arguably the last straw for the European Commission, concerned what became known as the "tampon tax".

The political controversy surrounding the application of general consumption taxes to women's sanitary products did not start in Europe. There has been an ongoing debate in various countries, including Canada and the US, where pressure from constituents had already lead to the decrease of the tax rate on those products in several states,[111] and Germany, where the rate has also been reduced with effect from Jan 2020.[112] The debate has been particularly consequential in the UK, however, where the debate dates back to the late 1990s,[113] but it intensified significantly in the period that preceded the UK Brexit Referendum in 2016.[114] The so-called tampon tax became one of the most highly politicised tax law issues of 2015, and three months before the Brexit Referendum, the UK Prime-Minister David Cameron announced that he had secured agreement with his counterparts at the European Council to change the "far too inflexible" VAT system.[115] That same month, following an EU Council Ministers meeting, it was reaffirmed that the European Commission would provide options for Member States to zero-rate sanitary products.[116] The timing of the announcement seems to indicate therefore that the UK tampon tax weighted heavily on the Commission's decision to reverse its traditional position on the VAT

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[107] European Commission, *Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax*, COM(2018) 20 final, 18 January 2018. On the details of the proposal see I. Lejeune and C. Herbain, "A revamped flexibility on VAT rates for Member States" (2018) *British Tax Review* 2, 161-165; and H. Kogels, "The Sweet Dream of a Simple VAT Rate Structure" (2017) *EC Tax Review* 6, 290-291.

[108] R. de la Feria, "The Definitive VAT System: Breaking with Transition" (2018) *EC Tax Review* 3, 122-126.

[109] R. de la Feria and M. Schofield, "Towards an [Unlawful] Modernized EU VAT Rate Policy" (2017) *EC Tax Review* 2, 89-95.

[110] VATlive, *Portugal restaurant VAT cut to 13%,* 1 July 2016. See also C. Teixeira, "Guia para perceber o que muda no IVA da restauração", *Visao*, 1 July 2016; and A. Pereira and R. Pereira, "A lower VAT rate on Electricity in Portugal: Towards a cleaner environment, better economic performance, and less inequality" (2018) *Energy Policy* 117(C), 1-13.

[111] B. Crawford and C. Spivak, "Tampon Taxes, Discrimination, and Human Rights" (2017) Wisconsin Law Review, 491-549.

[112] N. Schmidt and S. McKenzie, "Tampons will no longer be taxed as luxury items, after landmark German vote", *CNN*, November 8, 2019.

[113] Detailed analysis is provided in M. Schofield and R. de la Feria, "Section 126: VAT: women's sanitary products" (2016) *British Tax Review* 5, 611-618.

[114] A. Seely, *VAT on Sanitary Protection*, Briefing Paper 01128 (15 November 2016), UK House of Commons Library.

[115] *Hansard*, HC, col 1245 (21 March 2016).

[116] European Council press release, European Council conclusions, 17–18 March 2016 (2016, press release 143/16).

base – which is rather ironic given the result in the Brexit Referendum the following June. Meanwhile, in Australia, the public debate surrounding the tampon tax was also gathering momentum.

Designing the Australia GST Base

One might have hoped that Australia's introduction of a VAT in the form of the goods and services tax (GST) in 1999, would have benefitted from the experience of the longer established VAT systems. Although it did do so in many ways, and although the Australian approach is both novel and admirable in many respects, it has not escaped the pitfalls of base discussions. As a result of those discussions, Australia ended up introducing a dual-rate system: a zero rate, designated in the legislation as GST-free, applicable only to food; and a standard rate of 10%.

The introduction of a GST in Australia had seemed, at the time of its introduction, a relatively remote prospect. The then Prime Minister had been on record saying that his party would "never ever" re-attempt to introduce a GST.[117] This public position was, three years later, reversed when it was announced that the 1998 general election would seek a mandate for tax reform including the introduction of a GST as part of a broader tax reform. Not surprisingly, given the background, the reappearance in 1999 of the proposal to introduce GST was not without political turbulence. Although Prime Minister John Howard did win the 1998 election he did not have a Senate majority, and the fate of the GST was reliant on the support of either independent senators or the Australian Democrats. Whilst the Australian Democrats agreed to support the Government's GST implementation, they did so on the proviso that it contained certain concessions.[118]

The political machinations became of national interest as the government focussed on key opposition politicians in order to secure the passing of the GST legislation.[119] Early on the focus was on the Tasmanian Senator Brian Harradine who could be said to have held the balance of power in the Senate at the time.[120] The Senator ultimately did not support the GST, on equity grounds.[121] Regressivity concerns also dogged the political progress of the legislation at the next stage. Having lost Senator Harradine, the government courted the Australian Democrats party, which had already expressed the view that most food should be GST-free (zero-rated).[122] The party's position was that food should not be taxed because it was satisfied that: taxing food would make the GST regressive; the benefits of tax reform could be delivered with GST-free food; making food GST-free would help rural Australia as it would not inflate prices of (and thus would maintain demand for) food such as local horticultural

[117] M. Grattan "Howard bans GST 'forever'", *The Age* newspaper, 3 May 1995.
[118] D. Jenkins "10 years of GST – The Trials and Tribulations: What has changed?" *Taxation Institute of Australia*, National GST Conference, 3-4 September 2009.
[119] As discussed in detail in K. James, "We of the 'never ever': The History of the Introduction of a Goods and Services Tax in Australia" (2007) *British Tax Review* 3, 320-348.
[120] M. Kingston "Brian Harradine, man of honour" *Sydney Morning Herald,* 24 June 2004.
[121] Ibid.
[122] See *Main Report: Senate Select Committee on A New Tax System*, Commonwealth of Australia April 1999, at 371 et seq.

products; GST-free food would improve public health standards (by taxing 'junk' food but not 'healthy' foods); making food GST-free would be more effective than compensating lower income individuals and families for taxes on food; and making food GST-free would not lead to a "compliance nightmare".[123]

