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The UK VAT at 50: the Good, the Bad and the Ugly

Rita de la Feria*

Adopted 50 years ago, the UK VAT is one of the oldest VATs in the world. On its 50th anniversary, this article considers its strengths and weaknesses, and sets out a vision for what should be the priorities for reform. It argues that, being an early adopter of a tax that would go on to become a global tax phenomenon, has had significant consequences on the design and functioning of the tax. On one hand, it has allowed the UK to benefit from the technical advantages of the tax, namely in terms of efficiency and neutrality, whilst at the same time contributing to the country's global soft power within the tax field. On the other hand, it has enshrined some initial administrative and design features, which have stalled progress, and have resulted in the UK VAT lagging behind those of other countries. Whilst slow progress is being achieved in some areas, namely digitalisation of tax administration, in other areas, it is still absent. It concludes that making the UK VAT fit for the next 50 years, means not only a continuation of the process of modernising its administration, but also entails addressing the elephant in the room: reforming the UK VAT base.

It was a grey, drizzling, Sunday morning, on what had been a relatively dry year for UK patterns. For most British citizens there was nothing particularly remarkable about that Sunday, April 1st, 1973, except for the announcement, by John Lennon and his wife Yoko Ono, of the birth of a conceptual country, Nutopia.[1] Tax experts, however, knew better; they knew UK history was being made on that April's Fool Day, 1973, not by the birth of Nutopia, but by the birth of a new tax, the Value Added Tax (VAT). Not even those tax experts, however, could have predicted how successful VAT would become in the next 50 years. In the UK, as globally, VAT turned out to be a remarkable success story, an "unparalleled tax phenomenon".[2]

VAT History

The history of VAT is relatively recent. Its theoretical roots can be found in the period shortly after the First World War when an American scholar, T.S. Adams, and a German industrialist C.F. von Siemens, separately, but almost at the same time, wrote papers setting out proposals for the tax. The timing of the first proposals remains unclear, but it is most likely that C.F. von Siemens pamphlet slightly preceded Adams' work by a year.[3] As is so often the case, however, the ultimate adoption of the VAT

* Professor of Tax Law, University of Leeds; Editorial Board member. This note is based on a speech delivered at the ICAEW conference, *VAT at 50 – Where Next?*, held in London, on May 22, 2023.

[1] M. Bannister, "And the world will be as one" - John Lennon, Yoko Ono and Nutopia" (2021) *Transformations* 35, 91-103.

[2] A. Tait, *Value Added Tax: International Practice and Problems* (IMF, 1987).

[3] 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* (Wolters Kluwer, 2013), 3-36.

had little to do with those grand theoretical concerns, but was rather a response to, on the ground, pragmatic considerations.

Struggling to rebuild its economy three years after the end of the Second World War, the French government decided to try a unique gamble: to substitute the existing cumulative tax, the turnover tax, by a non-cumulative one.[4] At the time, there were two models for final consumption taxes that eliminated cascading taxes on businesses: the first was the Retail Sales Tax (RST), applied in in most sub-national jurisdictions in the USA, the second was the VAT. Although an ideal RST and an ideal VAT should be economically equivalent,[5] in practice their differences, in particular as regards the remittance method, affects their economic impact and administrative efficiency, and means that VAT is a technically superior tax.[6] With relatively limited knowledge of the impact of these differences, however – which would only become fully evident many decades later – France chose VAT, and the gamble paid off.[7]

Fast-forward a few years, and there was a growing awareness within the newly established European Economic Community (EEC) that turnover taxes played a fundamental role in the European integration process: if a common market was to be established, harmonisation of these taxes was necessary.[8] This awareness led the EEC Treaty to include a specific provision (Article 99), which more than provided a legal basis for the harmonisation of turnover taxes, it mandated it. Acting on that mandate, the European Commission set-up several working groups to determine whether harmonisation of turnover taxes was indeed necessary "in the interest of the common market", and if so, what were the available routes to achieve such harmonisation. The most influential of these working groups was the Fiscal and Financial Committee, chaired by Fritz Neumark, which reporting in 1962 recommended that Member States should abolish cumulative turnover taxes and replace them with VAT; a conclusion that has been characterized as "audacious", given that at the time all Member States, with the exception of France, applied cumulative taxes.[9] Critically, although the report presented several reasons in support for its conclusion, a key factor was the perceived neutrality of the VAT. In 1967, following lengthy and

[4] Ibid.
[5] S. Cnossen, "VAT and RST: A Comparison" (1987) *Canadian Tax Journal* 35(3).
[6] J. Slemrod, "Does It Matter Who Writes the Check to the Government? The Economics of Tax Remittance", (2008) *National Tax Journal* LXI(2), 251−275; and D. Pomeranz, 'No Taxation Without Information: Deterrence and Self-Enforcement in the Value Added Tax' (2015) *American Economic Review* 105, 2539.
[7] At the time, the introduction of the VAT was characterized as 'an invention of the first order', and France as an 'innovator in taxation', see C.S. Shoup, "Taxation in France" (1955) *National Tax Journal* 8(4), 325−344.
[8] A comprehensive historic analysis of the role of VAT in the European integration process, from the European Coal and Steel Community to the European Union (EU), is provided in R. de la Feria, "VAT and the EC Internal Market: The Shortcomings of Harmonisation", in D. Weber (ed.), *Traditional and Alternative Routes to European Tax Integration* (Amsterdam: IBFD, 2010), 267-308.
[9] B. Terra and P. Wattel, *European Tax Law* (The Hague: Kluwer Law International, 2022).

difficult negotiations, the First and Second VAT Directives were approved,[10] thus establishing what would later become the EU VAT system.

