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Reforming VAT Concessions: A Tax Expenditure Analysis

Yige Zu*

Abstract

Although VAT concessions have long been viewed as sources of revenue loss, economic distortions and increased compliance and administrative costs, they have proved stubbornly resistant to removal or modification. This article suggests a new mode of analysis that could be used as a reform tool. It first applies tax expenditure analysis to VAT concessions, recognising the cost of these *concessions not as* “lost revenue”, *but rather* as notionally received and then applied revenue. Under tax expenditure analysis, concessions are treated as the equivalent of, and a substitute for, direct spending programmes. Intended to achieve a variety of equity, social and economic outcomes, VAT concessions in practice more often than not operate as unfair and inefficient spending programmes, generating significant legal and economic distortions in the tax system. The article then shows how the measurement of the cost of concessions as a proportion of potential VAT revenue can better reveal their budget impact. Ideally, VAT concessions should be replaced with fairer and more efficiently targeted alternative instruments. Improved policy and legislative design techniques can be used to target concessions more effectively where their removal is politically unattainable.

Introduction

A benchmark Value Added Tax (VAT) applies the same tax burden to all types of supplies, so that the tax is neutral in its application to all consumption. With no impact on consumption or production in the absence of tax biases, economic outcomes are shaped by market forces. Many real-world VATs, however, only reach just over half of the theoretical model VAT base. Two factors may explain the disconnect between a good VAT in theory and the real VATs in practice: poor administration of the tax and deliberately adopted concessions that explicitly reduce or eliminate the VAT payable on designated types of consumption.¹ In developed economies with advanced administrative regimes in place, the gap is primarily explained by the adoption of tax concessions.

Concessions in a VAT system can take three forms: full taxation but at a reduced rate; input taxation, treating the supply as an exempt supply but denying the supplier any credits for tax included in the price of business inputs; or a full removal of tax by zero-rating the supply and allowing full input tax credits. The traditional VAT, represented by the EU, uses the first

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¹ M. Keen, “The Anatomy of the VAT” (2013) 66 National Tax Journal 424.

two methods to provide concessions. Some modern VAT systems such as those in Australia and Canada use the second and third methods.

Concessions are adopted for a variety of reasons. The goal of some is to reduce the regressivity of the VAT that is born disproportionately by lower income persons who apply far greater shares of their income to consumption than their higher income counterparts. A second aim is to subsidise (and hence encourage) the consumption of what the legislature perceives as merit supplies such as education or health supplies that it believes generate positive externalities which might not be recognised by consumers faced with fully taxed supplies, or to subsidise particular types of suppliers. A third objective is to facilitate efficient VAT administration through what might be labelled “technical concessions” that reduces VAT liabilities associated with abnormally high administrative and compliance costs or where there is uncertainty as to how particular types of transactions can be subject to tax.² Sometimes concessions arise merely because of accidents or inadvertence or practice based on administrative rulings or judicial precedents that misconstrued the purpose of provisions.

Concessions in a VAT have been shown to be inefficient subsidy tools, providing misguided benefits, distorting consumption, production and investment decisions, and giving rise to substantial administrative and compliance costs. Experience to date, however, suggests that they may be an unavoidable feature of the VAT as time and again politicians opt for VAT concessions as the preferred delivery vehicle to achieve all the rationales for reduced taxation. The ideal from a tax policy perspective would be a two pronged approach based first on the adoption of a simple and efficient comprehensive VAT allied with direct programmes to promote the consumption of merit goods or services and reduce the regressivity of consumption taxation and secondly the use of alternative tax law approaches to address the costs of imposing the tax in technically challenging areas. But the reality is that concessions are more likely than not to remain as a central feature of many countries’ VAT systems. The challenge, therefore, is to design concessions that mitigate their undesirable consequences.

The negative ramifications of VAT concessions have long been recognised and tax reform literature almost uniformly advocates their removal as the optimal way to address these problems.³ There is dearth of literature on how the negative aspects can be addressed or at least mitigated if they are to remain and none that analyses the issue in terms of an overarching conceptual framework. From a tax policy viewpoint, concessions that reduce the VAT payable under a neutral benchmark VAT are now treated for national budget purposes as indirect outlays or, as they are labelled in budget documents, “tax expenditures”. The revenue forgone from incompletely taxed consumption is equivalent to direct budget expenditures. These could be substituted to subsidise directly the preferred consumption were the VAT to apply uniformly to all consumption, or applied to offset the costs of applying the VAT fully to consumption of

² For an explanation of “technical tax expenditures”, see C. Heady, “Tax Expenditures: Definitional and Policy Issues” in L. Phillips, N. Brooks and J. Li (eds), *Tax Expenditures: States of the Art* (Toronto: Canadian Tax Foundation, 2011).

³ See, e.g., J. Mirrlees, et al., *Tax by Design* (Oxford: OUP, 2011), 216-230; A. Tait, *Value Added Tax: International Practice and Problems* (Washington, D.C.: International Monetary Fund, 1988), 44; I. Crawford, M. Keen and S. Smith, “Value Added Tax and Excises” in S. Adam, et al., *Dimensions of Tax Design: The Mirrlees Review* (Oxford: OUP, 2010); cf. qualified views for developing countries: S. Cnossen, “Global Trends and Issues in Value Added Tax” (1998) 5 *International Tax and Public Finance* 399; R. Bird and P-P. Gendron, *The VAT in Developing and Transitional Countries* (Cambridge: CUP, 2007).

services or supplies made by selected enterprises that would give rise to significant and costly administrative problems. Recognition of VAT concessions as tax expenditures opens the door for a conceptually sound analysis of their design and operation. As spending measures, they must be evaluated by using the same (budgetary) criteria that are used in evaluating direct spending programmes.⁴

This article examines concessions from a tax expenditure perspective, with the aim of developing a better process for reform. It focuses only on concessions adopted for non-technical reasons, that is, to reduce regressivity or to promote the consumption of supplies that are perceived to be socially desirable. While many VAT concessions in the UK are home grown, many others conform with dictates set out in EU law. An opportunity to reform the UK VAT to remove EU-mandated concessions will open soon and this opportunity could be used to address indigenous concessions as well. At the same time, the conclusions reached in this article may have broader application as the EU moves to consider options for modifying the rules governing concessional VAT rates.⁵

Tax expenditure analysis normally involves a three-stage inquiry. The first step is to ask whether a tax expenditure serves a valid government objective. If the answer to the first question is yes, the second question to be answered is whether a tax expenditure or a direct spending programme is a better instrument to achieve the government's objective. Finally, if the government decides to deliver subsidies through the tax system, the third question to be resolved is how should a tax expenditure be designed to achieve most effectively its intended objective.

This article uses this approach to analyse concessions in VAT laws. It takes as a given in respect of the first stage of analysis that governments have concluded the goals explaining tax expenditures are desirable policy objectives and turns to the second and third stages, treating tax concessions as the equivalent of explicit government outlays and considering whether the implicit expenditures are distributed in a fair and efficient manner, with minimal collateral distortions or whether alternative direct expenditure programmes or better designs for tax expenditures are desirable. To the extent that current VAT concessions are demonstrated to be a poor instrument for delivering subsidies, the article proposes suggestions for policy and legislative reform. The most significant constraint on reform is political perceptions of the unacceptability of alternatives to current concessions. A possible catalyst for overcoming this inertia might be the adoption of a new tool to measure the revenue impact of concessions (the VAT tax expenditures ratio or the VTER) that is better suited to tax expenditure analysis than presently used measurements.

⁴ N. Brooks, "The Under-Appreciated Implications of the Tax Expenditure Concept" in C. Evans and R. Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Sydney: Thomson Reuters, 2009).