In the course of its deliberations and submissions the Democrats considered the options available for defining what is meant by "food" and considered what it considered as "the British option" of GST-free status for food other than restaurant and take-away food; recognizing a need to minimize distortion between the takeaway and grocery sectors;[124] "the Dutch option" of taxing all food at the same concessional rate, acknowledging that this would create a larger revenue gap and affect many more suppliers of food;[125] and "the Irish option" of zero-rating all food aside from a list of luxury or non-essential products.[126] What was ultimately agreed corresponds to the current Australian model which taxes all but a relatively large category of "food for human consumption".[127]

As time went on, the Australian GST followed the course that one might expect in light of the European experience. The same spillover costs emerged, and the *Lansell House* mini ciabatte case, referred to above, became Australia's version of the Jaffa cakes dispute in the UK. Many other disputes, such as that concerning the sale of salads in supermarkets, have not been litigated. Raw food is GST-free but prepared meals are subject to GST.[128] As a result, lettuce leaves and sliced tomato might be GST-free sold separately, but fully taxed if sold packaged and (especially) with dressing.

Equally, the pressure experienced in Europe to further narrow the tax base, soon also became apparent in Australia. From food, to medical supplies: not only are some healthcare products also GST-free, but the list of GST-free products can be extended by a simple executive order of the Health Minister.[129] It was in that context that the public debate surrounding the tampon tax started gathering momentum.[130] After extensive debate, and a concerted campaign by special interest groups, in 2019 "feminine hygiene products" were added to the list of items categorised as GST-free health goods.[131]

IV. The Political Dynamics of General Consumption Taxes' Rates

The European and Australian experiences demonstrate the strength of political resistance to single-rate, broad-base VATs, both when reforming an existing tax system, and when designing a new one. Not

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[123] Id at 371-378.
[124] Id, at 374-376.
[125] Id at 376-377.
[126] Id at 377-378.
[127] See *GST-free Food Guide "good news" for consumers*, Press Release of Australian Democrats, 14 June 2000 at http://www.democrats.org.au/news/index.htm?press_id=614&display=1.
[128] See *Australian Taxation Office guidelines*, available at: https://www.ato.gov.au/print-publications/gst-and-food/?page=5 (accessed 28/8/20)
[129] See s 38-47 *A New Tax System (Goods and Services Tax) Act 1999*.
[130] G. Jackson, "The "tampon tax" is not a marginal issue — it's the force of structural sexism at work" *The Guardian (Australia)*, Opinion, 25 July 2016.
[131] A New Tax System (Goods and Services Tax) (GST–free Health Goods) Determination 2018.

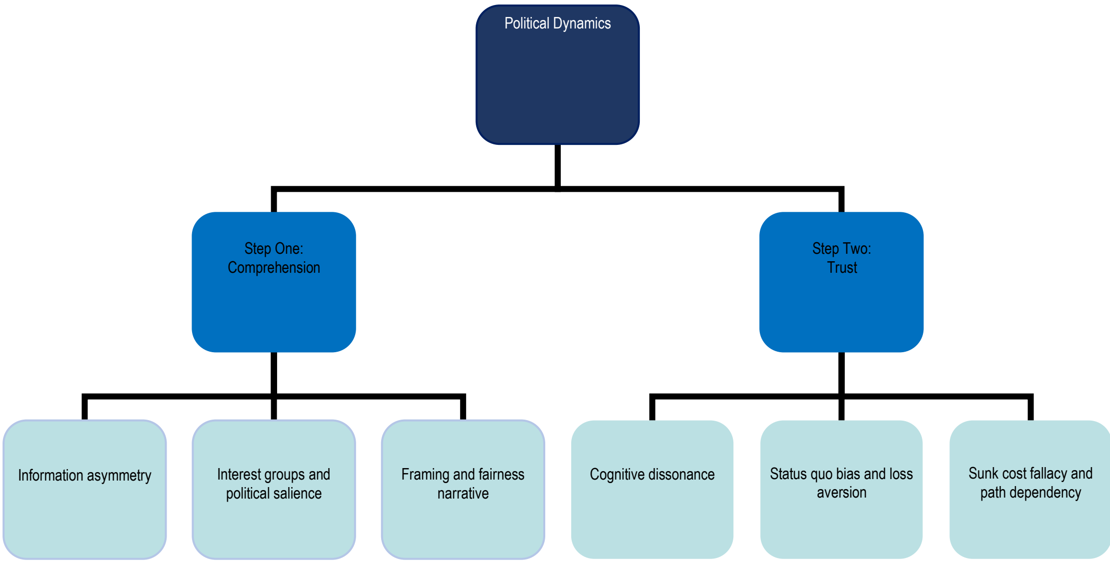
only is it nearly impossible to broaden the base, but there is a constant and often systematic pressure to further narrow that base. Comparison between European and Australian experience shows that, as a result of these double dynamics, and despite narrowing pressures being present in every system, base erosion is significantly higher in systems that had a narrow base to start with – or put in another way, reforming is harder than designing, and mistakes in VAT design are extraordinarily hard to correct.[132] The obvious question that emerges then is what determines these dynamics, and why resistance to broad based VATs is so prevalent. This is the case even in countries that, like European countries and Australia, have strong tax administrations and welfare-targeting capacity, and despite strong evidence against the effectiveness of using reduced rates – or exemptions – to achieve social and distributional aims. Like other areas of the tax system where there is a gap between efficiency and fairness perceptions, the answer rests in the political constraints of tax reforms generally,[133] and of general consumption taxes in particular. Yet, whilst there is widespread awareness of this reality –[134] and even though there is a growing literature on political economy of taxation more generally – there has been so far limited research on the political dynamics of consumption taxes.[135]

Political Obstacles to a Broad VAT Base

Analysis of the tax reform and design processes in Europe and Australia, respectively, demonstrates that these dynamics of consumption tax base can be separated into two sequential steps. In both these steps various political and behavioural factors present obstacles to base broadening measures, and that push for base narrowing ones, as follows: a first step, when the main factors at play relate to the comprehension of the proposed tax policy; and a second step, when the main factors at play concern trust in the proposed tax policy. Whilst these two steps are often sequential, i.e. trust comes into play when the true effects of the policy are highlighted and the information asymmetry overcome, at times the two steps happen concurrently with interest groups also experiencing and instrumentalising loss aversion and status quo bias. Table 2 below summarises the various dynamics at play.

