The Impact of Public Perceptions on General Consumption Taxes

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The traditional view as regards general consumption taxes is that excluding certain products from the base decreases their natural regressivity. Whilst this view has been consistently put into question over the last thirty years, public perceptions are still heavily influenced by it. Using the old European VAT system and the newer Australian VAT system as case studies, we demonstrate how policy debates and changes in VAT rates have been heavily influenced by those public perceptions – against the evidence – and how industry groups, which would be set to lose out from specific policies, are able to use the information asymmetry subjacent to those perceptions to defend their interest in favour or against reform. The paper presents a novel analytical framework of the likely factors behind the prevalence of those public perceptions, and demonstrates how, in the absence of external pressures, they result in increased use of reduced rates over time, and the consequent narrowing down of the tax base.

I. Introduction

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

Yet, in the last decades, an overwhelming body of legal and economic evidence has been building up against the use of multiple VAT rates structures. Applying more than one rate of VAT gives rise to significant legal difficulties, creates economic distortions, and it is at best unclear whether it has the social and distributional effects that it aims to achieve. Yet, despite the evidence, multiple rates are still widely used. Therefore , beyond demonstrating that using VAT reduced rates is an inefficient method of

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

achieving social and distributional aims, the question which *should* be asked is why is the allure of applying reduced rates of VAT so hard to resist. Not only why have so many countries opted to apply reduced rates of VAT in the first place, despite strong evidence against it, but also why does their use not decrease – and in some cases has increased – over time. The aim of this paper is to answer these questions, using the European and Australian experiences as case studies. In doing this, it starts filling an existing gap in the literature: whilst there is now a sizeable, and growing, literature on the political economy of taxation, there is limited, if any, work done on consumption taxes, despite their relevance from a public finances perspective.

The choice of European countries and Australia is based on their very different VAT experiences. Regarded as the birth place of today's VAT,[2] Europe has in place a so-called traditional VAT, where differentiated rates structures date back to the introduction of the tax itself, at a time when evidence regarding potential negative consequences of applying multiple rates was unavailable. Notwithstanding this initial unawareness, difficulties have been evident for some decades, and in the last thirty years there have been several attempts to amend European rates structures to reflect this reality. Yet, all attempts that entailed a reduction of rate differentiation, and therefore a broadening of the base, were met with significant resistance, with the most recent agreed-upon amendments, or even proposals, to the rates structure having increased the level of differentiation, rather than decreasing it. As a result, today more goods and services are subject to reduced rates in Europe, than even as recently as fifteen years ago. Australia, on the other hand, has a much more recent GST, having only been introduced in 2000; and it is one of the countries around the world said to apply a modern VAT.[3] By the time Australia introduced its system, there was a clear awareness of the legal difficulties and economic distortions caused by multiple rates structures. Mindful of this reality rates differentiation was not part of the initial Australian GST design. Yet, in a last minute decision amidst political fears over the impact amongst lower income households of introducing GST on food, zero-rating was introduced,[4] and its scope of application, and potentially narrowing of the base, has been a topic of public discussion since.

Part Two of this paper presents the case against rate differentiation, by presenting a cost-benefit analysis of its use, focusing upon the legal and economic dynamics of multiple rates structures. Attention will then turn to the design of VAT rates structures. Part Three concentrates on the European experience, analysing the historical development of rates structures in European countries, in particular failed attempts to limit rate differentiation and the recent trend towards increased use of reduced rates.

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

[3] The expression 'modern VAT' to classify the new, improved VAT model, first introduced in New Zealand in the 1980s, as opposed to the 'traditional VAT' used in Europe, appears to have been coined by L. Ebrill, et al, *The Modern VAT* (International Monetary Fund 2001).

[4] Chapter 1, Further Supplementary Explanatory Memorandum (Senate) A New Tax System Goods and Services Tax Bill 1999 and amendments in subdivision 38AA.

In Part Four the Australian experience will be assessed, analysing the negotiation process which led to the inclusion of rate differentiation in the newly designed tax, and the recent extension of reduced rates to other products. It is argued in Part Five that the European and Australian experience demonstrate on how political economy pressures have both stopped the broadening of the EU VAT base, and influenced the initial design of the Australian GST base. It is further argued that those experiences also show that, in the absence of external pressures, the same political economy pressures determine the narrowing of the tax base, either by an increase in rate differentiation, or the extension of reduced rates to further products. These political economy pressures seem to be primarily motivated by traditional views over the positive impact of reduced rates on decreasing the regressivity of the tax, furthered by framing and fairness narratives, and the behavioural biases that generally present a constraint to policy reform.