⁵ European Commission, *Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax (VAT) as regards the rules governing the application of VAT rates* (22 December 2016).

Identifying and classifying VAT tax expenditures

The phrase “tax expenditures” was first coined by Stanley Surrey, then Assistant Secretary of the US Treasury, in 1967.⁶ Surrey’s seminal paper on the subject in 1970, followed by his 1973 book, laid the foundation for future work on tax expenditure analysis.⁷ In 1974, the US adopted an annual tax expenditure,⁸ prompting the development by British academics of a UK tax expenditure account in 1978,⁹ with the first UK government account appearing soon afterwards.¹⁰

Tax expenditures are generally defined as reductions in tax liabilities relative to a benchmark tax that are implemented by way of tax provisions.¹¹ The concept is based on an identification of two distinct types of provisions in a tax act.¹² The first is normative tax provisions that define the basic elements necessary for the operation of the tax system.¹³ The second type comprises concessional deductions, exemptions, preferential rates, credits or tax deferrals that provide relief from the tax otherwise determined by applying the normative tax measures.¹⁴ The relief from tax is conceptually equivalent to the collection of tax under the normative tax system and payment of an amount equal to the tax concession benefit as a direct subsidy. As a consequence, for budget purposes these tax reliefs were referred to as tax expenditures.

In the late 1960s, Surrey advocated a cautious and conservative approach to the identification of tax expenditures in pursuit of his immediate goal of the adoption of a tax expenditure budget. He very deliberately did not use a theoretically ideal tax base as the benchmark for identifying tax expenditures, instead accepting almost all structural features of the US income tax as it then stood in his benchmark so only explicit and deliberate tax preferences were recognised as indirect budget outlays.¹⁵

By the time tax expenditure statements had become accepted budget tools, and the first tax expenditure budgets incorporating VAT were prepared, many countries had moved from the cautious and pragmatic approach to defining the benchmark base initially advocated by Surrey to a more conceptual approach. The benchmark adopted for VAT was closer to a neutral tax applied to the economic concept of consumption, recognising that both structural and compromise design features of the tax law have the same economic and fiscal consequences as deliberate concessions.¹⁶

⁶ S.S. Surrey, “The United States Income Tax System- The Need for Full Accounting” in W.F. Hellmuth and O. Oldman (eds), *Tax Policy and Tax Reform: 1961-1969. Selected Speeches and Testimony of Stanley S. Surrey* (Chicago: Commerce Clearing House, 1973).

⁷ S.S. Surrey, “Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures” (1970) 83 *Harvard Law Review* 705; S.S. Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditure* (Cambridge, MA: Harvard University Press, 1973).

⁸ Congressional Budget and Impoundment Act of 1974.

⁹ J.R.M Willis and P.J.W. Hardwick, *Tax Expenditures in the United Kingdom* (London: Heinemann Educational Publishers, 1978).

¹⁰ HM Treasury, *Public Expenditure White Paper* (HMSO, 1979) Cmnd. 7746.

¹¹ Heady, above fn.2; OECD, *Tax Expenditures in OECD Countries* (Paris: OECD Publishing, 2010).

¹² S.S. Surrey and P.R. McDaniel, “The Tax Expenditure Concept: Current Developments and Emerging Issues” (1979) 20 *Boston College Law Review* 225.

¹³ Surrey and McDaniel, above fn.12.

¹⁴ Surrey and McDaniel, above fn.12.

¹⁵ S.S. Surrey, “Tax Expenditure Analysis: The Concept and Its Uses” (1979) 1 *Canadian Taxation* 3.

¹⁶ OECD, *Choosing a Broad Base- Low Rate Approach to Taxation* (Paris: OECD Publishing, 2010).

There are, to be sure, country differences between benchmark VAT models at the margins, leading to differences in the identification of some tax expenditures, and consequently making cross-country comparisons problematic.¹⁷ However, all countries with tax expenditure accounts broadly agree the benchmark VAT is one that is imposed uniformly across all consumption, yielding no biases or distortions in the marketplace. An alternative benchmark in theoretical literature based on optimal tax theory developed by Ramsay suggests that it is possible to maximise revenue without impinging on economic efficiency by adjusting the tax rates to the demand elasticities of different types of goods and services.¹⁸ This implies that higher VAT rates should be applied to price inelastic types of consumption goods, since the demand for these goods will not change in the face of slight price rises.¹⁹ Before Ramsay optimal tax theory could be put into practice, however, the price elasticity of every product and service in the market would have to be determined, subject to regular recalculations as price elasticity is influenced by changes in consumer preference, technological development and the launch of new products.²⁰ The administrative complexity of such activities means that the optimal tax theory has little practical relevance to the setting of VAT rates. A single rate and broad base remain one of the key design norms of a good VAT.

While in theory any deviation from the benchmark is conceptually the equivalent of full taxation and a compensatory direct subsidy for the particular type of consumption, it is clearly far easier to hypothesise a rationale for deviations deliberately adopted to offset the regressivity of the VAT or to provide subsidies or incentives. Reduced rates or a zero rate applied to essentials such as food and energy that account for higher proportions of the income of lower income persons than of the wealthy are intended to counter regressivity.²¹ Reduced rates and exemptions are used to encourage consumption of goods or services that have perceived social value or positive externalities and which would be under-consumed in a neutral market, particularly by lower income persons.²² Subsidised goods and services with perceived broad social benefits may include books, education, medical care, cultural and religious activities, as well as products with environmental benefits. In some other cases, exemptions are used as tax incentives to achieve specific economic objectives²³ or to support particular types of enterprises.

Although this study focuses on these VAT measures deliberately adopted as subsidy measures, other features in VAT laws that deviate from a benchmark equally amount to implicit tax expenditures. Examples include exemptions used to overcome technical challenges in applying the VAT to some types of supplies and relative excessive costs incurred by some enterprises. The application of VAT to financial supplies, for instance, raises a host of technical issues that can be overcome in theory but the administration and compliance costs that solutions

¹⁷ OECD, above fn.16.

¹⁸ F.P. Ramsay, "A Contribution to the Theory of Taxation" (1927) 37 *The Economic Journal* 47.

¹⁹ W.M. Gentry, "Optimal Taxation" in J.J. Cordes, R.D. Ebel and J.G. Gravelle (eds), *The Encyclopedia of Taxation & Tax Policy*, 2nd edn (Washington, D.C.: The Urban Institute Press, 2005).

²⁰ Copenhagen Economics, *Study on Reduced VAT Applied to Goods and Services in the Member States of the European Union: Final Report* (2007).

²¹ S. Cnossen, "What Rate Structure for a Value-Added Tax?" (1982) 35 *National Tax Journal* 205.

²² A. Seely, *VAT: European Law on VAT Rates* (House of Commons Briefing Paper Number 2683, 25 November 2015).

²³ See Bird and Gendron, above fn.3, 127-130.

would entail are thought to be excessive relative to the additional revenue that would be raised. The approach adopted in most VAT jurisdictions is to exempt the supplies. Similarly, small enterprises can be taxed in the same manner as all other businesses but relative compliance costs faced by these persons as a percentage of turnover could be many multiples of that of larger businesses. To avoid this outcome, most VAT regimes use a registration threshold and treat small businesses with turnovers below the threshold as out-of-scope enterprises, the equivalent of classifying all their supplies as exempt supplies. While neither feature is explicitly adopted as a concession, both result in revenue forgone and amount to implicit subsidies.