Table 2: Political Obstacles to Broad Base VATs

[132] R. de Mooij and M. Keen, n. 10 above, at 35.
[133] M. Castanheira et al, n. 3 above.
[134] OECD, n. 17 above. It was even mentioned in former UK Prime Minister David Cameron's biography, *For the Record* (William Collins, 2019).
[135] For an early exception, regarding the introduction of VAT in Japan, see N. Hosaka, "The Political Economy of Consumption Tax" (1990) *Japanese Economy* 18(4), 19-47.



The starting point would appear to be the information asymmetry between the general public, i.e. voters, and policy makers. Whilst analysis is often based on the assumption that voters and politicians have access to the same information, in reality it is too costly time-wise for voters to collect extensive information about each policy,[136] and voters should instead be "rationally ignorant".[137] It is generally unreasonable to expect voters to fully understand the tax system, and its legal and economic effects,[138] but more so as regards consumption taxes, and their impact on price-formation or income distribution. General consumption taxes, and VAT particularly, are neither intuitive, nor salient: although multi-stage collection has many advantages from both an administration and a behavioural perspective,[139] it makes the functioning of the tax less intuitive; and consumption taxes generally have been found to be generally less noticeable to taxpayers than other taxes.

The 'fiscal illusion', often referred to as the Mill's hypothesis after its first proponent, determines that consumption taxes are less visible to taxpayers than income taxes, and that taxpayers often underestimate the burden associated with them. In other words, their tax salience, namely the extent to which taxpayers' account for their cost when making decisions, is low. This has been found to be generally the case both when making purchasing decisions (*market tax salience*), and when making voting decisions (*political tax salience*).[140] Various empirical studies have now confirmed that consumption taxes have low market salience. Interestingly, however, and somewhat counterintuitively, this is the case both when prices are displayed as tax-inclusive, and when prices are displayed without the tax, with the tax added at the till. The intuition would be that tax-inclusive pricing would result in lower salience than tax non-inclusive pricing, yet this does not appear to be the case due to a

136 J. Stiglitz, "The private uses of public interests: incentives and institutions" (1998) *Journal of Economic Perspectives* 12(2), 3-22.
137 A. Downs, "An economic theory of political action in a democracy" (1957) *Journal of Political Economy* 65(2), 135-150.
138 J. Alt, I. Preston and L. Sibieta, n. 2 above.
139 R. de la Feria, "Tax Fraud and Selective Law Enforcement" (2020) *Journal of Law and Society* 47(2), 193-259.
140 D. Gamage and D. Shanske, n. 32 above.

behavioural bias known as spotlighting: taxpayers spotlight on the prices displayed at the time of the decision-making, disregarding taxes that are assessed at the till, after that purchase decision has been made.[141] Whilst political tax salience has been said to be traditionally difficult to measure empirically,[142] the specific case for low political salience of consumption taxes has been often and convincingly presented.[143] Not only has this low salience allowed states to increase consumption taxes with less resistance –[144] a phenomenon evident in both the relative increase in the share of consumption taxes in the overall tax burden worldwide, and recently in the response of EU Member States to the financial crisis – but it has been found to distort democratic decisions.[145]

The information asymmetry, generally present in public policy, but enhanced in the case of consumption taxes by their less intuitive nature and their lower tax salience, presents itself as a fertile ground for manipulation.

Traditional political economy arguments suggest that the long lasting persistence of inefficient institutional features is due to the fact that they benefit the majority of the voting population.[146] This is not the case, however, with VAT exclusions from the base, which lead to significant tax reductions to a minority only –specific industries and/or higher income households – to the detriment of the majority – mid and lower income households. Previous studies on the political economy of taxation have sought to explain these tax expenditures as a result of a Government incentive to target resources on narrow groups of mobile voters in key battlefields, to ensure higher winning probabilities.[147] Whilst this may certainly be a contributing factor, it fails to explain the broad public support – not just of mobile, key, voters – for specific tax expenditures, not least VAT reduced rates and exemptions.

It is easy to grasp why producers (or sellers) of products already subject to reduced VAT rates or exemptions may be keen to keep them, or why suppliers of products not yet subject to those preferential treatments may be keen to introduce them, not least when considering the varying rate of pass-through to consumers. For sellers a reduction in the general consumption tax can be either passed on to consumers through lower prices, absorbed as increased margins, or both; all options will benefit the

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[141] R. Chetty et al, n. 36 above. For a detailed discussion of the various empirical studies on the impact of spotlighting in taxation, see D. Gamage and D. Shanske, n. 32 above.
[142] A. Finkelstein, "EZ-Tax: Tax Salience and Tax Rates" (2009) *Quarterly Journal of Economics* 124, 969.
[143] R. Bird, "Visibility and Accountability – Is Tax-Inclusive Pricing a Good Thing?" (2010) *Canadian Tax Journal* 58, 63-68; N. Gemmell O. Morrisey and A. Pinar, "Tax Perceptions and the Demand for Public Expenditure: Evidence from UK Micro Data" (2003) *European Journal of Political Economy* 19, 793; and M. Keen and B. Lockwood, "Is the VAT a Money Machine?" (2006) *National Tax Journal* 59(9), 905.
[144] R. Sausgruber and J.R. Tyran, "Testing the Mill's Hypothesis of Fiscal Illusion" (2005) *Public Choice* 122(1), 39-68. See also J. Ashworth and B. Heyndels, "Politician's Options on Tax Reform" (2008) *Public Choice* 103, 117-138; and T. Blumkin et al, "Are Income and Consumption Taxes Ever Really Equivalent?" (2012) *European Economic Review* 56, 1200-1219.
[145] E. Kiser and S. Karceski, "Political Economy of Taxation" (2017) *Annual Review of Political Science* 20, 75-92.
[146] S. Barbaro and J. Suedekum, "Voting on Income Tax Exemptions" (2009) Public Choice 138, 239-252. See also W. Schoen, "Taxation and Democracy" (2018) *Tax Law Review* 77(2).
[147] M. Castanheira and C. Volenduc, "Economie Politique de la Taxation" (2006) *Reflects et Perspectives de la Vie Economique* 45(3), 19-37; and R. de Mooij and G. Nicodeme, "Corporate Tax Policy and Incorporation in the EU" (2008) *International Tax and Public Finance* 15, 478-498.