II. VAT Reduced Rates: Traditional vs Modern View

Despite the widespread perception of VAT as a naturally regressive tax, the question is not as straightforward as it initially appears, and it is far from settled. Although questions have been raised on the possible bias over the measurement of VAT regressivity generally,[5] the main source of contention relates to how regressivity is assessed, namely whether it should be assessed relative to current income, or to current consumption.[6] VAT is particularly regressive if regressivity is assessed relative to income, but much less so when it is assessed relative to consumption, which is regarded as a better indicator of lifetime welfare.[7]

It is undoubtedly true that to the extent that all income is consumed, VAT is equivalent to a flat-rate, proportional, tax, rather than a regressive one, and this will indeed be the case for those at the lower end of the income distribution; to the extent, however, that not all income is consumed and savings come into place, regressivity becomes a concern. Of course, it can be argued – and it often is – that savings are mere deferred consumption. Yet, that argument does not fully convince, for two reasons. The first is that, whilst savings can be seen to some extent as deferred consumption, they are much more than that, such as further income generators, so that until consumption takes place, individuals will

[5] F. Gastaldi et al, "Regressivity-Reducing VAT Reforms" (2017) *International Journal of Microsimulation* 10(1), 39-72.

[6] R. de Mooij and M. Keen, "Fiscal Devolution and Fiscal Consolidation: The VAT in Troubled Times" in A. Alesina and F. Giavazzi, *Fiscal Policy after the Crisis* (University of Chicago Press, 2013), 443–485.

[7] E. Caspersen and G. Metcalf, "Is a Value Added Tax Regressive? Annual Versus Lifetime Incidence Measures" (1994) *National tax Journal* 47(4), 731-746. See also N. Warren, A. Harding and R. Lloyd, "GST and the changing incidence of Australian taxes: 1994-95 to 2001-02" (2005) *eJournal of Tax Research* 3(1), 114-145; G.N. Carlson and M.K. Patrick, "Addressing the Regressivity of a Value-Added Tax" (1989) *National Tax Journal* 42(3), 339-351; G.P. Jenkins, H. Jenkins and C.Y. Kuo, "Is the Value Added Tax Naturally Progressive?" *Queen's Economics Department Working Paper* No. 1059, 2006; R.F. van Brederode, "VAT's Regressivity: Empirical Truth or Political Correctness" (2007) *International VAT Monitor* 2, 86-92; and S. Cnossen, "The Value-added Tax: Key to a Better Tax Mix" (1989) *Australian Tax Forum* 6(3), 265-281.

extract significant benefits from their savings holding. The second, and perhaps more important reason is that, the higher the savings, the more deferred in time the consumption will potentially be, and *ad extremis* it can be passed on inter-generationally to a time when consumption is no longer taxed. It is therefore more realistic to argue that whilst VAT is a proportional tax for the lowest income deciles, where all income is spent on consumption, it becomes regressive once part of that income is saved, and the higher the percentage of income saved, the more regressive the tax will be. The question is then, how to address this regressivity.

Reduced rates are one of two methods traditionally used to address vertical equity concerns – either to diminish the regressivity of VAT, or to increase consumption of perceived merit goods – the other being exemptions. Whilst the reasons for the use of reduced rates in older VATs are rather more prosaic,[8] early literature on optimal consumption taxation does provide backing for the use of differentiated rates.[9] Yet, the reduced rates in existing VATs do not follow the inverse elasticity rule suggested in early optimal taxation theory: firstly because, in practice, the information on consumers' behaviour needed to operate a differential tax regime that improves, rather than worsens, economics welfare is so extensive as to make such regimes impractical;[10] and secondly, the traditional use of reduced rates by VAT systems to reduce the regressively of the tax, tends to result in precisely the opposite result to that suggested under that rule, namely the higher taxation of highly inelastic products, such as food and utilities. There is therefore limited literature support, in optimal taxation theory or otherwise,[11] for the use of differentiated rates as applied in older VATs, such as the European ones. This is because, not only is there now extensive evidence that reduced rates carry significant costs beyond the obvious loss of revenue, but there are also significant doubts as to its potential benefits, namely whether applying reduced rates truly achieves social and distributional aims.

