

Simplify VAT to cut costs, raise revenue and help the poor, says study prepared for the Mirrlees Review

Abolishing zero and reduced rates of VAT would cut compliance and administration costs for business and government, interfere less with people's spending decisions, and raise enough revenue both to improve the living standards of poorer families and to cut other taxes by £11 billion, according to a study commissioned by the Mirrlees Review of the UK tax system, which is being chaired by Nobel prize-winner Professor Sir James Mirrlees for the Institute for Fiscal Studies.

The current 17.5% standard rate of VAT is around the average for industrial countries, but the UK applies zero rates more extensively than most other countries, according to the study by Ian Crawford (Oxford University and IFS), Michael Keen (International Monetary Fund) and Stephen Smith (University College London and IFS)¹. Children's clothing, most foodstuffs and residential housing are among the items zero-rated, while a reduced rate of 5% applies to domestic energy and other items such as contraceptives, children's car seats and some energy saving products. Comparing the revenue currently raised from VAT with the amount that which would be raised if the standard rate were applied to all consumer spending, the UK has a relatively narrow VAT base by industrial country standards. New Zealand comes closest to applying a uniform rate to all consumption.

Applying zero or reduced rates of VAT to items on which poorer households spend a relatively large proportion of their budgets is a blunt instrument with which to help the less well off, as richer households typically gain more in cash terms from these tax breaks than poorer ones. Scrapping the existing zero and reduced rates of VAT—perfectly consistent with EU rules—would raise around £23 billion. If £12 billion of this extra revenue were spent increasing means-tested benefit and tax credit rates by 15%, this would leave the poorest three-tenths of the population better off on average while still raising £11 billion to cut other taxes or to spend in other ways. It would also have only a temporary effect on inflation, reflecting a one-off jump in prices (the Retail Prices Index) of around 3.5%. This package is only illustrative, but shows that it would not be difficult to compensate most poor losers from the move to a uniform VAT—indeed the extra revenue raised could be used to make them better off from the change. The only barrier is the reluctance of politicians to be seen to propose taxing “essential” items.

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IMPORTANT: Please note that the research described in this Release is a submission to the Mirrlees Review and that the conclusions reached will not necessarily be adopted in the final report. We will be publishing a number of such submissions over the coming weeks and the review team would welcome feedback to mirrleesreview@ifs.org.uk

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¹ <http://www.ifs.org.uk/mirrleesreview/reports/indirect.pdf>

A stronger argument for having different VAT rates on different goods and services is that the Government should impose a lower rate on work-related items (such as commuting costs) and a higher rate on leisure-related ones, so as to offset the overall disincentive to work created by taxation. However, the study suggests that we cannot be confident that the potential efficiency gains from differentiating VAT rates in this way would outweigh the costs of greater complexity and the advantage of a single rate in making it easier to resist political pressure to provide favourable treatment to particular sectors or items.

The study also argues that the Government should urge its fellow member states to remove a range of outdated exemptions under the common EU VAT rules, notably in respect of financial services. Given this freedom, one potentially attractive (though as yet untried) reform would be to treat all cash inflows into financial services companies as VAT-able sales by them and all outflows as purchases, while zero-rating transactions with registered businesses. Removing exemptions in the financial and other sectors would raise revenue for the Government, cut compliance and administration costs, and reduce distortions to competition and trade that are likely to become increasingly problematic.

Action at the EU level is also required to provide a lasting solution to “carousel fraud”, which is made possible by the zero-rating of exports from one EU country to another. In the absence of a single VAT applied across the EU, the two most appealing solutions are to maintain the domestic zero-rating of exports while imposing an EU-wide VAT on intra-union trade (‘CVAT’) or to tax all business-to-business transactions within the EU at a common rate while leaving member countries free to choose the rate they apply to final sales (‘VIVAT’). Both have pros and cons, but either would be an improvement on the current system.

The study also examines excise duties on tobacco and alcohol, which are substantially higher in the UK than in many other EU countries. Given that smokers die early, saving the rest of society a considerable sum in pension and old-age care costs, it is far from clear that the current high rate of tobacco duty can be justified on the grounds of the external costs of smoking. But given people’s lack of self-control and tendency to take decisions today that they will regret tomorrow, high rates of tobacco duty may be appropriate to help protect people from the consequences of their own decisions. High levels of alcohol duty may be justified by the cost of drink-driving and other criminal behaviour, but it is not a particularly well-targeted policy. Duty levels high enough to curb abusive drinking by a minority impose significant welfare costs on the majority of non-abusive drinkers.