With the approval of those Directives in 1967, VAT becomes part of the *acquis communitaire*, and thus any country joining the EEC from that date onwards was required to implement it – a critical factor in the initial spread of VAT within Europe. This was the case with the UK, Ireland and Denmark, in 1972, which were thus required to abolish their existing turnover taxes, or equivalent, and introduce a VAT. As opposed to other Member States – including Ireland – at the time of accession, the UK did not have a turnover tax, but it did have a Purchase Tax, which applied (solely) to the wholesale of luxury goods. As discussed further below, this was to play a critical role in the design of the new UK VAT.

From Europe to the rest of the world, the VAT quickly spread: initially through parts of Latin America, then from the 1980s onwards, throughout Asia and Africa. By 2022, over 170 countries had a VAT;[11] the latest countries to join the VAT club, within the last five years, having been six Gulf countries – namely Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates – and a few African countries, most notably Angola. Today, only a few countries do not have a VAT, the most significant of those being the USA. Whilst the causes for this remarkable spread have been subject to some debate, they are likely to be a mixture of technical and practical reasons. From a technical perspective, the VAT's revenue mobilisation capacity, as well as its neutrality and its relative imperviousness to fraud, are known to be key factors.[12] These technical factors on their own, however, are unlikely to explain the rise of the VAT.[13] Instead other political and/or economic factors, such as EU membership candidacy, participation in an IMF programme, and yardstick competition with neighbouring countries, are all likely to have played a role.[14] Nevertheless, whatever the reasons, it is clear that the UK – somewhat accidentally – was at the forefront of a global tax phenomenon.

That status has had very significant consequences. Indeed, whilst as discussed further below, the UK has benefitted immensely from being an early adopter of the VAT, this has also had some (considerable) disadvantages. The main one of these has been the fact that the early UK VAT system created a path dependency, both legislatively, and as regards the administration of the tax, which has made it hard to adapt the tax to either new scientific knowledge or to technological developments. Some mistakes made in the initial design of the VAT – which other countries were able to avoid largely as a result of learning from the experience of countries like the UK and other EU Member States – have proved nearly

[10] First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes, OJ 71, 14/04/1967, 1301; and Second Council Directive 67/228/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes – Structure and procedures for application of the common system of value added tax, OJ P71, 14/04/1967, 1303.
[11] OECD, *Consumption Tax Trends* (Paris: OECD Publishing, 2022).
[12] M. Keen and B. Lockwood, "The value added tax: Its causes and consequences" (2010) *Journal of Development Economics* 92, 138–151.
[13] K. James, *The Rise of the Value-Added Tax* (CUP, 2015).
[14] M. Keen and B. Lockwood, fn. 12 above.

impossible to correct. Additionally, in contrast with late adopters of the VAT, which have been able to take full advantage of new technological developments, UK VAT administration and compliance is still to some extent trying to break free from the pre-digital era; set in its own ways, either too conservative or too cumbersome to modernise.

The remainder of this note considers the good, the bad, and the ugly of UK VAT. First, it highlights the overwhelming success of the UK VAT, and the high-level of technical expertise developed in the UK as regards the tax, over the last 50 years (the good). Second, it considers the latest developments worldwide in the use of new technologies to assist with VAT administration and compliance, and demonstrates how the UK is now lagging substantially behind other countries in this area (the bad). Third, it discusses the UK VAT base, and how/why design errors made at the outset have proved impossible to correct with damaging consequences for the efficiency of the tax, and limited, if any, equity gains (the ugly). Finally, it concludes with some brief considerations on the way forward, and how to make the UK VAT fit for the next 50 years.

The Quiet Success of the UK VAT

VAT is today the second most important tax in the country, after personal income taxes. In 2020/2021, VAT collected £143 billion, or just over 15 percent of total tax revenue, corresponding to 5.6% of GDP. Whilst this represents a slight decrease on previous years – until the pandemic VAT receipts had been equivalent to between 5.8% and 6.1% of GDP – it is still extremely significant. Only the two personal income taxes collected more, namely £386 billion; to put into context, corporation tax, which gets so much policy and public attention, collected less than half of VAT, at £68 billion.[15]

The significance of VAT within UK public finances is not only high, but it has been increasing steadily over the last 50 years since its introduction. Pre-VAT revenue from general taxes on goods and services (largely the Purchase Tax) represented approximately 2 percent of GDP; by 1985, post-VAT, that number had risen to 5 percent, and it is now close to 7 percent of GDP.[16] This increase in significance is, to a large extent, a reflection of changes in the standard rate of VAT.

As set out in the table below, whilst the standard rate of VAT was initially 10 percent, by the end of the decade it was already 15 percent. Just over a decade later it was increased to 17.5 percent; then in the wake of the financial crisis it was increased to 20 percent. It has been at that level since 2011. Throughout its 50 years history, the standard rate of VAT only decreased on two occasions, both relatively short-lived: in 1974, from 10 to 8 percent, when the reduction of the standard rate lasted five years, before being increased in 1979 to 15 percent; in 2008, from 17.5 to 15 percent, when the reduction of the standard rate (always meant to be temporary) lasted one year, before being raised back to 17.5 percent. The luxury rate of VAT was abolished in 1979, and - in line with the global trend – was never

[15] M. Keep, *Tax Statistics: an Overview*, House of Commons Library, 16 January 2023.
[16] Ibid.

again re-instated. Most of the changes to rates in the last 50 years have been, therefore, to the goods and services that fall under each rate. The tendency here has generally been the opposite to that of the standard rate: whilst the standard rate has been increasing, the base has been (slightly) narrowing. On the whole, the increases in the standard rate have been more than sufficient to offset the comparatively less significant narrowing of the base, which is largely why VAT revenues have continued to increase. Nonetheless, it is interesting to consider the reasons behind these two opposing trends, as they are symptomatic of some of the challenges faced by the UK VAT.