VAT tax expenditures as spending programmes

Viewed objectively, the preference of legislatures for tax expenditures over direct expenditures is odd and the rationales commonly offered for following the tax expenditure path often seem weak when subject to critical scrutiny. It is claimed, for example, that tax expenditures reduce the administrative costs that would have been incurred by spending ministries if direct subsidies had been used.²⁴ Provision of subsidies by way of reduced taxes does not eliminate the need to identify qualifying recipients and arrange for the distribution of benefits, however. Delivering a subsidy via the tax system simply shifts responsibilities for these activities from a spending ministry to tax administrators.

Evaluated as the spending programmes to which they amount, tax concessions raise serious concerns in terms of fairness, targeting efficiency and budget control. The alleged administrative advantage of tax expenditures, even if it were to materialise, must be considered in light of these concerns.

Fairness

Tax expenditures in the form of exemptions, allowances, rate reliefs and deferrals provide benefits in proportion to the recipient's tax liability. In the case of a progressive income tax with increasing rates of tax applying to higher slices of income, the benefit of tax concessions rises with income in both absolute terms and relative terms. A concessional £1.00 deduction for a personal expense yields a 30p subsidy for a person in the 30 per cent bracket, a 25p subsidy for a person in the 25 per cent bracket, and a 10p subsidy for a person in the 10 per cent bracket. This redistributive element is absent from the benchmark VAT, which imposes a single rate of tax on all consumption with the aim of achieving economic neutrality, leaving redistribution goals to other taxes and to spending programmes. The upside-down character of concessional income tax deductions does therefore not apply to the VAT. A £1.00 supply of zero-rated food saves 20p tax for the rich and 20p tax for the poor. However, whatever the type of supply receiving concessional treatment, higher income persons are likely to acquire more in absolute terms than low income persons.²⁵ While the value of the subsidy does not rise with income for each pound spent, it does rise in absolute terms. The concession thus provides a

²⁴ D-J Kraan, "Off-budgeting and Tax Expenditures" (2004) 4 OECD Journal of Budgeting 121; J. Tyson, *Reforming Tax Expenditures in Italy: What, Why, and How?* (IMF Working Paper WP/14/7, 2014).

²⁵ L. Ebrill, et al., *The Modern VAT* (Washington, D.C.: International Monetary Fund, 2001), 75.

larger proportional benefit to the poor, but a larger absolute benefit to the rich.²⁶ The tax expenditure is both unfair in terms of who receives the largest subsidy and illogical from a social welfare perspective. Subjecting concessional supplies to full VAT could yield sufficient revenue to reimburse low income persons for the cost of tax on their concessional consumption and yield additional resources for further social welfare programmes.

Targeting efficiency

Targeting efficiency – ensuring expenditures reach the intended beneficiaries in the least costly manner with minimum spillover to other persons – is a prime design objective for any government spending programme. Implicit in the social contract that includes a compulsory transfer of income and expenditure from individuals to the state is an understanding that the funds will be used efficiently. The logic applies equally to appropriations for direct expenditure programmes and amounts disbursed by way of tax expenditures.

Targeting efficiency for subsidies, be they delivered as tax expenditures or direct spending programmes, has two elements. The first, which might be labelled object efficiency, seeks to ensure that subsidies are not wasted where they are not needed and do not detract from desired distributional outcomes. The second, which could be described as class efficiency, is a two-step process, determining whether the subsidy is intended to subsidise suppliers or their customers and then ensuring the benefit reaches the intended class of recipients.

Different, but parallel, considerations apply to object efficiency where specific types of consumption are targeted to address regressivity and where they are targeted to promote the consumption of merit goods or services. Tax expenditures that are used to address regressivity should not reduce the VAT paid by high income consumers significantly more than it reduces the VAT paid by low income persons. Tax expenditures adopted to subsidise merit goods or services should not deliver windfalls to beneficiaries who would have consumed the same quantity of these supplies without a subsidy.²⁷

To the extent that concessions are intended to address the regressivity of the VAT and reduce the proportion of expenditure by lower income persons that is subject to tax, the efficiency goal coincides completely with the fairness criterion for evaluating tax expenditures. As noted earlier, however, tax expenditures to reduce regressivity deliver larger absolute benefits to higher income persons than to lower income consumers. The spillover of benefits in this case is significant.

Fairness and efficiency concerns may also appear to overlap with tax expenditures designed to subsidise the consumption of merit goods. Subsidised goods or services are consumed by both high income and low income persons, possibly creating the impression that the benefit is poorly targeted – higher income persons are less in need of a subsidy than lower income persons.²⁸ This view misconstrues the goal of merit supply subsidies, however. Their

²⁶ A 1994 South African report shows that only little more than one-third of the benefits of zero-rated basic foodstuffs went to households in the lower five income deciles: The Davis Tax Committee, “First Interim Report on VAT to the Minister of Finance” (2014).

²⁷ The problem is set out in J. Harris “Tax Expenditure Control” in J. Rabin (ed.), *Handbook of Public Budgeting* (New York: CRC Press, 1992).

²⁸ For the view that reduced rates can be used to make merit goods more accessible for low income households, see Copenhagen Economics, above fn.20, 5.

aim is not to offset the regressivity of the VAT and subsidise consumption by lower income persons, but rather to influence consumption choices of all consumers. By reducing the cost of subsidised supplies relative to fully taxed supplies, the concessions will, it is hoped or anticipated, alter consumption choices and increase consumption of merit supplies by persons of all income brackets. If education, for example, is worthy consumption, it should be encouraged by way of price bias for persons of all income groups. At the same time, it could be argued that price has relatively little impact on higher income persons. If all alternatives are affordable – education at 100 and movies at 50, a subsidy to reduce the cost of education to 50 may not affect consumption decisions and would act as a genuine windfall for consumption that is chosen without regard to cost.

Subsidies delivered by way of direct spending programmes are most commonly provided directly to the intended beneficiaries. Tax expenditure subsidies in the form of zero rate or reduced rate supplies are normally applied to designated supplies. The intention, presumably, is to benefit final consumers by way of price reductions. Tax expenditure subsidies in the form of exemptions sometimes apply to specified supplies and sometimes apply to specified suppliers²⁹ and the concession may be intended to subsidise either consumers or suppliers.³⁰ The designation of healthcare and medical services or nursing home services as exempt supplies, for example, is presumably intended to subsidise consumers of those services. The designation of services provided by the disabled as exempt supplies, on the other hand, might be intended to provide benefits to the suppliers.

From a targeting perspective, subsidies adopted for the benefit of final consumers will only be efficient if they are passed on to the intended beneficiaries. Subsidies adopted to benefit particular types of suppliers may be efficient if the supplier is able to absorb a significant portion of the subsidy or if the supplier is able to pass on the benefit and increase volume at the expense of suppliers not entitled to the benefit. Where the benefit of the concession is actually enjoyed will depend entirely on the elasticity of the supply or whether the concession applies across an entire sector. If easily substitutable supplies are available, the benefit is more likely to be passed on to final consumers. If, however, there are no obvious substitutes, the concession may be appropriated by the supplier (or an enterprise higher up the production chain). That is, the subsidy may provide a higher profit margin for businesses rather than lower prices for consumers. There is evidence, for example, that a concession for children's shoes, for which there is no substitute, may not reach consumers at all.³¹ Similarly, a concession across a full sector such as labour-intensive industries may have little impact on final prices or consumption across the sector, with the benefit of the subsidy apparently absorbed elsewhere.³²

Targeting efficiency is further threatened in the case of exempt supplies that might be made to both final consumers and registered businesses. With no corresponding recovery of input tax, an "exempt" supply is actually, as at least one jurisdiction has explicitly labelled it,

²⁹ Bird and Gendron, above fn.3, 125.