sellers, either through potential increased sales – resulting from new consumption, or from a consumption-shift from equivalent or substitute products that do not benefit from the tax reduction – increase in profits, or both. Elimination of these VAT concessions will result in certain and visible losses for these groups: the rents from tax exemptions are large and concentrated, whilst their costs, such as distortions and qualification problems, are diffuse, so special interest groups have an incentive to keep those concessions through lobbying, despite the inefficiency it creates.[148] What is significantly less clear is why the majority, who loses out from the granting of these concessions, would support their maintenance or even increase their scope of application. The answer lies partially in the information asymmetry, and partially in the framing of the narrative by interest groups.

The low salience of consumption taxes generally determines that discussion over the application of reduced VAT rates or exemptions only arises in one of the following three circumstances: in the context of a proposed new general consumption tax (*design*), a proposed base-broadening initiative (*reform*), or base-narrowing pressures (*reform*). The first two situations are Government led, whilst the third tends to be led by interest groups. In all three the existing information asymmetry, enhanced by the non-intuitive nature of consumption taxes, allows special interest groups to fill that information gap with a fairness-centric narrative that increases the political salience of the tax –[149] but critically, not its market salience, as the low market salience of consumption taxes allows those groups to decide freely on price formation once the political debate is won. The difference in the various situations resides solely in the narrative's ultimate objective: in the first two situations that narrative is deployed to resist increased taxation, either by imposition of a new tax or by removal of an existing preferential tax treatment; whilst in the third situation the narrative is deployed to decrease taxation, by introducing a new preferential tax treatment.

Voters tend to favour redistributive tax policies – even if this tendency has been declining –[150] and as such, framing the debate around redistributive concerns has shown itself to be particularly effective. Voters cannot be expected to know complex policy issues generally,[151] and the somewhat counter-intuitive effects of reduced rates on income distribution in particular. Therefore, claiming the protection of lower income households as motivation for opposing specific changes – such as full-taxation of meritorious items like food, (private) healthcare, or (private) education – seems not only credible, but critically, intuitive. Similarly advocating the extension of reduced rates to other meritorious items based on distributive concerns, feels intuitively to be a worthy cause.[152] The framing of the narrative around

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[148] E. Ilzetzki, "Tax Reforms and the Political Economy of the Tax Base" (2018) *Journal of Public Economics* 164, 197-210. See also G.M. Grossman and E. Helpman, *Special Interest Politics* (MIT Press, 2002).

[149] On why we (humans) find fairness-centric narratives so compelling, see W. Storr, *The Science of Storytelling* (William Collins, 2019).

[150] J. Alt, I. Preston and L. Sibieta, n. 2 above.

[151] H. Mercier, *Not Born Yesterday – The science of* Who *we trust and* What *we believe* (Princeton University Press, 2020).

[152] On the power of intuition in decision making, see H. Mercier, n. 162 above, and C. Sunstein, *Simpler: The Future of Government* (Simon & Schuster, 2015).

these concerns is evident in both the European and Australian debates: from opposition to full-taxation of children shoes in Ireland, and extension of reduced rates to e-books in the EU (*tax reform*), to zero-rating of food in Australia (*tax design*). As the tampon tax debate demonstrates, however, distributive concerns are not the only possible fairness-centric narrative: there the narrative focussed on gender equality concerns.

The debates on e-books and women's sanitary products also highlight one of the key differences between design and reform, and why narrowing pressures are much stronger on VAT systems that already have a narrow base: a relative fairness argument is much easier to mount than one based on absolute fairness. Where other products are already subject to reduced rates or exemptions it is easy – and indeed reasonable – that debates arise over the relative merit of items not yet subject to similar concessions.[153] *Why this and not that? Why books and not e-books? Why other hygiene products and not women's sanitary products?* CJEU jurisprudence on the principle fiscal neutrality, discussed above, provides legal grounds for the relative fairness argument, and insofar as gender-differentiated taxes are concerned, so does the European Court of Human Rights.[154] The narrower the base the more convincingly can the relative fairness argument be made. On the contrary, in tax design situations, the narrative must focus on the absolute fairness of excluding certain products from full taxation – an argument that can and often is made based on distributive concerns, but which is harder to make otherwise, not least because it lacks the same legal-backing as the relative fairness argument.

Beyond fairness, the European and Australian experiences demonstrate that other elements are critical to the effectiveness of the narrative. Keeping the focus on one element of the proposed tax reform – one that lends itself to a fairness-centric narrative – whilst disregarding the tax system as a whole,[155] or even the full proposed tax design/reform, also prevents voters from making relevant comparisons or deductions. There are various examples – both in Europe and Australia – of narrative framing around one single product affected by the proposed reform, perhaps the most infamous of which is the children's shoes case in Ireland.

A "tax aversion label hypothesis" has also been suggested in the US: the use of the word "tax" supposedly increasing the political salience of the policy, and use of alternatives, such as the UK's National Insurance Contribution, to enact government policies seen as preferable.[156] Whilst there has been limited empirical evidence for this hypothesis, the tax label technique has been frequently used in consumption tax narratives to invoke negative emotions. The most paradigmatic example of its deployment is the tampon tax – a label used in various English-speaking countries to refer to different

[153] As the legal history of consumption tax reform in Canada also demonstrates, see R. Bird, "The GST in Canada: Plus Ça Change, Plus C'Est La Meme Chose?" (2009) *Bulletin for International Taxation* 7, 414-423.
[154] As convincingly argued by B. Crawford and C. Spivak, n. 119 above.
[155] J. Alt, I. Preston and L. Sibieta, n. 2 above.
[156] D. Gamage and D. Shanske, n. 32 above.

circumstances, and even different taxes –[157] but it is manifest in various other policy debates, particularly in the UK, including where the policy at stake does not concern tax.[158] Would the political salience of the debate be identical had the narrative referred to the VAT treatment of women's sanitary products, rather than the tampon tax? Whilst the contra-factual is not available, one suspects it would not. Not least because one other factor that influences the effectiveness of the narrative is the media, whose preference is for short, snappy, labels.

