The 40th anniversary of VAT in the UK

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Foreword

In this paper, Chas Roy-Chowdhury the ACCA head of taxation, provides a high-level review of the first 40 years of VAT in the UK, its context in the European Union and its future prospects. We see in the paper the general trend towards governments using VAT to a much greater extent as a significant revenue raiser and the increasing pressures to broaden the VAT base by reducing exemptions and zero rates.

The paper also looks at some of the complexities of the VAT system under the European Union dimension, the way that fraud has added to complexity and the challenges which have prevented the European Member States from moving to a simplified single market regime.

Mukesh Gunamal
Chair, ACCA Global Forum for Taxation

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by Chas Roy-Chowdhury, head of taxation, ACCA

THE ORIGINS OF VAT

For many people in the UK VAT has always been a part of their lives, but in fact it has been in use in the country for (only) 40 years. The adoption of VAT had been a requirement for membership of the European Economic Community. Hence, on 1 April 1973 the previously levied Purchase Tax was replaced by Value Added Tax (VAT). France had been the first country to introduce the tax, around nineteen years previously, in 1954.

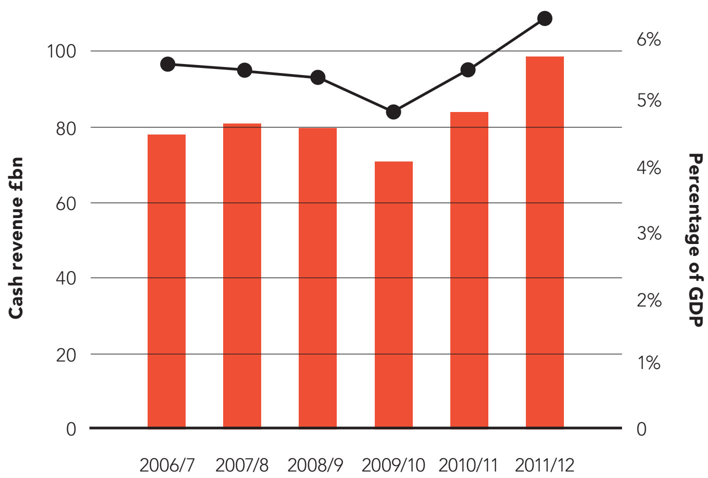
The concept originated in Germany, and represented a significant departure from previous forms of sale/purchase tax. Yet it is now the most widely used form of consumption tax in the world.

When VAT was first launched in the UK Anthony Barber, the Finance Minister, who presided over its introduction in 1973 misleadingly described it as a simple tax. Nonetheless, it was widely accepted that the government needed to raise revenue and the buying and selling activities essential to modern economies presented an irresistible opportunity for revenue collection.

THE CURRENT SITUATION WITH THIS 'SIMPLE' TAX

In the UK, VAT is the third-highest revenue generator, bringing in close to £100 billion a year. In fact, since the rate went up from 17.5% to 20% in 2010 it is quite close to becoming the second highest revenue source in the UK. It competes with National Insurance for second spot and Income Tax holds the undisputed first spot.

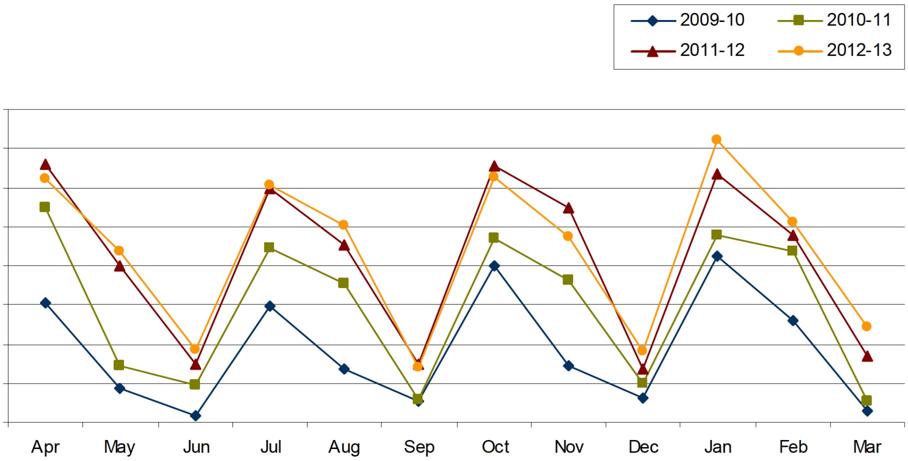
Figure 1: VAT receipts from 2006 to 2012



Data released by HM Revenue and Customs, 21 March 2013.