³⁰ J. Englisch, "The EU Perspective on VAT Exemptions" in R. de la Feria (ed.), *VAT Exemptions: Consequences and Design Alternatives* (Alphen aan den Rijn: Wolters Kluwer, 2013).

³¹ European Commission, *Reduced rates of VAT: frequently asked questions* (MEMO/03/149, 2003).

³² See Copenhagen Economics, above fn.20, 10; Commission of the European Communities, *Report from the Commission to the Council and the European Parliament, Experimental application of reduced rate of VAT to certain labour-intensive services* (COM (2003) 309 final); R. de la Feria, "Blueprint for Reform of VAT Rates in Europe" (2015) 43 *Intertax* 155.

an input taxed supply.³³ The paradox of VAT in conventional Anglo terminology, thus, is that for registered businesses, an acquisition of a taxable supply is tax free while an acquisition of an exempt supply is actually taxable.³⁴ As the tax cannot be recovered by business customers, the input tax component becomes another element of the cost of acquisitions to be factored into the final selling price. If exempt supplies or supplies by exempt suppliers are made directly to final consumers, the reduced tax burden of exempt supplies may be enjoyed by the intended beneficiaries. However, if input taxed supplies are acquired by other businesses, what was intended to be a subsidy becomes an additional cost for the customer that is likely to actually increase prices for supplies further down the production chain. The outcome is grossly inefficient from a targeting perspective – a subsidy intended for final consumers will have imposed a burden on registered business customers that can be expected to be passed on to customers of other goods and services. As tax is imposed on tax, an apparent tax expenditure becomes a negative tax expenditure yielding VAT revenue higher than would be collected on a taxable supply subject to the standard rate.³⁵

Budget control

The problem of inefficient outlays by way of tax expenditures is exacerbated by the difficulty of controlling the quantum of expenditures, the limited ongoing evaluation and scrutiny they receive and their proclivity for expanding. Unlike direct expenditures, which are appropriated by the legislature prior to the release of funds and which can be subject to strict annual limits, tax expenditures are “open-ended government spending” programmes, the value of which is discovered by the government only after the fact.³⁶ It is not until the tax expenditure budget for a year is completed that the government learns how much subsidised consumption has taken place and how much revenue has been applied to this consumption as a result.

Nor does the parliament know the extent of its subsidy at a micro level, even if it is assumed that 100 per cent of the subsidy is passed on to consumers. A zero rate means there is no tax whatsoever on the supply. A reduced rate means the only tax included in the final sale price is the lower rate of tax. However, as noted earlier in the case of exempt supplies, the impact of the subsidy is inherently inconsistent, dependent entirely on the nature of the supply and supplier. Although there may be no tax imposed on the final sale, all input tax previously collected remains in the sale price. It is impossible for the legislature to know the value of the subsidy it is providing where it exempts final supplies but leaves an unknown amount of input tax embedded in the price. The subsidy may be small or effectively non-existent if there have been one or more exempt supplies along the supply chain to the final sale.

³³ Australia uses the term “input taxed supply”.

³⁴ R. de la Feria and R. Krever, “Ending VAT Exemptions: Towards a Post-Modern VAT” in R. de la Feria (ed.), above fn.30.

³⁵ A. Schenk, V. Thuronyi and W. Cui, *Value Added Tax: A Comparative Approach*, 2nd edn, (Cambridge: CUP, 2015), 269.

³⁶ Z.L. Swift, H.P. Brixi and C.M.A. Valenduc, “Tax Expenditures: General Concept, Measurement, and Overview of Country Practices” in H.P. Brixi, C.M.A. Valenduc and Z.L. Swift (eds), *Tax Expenditures – Shedding Light on Government Spending through the Tax System: Lessons from Developed and Transition Economies* (Washington, D.C.: The World Bank, 2004).

At the same time, from a budget control perspective, the overall impact of exemptions is substantial. The tax expenditure for education in the UK, for example, climbed from £2.5 billion in 2012-13 to £3.85 billion in 2015-16 with no Parliamentary approval, while the tax expenditure for financial and insurance supplies almost trebled over the same period, rising from £2.65 billion to £7.15 billion.³⁷

Tax expenditures are also more prone to “exemption creep”,³⁸ a consequence of the propensity of concessions to “feed on one another”.³⁹ Reduced and zero rates and exemptions incentivise registered businesses to lobby for further concessions or call for the extension of favourable tax treatment to similar or related supplies to level the playing field. For example, for many years there was a vigorous debate in the EU on whether there was a plausible rationale for applying a reduced rate or zero rate to printed books and standard rate to e-books.⁴⁰ The European Commission has recently proposed to extend current VAT concessions to e-publications.⁴¹ Tax expenditures are almost certainly more vulnerable to lobbying and uncontrolled expansion than direct spending programmes that are subject to strict scrutiny.⁴²

Operational consequences of VAT tax expenditures

Apart from their troublesome outcomes as spending measures, VAT concessions are problematic in terms of their economic, legal and administrative impacts. Each effect presents further compelling rationales for reform.

Economic distortions

If VAT is imposed on a broad base and at a single rate, all consumption is subject to the same level of tax and other than constraining the total amount of consumption, the tax has no impact on market decisions. The extensive use of VAT concessions undermines the neutrality and equality in actual VAT systems, distorts consumption decisions, and impacts on production and investment decisions as well as business structure choices.

In addition to their macro effect on the economy, concessions create distortions and biases within individual firms. Competitive pressures for innovation and more efficient means of production are removed for suppliers of goods or services enjoying lower VAT rates. Producers not only shift production from higher taxed products to lower taxed ones but repackage and rebrand to shift products from one category of supply to another.⁴³

While all concessions raise economic efficiency concerns, the distortions caused by exempt supplies can be particularly pernicious. As noted earlier, when an exemption arises at

³⁷ HMRC, *Estimated Costs of Principal Tax Reliefs* (2016).

³⁸ See Ebrill, et al., above fn.25, 89.

³⁹ See Bird and Gendron, above fn.3, 128.

⁴⁰ See e.g., *European Commission v France* (C-479/13) [2015] STC 1706 (ECJ); *European Commission v Luxembourg* (C-502/13) [2015] STC 1714 (ECJ); *K Oy* (C-219/13) [2015] STC 433 (ECJ); European Commission, *Summary Report of the Outcome of the Public Consultation on the Green Paper on the Future of VAT Towards a Simpler, More Robust and Efficient VAT System* (2011), 36.

⁴¹ European Commission, *Commission proposes new tax rules to support e-commerce and online businesses in the EU* (2016).

⁴² Tyson, above fn.24.

⁴³ de la Feria, above fn.32.

intermediate stages and exempt supplies are used as inputs in the production of taxable supplies at the subsequent stages of the business chain, the “logic of the VAT”⁴⁴ is violated and the business-to-business chain of tax and credit is broken. Non-recoverable input VAT forms part of the cost for business purchasers, leaving registered businesses that provide exempt supplies with embedded input tax and their competitors that provide fully taxable substitutes sit in starkly different competitive positions when selling to registered businesses. Businesses providing exempt supplies will be at a competitive disadvantage since their VAT exclusive prices to registered business customers will be higher than those of businesses that provide fully taxable supplies. Taxable persons who are entitled to input credits are likely to seek substitutes for exempt acquisitions with non-deductible embedded input VAT.