UK VAT Rates History

Entry Into Force	Standard Rate	Reduced Rates	Luxury Rates
April, 1973	10%	0%	-
July, 1974	8%	0%	12.5%
November, 1974	8%	0%	25%
April, 1976	8%	0%	12.5%
June, 1979	15%	0%	-
March, 1991	17.5%	0%	-
April, 1994	17.5%	0% 8%	-
September, 1997	17.5%	0% 5%	
December, 2008	15%	0% 5%	-
January, 2010	17.5%	0% 5%	-
January, 2011	20%	0% 5%	-

Usually no-one notices VAT – or rather, we notice it less. The "fiscal illusion", often referred to as the Mill's hypothesis after its first proponent,[17] 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).[18] Political tax salience has been traditionally difficult to measure empirically,[19] but insofar as the low political salience of consumption taxes are concerned, as the relative share of consumption taxes in the overall tax burden worldwide has increased – similarly to what has happened in the UK – there is now solid

[17] R. Sausgruber and J.R. Tyran, "Testing the Mill Hypothesis of Fiscal Illusion" (2005) *Public Choice* 122(1), 39.
[18] D. Gamage and D. Shanske, "Three Essays on Tax Salience: Market Salience and Political Salience" (2011) *Tax Law Review* 65, 23.
[19] A. Finkelstein, "EZ-Tax: Tax Salience and Tax Rates" (2009) *Quarterly Journal of Economics* 124, 969.

evidence that states can increase consumption taxes with less resistance,[20] and that indeed this distorts democratic decisions.[21]

This explains why the standard rate of VAT has steadily increased over the last 50 years; and also why VAT receives such limited public attention, despite its undeniable success. It does not explain, however, why the base has been narrowing over-time. This issue will be discussed in further detail below, but the short explanation is that the base tends to narrow when the political salience of the VAT as regards specific products is raised – usually as a result of public campaigns by special interest groups. Before addressing the UK VAT base design (the ugly), and other limitations in the functioning of the UK VAT (the bad), some final considerations as regards the UK VAT success (the good), which is rarely, if ever, discussed: soft power.[22]

Whilst the extent of British soft power – 'punching above its weight' – is often acknowledged and debated within political science and international relations contexts,[23] rarely is this a topic of debate within legal ones. Nevertheless, law plays a key role in what is regarded as one of the three main sources of soft power resources, namely political values – and from this perspective, perhaps, rather unlikely, the UK tax system is a great success story. The UK leadership on global tax negotiations and ability to shape global tax outcomes is now well-known,[24] but rather less so, is the mimetic effect that UK tax system gives rise to: whether in law or practice, other countries copy what the UK does. This effect, recently identified within anti-avoidance mechanisms,[25] is also present in VAT. Countries looking at VAT issues, whether in terms of policy or practice, often look up to the UK as an example; UK VAT court decisions are widely reported worldwide in major outlets;[26] and what tax expert in the world has not heard of the Jaffa Cakes story?

This global standing within VAT is undoubtedly in part a result of being one of the few early adopters of the tax: countries implementing the tax for the first time will naturally look at those with previous experience. However, this early adopter status cannot fully explain that global standing. Several other European countries have had a VAT for as long (Ireland, Denmark), or for even longer than the UK

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[20] J. Ashworth and B. Heyndels, "Politicians' Options on Tax Reform" (2000) 103 *Public Choice* 117; and T. Blumkin, et al., "Are Income and Consumption Taxes Ever Really Equivalent?" (2012) 56 *European Economic Review* 1200.

[21] E. Kiser and S. Karceski, "Political Economy of Taxation" (2017) 20 *Annual Review of Political Science* 75.

[22] A rather elusive concept, coined by J Nye in the late 1980s, to generally describe "the ability to attract and persuade", see further, J. Nye, *Soft Power: The Means To Success In World Politics* (Public Affairs, 2004).

[23] C. Hill and S. Beadle, *The Art of Attraction: Soft Power and the UK's Role in the World*, British Academy Report, March 2014.

[24] From discussions on the global corporate tax deals, see R. de la Feria, "The Perceived (Un)Fairness of the Global Minimum Corporate Tax Rate" in W. Haslehner et al (eds), *The Pillar 2 Global Minimum Tax* (Edward Elgar, 2023), forthcoming, and references cited therein; to maintaining the tax veto at EU level, see R. de la Feria "Pillar 2, Fiat, and the EU Unanimity Rule on Tax Matters" (2023) *EC Tax Review* 1, 2-8, and references cited therein.

[25] I. Guterres Figueiredo, "The EU GAAR: Minimising Risk Through Mimicking Behaviour", mimeo.

[26] See recently A. Holpuch, "The Purpose of Extra-Large Marshmallows? A U.K. Court Weighs In", *New York Times*, October 8, 2022.

(original EEC Member States), and do not enjoy the same level of soft power or ability to influence VAT thinking. The 'ability to attract and persuade' in this area can also be partially attributable to the use of English language, or the widespread online availability of relevant policy documents and judicial decisions, free of charge – all factors that have been identified as significant in igniting the mimetic effect in other tax areas.[27] However, yet again, these factors cannot explain the UK standing. The same could be said of Australia or Canada, for example, which arguably have a better VAT system.