Finally, who delivers the narrative has also a significant impact. Generally, the most important factor adults take into consideration when deciding whether or not someone is lying is that person's motivation: having an incentive to lie makes credibility drop massively.[159] Using a fairness-centric narrative is therefore also useful insofar as it disguises groups' self-interest, and presents wider concerns as the main motivation for the adopted position. Similarly, enrolling the assistance of others, outside the interest groups, to deliver the narrative can also increase its credibility. The role of the media in both coalescing interest groups, and increasing the political salience of the fairness-centric narrative, is fundamental. Empirical studies in political science confirm that media can have a significant impact on public perceptions, not by telling the public how to think, but by telling them what to think about (agenda setting), how best to understand issues (framing), and what criteria to use when evaluating politicians.[160] Whilst in tax policy this role is often perceived positively, as a method of enhancing political accountability in face of information asymmetry,[161] it also has the (potentially negative) spill over effect of amplifying selective narratives by special interest groups. Similarly, enlisting the assistance of NGOs – sharing with, or even transferring to them the ownership of the narrative – has the potential to increase its political salience, whilst adding legitimacy to the fairness-centric framing.[162] It is also more likely to increase take-up, as generally people are more likely to take into account the opinion of those whom they perceive as having interests that align with their own.[163]

Information asymmetry and lobbying by special interest groups only partially explains the political resistance to broad based consumption taxes. If that was the only problem, presumably eliminating this asymmetry, by providing clear information to voters on the effects of reduced rates or exemptions,

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157 B. Crawford and C. Spivak, n. 119 above.

158 The hotly debated "bedroom tax", for example, concerned the removal of welfare benefits, see P. Butler and H. Siddique, "The Bedroom Tax Explained", *The Guardian*, 27 January 2016. See also S. Gibbons et al, "The Bedroom Tax" (2020) *Regional Science and Urban Economics* 82, 103418.

159 C. Street and D. Richardson, "Lies, damn lies, and expectations: How base rates inform lie-truth judgments" (2015) *Applied Cognitive Psychology* 29(1), 149-155.

160 H. Mercier, n. 162 above, at 137. See also J.M. Snyder and D. Stroemberg, "Press coverage and political accountability" (2010) *Journal of Political Economy* 118(2), 355-408; S. Iyengar and D.R. Kinder, *News That Matters: Television and Public Opinion* (Chicago University Press, 1987); and W.A. Gamson, *Talking Politics* (Cambridge University Press, 1992).

161 T. Besley, R. Burgess and A. Pratt, "Mass Media and Political Accountability" in R. Islam (ed), *The Right to Tell: The Role of Mass Media in Economic Development* (World Bank, 2002).

162 A phenomenon that is not exclusive to tax policy, see J. Dean, *The Good Glow: Charity and the Symbolic Power of Doing Good* (Policy Press, 2020).

163 J.A. Sniezek et al, "Improving judgement with pre-paid expert advice" (2004) *Journal of Behavioral Decision Making* 17(3), 173-190.

would be sufficient. Whilst it would be comforting to think that this would be the case, experience shows that it is not:[164] combating information asymmetry is necessary, but not sufficient to overcome resistance.[165] This is because, even when information is symmetric, there is a trust problem that is partially explained by cognitive biases, including cognitive dissonance, loss aversion and status quo bias, and by the voters' general distrust of two-step policies.

The effectiveness of providing information on the effects of VAT concessions is dependent, first and foremost, on whether that information will be believed by voters (and individual policy-makers). The non-intuitive nature of consumption taxes generally, and VAT in particular, however, may prevent that from happening: a fairness-centric narrative arguing for the redistributive effects of reduced rates to essential products "feels" naturally intuitive; on the contrary, explaining that those concessions may in fact have negative distributional effects, does not. Intuition is a powerful decision-making motor, particularly as regards complex politics and economics issues,[166] and ideas that do not feed into our intuitive concepts, or go against them, face severe obstacles from our cognitive vigilance mechanisms.[167] Thus, when confronted with information that is inconsistent with that intuition voters (or individual policy-makers) may experience cognitive dissonance,[168] and thus attempt to reduce that tension by not only distrusting the new information provided and resist the proposed change,[169] but may actually further entrench their previously held beliefs.[170] The reaction of individual policy-makers in Australia, which ultimately led to introduction of zero-rates for food items at the last minute is a paradigmatic example.

Even in the absence of cognitive dissonance – or where the new information is so convincing as to overcome it – other cognitive biases come into play, particularly as regards tax reforms. Believing that the current system is unlikely to yield the envisaged benefits is not the same as believing a new system would be better. What if the proposed system is even worse that the existing one?

Status quo bias is not exclusive to tax policy. Every public policy reform generates uncertainty that is experienced asymmetrically between losers and gainers: while losers are easily identified, gainers are more uncertain,[171] either because the gains are diffuse (e.g. through the whole population), or because there are no guarantees they will indeed take place. Reduced VAT rates or exemptions may be unlikely

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[164] R. de Mooij and M. Keen, n. 10 above.
[165] The role of the various elements in overcoming resistance is discussed further below.
[166] H. Mercier, n. 162 above, at 61. See also P. Boyer and M.B. Peterson, "Folk-economic beliefs: An evolutionary cognitive model" (2018) *Behavioral and Brain Sciences* 41, 158.
[167] H. Mercier, n. 162 above, at 221.
[168] J. Konow, "Fair Shares: Accountability and Cognitive Dissonance in Allocation Decisions" (2000) *American Economic Review* 90(4), 1072-1092.
[169] S. Ranchordas, "One Foot in the Door: Evidence-Based Limits on the Legislative Mandate" (2018) *Hukim – Journal on Legislation 207*. On cognitive dissonance generally, and other cognitive biases, see D. Kahneman, *Thinking, Fast and Slow* (Farrar, Straus and Giroux, 2011).
[170] H. Mercier, n. 162 above, at 208-210.
[171] R. Fernandes and D. Rodrik, "Resistance to Reform: Status quo bias in the presence of individual uncertainty" (1991) *American Economic Review* 81, 1146-1155.