Once the business-to-business tax relief feature of the VAT is broken, the embedded VAT remains in the production chain forever. The tax component will thus be subject to VAT again and result in tax-on-tax cascades.⁴⁵ The longer the chain, the greater the level of cascading there will be. Confronted with disadvantage in terms of price competitiveness, some taxable persons may seek to absorb non-recoverable input VAT in their operating costs, yielding lower profit margins and further distortionary consequences.⁴⁶

A further bias created by the use of exempt supplies as a subsidy is the incentive for self-supply. To avoid input tax on acquisitions, taxable persons making exempt supplies may seek greater vertical integration by bringing services that can be more efficiently outsourced into the business.⁴⁷ Exemptions thus potentially encourage in-house production, which inhibits specialisation and could lead to the growth of far less efficient businesses.

Exemptions also create a preference for imports by taxable persons making exempt supplies and final consumers.⁴⁸ Domestically-sourced exempt supplies are input taxed, meaning undeducted input tax is embedded in the price. Imported exempt supplies, in contrast, have no tax in the source jurisdictions, where they are treated as zero-rated exports and no tax on importation so are completely free of explicit or implicit (embedded) VAT. Firms using exempt supplies as inputs may thus prefer exempt imports to domestically produced supplies. The efficiency loss associated with all the economic distortions is difficult to measure, in particular insofar as the exact impact of exemptions on the integrity of the VAT is unclear. Nevertheless, it could be presumed that the inefficiencies are not trivial.⁴⁹

Legal difficulties

The complexity of the VAT system attributable to concessions is reflected in the legislation itself. The legal definitions used to identify supplies subject to lower rates or different tax treatment (taxable versus exempt) are not replicated in economic or commercial reality. The flexibility of modern commerce and commercial relations provides almost infinite

⁴⁴ See Crawford, Keen and Smith, above fn.3, 351-352.

⁴⁵ Tait, above fn.3, 50.

⁴⁶ PwC, “Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services. Final Report to the European Commission.” (2006).

⁴⁷ H. Grubert and R. Krever, “VAT and Financial Services: Competing Perspectives on What Should Be Taxed” (2012) 65 Tax Law Review 199.

⁴⁸ Ebrill, et al., above fn.25, 88.

⁴⁹ Crawford, Keen and Smith, above fn.3, 352.

opportunities for the repackaging or recharacterisation of supplies. Any concession that carves out particular supplies for concessional treatment, be it exemption, lower rate or zero rate, creates a legal distinction that raises a host of definitional and interpretative problems including boundary issues between the various types of supplies and the problem of multi-element supplies comprising two or more separate types of supplies. In addition, exempt supplies that are accompanied by a denial of input tax credits invite creative business arrangements to bypass the blocked credits.

The first issue that arises where the VAT applies in a different manner to similar supplies is how taxable persons and tax authorities should categorise products that do not clearly fall in one camp or the other. The boundaries between comparable products are far from intuitive and the indistinct borders both invite confusion and tempt taxable persons to push the boundaries, sometimes aggressively. Enormous administrative and judicial resources are then needed to draw the lines on a case by case basis. No cases better illustrate these phenomena than the UK “Jaffa Cake” litigation⁵⁰ that commenced with a food manufacturer successfully arguing that its confectionary product should be characterised as a zero-rated cake rather than a standard-rated biscuit, a distinction that could not plausibly be defended on policy grounds in the first place.

In many cases, confusing borders are rendered even more indistinct with exceptions to exceptions. Food in the UK is zero-rated but cooked meals are not unless they are prepared as cold take-away food, leaving taxable persons, tax administrators and inevitably tax judges with the arduous task of determining how warm the food is when served or the manner in which the food is served.⁵¹ The seemingly insignificant questions are however key factors in determining VAT liability within the meaning of the law. The boundary problems would make the tax system vulnerable to avoidance and fraud as the arbitrary distinctions (made in either statutes or case law) provide taxable persons with incentives to deliberately misclassify items to take advantage of the concessional treatment.

A second issue that arises where different supplies are treated differently for VAT purposes is how to deal with multi-element supplies. A single notional supply may include components that on their own constitute different categories of supplies in terms of rates or character as fully taxable or exempt or zero-rated supplies. Since a large number of supplies in the contemporary economy are bundled supplies with multiple components, ambiguities exist as to whether multi-element supplies are mixed supplies that are separable into differently taxed components or composite supplies that take on the tax character of the principal component. The general rule is that a multi-element supply is considered a composite supply if the elements are integral parts of an overall supply, and a mixed supply if the elements are separable and each of them serves for its own purpose. While the general rule seems to be straightforward, the leading cases on mixed and composite supplies show that the distinction

⁵⁰ United Biscuits (UK) Ltd v CC&E [1991] LON/91/160. VAT Decision 6344.

⁵¹ See *Mucho Mas Limited t/a Chilango v HMRC* [2016] UKFTT 0302 (TC) (burritos, tacos and other Mexican food are standard-rated cooked hot meals and not zero-rated cold packed food); *HMRC v Compass Contract Services UK Ltd* [2006] EWCA Civ 730; [2006] STC 1999 (sandwiches, salads, snacks and drinks sold at outlets in the BBC Television Centre are zero-rated food supplies and not supplies made in the course of catering).

between them is never clear cut in practice.⁵² They also open the door to tax minimisation arrangements. A decision that in-flight catering is zero-rated as an integral part of a (zero-rated) supply of transport⁵³ was likely a factor that prompted a train operator to offer dinner trips comprising a short circular train trip with a haut cuisine meal of a value many times that of the train trip that ended up exactly where it started. In this case, the court agreed with the tax authority's view that the supply was a mixed supply and allowed the authority to allocate the cost of the ticket mostly to a standard rated meal, with a small remainder treated as consideration for zero-rated circular rail transport services.⁵⁴

Over time, common law jurisdictions will develop tests to distinguish composite and mixed supplies and civil law judges with an understanding of tax principles will develop interpretation norms that establish some guidance for taxable persons and tax administrators. However, as ongoing litigation of mixed and composite supply cases demonstrates, the cases turn on the facts, making it impossible to develop precise boundaries from case law precedents or civil law principles.

The juxtaposition of exempt and taxable supplies in national VAT laws invites tax minimisation schemes by suppliers seeking entitlement to input tax credits for acquisitions that ultimately relate to exempt supplies. The legality of schemes that unambiguously build on the provisions in VAT laws adds a veneer of respectability and legitimacy that attracts both commercial and non-profit enterprises into tax minimisation arrangements. *Principal and Fellows of Newnham College in the University of Cambridge v HMRC*⁵⁵ provides an example where the foundations in national law made it almost impossible for the tax authority to use specific anti-avoidance rules to combat the scheme. Most likely, similar difficulties will be encountered with general anti-avoidance rules or doctrines.⁵⁶

Additional complexity arises where complex intra-group arrangements including internal transfer pricing are used to maximise input tax entitlements as cases such as *Halifax plc and others v CC&E*⁵⁷ and *HMRC v BUPA Purchasing Ltd & Ors*⁵⁸ illustrate. Once again, where the structure of the law provides strong economic incentives for avoidance, solutions that rely solely on anti-avoidance measures will have limited impact. Policy-oriented judicial doctrines can arrest the spread of schemes, but in the longer term the more logical solution is to reform the structural features that encourage and reward successful avoidance arrangements.

⁵² See e.g., *Card Protection Plan Limited v CC&E* [2001] UKHL 4; [2001] STC 174; *Card Protection Plan Limited v CC&E* (C-349/96) [1999] STC 270 (ECJ) (registration services for credit card insurer are part of a composite supply of insurance); *RLRE Tellmer Property sro v Finančni Reditelstvi v Usti nad Labem* (C-572/07) [2009] ECR I-4983; [2009] STC 2006 (ECJ) (supply of residential premises and cleaning services for a building's common areas is a divisible mixed supply); *Levob Verzekeringen BV v Staatssecretaris van Financiën* (C-41/04) [2005] ECR I-9433; [2006] STC 766 (ECJ) (supply of software and customisation and training services is a single composite supply).