The UK soft power in this area is therefore likely to be a result of a conjugation of all those factors, and one more: over the last 50 years the UK has accumulated high VAT expertise at every level, whether in policy, private practice, tax administration, or the judiciary.[28] Alas, that expertise could be put to better use, and the soft power stronger, if only the UK VAT system did not suffer from some significant deficiencies. It is to those we now turn.

The Almost Digital UK VAT

Developments over the last decade in the use of technology generally, and AI in particular, in tax administration and compliance has been nothing short of outstanding. The initial stages of digitalisation and the use of AI-based technologies in tax compliance and enforcement dates back to the 1970s,[29] and the generalised use of technology at a global scale arguably started in the 1980s, with the digitalisation of tax compliance, such as electronic invoices and e-tax returns. However, it was only in the 2010s that the use of sophisticated technologies and AI by tax administrations spread. Today, not only are taxpayers increasingly making use of automated systems in tax compliance;[30] but perhaps more importantly, tax administrations are also increasingly reliant on new technologies as compliance-enhancing tools.[31] A recent OECD survey indicated that, in the 59 countries surveyed, more than 90 percent of business taxpayers were filing their returns electronically; 50 percent of tax administrations used digital assistants such as "chatbots"; more than 80 percent were using risk management analytical tools; and close to 75 percent used cutting-edge big data techniques.[32] Tax administration AI is now the norm within European tax administrations.[33]

[27] I. Guterres Figueiredo, fn. 21 above.
[28] On the link between technical expertise and soft power, see A. Buchanan and R. Keohone, "The Legitimacy of Global Governance Institutions" (2006) *Ethics: International Affairs* 20(4), 414; and S. Wall, "Democracy and Equality" (2007) *Philosophical Quarterly* 57(228), 416-438.
[29] For a more detailed analysis of the use of technology in tax administration, see R. de la Feria and A. Grau, "The Robotisation of Tax Administration" in A. Grau (ed), *Interactive Robotics: Legal, Ethical, Social and Economic Aspects* (Springer Nature, 2022), Ch 20, 115-123.
[30] J. Blank and L. Osofsky, 'Automated Legal Guidance' (2021) *Cornell Law Review* 106.
[31] OECD, *Tax Administration 2019: Comparative Information on OECD and Other Advanced and Emerging Economies* (Paris: OECD Publishing, 2019).
[32] OECD, *Tax Administrations Continue to Accelerate Their Digital Transformation* (September 15, 2021).
[33] D. Hadwick, 'Behind the One-Way Mirror: Reviewing the Legality of EU Tax Algorithmic Governance' (2022) EC Tax Review 31(4), 184-201.

At a global level, the use of technology in tax administration is now, not only pervasive but also diverse. Whilst there are many different AI tools in use globally, some of the most significant – and controversial – can be divided into three main types, as follows: risk assessment tools, real-time technology, and compliance assistance technology. The first two types can be broadly characterised as negative incentives to compliance, or anti-fraud mechanisms, the third as positive incentives to tax compliance, or compliance-enhancing mechanisms. Whilst none of them are exclusively applied to VAT, all have had a significant impact on the administration of the tax worldwide.

Risk assessment analytical tools have spread throughout the world.[34] Some of these tools focus on identification of high-risk taxpayers, including through big data sourcing and profiling, such as the Italian's FALCO system, or the Dutch XENON robot.[35] Others are aimed at improving the effectiveness of tax audits, known as computer-assisted audit tools and techniques (CAATTs), which have been implemented by several countries, including Australia, Finland, Germany, Indonesia and the US.[36] One of the most promising – although also more intrusive – AI developments, with particular impact on VAT, is *real-time technology*: the electronic matching-up of invoices in a data-warehouse, in real-time, so as to identify fraud and/or prevent it from ever taking place.[37] In 2010, Israel was the first country to successfully implement a new online system that matched-up invoices at a massive data-warehouse; the model was soon copied by others, including Portugal, Russia,[38] and more recently Slovenia.[39] The most recent addition to this select club is Uzbekistan, which in 2022 implemented a real-technology system that can monitor in real-time all transactions taking place in the country, and is thus able to generate an individual risk factor for each and every single VAT registered business in the country.[40] Finally, *compliance assistance technology* is another area of significant growth in AI usage. Whilst tax compliance AI is often provided by private entities, its usage has been often encouraged by tax administrations, with governments increasingly relying on AI to help the public understand and apply the law.[41]

Beyond the above applications, there are also now proposals suggesting the use of these technologies in ways that go further than mere tax compliance and administration, and would instead provide real-world solutions to substantive VAT policy problems. This is the case with proposals to address the

[34] OECD, *Tax Compliance by Design: Achieving Improved Compliance by Adopting A System Perspective* (OECD Publishing, 2014).
[35] T. Ehrke-Rabel, "Big Data in Tax Collection and Enforcement" in W. Haslehner et al (eds.), *Tax and the Digital Economy* (Kluwer, 2019), 283-334.
[36] A. Darono and D. Ardianto, 'The use of CAATTs in tax audits – lessons from some international practices' (2016) *eJournal of Tax Research* 14(2), 506-526.
[37] R.T. Ainsworth, 'Refund Fraud? Real-Time Solution! Digital Security Borrowed from the VAT (Brazil, Quebec & Belgium)', (2012) *Boston University School of Law Working Paper* 12-15.
[38] C. Giles, 'Russia's role in producing the taxman of the future', *Financial Times*, July 29, 2019.
[39] T. Ehrke-Rabel, n. 35 above.
[40] UzDaily, *Rita de la Feria: serious growth and evolution of the tax system in Uzbekistan over 3 years*, August 25, 2022.
[41] J. Blank and L. Osofsky, fn. 30 above.