The UK government data displayed in Figures 1 and 2 show the upward trend for VAT revenues in the UK since 2009. This has occurred even though the UK economy has been suffering from low economic growth since 2008.

Figure 2: VAT receipts – year-on-year comparison



Data released by HM Revenue and Customs, 21 March 2013.

The peaks and troughs in the graph are explained by the way that businesses account for VAT on a quarterly basis. The tax is also highly resilient to the fortunes of the economy, unlike Corporation Tax or Income Tax, which can fluctuate quite significantly.

There are a number of issues today concerning the use of VAT but perhaps the greatest problem is its complexity. Arguably, the desire of the UK and other member state governments to obtain as much tax as possible from VAT has been the main reason for the system's complexity. When it was introduced to the UK in 1973 its rate was set at 10%, but this has now doubled. At the time of its introduction to the UK, VAT had many zero rates and exemptions but a number of those have now disappeared. For instance, food sold already heated was originally zero rated but since 1984 it has been subject to the full VAT rate. Domestic fuels were also zero-rated but have since become subject to a 5% reduced rate, which also applies to a number of other goods and services.

The high 20% tax rate and its 'cliff-edge' effect are among the biggest causes of complexity. The UK government's determined efforts to stop avoidance of this significant tax and, of course, various attempts by some businesses and some sections of the public to evade it, have also contributed.

THE EUROPEAN DIMENSION

There are two European Commission VAT Expert Groups, and in ACCA's view it appears that in comparison with other countries the UK actually does quite well in reducing unnecessary complexity and very well when it comes to collaboration between taxpayers and the fiscal authorities.

One of the greatest strengths of the UK, which creates a good business landscape, is public willingness to criticise, debate and discuss. Both face to face as well as through the media, the government and HMRC are willing quite often to listen to the views of taxpayers. ACCA can set up meetings to deal with specific issues and take forward proposals to the government on how the legislation might work better with specific changes.

Single market

This has been a source of both advantages and disadvantages, as well as a lot of complexity. In general, there is a lot of sense in having a single market for goods and services. The main problem here is each government's desire to subject them to VAT. There cannot be a true single market until double (VAT) taxation and complexity are eliminated, because each member of the European Union wants to make sure that it receives its 'cut' of tax revenues.

In the 1990s it looked likely that the definitive system of VAT would be introduced, otherwise known as 'the origin system'. This was and still is a very idealistic idea, set out in a paper by the European Parliament Directorate General.[1] While this paper sets out a theoretically utopian VAT system, the realities of government seem to have been missed.

The origin system would mean that the EU would be treated as a single country for VAT purposes. All transactions would be taxed as though they occurred in the same country. Hence, as an example, an item sold from Germany to France would be taxed in Germany and shipped to France. Then if a business in France did further work on that item before selling it on, that business would be entitled to recover from the French government the input tax for the German VAT.

1. http://www.europarl.europa.eu/workingpapers/econ/pdf/e5en_en.pdf

Nonetheless, even with the use of a clearing bank there would still have been a lot of unhappy member states, as shown in Table 2.

In 1986 there would have been a massive loss of revenue to many member states from the adoption of the origin principle without the use of a so-called clearing bank.

The clearing bank was to be a reallocation mechanism for the VAT that was collected in the 'wrong' country. So in the example above, the German government would pay VAT across to the French government to cancel out the loss of the VAT where the good was not zero rated at the border. Multiply this equalisation by billions of transactions and you can see exactly how complex the system would be.

For businesses, however, having the whole of the EU treated as a single country would have been truly beneficial.

Arguably, it was not the complexity of the proposals that killed the chance of a unified VAT system in the 1990s but rather a lack of trust between member states. There was no way, nor will there be in the foreseeable future, that one member state would trust another with its own tax revenues.

Hence today VAT is one of the most complex and business-unfriendly tax systems it is possible to devise. It is difficult to believe that there is supposed to be the same VAT system across the whole of the European Union, starting from the common base of the Sixth VAT Directive.