⁵³ *British Airways v CC&E* [1990] STC 643 (CA).

⁵⁴ *Sea Containers Services Ltd v CC&E* [2000] STC 82 (HC).

⁵⁵ *Principal and Fellows of Newnham College in the University of Cambridge v HMRC* [2008] UKHL 23; [2008] STC 1225.

⁵⁶ G. Morse, "HMRC v Principal and Fellows of Newnham College in the University of Cambridge: VAT Anti-avoidance—the End of an Era?" [2008] BTR 542.

⁵⁷ *Halifax plc and others v CC&E* (C-255/02) [2006] ECR I-1609; [2006] STC 919 (ECJ).

⁵⁸ *HMRC & BUPA Purchasing Limited & Ors* [2007] EWCA Civ 542; [2008] STC 101.

Administrative and compliance costs

The use of concessions inevitably leads to an increase in compliance burden for registered businesses and administrative burden for tax administrators. In the first place, resources are needed to distinguish fully taxable, reduced rate, zero rate and exempt versions of often similar supplies. Further efforts are needed to distinguish composite from mixed supplies and then to dissect the latter into component parts. Once these steps are completed, registered persons need to divert time and resources to carry out additional accounting activities, including separating records of sales and purchases of the different categories of supplies.⁵⁹

A further step is required when businesses make both exempt and taxable supplies. In these cases, the businesses must apportion the use of inputs between the production of taxable and exempt supplies, with input tax credits available for the former group of inputs only. The apportionment, however, is not always straightforward, as many inputs are indistinguishably related to both taxable and exempt supplies. Many countries allow taxable persons to self-select apportionment methods appropriate to their business model, while providing safe-harbour rules to the risk averse. This increases compliance costs as businesses make calculations based on alternative formulae to achieve an optimal tax result. The legitimacy of their chosen methods is often tested through costly litigation.⁶⁰

All concession issues that increase compliance costs equally impact on administrative costs for tax authorities. Officials processing and auditing VAT assessments must evaluate the distinctions made by taxable persons between fully taxed, reduced rate, zero-rate and exempt supplies, their characterisations of bundled supplies as mixed or composite supplies, their dissection of elements in the case of mixed supplies, and their apportionment of input tax credits where they make taxable and exempt supplies. Further and significant resources are needed to uncover avoidance schemes attributable to the interaction of fully taxed and concessional supplies.⁶¹

Exact measurements of the effect of concessions on compliance costs or consequent administrative costs have yet to emerge and comparative measurements of compliance costs have proven difficult.⁶² However, a rough indication of relative compliance costs may be garnered from a comparison of compliance costs as a proportion of revenue, provided the standard rates are similar. A comparison of compliance costs in Denmark and Croatia, which share the same standard rate, offers an illustration. Compliance costs have been estimated to be 0.3% of the total VAT collections in Denmark, the lowest in the EU, and between 16-25%

⁵⁹ Ebrill, et al., above fn.25, 78.

⁶⁰ See e.g., *HMRC v Lok'nStore Group Plc* [2014] UKUT 0288 (TCC) (taxable person allowed to apportion inputs attributable to taxable sales on the basis of floor space); *The Hurlingham Club v HMRC* [2015] UKFTT 76 (TC) (taxable person not allowed to apportion on the basis of floor space).

⁶¹ US Government Accountability Office, *Value-Added Tax: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition* (Report to Congressional Requesters GAO-08-566, 2008).

⁶² C. Sandford, "International Comparisons of Administrative and Compliance Costs" (1994) 11 *Australian Tax Forum* 291.

in Croatia, the highest in the EU.⁶³ The absence of any reduced rate in Denmark may well be one reason for the notably low compliance costs in that country.⁶⁴

Reforming VAT concessions

Tax expenditure analysis of VAT concessions in the form of reduced rates, zero rate and exemptions suggests they are ill-suited tools to achieve social and economic objectives. But while the revenue cost of VAT concessions is now commonly recorded in tax expenditure accounts, tax expenditures as spending programmes continue to evade scrutiny equal to that of direct expenditures. New methodology is needed to bring these into the budget process. Tax expenditures found wanting in terms of fairness, targeting, or economic impact can then be replaced with direct expenditure programmes or modified to achieve better their intended purposes.

Recognising equally indirect and direct spending programmes

The foundation of tax expenditure analysis as a tool to reform tax concessions is full recognition of tax expenditures as government spending programmes. Currently, cost analysis of tax expenditures characterises these measures in terms of lost revenue, not applied revenue. In one sense, this is not surprising. The ability of VAT to raise a significant amount of revenue is the key attribute of the tax that explains its attractiveness to governments. If concessions are not correctly recognised as indirect expenditures, their effect appears to be to undermine seriously the revenue potential of the VAT,⁶⁵ among other things necessitating higher standard rates to replace lost revenue.⁶⁶ If, on the other hand, concessions are treated as indirect expenditures, their abolition would not necessarily be seen as a prompt for lower standard VAT rates. In the alternative, they could be replaced with equally costly, but likely fairer and more efficient, direct spending programmes or their elimination could provide resources for other government initiatives.⁶⁷

Cost analysis of tax expenditures as lost revenue has been driven to a large extent by the work of international agencies such as the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD). These agencies calculate the gap in VAT collections from a theoretically comprehensive consumption base using national accounts to estimate total consumption. The bases used by the IMF and the OECD to measure potential consumption differ slightly. The IMF's "C-efficiency" formula uses the value of VAT-exclusive national consumption and the OECD's VAT revenue ratio (VRR) formula uses the value of VAT-inclusive national consumption.⁶⁸

⁶³ S. Adam, D. Philips and S. Smith, *A Retrospective Evaluation of the EU VAT System* (European Commission 2011), 111-112.

⁶⁴ Adam, Philips and Smith, above fn.63.

⁶⁵ P-P. Gendron, "Canada's GST at 21: A Tax Expenditure View of Reform" (2012) 1 *World Journal of VAT/GST Law* 125.

⁶⁶ C. Ball, J. Creedy and M. Ryan, *Food Expenditure and GST in New Zealand* (New Zealand Treasury Working Paper 14/07, 2014).

⁶⁷ Brooks, above fn.4, 242.

⁶⁸ OECD, *Consumption Tax Trends 2016: VAT/GST and Excise Rates, Trends and Policy Issues* (Paris: OECD Publishing, 2016).

Both the C-efficiency and VRR measurements suffer from three shortcomings when used as tools to measure the revenue cost of tax expenditures. The first is that the measurement of consumption in national accounts varies in some respects from the generally accepted notion of consumption for VAT purposes.⁶⁹ There may be differences, for example, in the treatment of public services, imputed rent for owner-occupied housing, sales of second-hand goods, and other values.⁷⁰

Secondly, and more importantly, the C-efficiency and VRR calculations measure the difference between VAT collected and potential VAT on all consumption without distinguishing revenue forgone for concessions from revenue lost to evasion or avoidance. Attempts have been made to decompose the C-efficiency and VRR into policy gap (revenue forgone by way of concessions) and compliance gap components in order to assess the respective impacts of the two components on VAT revenue.⁷¹ The approach that is commonly used is to estimate the total C-efficiency/VRR gap, subtract the compliance gap, and calculate the policy gap as a residual.⁷² This measurement, however, remains one based solely on theory, with no connection to revenue budget accounts.