to bring the envisaged benefits: they may not be fully passed-through, they may primarily benefit richer households, they may limit the provision of public services, and create many spill over costs, but what if the benefits envisaged by a base-broadening reform do not materialise? Voters – as well as businesses – may experience loss aversion, namely the tendency to prefer avoiding losses to acquiring bigger gains. This loss aversion is also manifested in a tendency by voters to regard so-called two step policies – those whereby the first step is the removal of a benefit, and the second, subsequent, step is the attribution of a different benefit – with suspicion,[172] as the temporal gap between the two steps would tend to increase the loss aversion. Finally, sunk costs fallacy, whereby an individual or group confronted with negative outcomes from a decision nevertheless prefers to standby that decision instead of altering course may also play a role.

All these political obstacles to broad-base general consumption taxes, and the pressure for base narrowing – from information asymmetry to cognitive biases – are present in both tax design and tax reform situations. What explains the difference between the strength of the resistance in tax design and that experienced in tax reform situations, is the intensity in which some of these factors are experienced. Two obstacles in particular are stronger in reform situations, namely the effectiveness of the fairness narrative by special interest groups, and the level of status quo bias and loss aversion.

As the European and Australian experiences demonstrate, the anti-base broadening – or further base-narrowing – narrative is not only more effective in tax reform situations, but their effectiveness is inversely proportional to the existing size of the base, i.e. the narrower the existing base the more effective the narrative. This results from two factors. Firstly, special interest groups will invest greater resources in fighting reform when the base is already narrow; and whilst they may be willing to forgo their own preferential tax treatment if all preferential treatments are eliminated, they are less likely to forgo their preferential tax treatment in isolation, and fight harder as a consequence.[173] Secondly, as discussed above, a fairness narrative that relies on the comparative merit of products, rather than their absolute merit, is significantly more convincing.

The status quo bias and loss aversion are also more pronounced in tax reform situations. Giving up on an existing VAT concession is bound to create higher levels of resistance, not least because the efficiency gains of incremental reforms are less clear than those of a brand new tax design, and thus less likely to be enough to overcome the loss aversion. As highlighted by the comparison between the European and the Australian experiences, the existence of a VAT law in and of itself will also create path dependence and legal entrenchment, which are not present in the discussion of a brand new

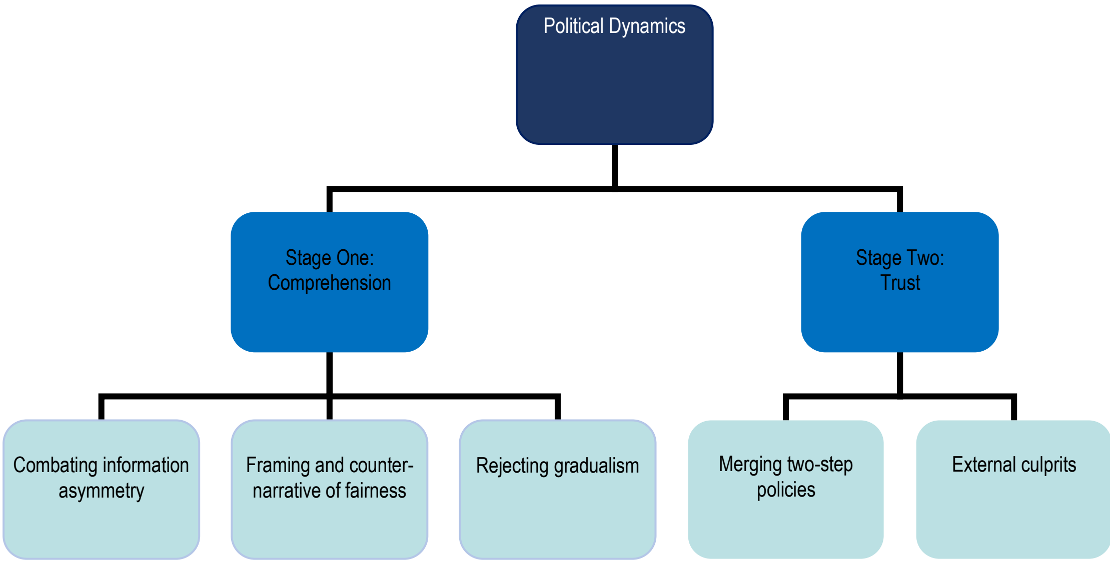
[172] J. Stiglitz, n. 147 above, at 8-11.
[173] E. Ilzetzki, n. 159 above.

law.[174] Sunk costs fallacy and the frictions that naturally arise from a significant legal shift will help embed the existing law into the wider legal system, limiting the opportunity for significant changes.

Overcoming the Political Obstacles to a Broad VAT Base

To approve a broad-based general consumption tax – either *ex novo*, or through reform – all the above obstacles must be overcome. For this it is not only necessary that the public understands the proposed tax policy and its rationale, but also that the public trusts the outcome. Table 3 below summarises the various elements of the pathway offered to overcome the obstacles.