As the member states cannot find common ground in moving towards a 'single state' solution to VAT there are vast amounts of fraud and complexity within the European system. While member states and the EU Commission seek solutions, the real winners seem to be those who do not wish to pay VAT. A landscape is created with cliff edges between full VAT liability and zero liability. Not surprisingly, fraudsters have found ways of obtaining a VAT refund without paying VAT themselves; they then disappear before the tax authorities can catch up with them. This is the so-called 'missing trader' fraud problem.

In addition, in the current system double taxation can occur as no member state wishes to forgo an opportunity to tax a transaction.

Table 1: Gains and losses of revenue under the Origin System, based on 1986 figures

Member state	Gains/loss (ECUm)	As a % of GDP
France	–2,421	–0.34
Belgium/ Luxemburg	747	0.62
Netherlands	1,509	0.86
Germany	3,535	0.38
Italy	–147	–0.03
UK	–1,845	–0.33
Ireland	–52	–0.21
Denmark	–680	–0.82
Greece	–437	–1.08
Portugal	–77	–0.26
Spain	–132	–0.06

Source: COM(87)323

Table 2: Assumed gains and losses of revenue under the origin system, based on 1992 figures

Member state	Gains/loss (ECUm)	As a % of GDP
France	–1,100	–0.11
Belgium/ Luxemburg	150	0.08
Netherlands	2,550	1.03
Germany	1,700	0.11
Italy	–600	–0.06
UK	–650	–0.08
Ireland	700	1.8
Denmark	400	0.36
Greece	–950	–1.58
Portugal	–900	–1.38
Spain	–1,300	–0.29

Source: COMEXT, EUROSTAT

Fraud

Missing trader fraud is facilitated by the zero rating of cross-border transactions of high-value consignments where the input tax is recovered in the recipient state and the trader absconds before paying the output tax. One simple way to stop compliant traders from being duped into trading with such fraudsters is by keeping them informed of high-risk businesses. That is, actually giving them names and details of these fraudulent businesses so that if the innocent business encounters them, its managers will know not to trade. The UK tax authorities are very good at passing on this type of information but in many other member states even if the information is known by the tax authorities it is not generally passed on.

In some member states there may be legal barriers to the dissemination of the information but in many there are no such difficulties. Member states need to make more effort to reduce the billions of pounds of fraud that occur every year in this area and pass the information on to businesses.

The unthinkable

The EU today has a huge diversity of main VAT rates. Hungary has an eye-watering 27% rate while in Luxembourg it is only 15%. Compared with the US rates for sales tax this is still high. Nonetheless, the real problem lies in the plethora of reduced rates and exemptions, which produce the complexity and therefore the opportunities for both fraud and tax litigation . It would help enormously if member states sought to harmonise their various reduced rates at a common, low level. This should not be an exercise in raising taxes but in reducing them. After all, the reduced rates are applied to essential items.

Such a process would benefit the less well off as well as helping small businesses to understand more easily the rates they should apply in different member states.

The real losers

Arguably, the real losers in the present complex system, with its lack of a one-state solution to the VAT question, are consumers and small businesses. The consumer is forced to pay higher prices for the instances of double taxation and the wish of EU governments to seek to raise as much from VAT as they can get away with. There is also a lack of European business competition, as most small businesses are excluded from the single market by the complexities of accounting for VAT across what are soon to be 29 member states, as well as by the number of languages involved. On the issue of SME access to the single market, the EU Commission is trying hard to get member states to focus serious attention on the problems that exist.

To begin with, the Commission is trying to make the necessary VAT information available over the internet in multiple languages so that SMEs can more readily assess whether it is viable for them to operate outside their own home market.

Arguably, one of the biggest causes of the complexity of the VAT is the lack of commercial experience of those working within the tax authorities across the EU. This general lack of commercial experience affects the whole theoretical approach to VAT law.

CONCLUSION: THE NEXT 40 YEARS

This paper has looked at the first 40 years of VAT in the UK together with the EU dimension and the future prospects.

In many ways, VAT in the EU gives value added tax a bad name. It was never meant to be anything like as complex as the EU has made it, and nor was it ever meant to be set at such high rates or to raise so much tax revenue. After all, it is not a progressive tax and does penalise the less well off, notwithstanding the mitigating effects of the reduced and zero rates.

Before the eurozone debt problems emerged, many people would have predicted that VAT would not still be around in 40 years' time in its current form. In reacting to the crisis, however, the eurozone countries – especially Germany – have all but ignored the markets and commercial reality, and this suggests that the VAT system in its present form will still be around in 40 years' time, 'alive and kicking' and even more complex than it is today.

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