regressivity in VAT, without using exclusions from the tax base, through transfers making use of real-time technology;[42] as well as proposals in some countries to provide compliance assistance software to traditionally informal and thus difficult to tax sectors, such as agriculture, therefore eliminating the need for the implementation of special tax regimes. The advancements have been so far-reaching in this area that in many countries a fallacy has started to developed, namely that implementation of AI technology in tax administration can compensate for deficient tax law/policy design, dispensing with the need for tax law reform.[43]

Whilst it would be wrong to suggest that the UK has not improved tax administration and compliance through the use of technology, it is nevertheless fair to say that it lags significantly behind many other countries – developed countries, both within and outside Europe, as well as many developing countries – in the process of digitalisation of tax processes. As recently acknowledged by the Government, "*whilst great strides have been made in opening up digital tax services, many of these are built on old technology and manual, paper-based processes*".[44] The response has been to set out a 10-year strategy to modernise UK tax administration, based on real-time technology, which although falling short from the invoice matching mechanism set-out above, it will nevertheless allow real-time reporting. As part of this strategy, Making Tax Digital was rolled-out for VAT in 2019. Although evaluation of the programme so far has reportedly been overwhelmingly positive, one of main problems identified by businesses has been the costs of transition.[45] Further progress in digitalisation tax administration and compliance towards an AI system akin to that applied in Russia, or even the more sophisticated system just introduced in Uzbekistan, is likely to be somewhere in the distance; the use of these technologies to resolve substantive VAT policy problems, as highlighted above, remains a pipedream.

Why has the UK VAT lagged behind other countries in this area? After all, as the Government correctly points out, the UK has one of the best tax authorities in the world;[46] indeed, as highlighted above, this high-level of technical expertise is at the heart of the UK soft power on VAT. The short answer is that, to some extent, the UK VAT is a victim of its own success.

First, in many countries, implementation of new AI is regarded as an effective method to compensate for weaker tax administration capacity – either due to chronic low capacity, or to under-resourcing – or to address high levels of non-compliance – whether due to error, informality, or systemic fraud.[47] Whilst there is an argument to suggest that the HMRC is also now under-resourced, traditionally, the

[42] R. de la Feria and A. Swistak, "Designing a Progressive VAT", *mimeo* (forthcoming).
[43] R. de la Feria, "Tax Enforcement vs Tax Reform: The AI Fallacy of Unconstrained Success", mimeo; and R. de la Feria and A. Schoeman, "Addressing VAT Fraud in Developing Countries: The Tax Policy-Administration Symbiosis" (2019) *Intertax* 47/11, 950-967.
[44] HMRC and HMT, *Building a trusted, modern tax administration system*, Corporate Report, 21 July 2020.
[45] HMRC, *Making Tax Digital: An evaluation of the VAT service and update on the Income Tax Service*, Budget 2020, 6 March 2020.
[46] HMRC and HMT, fn. 44 above.
[47] R. de la Feria and A. Grau, fn. 29 above.

UK has had neither of these problems: the tax administration has high-capacity, and non-compliance in VAT is a relatively small problem when compared to other countries. VAT revenues are high, and the UK VAT (compliance) gap is low.[48] This means, in practice, that the UK has never felt the sense of urgency in modernising VAT administration and compliance that other countries did.

Second, whilst path dependency – and its close relative, legal entrenchment – is a phenomenon usually associated with public policy,[49] as opposed public administration or enforcement, status quo bias can also occur as regards the latter. Every public reform generates uncertainty that is experienced asymmetrically between losers and gainers: while losses are easily identified, gains are more uncertain,[50] either because the gains are diffuse (for example, through the whole population), or because there are no guarantees they will indeed take place. What if the envisaged gains of implementing new tax administration AI do not materialise? There is a certain degree of uncertainty – even if the risk is minimised by other countries' experiences. The losses, however, are much clear and measurable. The Making Tax Digital Evaluation focussed (naturally) on the transition costs of businesses, but of course the transition entails a very significant investment by tax administrations. Cost-benefit analysis and enforcement elasticities come into play. It is common –and natural– for tax administrations to assess the relative effectiveness of these a range of possible measures available to improve compliance.[51] Measuring and designing administrative actions in light of enforcement elasticities, or more generally, of the marginal revenue and costs associated with administrative actions, is perceived as necessary for optimal tax administration.[52] When resources are shrinking,[53] as it has been the case in the UK,[54] the marginal value of the costs associated with significant investments increases. Given the various dynamics at stake, it is unsurprising that path dependency in this area has proven difficult to break.

These two factors put together can be summed up in one question: it has worked well so far; why change? As the UK has somewhat belatedly realised, there are actually very good reasons to change. Whilst digitalisation of tax administration and compliance brings many challenges and risks, there is a reason why it has spread so quickly globally within the last decade: it works.[55] Not only has it proven