This distinction exposes the third shortcoming of C-efficiency and VRR measurements as a basis for tax expenditure analysis. Even if measurements derived from national accounts were to disaggregate shortfalls into policy and compliance components, their starting point, total consumption based on national accounts, might differ significantly from the aggregate tax bases of benchmark VATs used in tax expenditure budgets. What is needed is a measurement of the policy gap using a base that the legislature recognises as a realistic tax base, not a theoretical base never within its contemplation. Equally importantly, the gap must be treated not as a loss of revenue but rather as revenue notionally collected and spent by way of indirect expenditures.

The most useful tool for budget purposes will be an account derived from actual budget data of revenue received and revenue forgone on consumption that national authorities have explicitly recognised as untaxed consumption. That is, national tax expenditure budgets implicitly recognise total VAT revenue as comprising two components – a portion that is collected and then expended through direct expenditures and a portion that is notionally collected and immediately remitted as tax expenditures. The challenge is to modify budget processes so both types of expenditure receive equal recognition. To date, the two components have been analysed in isolation. If they are combined, the actual cost of tax expenditures and direct expenditures can be evaluated in terms of true VAT revenue, which comprises both collected tax and tax forgone prior to collection. The proportion of potential revenue expended by way of tax expenditures can be expressed as a VAT tax expenditures ratio (VTER). In figures, the VTER would be:

⁶⁹ L. Barbone, et al., Study to Quantify and Analyse the Gap in the EU-27 Member States: Final Report (TAXUD/2012/DE/316, 2013).

⁷⁰ Keen, above fn.1, 432-434; and OECD, above fn.68, 109-116.

⁷¹ B. Clements, V. Perry and J. Toro, From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies (Washington, D.C.: International Monetary Fund, 2010); Keen, above fn.1.

⁷² See Clements, Perry and Toro, above fn.71.

$$\text{VTER} = \frac{\text{VAT tax expenditures}}{\text{VAT tax expenditures} + \text{revenue collected}}$$

Tax expenditure accounts measure the value of tax expenditures on the assumption that if concessional taxed consumption were fully taxed, the forgone revenue would be recovered completely. It could thus be argued that using raw tax expenditure figures as revenue forgone exaggerates the impact of these concessions; were the supplies subject to tax, suppliers might resort to avoidance or evasion arrangements that provide no benefit so long as a concession applies. It is equally probable, however, that compliance could improve as concessions are removed and the foundation for current avoidance arrangements disappears. In any case, the impact of improved or reduced compliance is likely to be negligible in terms of the overall measurements.

Data drawn from national tax expenditure accounts shows the VTER for the UK (a jurisdiction using a traditional VAT standard and reduced rate model, as well as a zero rate for some domestic supplies) and Australia (a jurisdiction using a modern VAT single positive rate model and a further zero rate for some domestic supplies) to be 0.38⁷³ and 0.29⁷⁴ respectively in 2015-16. The result is consistent with a supposition that VAT concessions are used with greater caution in more recently adopted VAT systems. In VTER terms, UK legislators are distributing well over one-third of their VAT revenue through tax expenditures that likely have not been reviewed since inception. In contrast, every pound of the remaining revenue is subject to vigorous debate and review in two houses of Parliament before expenditure, not to mention rigorous analysis in the press and by academia and external research bodies.

The VTERs for different countries are not directly comparable given the diversity in the views of a benchmark VAT (and consequently what constitutes VAT tax expenditures). On a country-by-country basis, however, the VTER can show the proportion of VAT revenue disbursed by means of tax expenditures utilising each government's own accounts. Legislators can be held accountable for tax expenditures in the same way as they are for direct expenditures. Tax expenditure analysis can then be incorporated directly into the budget process.

Removing VAT concessions

Reform of VAT concessions must be tailored to their objectives. One group of VAT concessions is intended to subsidise particular types of suppliers or to encourage consumption of particular goods or services (merit supplies). This type of subsidy can be delivered more efficiently and with greater transparency through direct spending programmes.

The second type of concession is designed to moderate the regressive impact of the VAT, reducing the tax burden for lower income persons in general, as opposed to subsidies for particular suppliers or types of supplies. Once again, direct expenditures provide the optimal response. The most efficient way of offsetting the VAT burden for low income persons is to provide tapering compensatory entitlements based on income. These can be made directly as

⁷³ Author's own calculation. Sources: HMRC, Value Added Tax (VAT) Factsheet 2015-16 (2016); HMRC, above fn.37; HMRC, Estimated Cost of Minor Tax Reliefs (2016).

⁷⁴ Author's own calculation. Sources: The Treasury, Australian Government, 2016 Tax Expenditures Statement (2017); and Australian Taxation Office, Australian Government, Taxation Statistics 2014-15 (2017).

welfare payments or indirectly by means of a progressive and refundable tax credit incorporated in the income tax system. The latter may be more cost efficient from an administrative perspective as the same agency measures income and distributes benefits based on that measurement. The Canadian compensatory tapering and refundable tax credit system⁷⁵ provides a working example of this tool.

Compensatory payments are not only more efficient in directly offsetting the regressivity of the VAT but also avoid the paternalism found in most systems using tax relief for specific types of supplies as a means of offsetting regressivity. They achieve neutrality and remove distortions while providing visible assistance for those who would otherwise benefit from specific tax expenditures in VAT systems intended to reduce regressivity. The visibility in turn enhances the political support for reform by establishing a direct nexus between the replacement of concessions and the substitution of direct or tax credit payments in their stead.⁷⁶

Designing VAT concessions

However strong the case may be for replacing VAT concessions with more efficient alternative instruments, experience shows that it is difficult to remove tax expenditures once they have been adopted.⁷⁷ This is especially true if concessions were adopted for historical or political reasons such as the path dependency concessions transferred into the EU VAT system to replicate preferential treatment in the predecessor turnover tax systems.⁷⁸ Concessions for food are particularly resistant to change in jurisdictions where their adoption was required to win initial public or political acceptance for a VAT that was perceived to be inherently regressive.⁷⁹ A “temporary” zero-rating of food adopted when the VAT was introduced in the UK remains in effect 44 years later.⁸⁰

What options are available if it is conceded that complete removal of concessions is politically unattainable in many of the countries in which they are used extensively? The second-best reform option within these political constraints is the better design of concessions that target intended beneficiaries more effectively, minimise distortions, and reduce administration and compliance costs. In the case of subsidies to offset the regressivity of the VAT, policy decisions may feed directly into the design of the VAT law. In the case of concessions that were adopted to subsidise the consumption of merit supplies, it may be possible to piggyback the concessional measures in the VAT law on to other legislation that implements policy decisions directly.

⁷⁵ Known as the Goods and Services Tax/ Harmonised Sales Tax (GST/HST) credit.

⁷⁶ See R. Bird and P-P. Gendron, “Sales Taxes in Canada: The GST-HST-QST-RST ‘System’” (2010) 63 Tax Law Review 517 on Canada’s experience when the nexus was not established.

⁷⁷ See Crawford, Keen and Smith, above fn.3, 301.

⁷⁸ On path dependency concessions, see S. Cnossen, “The Technical Superiority of VAT over RST” in J.G. Head (ed.), *Australian Tax Reform in Retrospect and Prospect* (Sydney: Australian Tax Research Foundation, 1989); Commission, Proposal for a sixth Council Directive on the harmonization of Member States concerning turnover taxes - Common system of value added tax: Uniform basis of assessment (COM (73) 950, 1973).

⁷⁹ A concession for food was seen as crucial to the acceptance of GST in Canada, for example; see Bird and Gendron, above fn.76.

⁸⁰ Council Directive 77/388/EEC 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 [1977] OJ L145/1.