VAT Incidence and Distributional Impact

As a pre-condition for reduced rates to achieve the sought after distributional and social aims, the decrease in the tax rate must be passed on to consumers, in the form of price reductions. Theoretically, this should indeed be the case: in a perfectly competitive market, it is assumed that a decreased in taxes should result in a decrease in prices, and indeed in policy circles it is almost universally assumed that indirect tax changes are fully and exactly passed through to consumer prices.[12] Markets, however,

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[8] As discussed in R. de la Feria and R. Krever, n. xx above.

[9] F.P. Ramsey, "A Contribution to the Theory of Taxation" (1927) *Economic Journal* 37, 47-61; W.J. Carlett and D.C. Hague, "Complementarity and the Excess Burden of Taxation" (1953) *Review of Economic Studies* 21, 21-30; and A. Sandmo,"A Reinterpretation of Elasticity Formulae in Optimum Tax Theory" (1987) *Economica* 54(213), 89-96.

[10] OECD, "Choosing a Broad Base-Low Rate Approach to Taxation" (2010) *OECD Tax Policy Studies* 19.

[11] For a modern approach to consumption taxes under optimal tax theory see P.B. Sorensen, "The Theory of Optimal Taxation: What is the policy relevance?" (2007) *International Tax and Public Finance* 14, 383-406; and H.J. Kleven, "Optimum Taxation and the Allocation of Time" (2004) *Journal of Public Economics* 88, 545-557.

[12] R. Bird and PP Gendron, *The VAT in Developing and Transitional Countries* (Cambridge: Cambridge University Press, 2007).

are often not perfectly competitive, and theory makes clear that pass-through may be less than complete (under-shifting), or more than complete (over-shifting).[13] For a long time, economic literature provided sound theoretical insights into the efficiency of consumption taxes, but the empirical work was not as widely developed.[14] For the last decade, however, there has been a wealth of studies on the incidence of VAT. Whilst these studies do not reach fully uniform results, and show instead varying degrees of pass-through to consumer prices, clear patterns have emerged that cast doubts over the full pass-through assumption in policy circles.

One of the first, and most significant, studies was the so-called "labour-intensive services experiment". Carried out across several European countries, and across a range of industries, from hairdressing to cleaning, the aim of the study, implemented in 1999, was to test the impact of the introduction of reduced rates of VAT on job creation. In 2003, a report from the European Commission confirmed that the impact of the new reduced rates on prices of labour-intensive services was minimal: when conducting price surveys, Member States found that reduced rates of VAT were reflected in consumer prices only partially or not at all, and that at least part of the VAT reduction was used to increase the margins of service providers; where the VAT reduction had been passed on to the consumer, Member States found that this was only a temporary measure and prices would subsequently increase.[15] Overall, the study concluded that, partially due to the lack of effect on prices, the aims of the experiment, namely to increase employment and to combat informality, had not been achieved.[16]

Around the same time, a second experiment to assess the impact of reduced rates on prices took place in Ireland. In 2001, struggling to contain high inflation, the Irish Government reduced the rate of VAT from 21% to 20%. In a speech, the Finance Minister stated that the government expected to see "the VAT reduction passed on to the consumer and not absorbed in higher retail margins". In 2002, Ireland decided to raise the rate of VAT back from 20% to 21%, after the Government concluded that the lower rate of VAT had not been passed on to consumers.[17]

Changes in European domestic VAT rates structures in the last decade have also opened up opportunities for new empirical studies on the price incidence of the tax,[18] and there is now a significant body of literature exploring the topic, displaying clear trends and response patterns. The main take-away is in line with the results of the labour intensive services and the Irish experiments: there is near

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[13] D. Benedek *et al*, "Varieties of VAT Pass Through" (2019) *International Tax and Public Finance* 26.
[14] T. Kosonan, "More and Cheaper Haircuts After VAT Cut? On the Efficiency and Incidence of Service Sector Consumption Taxes" (2015) *Journal of Public Economics* 131, 87-100.
[15] See *Experimental application of a reduced rate of VAT to certain labour-intensive services*, Report from the Commission to the Council and to the European Parliament, COM(2003) 309 final, 2 June 2003; and *Evaluation report on the experimental application of a reduced rate of VAT to certain labour-intensive services*, Commission Staff Working Paper, SEC(2003) 622, 2 June 2003. For a detailed analysis of the "labour-intensive services experiment" see point 3.2 below.
[16] SEC(2003) 622, 2 June 2003, n. xx above, at 28.
[17] Ibid, at 26.
[18] On the changes in European domestic VAT rates since 2018, see R. de la Feria, "Blueprint for Reform of VAT Rates in Europe" (2015) *Intertax* 43(2), 154-171.