[48] The latest VAT Gap is estimated at 7 percent, see HMRC, *Tax Gap Estimates for 2020 to 2021*, 23 June 2022.
[49] J. Bell, "Path Dependence and Legal Development" (2012) *Tulane Law Review* 87, 787; and S. Ranchordas, "One Foot in the Door: Evidence-Based Limits on the Legislative Mandate" (2018) H*ukim —Journal on Legislation* 207.
[50] R. Fernandes and D. Rodrik, "Resistance to Reform: Status quo bias in the presence of individual uncertainty" (1991) *American Economic Review* 81, 1146.
[51] A. Plumley, *The Determinants of Individual Income Tax Compliance*, Department of the Treasure – Internal Revenue Service Publication 1916, 1996, at 40.
[52] M. Keen and J. Slemrod, "Optimal Tax Administration" (2017) *IMF Working Paper* WP/17/8, at 18. See also E. Crivelli, "A basic tool to assess tax administration strength in emerging Europe" (2018) *Economics of Transition* 26(3), 1-31.
[53] There is a growing literature on optimal strategies to maximize tax revenue when enforcement resources are limited, see Y. Kuchumova, "The Optimal Deterrence of Tax Evasion: The Trade-Off Between Information Reporting and Audits" (2017) *Journal of Public Economics* 145, 162-180.
[54] House of Commons Committee of Public Accounts, *HMRC performance in 2021–22*, Thirty-Third Report of Session 2022–23, 19 December 2022.
[55] R. de la Feria and A. Grau, fn. 29 above.

to be extremely effective in decreasing non-compliance – fraud as well as error and negligence – but it has other positive spillover effects, such as the elimination of noise, the cognitive bias that results in unwanted variability in judgment, and which has been found to be pervasive in administrative adjudication.[56] Alas, the reasons to change the UK VAT base are even stronger.

The Impossible UK VAT Base

The elephant in the room of the UK VAT is undoubtedly its base. Even if major strides were made as regards digitalisation of administration and compliance, those advancements will always be hampered by the current design of its tax base. At present, the UK does not tax approximately half of its hypothetical VAT base. Estimates of UK VAT c-efficiency – the standard metric of VAT revenue performance, defined as the difference between the real VAT base (how much revenue is collected) and the hypothetical VAT (how much could be collected, where the standard rate applied to all consumption) – are below 50.[57] This is a very low c-efficiency level by international standards: the OECD average is nearly 10 points above, whilst New Zealand scores just below 100.[58] Why?

Lower than 100 c-efficiency, or a gap between real and hypothetical VAT base, can be potentially attributable to two elements: *(i)* the compliance gap, i.e. what is usually designated as the "VAT gap", which is the revenue lost to non-compliance, from error or negligence, to organised fraud; and *(ii)* the policy gap that is the revenue lost from deliberate policy choices, such as reduced rates or exemptions.[59] Whilst disentangling the two elements is not easy, generally the compliance gap tends to have a bigger impact in the low c-efficiency of developing countries for a variety of reasons – informality being the most obvious, but also weaker border controls, and institutional framework;[60] on the contrary, in developed countries a low c-efficiency cannot be attributed primarily to the compliance gap, which in those countries tends to be low by comparison. In developed countries, like the UK, therefore, a low c-efficiency is generally indicative of a high policy gap. Or said in another way, the UK has (by choice) one of the narrowest VAT bases in the world.

This narrow base has three main sources, namely: *(i)* extensive use of reduced rates, most notably zero-rating; *(ii)* extensive number of exemptions; and *(iii)* high registration threshold. The extensive number of exemptions was, to a large extent, not a result of a UK tax policy choice: the use of exemptions was mostly harmonised at EU level, and thus the UK was – to some extent – compelled to apply them. The

[56] C. Sunstein, "Governing by Algorithm? No Noise and Potentially Less Bias" (2021) *Harvard Public Law Working Paper* 21-35.
[57] In 2005, UK VAT c-efficiency was estimated to be 49 points, see I. Crawford, M. Keen and S. Smith, "Value added tax and excises" in S. Adam et al (eds), *Dimensions of Tax Design: The Mirrlees Review* (OUP, 2010), Chapter 4. The latest estimates, using a slightly more recent metric, the VAT Revenue Ratio, indicate a not insignificant decrease in UK VAT efficiency since, now estimated at 44 points, see OECD, n. 11 above.
[58] OECD, fn. 11 above.
[59] M. Keen, "The anatomy of the VAT" (2013) *National Tax Journal* 66(2), 423.
[60] P. Morrow, M. Smart and A. Swistak, "VAT Compliance, Trade, and Institutions" (2022) *Journal of Public Economics* 208.

same cannot be said of the other two factors that explain a narrow base: neither the use of reduced rates, nor the registration threshold level was regulated at EU level; EU legislation *allowed*, but did not require, the application of up to two reduced rates, subject to a *de minimis* rule of five percent.[61] Indeed the opposite: the UK had to secure derogations from EU VAT rules both to apply zero-rating to domestic supplies, and to apply a registration threshold above a minimum level (at present €5,000) – both secured at the time of EU accession, and maintained during the various VAT Directive negotiations since.[62] Today, all three sources could – and indeed should – be re-considered.

Whilst it is beyond the scope of this note to provide a detailed analysis of deficiencies of narrow VAT bases, these are today well-known. Insofar as reduced rates and exemptions are concerned, there is limited evidence of their benefits, and extensive evidence of their costs. As a pre-condition for reduced rates or exemptions to achieve the sought after distributional and social aims – including the decrease in regressivity – the tax rate cut must be passed on to consumers, in the form of price reductions. Theoretically, this should indeed be the case. Yet, there is now a wealth of studies on the incidence of VAT indicating that cuts are often not fully passed through to consumers.