Differences in the external costs of drinking and smoking from country to country suggest that it would not be desirable to impose uniform levels of excise duties across the EU. But big differences in duty rates do encourage smuggling and tax evasion, which in turn encourages countries to set relatively low rates. This suggests that it would be sensible to increase the existing floors on excise duties imposed by the EU to a level which would help prevent inefficient downward pressure on duty rates.

The Mirrlees Review team also asked leading international experts to comment on the proposals made by Crawford, Keen and Smith and on the wider issues they discuss:

- Richard Bird (University of Toronto) notes that because input VAT cannot be credited to companies that do not themselves pay the tax, VAT offers an effective way to tax the informal

sector. But this might also create a barrier to the growth of small businesses. More countries are now imposing a gross receipts tax on small businesses, either within VAT or as a separate levy².

- Ian Dickson (Burleigh Evatt) and David White (Victoria University of Wellington) argue that the move to a uniform VAT (the Goods and Services Tax) in New Zealand does appear to have delivered the benefits claimed for it. They add that New Zealand experience suggests that the public can be persuaded of the merits of such a reform, on the understanding that poorer households would be compensated through the welfare system for any increase in costs they suffered³.
- Sijbren Cnossen (CPB Netherlands Bureau for Economic Analysis) is not persuaded that the zero-rating of exports from one EU country to another needs to be dropped in order to tackle fraud, arguing that VIVAT would create additional complexity and might violate the principle of subsidiarity. He argues that VAT co-ordination efforts should instead focus on improving information exchange between tax authorities and on establishing bilateral and multilateral VAT audit and investigation units. He also supports the case for repealing most VAT exemptions, especially that of cultural services⁴.
- Jonathan Gruber (Massachusetts Institute of Technology) argues that the current high level of cigarette duty (relative to the external costs of smoking) can be justified because of the potential damage to smokers themselves. Higher cigarette taxes lead to higher levels of reported well-being among smokers, as they recognise the value of the tax as a device that can help them break the habit. With regard to alcohol, Gruber notes that it might be a good idea to tax alcohol more heavily at pubs and clubs, as excessive drinkers there do more harm through drunk-driving than those who drink at home. Concern for obesity strengthens the case for avoiding lower rates of VAT on food than other goods, with poorer households compensated in other ways⁵.

Commenting on the study and commentaries, Robert Chote, Director of the IFS, said:

“VAT is widely recognised as one of the most efficient taxes in the policymaker’s armoury. But these contributions to the Mirrlees Review suggest that there are real improvements to be made, both through domestic reform and efforts to change EU rules. The authors make a powerful case on efficiency, fairness and practical grounds for moving to a uniform rate of VAT, rather than the complex mix of full, zero and reduced rates and exemptions we have at the moment. The main obstacle to such a reform appears to be a lack of political leadership, which is perhaps understandable when the public focus on individual elements of the tax system rather than on the whole.

We are very grateful to the authors of the main study, and to the commentators, for their important contributions. They are very valuable and interesting pieces of work in their own right, as well as providing food for thought for Sir James and his team when they draw up their final conclusions.”

² http://www.ifs.org.uk/mirrleesreview/commentaries/bird_commentary.pdf

³ http://www.ifs.org.uk/mirrleesreview/commentaries/dickson_white_commentary.pdf

⁴ http://www.ifs.org.uk/mirrleesreview/commentaries/cnossen_commentary.pdf

⁵ http://www.ifs.org.uk/mirrleesreview/commentaries/gruber_commentary.pdf

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Notes to editors:

1. The Mirrlees Review, funded by the Nuffield Foundation and the ESRC, brings together IFS researchers and other international experts to identify what makes a good tax system for any open developed economy in the 21st century and to recommend how the UK tax system might realistically be reformed in that direction (<http://www.ifs.org.uk/mirrleesreview>). The project has been inspired by the 30th anniversary of the 1978 Meade Report, a landmark in the study of tax design and perhaps the most influential output of the IFS to date.
2. The Review is chaired by Nobel Laureate Professor Sir James Mirrlees of the University of Cambridge. The Commission's work is being directed by Tim Besley (LSE, IFS and Bank of England), Richard Blundell (IFS and UCL), Malcolm Gammie QC (One Essex Court and IFS Tax Law Review Committee) and James Poterba (MIT). The editorial team comprises: Stuart Adam (IFS), Stephen Bond (Oxford and IFS), Robert Chote (IFS), Paul Johnson (IFS and Frontier Economics) and Gareth Myles (Exeter and IFS). The final report will be published by Oxford University Press early in 2009.
3. A wider group of more than 60 IFS researchers and leading experts from around the world has contributed chapters, commentaries and special studies on key themes of the research. Pre-publication versions have been released on the IFS website: <http://www.ifs.org.uk/mirrleesreview/publications.php>. The final versions will be published by Oxford University Press as a companion volume to the final report.