unanimity in finding less than full pass through on prices. Prices tend not to reflect changes in VAT rates – or at least, not fully. The response to VAT changes is, however, heterogeneous, and depends on not only the type of change, but the product type and firms' characteristics. Changes in the level of standard rates are more likely to be passed on to consumers, than changes in reduced rates' levels or base narrowing reclassification measures;[19] wide-ranging changes that affect a small consumption share are less likely to be passed on to consumers, than changes that affect around half of the consumption share;[20] and, as opposed to what tax incidence theory indicates, the response to rate changes is asymmetric, and increases are more likely to be passed on than are decreases.[21] Bigger firms are also more likely to pass on rate reductions on prices, than are smaller firms;[22] reductions for products in more competitive markets are more likely to be passed on, than are those where there is imperfect competition;[23] and firms operating in sectors with low profit margins are less likely to pass on VAT decreases, than are firms operating in sectors with high profit margins.[24]

How to explain these results? The most typical explanation for the lack of full pass-through of VAT changes on consumer prices is that it results from inelastic supply and demand or imperfect market competition.[25] Another possible explanation for the lack of effect on prices, particularly in the context of temporary changes such as the labour-intensive services experiment, is the assumption of fixed costs for changing prices.[26] Cognitive biases may also play a role. Anchoring, whereby an individual depends on an initial piece of information to make subsequent judgments, may help explain the lack of pass-through if consumers make purchasing decisions on the basis of the pre-VAT reduction price (anchor). The low market salience of indirect taxes, resulting in consumers not always fully factoring in the price effects of general consumption taxes or excise duties in their purchasing decisions, may also contribute to the lack of pass-through.[27]

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[19] D. Benedek *et al*, n. xx above.
[20] Ibid.
[21] Y. Benzorty *et al*, "What Goes Up May Not Come Down: Asymmetric Incidence of Value-Added Taxes" (2018) *NBER Working Paper* 23849. See also R. Batista Politi and E. Mattos, "*Ad Valorem* Tax Incidence and After-Tax Price Adjustments: Evidence from Brazilian Basic Basket of Food" (2011) *Canadian Journal of Economics* 44(4), 1438-1470.
[22] T. Kosonan, n. xx above; and J. Harju *et al*, "Firm types, price-setting strategies, and consumption-tax incidence" (2018) *Journal of Public Economics* 165, 48-72.
[23] C. Carbonnier, "Who pays sales taxes? Evidence from French VAT reforms, 1987–1999" (2007) *Journal of Public Economics* 91, 1219-1229.
[24] Benzorty *et al*, n. xx above.
[25] D. Fullerton and G.E. Metcalf, "Tax Incidence" (2002) *Handbook of Public Economics* 26, 1787-1872; T. Kosonan, n. xx above; and S. Delipalla and M. Keen, "The comparison between *ad valorem* and specific taxation under imperfect competition" (1992) *Journal of Public Economics* 49, 351-367.
[26] M Golosov and R.E. Lucas, "Menu Costs and Phillips Curves" (2007) *Journal of Political Economy* 115(2), 171-199.
[27] R. Chetty et al, "Salience and Taxation: Theory and Evidence" (2009) American Economic Review 99, 1145. On the distinction between market and political salience, further discussed in Section V below, see D. Gamage and D. Shanske, "Three Essays on Tax Salience: Market Salience and Political Salience" (2011) *Tax Law Review* 65, 23-97.

Whilst all these explanations can certainly help to partly explain the results, they do not do so fully – in particular, they do not explain the heterogeneous response of firms, depending on size or business structure, or the different pass-through rates depending on share of consumption affected by the reform. Regardless of the reason – or most likely reasons – for the lack of pass-through of VAT changes on consumer prices, we now know that consumers tend not to get the benefit of reduced rates of VAT. This begs the further question of who does tend to benefit from this reduction in rates. Until recently there was limited concrete evidence on the main beneficiaries of reduced rate, although employees and a possible positive effect on (low-skill) employment had already been discarded;[28] a recent study, however, confirms the intuition that retailers – not consumers, employees or suppliers – are the primary beneficiaries of VAT reductions.[29]

The above studies cast doubts over whether reduced rates of VAT will be passed through to consumers. Yet, even assuming that, given the heterogeneity of the response to VAT reductions, reduced rates will indeed affect prices, there are still no guarantees of attaining the envisaged distributional and social aims. Economic literature has been consistently sceptical of the suitability of differentiated VAT rates to achieve distributional aims. Such aims are generally regarded as better addressed under an efficient, and welfare enhancing,[30] single rate system, with the yield then used to compensate lower-income households, either through welfare transfers, or progressive income taxes.[31] Only when there are no other means of compensating lower-income households, due to poor targeting capacity as it is the case in some developing countries, has an efficiency argument been made to justify the use of reduced rates of VAT.[32] This is partly because the most significant beneficiaries of the tax expenditure that result from the application of reduced rates of VAT are not lower-income households, but higher-income households.