To address the regressivity inherent in VAT systems, most VAT laws include concessions for “necessities”, in particular food.⁸¹ Empirical evidence suggests that concessions for items that account for a higher percentage of the budgets of lower income consumers can be effective in delivering relatively greater benefits to low-income groups, thereby increasing the progressivity of the VAT, at least in terms of consumption expenditure.⁸² However, as noted earlier, reducing the regressivity of the VAT in this manner comes at significant fiscal cost as it subsidises all consumption of designated items, both by low income and high income persons, and delivers a greater absolute benefit to higher spending, higher income persons. At the same time, fuzzy borders to concessionally taxed items increase administrative and compliance costs.

While inefficiency and complexity cannot be eliminated entirely so long as concessions remain in the VAT system, a better targeted list of concessionally taxed necessities can substantially reduce collateral costs. The policy objective is all too often lost in the current approach taken in many countries that is based on broad categories of necessities such as “food” along with ambiguous or arbitrary borders which are not obviously tied to the objective. The logic of distinguishing biscuits from cake, as noted earlier, or treating a supply of six doughnuts as zero-rated food and five doughnuts as fully taxed consumption (as is currently the law in Canada) to target tax relief for lower income persons is at best obscure. To achieve the intended policy and improve targeting efficiency, seemingly random designations that seek to second guess the needs of lower income persons should be replaced with narrowly targeted goods and services that comprise a large percentage of expenditure by lower income persons as identified by objective household expenditure survey data. Efficiency can be enhanced if the targets are reviewed regularly and adjusted as appropriate to changes in the consumption pattern of lower income persons. Better targeting in this way avoids excessive leakage of benefits to high income persons while reducing VAT administrative and compliance costs. Complex disputes over the characterisation of snack food as a cake or biscuit would not arise if a system similar to that used in South Africa were adopted, where the zero-rating of food is strictly confined to 19 items of basic foodstuffs.

Concessions used to subsidise various merit supplies are common in VAT systems. The logic of careful drafting to target tightly subsidies for merit goods applies equally to direct expenditures and tax expenditures. However, as a consequence of ambiguous drafting of tax expenditure provisions in VAT laws and consequent judicial rulings that often misconstrue the intended goals of concessions, the types of supplies that are subject to lower rates or exemptions often extend far beyond a rational target for merit goods or those that would likely qualify for subsidies under a direct expenditure programme implementing deliberate policy choices.⁸³ Loosely drafted legislation invites suppliers to characterise their services as

⁸¹ New Zealand and Japan are notable exceptions where the VAT is imposed at a uniform rate, with no concessions for necessities.

⁸² Studies show that the progressive effects of rate differentiation were found in EU countries. See Cnossen, above fn.78, 346-347; Ebrill, et al., above fn.25, 109.

⁸³ The concessional treatment of books in the UK, for example, was presumably intended to subsidise the dissemination of knowledge and consistent with this idea, albeit using different reasoning, the High Court held that empty diaries and address books are not books because they are not designed to be read or looked at; see *CC&E v Colour Offset Ltd* [1995] STC 85 (QB). A similar result is to be found in *Donald Arthur Draper v CC&E* (27 April 1981) (unpublished), cited in *Harrier LLC v HMRC* [2011] UKFTT 725 (TC), where a tribunal concluded a wedding book is not a book. However, the First-Tier Tribunal decided more recently that photo

preferentially taxed supplies. In the UK, for example, suppliers of Pilates lessons,⁸⁴ belly dancing lessons,⁸⁵ golf lessons,⁸⁶ and college meals served to the general public⁸⁷ have attempted to present their supplies as exempt education supplies. It is almost inconceivable that suppliers would put forward similar arguments in the context of a direct expenditure programme for education.

In contrast to the loose language and apparently unprincipled application of tax expenditures in many VAT laws, direct expenditures are tightly drafted to avoid ambiguous boundaries and inappropriate applications of public funds. One technique for targeting tax expenditures is therefore to tie the tax expenditures to relevant direct expenditure laws or to laws that tightly regulate a field. Health tax expenditures, for example, could be limited to services that qualify for direct payments under a national health insurance regime.⁸⁸ Similarly, education tax expenditures could be tied to services defined under education institution legislation. Rather than setting out ambiguous tests such as the current UK concession for private tuition in “a subject ordinarily taught in a school or university”,⁸⁹ education supplies eligible for concessional treatment could be tied directly to well-established and clearly focussed education (expenditure) laws as is done in Australia.⁹⁰ Tightly drafted tax expenditure provisions could free tax administrators and appeal adjudicators from the almost impossible task of determining how the man on the Clapham Omnibus would interpret “a subject ordinarily taught in a school” and the many other vague terms that establish the artificial boundaries in VAT laws.

Conclusion

VAT concessions often operate as unfair and inefficient subsidy programmes that give rise to significant legal and economic distortions and high administrative and compliance burdens. While often described as a cause of revenue loss, they are more appropriately viewed as indirect revenue appropriations. The ideal reform would see the replacement of VAT concessions with fairer and better targeted direct expenditure programmes. However, the political economy reality in most countries probably removes the first best option from the table for some, but perhaps not all, concessions. The question then becomes which current concessions can be removed and replaced and which can be retained but improved and, in the case of the latter group, how they can be improved. The VTER approach outlined in this article to measure the cost of each concession and treat it as an expenditure made from total potential VAT revenue can provide a starting point for rigorous tax expenditure analysis of VAT concessions.

books comprising photographs taken by customers are books even though the design and contents are entirely customers' choice; see *Harrier LLC v HMRC*, above.

⁸⁴ *Hocking v HMRC* [2014] UKFTT 1034 (TC).

⁸⁵ *Cheruvier (t/a Fleur Estelle Belly Dance School) v HMRC* [2014] UKFTT 7 (TC).

⁸⁶ *Marcus Webb Golf Professional v HMRC* [2012] UKUT 378 (TCC); [2013] STC 574.

⁸⁷ *HMRC v Brockenhurst College* [2015] EWCA Civ 1196; [2016] STC 2145; *Brockenhurst College v HMRC* (C-699/15) [2017] STC 1112 (ECJ).

⁸⁸ E.g., (Australia) *A New Tax System (Goods and Services Tax) Act 1999*, 38-7, explicitly linking tax free medical services to those that qualify for direct subsidies under the national health insurance scheme.

⁸⁹ *Value Added Tax Act 1994*, Sch.9 Group 6 Item 2.

⁹⁰ *A New Tax System (Goods and Services Tax) Act 1999*, 38-85 and 195-1 defining tax free secondary and tertiary courses as those qualifying for financial assistance under the *Student Assistance Act 1973*.

Tax expenditure analysis suggests that concessions are not the best way to address the regressivity of a tax on consumption. The VAT is only one element in a larger tax and transfer system and its impact must be considered in the context of the overall progressivity of the entire tax system.⁹¹ Subsidies to address the regressivity of the VAT are best provided as direct welfare transfers or tapering and refundable income tax credits. To the extent political considerations warrant retention of subsidies in the VAT to address regressivity, concessions could be better targeted by using household expenditure data to focus on a limited range of necessities that account for a larger percentage of lower income consumers' budgets. Subsidies for merit supplies are best delivered through direct spending programmes. If the concessions used to subsidise merit supplies must remain in the VAT system, targeting efficiency can be enhanced by linking the tax expenditure provisions in VAT laws to direct expenditure or regulatory laws that more tightly define qualifying supplies. There are, to be sure, significant geo-political hurdles to be overcome in the reform of VAT concessions. However, tax expenditure analysis can provide a useful conceptual framework for the process.

⁹¹ Adam, Philips and Smith, above fn.63, 538.