Indeed, although the response to VAT changes is heterogeneous, and depends on not only the type of change, but also the product type and firms' characteristics, a clear pattern emerges from these studies, carried in a variety of geographical and economic contexts: prices tend not to fully reflect changes in VAT rates.[63] The most common explanation for these results is price elasticity and supply and demand dynamics,[64] but that explanation does not fully explain some of the heterogeneity patters that emerge from the literature. The most likely explanation is therefore that a conjugation of factors contribute to the decision on VAT pass-through, including not only price elasticity and demand considerations, but also cognitive biases and heuristics, as well as size and business structure.[65] Regardless of the reasons for the lack of pass-through of VAT changes on consumer prices, however, we now know that retailers—not consumers, and not event employees or suppliers—are the primary beneficiaries of VAT reductions.[66]

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[61] For a detailed analysis of the EU VAT rate structure see: R. de la Feria, "Blueprint for Reform of VAT Rates in Europe" (2015) *Intertax* 43(2), 154-171; and R. de la Feria and M. Schofield, "Towards an [Unlawful] Modernized EU VAT Rate Policy" (2017) *EC Tax Review* 2, 89-95.

[62] See former Articles 110 and 286 of the VAT Council Directive 2006/112/EC of of 28 November 2006 on the common system of value added tax, OJ L 347, 11.12.2006, p. 1–118, on zero-rating, and registration thresholds, respectively.

[63] A detailed review of this literature is provided in R. de la Feria and M. Walpole, "The Impact of Public Perceptions on General Consumption Taxes" (2020) *British Tax Review* 67/5, 637-669.

[64] D. Fullerton and G.E. Metcalf, "Tax Incidence" (2002) 4 *Handbook of Public Economics* 1787; T. Kosonan, "More and Cheaper Haircuts After VAT Cut? On the Efficiency and Incidence of Service Sector Consumption Taxes" (2015) 131 *Journal of Public Economics* 87; and S. Delipalla and M. Keen, "The comparison between ad valorem and specific taxation under imperfect competition" (1992) 49 *Journal of Public Economics* 351.

[65] This point too is explored further in R. de la Feria and M. Walpole, fn. 62 above.

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

Two recent studies in the UK have further confirmed this phenomenon. The first concerned the VAT cut on women's sanitary products in January 2021 – most commonly known as the abolition of the tampon tax –[67] the other the VAT cut on e-books in May 2020.[68] Both studies confirmed that prices did not decrease as a result of the VAT cut. Yet, even assuming that, given the heterogeneity of the response to VAT reductions, reduced rates will indeed affect prices, there are still no guarantees that the envisaged distributional and social aims will be attained – i.e. the benefits of applying reduced rates or exemptions are still dubious. This is 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, indicates that consumption, even of essential items, is overwhelmingly by the highest income households, so the VAT is passed-through, it is those households that primarily benefit from VAT decreases. Therefore, not only VAT cuts do not necessarily reduce the regressivity of the tax, but can, on the contrary, increase it. 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.[69] Applying reduced rates to some essential items, such as food, may indeed reduce VAT regressivity – although this is not necessarily the case, particularly in developing countries – as happens in the UK.[70] However, this potential and small decrease in regressivity comes at a very high costs.

As the difference between hypothetical and real VAT demonstrates, the revenue costs associated with exclusions from the VAT base are extremely high. These are all the more significant, when considering that the foregone revenue has the potential to affect mostly those in lower-income households, as by nature those are the ones who mostly benefit from public expenditure—whether by way of 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

[67] That cut followed a previous reduction, in 2016, to five percent, see R. de la Feria and M. Schofield, "Section 126: VAT : women's sanitary products" (2016) *British Tax Review* 5, 611-618.
[68] Tax Policy Associates, *How the abolition of the "tampon tax" benefited retailers, not women*, Report, 10 November 2022; and Tax Policy Associates, *How publishers lobbied to abolish VAT on ebooks, costing the taxpayer £200m, but kept the benefit for themselves*, 9 February 2023.
[69] This issue is further developed in R. de la Feria and A. Swistak, fn. 42 above.
[70] A. Thomas, "Reassessing the Regressivity of the VAT" (2020) *OECD Taxation Working Papers* 49.

to benefit mostly the three lowest-income deciles.[71] Beyond the revenue costs, however, exclusions from the VAT base also carry significant spillover effects, not least qualification and interpretation problems. On this regard, litigation levels in the UK are particularly telling.

Most tax experts worldwide have heard of the (in)famous *Jaffa Cakes* case,[72] but few realise that this case is just the tip of a very big iceberg of litigation regarding VAT classification problems.[73] Many other everyday food products have been the subject of court cases in the UK to determine their VAT treatment, such as Marks & Spencer teacakes,[74] Pringles,[75] or more recently, giant marshmallows.[76] Equally, just as few realise that most tax avoidance cases in VAT concern 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.[77]. Given that the greater the number of VAT rates, the lower the degree of compliance,[78] this link, between avoidance and base design, is unsurprising.

The case in support of a narrow VAT base is therefore extremely weak. The benefits are at best dubious: there is limited evidence that tax savings are passed on to customers; and even where such tax savings are passed on to customers, however, they tend to benefit overwhelmingly the richest households. The costs, on the other hand, are extremely high: the revenue costs are very significant, and the spillover effects are both varied and large. On the contrary, the case in favour of broadening the VAT base, is therefore overwhelming. So, why don't we? Alas, whilst the reason for introducing extensive zero-rating in the UK may be historical, the reasons for keeping it, and for continuing to narrow the base, are political.

The initial design of the UK VAT base was heavily influenced by its predecessor, the purchase tax: to a large extent the legislator sought to apply zero-rating to (some) of the products previously outside the scope of the purchase tax. The aim was therefore largely identical – namely not to tax essential products – but the legislative technique was the opposite: whilst the purchase tax applied to a positive list of luxury items, the VAT applied in principle to all products, apart to those essential items included in a

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[71] 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.