Table 3: Overcoming Political Obstacles to Broad Base VATs



It would be comforting to assume that in order to overcoming the obstacles to a broad-based general consumption tax it would be sufficient to combat the information asymmetry – from which many of the problems stem - by providing clear information on the distributive effects, and various spillover costs, of a narrow base. Indeed, there is evidence that providing information on tax policy effects can be an effective de-biasing mechanism – even if actual behaviour change is limited.[175] Critically, however, it is dependent on the how that information is delivered.[176]

As the European and Australian experiences highlight, simply providing information about the economic effects, revenue implications, or legal costs of applying reduced rates, is insufficient to overcome the resistance to either a base broadening reform or a broad-base design. Whilst mathematisation generally increases credibility,[177] justifying a tax reform or tax design narrative in terms of revenue maximisation or economic efficiency is bound to fail against the fairness-centric narrative of special

[174] J. Bell, "Path Dependence and Legal Development" (2012) *Tulane Law Review* 87, 787; and S. Ranchordas, n. 180 above.
[175] R. Chetty and E. Saez, "Teaching the Tax Code: Earnings Responses to an Experiment with EITC Recipients" (2013) *American Economic Journal: Applied Economics* 5(1), 1-31.
[176] R. Sausgruber and J.R. Tyran, "Are We Taxing Ourselves? How Deliberation and Experience Shape Voting on Taxes" (2011) *Journal of Public Economics* 95, 164-176.
[177] K. Eriksson, "The nonsense math effect" (2012) *Judgment and Decision Making* 7(6). 746-749.

interest groups. An effective information transfer mechanism is therefore more likely to be one that offers a counter fairness-centric narrative which addresses specific concerns, such as the distributional impact of reduced rates. *Is it fair to reduce the taxation of books, knowing that they are consumed primarily by the top quintile of the income distribution? Or, to reduce the taxation of private healthcare services, where the overwhelming majority of the population can only rely on public healthcare provision?* Highlighting the absence of self-interest in the reform – as policymakers are generally amongst the top quintile of the income distribution, base-broadening measures will, by nature, go counter to their own interest – will add extra legitimacy to the narrative. Finally, the role of emotions, and particularly that of compassion,[178] in political narratives has long been recognised has a powerful tool,[179] and tax policy is no different in this regard. To overcome the resistance to broad base VATs the public must not only *understand* what the consequences of narrow bases are, but they must *feel* why it matters. Consumption tax reform is not an abstract good, an end in itself, but rather an instrument to deliver concrete public goods: it is about taxing the consumption of the richest in our society; it is about new schools and new hospitals; it is about fairness.

Timing is also critical. Faced with strong resistance to broad bases – either when adopting a new VAT, or reforming an existing one – it is tempting to retreat into a gradualist approach, rather than adopting a "big bang" one. The idea being that splitting reforms can help overcome the resistance, by dividing the opposition and obtaining a different majority at each stage of the reform.[180] This is sometimes achieved by introducing a small list of VAT concessions – reduced rates or exemptions – in the expectation of moving to a broader base at a later stage (tax design); or by proposing targeted base broadening measures that keep many VAT concessions in the expectation that this will be a first step towards a broader base VAT (tax reform). Aware of the potential pitfalls, better design gradualist reforms may rely on a set of gradual and targeted reforms that follow one another,[181] or temporary legislative measures and sunset clauses.[182] Both mechanisms have been widely used in Europe as a method to overcome resistance to base broadening VAT reform, and as experience demonstrates, they have consistently failed. Proposed gradual reforms are not approved, temporary legislative instruments – such as the labour-intensive services experiment – become legally entrenched, deadlines in sunset clauses abolished, temporary measures renewed.[183]

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178 M. Nussbaum, "Compassion: The Basic Social Emotion" (1996) *Social Philosophy and Policy* 13(1), 27-58.

179 A. Prior, "Getting the Story Right: A Constructivist Interpretation of Storytelling in the Context of UK Parliamentary Engagement" (2018) *Politics and Governance* 6(4), 83-94; and A. Skonieczny, "Emotions and Political Narratives: Populism, Trump and Trade" (2018) *Politics and Governance* 6(4), 62-72.

180 M. Dewatripont and G. Roland, "Economic Reform and Dynamic Political Constraints" (1992) *Review of Economic Studies* 59(4), 703-730.

181 T. Boen et al, *Structural Reforms without Prejudice* (OUP, 2006).

182 S. Ranchordas, n. 180 above.

183 A common phenomenon in tax legislation, see J. Oh, "The Pivotal Politics of Temporary Legislation" (2015) *Iowa Law Review* 100, 1055; and R. Kysar, "The Sun Also Rises: The Political Economy of Sunset Provisions in the Tax Code" (2006) *Georgia Law Review* 40, 335.

The traditional explanation for why gradualism fails is that its efficiency may be weakened by a war of attrition between the different special interest groups.[184] Insofar as base broadening measures are concerned, however, the answer more likely lies in the response from interest groups to the reform proposal, and policymakers' capacity to counteract it. Firstly, as discussed above, special interest groups may be willing to forgo their preferential tax treatment in favour of a broad reform that eliminates all VAT concessions and brings efficiency gains; but less likely to forgo their preferential treatment in isolation.[185] As such, gradual reforms, whereby concessions are eliminated in stages, are more likely to solicit stronger resistance from those interest groups that are affected by the first stage of the reform. Secondly, as only a few products are initially affected, a gradual reform lends itself more easily to a comparative fairness narrative, which as discussed above is much more effective than a narrative that centres on the absolute merits of each product. Whilst a counter-narrative of fairness can be effective, political capital is spent on deploying that counter-narrative, so that the risk with gradual reforms is that all available capital is spent on the first stage of the reform, leaving limited or no capital to implement the remainder.

Even where the public understands the proposed tax policy and its rationale – the information asymmetry has been overcome by an effective narrative, timely deployed – there may still be a policy mistrust that must be addressed. An innovative way to overcome the scepticism of two-step policies, and decrease the status quo bias and loss aversion, is to (partially) merge the two-steps, i.e. to grant a new benefit at the same time as the old one is removed. Whilst it may not be possible to frontload the various benefits that result from a broad-base general consumption tax – not least revenue and efficiency gains – it is now possible to introduce welfare transfers, which protect lower income households, at the same time as tax becomes due. Under this progressive VAT, tax paid on consumption would be instantaneously re-paid to lower income households,[186] using real-time technology already used in various countries, including South Korea, Russia, Israel and Portugal, as an anti-fraud tool.[187]

Finally, external pressures can be particularly effective in overcoming cognitive biases – from cognitive dissonance to loss aversion – and breaking path dependency. This effectiveness can act on two different levels. Firstly, the experiences of other countries with broad or narrow base VATs, or those that have gone through base broadening reforms, can significantly strengthen the effectiveness of the political narrative.[188] Positive experiences (with broad base VATs) and negative experiences (with narrow base VATs) can provide additional reassurance and increase the legitimacy of the narrative, decreasing both cognitive dissonance, and loss aversion, by removing the possibility of first-mover

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[184] A. Alesina and A. Drazen, "Why are Stabilizations Delayed?" (1991) *American Economic Review* 81(5), 1170-1188.
[185] E. Ilzetzki, n. 159 above.
[186] R. de la Feria and A. Swistak, n. 43 above.
[187] R. de la Feria and A. Schoeman, n. 77 above, at 961-962.
[188] R. Sausgruber and J.R. Tyran, n. 187 above.

disadvantage. Whilst there is now some research done on first-movers advantage in tax policy, particularly in the context of tax competition,[189] there is limited or no discussion on first-mover disadvantages. Yet, knowing that broad base VATs did actually result in significant benefits in other countries – and are not merely theorised – not only adds credibility to the proposal, but allows followers to learn from mistakes of first movers, reducing the risk and decreasing the uncertainty of the benefits envisaged by the reform. Secondly, and perhaps more importantly, external elements can act as culprits.

According to the theory on policy reform, governments should reform more in times of crisis.[190] Empirical evidence on tax reforms backs that theory: one of the common features of the largest OECD reforms is that they occur in times of large financial needs (and are done in one sweep, rather than gradually),[191] and VAT is no exception As discussed above, the only significant VAT base-broadening reforms in European countries took place in the aftermath of the financial crisis. Financial crises, however, are not the only external elements that can have an impact on the success of the proposed reform. A recent paper evaluating the World Bank's activities found that its analytical and advisory products were particularly effective at influencing not only policy priorities, but their design and implementation.[192] Similarly, VAT base-broadening reforms in Portugal and Greece, in the wake of the financial crisis, resulted from the pressure put on by the so-called troika, composed of the IMF, the European Commission, and the European Bank; and recent proposals for the introduction of a new, broad-base, general consumption tax in Brazil have been heavily influenced by Brazil's candidacy to the OECD.[193] An external culprit reduces the political costs of the reform for national policymakers, by shifting responsibility and sharing its ownership.

V. Conclusion

When VAT was first introduced in Europe there was limited awareness of the effects of excluding some items from full-taxation. As such, policymakers relied on intuition – a general fairness intuition that essential items should not be taxed, and an educated-intuition that the natural regressivity of a general consumption tax could be decreased by removing those essential items from full-taxation. For the last 40 years, however, the evidence has been piling up against the distributional and efficiency costs of

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189 H. Kempt and R. Rota-Graziosi, "Endogenising Leadership in Tax Competition" (2010) *Journal of Public Economics* 94(9-10), 768-776; R. Altshuler and T.J. Goodspeed, "Follow the Leader? Evidence on European and US Tax Competition" (2015) *Public Finance Review* 43(4), 485-504; and J. Pin and X. Chen, "Endogenous Leadership in Tax Competition: A Combination of the Effects of Market Power and Strategic Interaction" (2017) *B.E. Journal of Economic Analysis & Policy* 17(1).

190 A. Alesina and A. Drazen, n. 195 above.

191 E Itzetzki, n. 158 above.

192 S. Knack et al, "How Does the World Bank Influence the Development Policy Priorities of Low-Income and Lower-Middle Income Countries?" (2020) *World Bank Policy Research Working Paper* 9225.

193 S. Johnston, "Brazilian Lawmakers Push Ahead With Major VAT Overhaul", *Tax Notes International*, 6 March 2020.

VAT concessions. Whilst there is still much that is unknown, there is now solid, and consistent, evidence showing that for a variety of reasons – that are just beginning to be understood – tax reductions are often not fully reflected in prices: even when reductions are passed through to consumers, it is the richest households that benefit most from those reductions; those reductions also constitute a significant tax expenditure; and beyond the revenue implications, they have significant spill over costs, not least in terms of efficiency and equity. The benefits of applying reduced VAT rates are therefore, at best, dubious, and the costs are extremely significant.

Whilst tax policy experts have been highlighting many of these concerns for decades, there is a surprising – or perhaps not so surprising – resistance to broad base VATs. European experience demonstrates that absent an external pressure, such as the 2008/2009 financial crisis, not only is it nearly impossible to approve a base broadening tax reform, but there is a constant base narrowing pressure that is often too difficult to resist. Similarly, the Australian experience demonstrates that the resistance to broad base VATs is still present in tax design *ex novo*, albeit weaker. The question, whose answer has so far eluded policymakers, is *why*. Whilst there has been a growing awareness that the answer lies in political, rather than policy factors, a full explanation of the various dynamics at play has previously been absent.

This article attempts to fill that gap by providing a new analytical framework of general consumption tax reforms, by using the legislative history of the EU and Australia, and drawing insights from political economy, political science, behavioural science, and regulatory theory. It is argued that information asymmetry is instrumentalised by special interest groups to resist base broadening reforms, using a fairness-centric narrative – and where possible, delivered by trusted sources – so as to give the appearance of lack of self-interest. That narrative in turn elicits in the public a reaction to the reform that is permeated by a variety of cognitive bias, including cognitive dissonance, status quo bias and loss aversion, and sunk cost fallacy.

Once the dynamics of resistance to broad-base general consumption taxes are understood, counteracting that resistance becomes easier. This article, therefore, has also presented a pathway for overcoming said resistance. Whilst providing information and argumentation are critical elements, so is the manner in which that information is delivered: a counter-fairness narrative that relies on emotion and intuition, and emphasises a lack of self-interest, is more likely to be effective, that one that is primarily focussed on aggregate efficiency gains. Timing is also critical, and gradual base-broadening reforms are less likely to succeed, than big-bang reforms that decrease loss aversion by frontloading some of the benefits of the reform, and in particular by protecting lower-income households in real time. Finally, if all else fails, find an external culprit.