[72] *United Biscuits (UK) Ltd (No. 2) v CC&E* [1991] BVC 818 (LON/91/160). 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.

[73] G. Morse, "Proctor & Gamble UK v HMRC (Pringles Two) — a very peculiar UK practice — the characterisation of food products for zero-rating" [2009] BTR 59; and I. Roxan, "Interpreting exceptional VAT legislation: or, are there principles in Pringles?" [2010] BTR 699.

[74] *Marks & Spencer plc v CC&E (No.5)* [2005] UKHL 53; [2005] STC 1254.

[75] *Procter & Gamble UK v HMRC* [2008] EWHC 1558 (Ch); [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] BTR 59.

[76] Innovative Bites Limited v HMRC [2022] TC08605

[77] This point is developed further in R. de la Feria and M. Walpole, fn. 61 above.

[78] A. Agha and J. Haughton, "Designing VAT Systems: Some Efficiency Considerations" (1996) 78(2) *Review of Economics and Statistics* 303.

negative list – a technique that to this day is nearly universal in VATs worldwide. The origins of the VAT base design, and the logic that permeated it, namely taxing the luxury items, not taxing essential items, is critical to understanding many of the public discussions concerning the VAT base which have taken place ever since. The luxury / essential logic is still subjacent to many of those public discussions, and underlies much of the public perceptions on the matter.

Whilst usually no-one notices VAT, changes to the VAT base have been at the forefront of some of the most notable public campaigns in the UK – and indeed political stories – of the last decade: from the pasties tax,[79] to the tampon tax,[80] e-books, and more recently, sunscreens.[81] Why these campaigns develop is clear: for industry groups, keen on obtaining tax breaks, a reduction in VAT can bring significant advantages, namely it may mean an increase in profit margins, an increase in the competitiveness for their products, or both. What is less clear is why these campaigns are often successful.[82]

VAT is not a particularly intuitive tax, and that makes it a particularly fertile ground for manipulation by special interest groups. Making the self-interested case for a tax break is unlikely to get attention or yield positive results, but with the right framing, the message is more likely to win public support. A fairness narrative that concentrates on key policy aims – such as gender equality, protection of the poorest, access to culture and education, or creation of employment, to name a few – and presents reductions in VAT as natural instruments for attaining those aims, feels to most not only reasonable, but indeed intuitive. Whilst these narratives are generally evident in campaigns the world over, there is often a local dimension added to them, and the UK is no exception. In the UK case, the local dimension is an implicit allusion to the purchase tax logic, which although long abolished, is more likely to feel familiar to the British public: tampons, books, sunscreens… are *essential*, not *luxury* products. This fairness narrative also helps thwart opposition: speaking out against the policy instrument, i.e. the tax break, can be easily reframed as opposition to the policy aim – and who would feel comfortable opposing such meritorious aims as gender equality, or protection of the poor, or indeed saying that tampons are a luxury?[83]

To move to a broad-based VAT these political economy obstacles must be overcome. For this to happen, it is not only necessary that the public understands the proposed tax policy and its rationale, but also that the public trusts the outcome. Experience indicates that this is not an easy task. Yet, given

[79] BBC, *Government does U-turn over 'Cornish pasty tax'*, May 28, 2012.
[80] The link between the tampon tax debate and the Brexit referendum is particularly noteworthy, see R. de la Feria and M. Schofield, fn. 61 above.
[81] R. Hall, "Charities call for scrapping of VAT on sunscreen amid skin cancer fears", *The Guardian*, May 15, 2023.
[82] In this autobiography, former Prime Minister Cameron claimed that one lesson he learned from the pasty tax debate was "Frankly, never touch VAT definitions. It's not worth the trouble", in D. Cameron, *For the Record* (William Collins, 2019).
[83] These points are also further developed in R. de la Feria and M. Walpole, fn. 62 above.

how narrow the UK VAT base is, even by international standards, and how significant the benefits of a broad VAT would be, looking ahead into the next 50 years, this is both the biggest priority – and the biggest challenge.

Looking Ahead to the Next 50 Years

Ongoing challenges to income taxation – not least growing labour mobility and automation –[84] coupled with the technical strengths of a VAT, mean that its relevance is likely to continue to increase at a global level. Well-designed, VAT is a robust tax, better equipped to withstand the challenges of a globalised, digitalised, economy, than most others: taxed at destination, efficient and neutral, easy to administer. It has served the UK extremely well over the last 50 years, to the point where it is now the second biggest source of tax revenue in the country; but it is old, and it needs refreshing. In this regard, for a variety of reasons – not least the revenue, litigation and administration costs exclusions from the base give rise to – base broadening comes through as a priority. Alas, whilst digitalisation of tax administration is already underway, base broadening is not. Indeed, if anything, the opposite: in the absence of resistance and counter-acting narratives, base narrowing is likely to continue, under the pressure of public campaigns mounted by special interest groups.[85] Winning that battle will require the help of us all. As in April 1973, most British citizens are today unaware of the impact that a reform of the VAT base could have on the country, on the standard of public services, and ultimately on their lives. Tax experts, however, are not – so, if not us, then who?

[84] R. de la Feria and G. Maffini, "The Impact of Digitalisation on Personal Income Taxes" (2021) *British Tax Review* 2, 154-168; and R. de la Feria and A. Grau, "Taxing Robots" in A. Grau (ed), *Interactive Robotics: Legal, Ethical, Social and Economic Aspects* (Springer Nature, 2022), Ch 17, 93-99.
[85] R. de la Feria and M. Walpole, fn. 62 above.