Given the regressive nature of VAT, at least at the higher-income deciles, it seems intuitive that applying lower rates of VAT will protect low-income households and limit the regressivity of the tax. Yet

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[28] T. Kosonan, n. xx above.

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

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

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

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

analysis of consumption patterns, and distribution of VAT payments by income decile or quantile, clearly indicate the opposite: since consumption, even of essential items, is overwhelming done by the richest income households, when there is a VAT reduction – assuming this reduction is passed-through – it is those households that primarily benefit from VAT decreases.[33] A recent empirical study found that in Ghana, the average estimated benefit received by the lowest consumption decile by the application of VAT reduced rates and exemptions was $16 per capita, compared to $190 per capita at the top end of the distribution.[34] The picture is even worse when high levels of informality are taken into account: a recent study found that the presence of large informal sectors in developing countries has a significant impact in the distributional impact of general consumption taxes.[35] The large negative relation between informal consumption shares – or from small businesses below the VAT registration threshold – and households' total expenditure means that applying reduced rates or exemptions will primarily effect the higher income households, whose consumption is concentrated in the formal sector or larger businesses.

In practice therefore, reduced rates of VAT, to the extent that they are passed through on lower prices, effectively subsidise the consumption of the households at the higher levels of the income distribution. This in turn means that, contrary to intuition, reduced rates of VAT, as with any other exclusions from the base, do not necessarily reduce the regressivity of the tax, but can on the contrary, may increase it.[36] 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 it is often the case with medical or education – as only high-income households tend to opt for private services – or where they apply to meritorious items, such as books or cultural events – as only high-income households consume these products.[37]

Revenue Costs and Spillover Effects

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

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33 This issue is further developed in R. de la Feria and A. Swistak, "The Progressive VAT", forthcoming. See also A. Bozio et al, *Fiscalite et redistribution en France: 1997-2012* (Institute des Politiques Publiques, 2012); and N. Ruiz and A. Tronnay, "Le caractere regressif des taxes indirectes: les enseignements d'un modele de microsimulation" (2008) *Economie et Statistique* 413, 21-46.
34 T. Harris et al, "Redistribution via VAT and cash-transfers: an assessment in four low and middle income countries" (2018) *IFS Working Paper* W18/11.
35 P Bachas et al, "Consumption Taxes, Redistribution and Informality" (2020) *IFS Working Paper* W20/14.
36 T. Harris et al, n. xx above.
37 R. de la Feria and A. Swistak, n. xx above.

The tax expenditures – defined as reductions in tax liability compared to the benchmark –[38] resulting from the use of reduced rates of VAT are likely to be extremely significant. Whilst it is not always easy to determine the exact size level of this tax expenditure,[39] c-efficiency levels do provide some indication, as in developed countries these levels tend to be attributable primarily to the VAT policy gap – i.e. revenue loss due to exclusions from the base – rather than the compliance gap, as it tends to be the case in developing countries.[40] It is therefore suggestive of the significance of the tax expenditure involved that European countries' VAT systems tend to rank below the OECD c-efficiency average, which stands at 52.9, and Australia scores just above the average with 53 points, whilst New Zealand, which amongst other broad-base features applies one single VAT rate, ranks at above 90 points.[41] Similarly, the VAT Revenue Ratio (VRR), which also measures the effectiveness with which taxes are collected, also suggest that most VATs have significant tax expenditures, with between half and one third of potential revenues lost due to exclusions from the base.[42] These results are in line with a recent calculation of the tax expenditure associated with exclusions from the VAT base in low and middle-income countries, which found that between 22% and 55% of potential VAT revenues was foregone as a result of those exclusions.[43]

The high levels of tax expenditures associated with reduced rates of VAT are all the more significant, because the foregone revenue has the potential to affect mostly those in lower-income households, as by nature of consumption patterns, those are the ones who mostly benefit from public expenditure – whether welfare benefits or others – such as education or healthcare services. In the UK, for example, the distributional impact of eliminating reduced rates of VAT, whilst increasing the range of social benefits, was found to benefit mostly the three lowest-income deciles.[44] Similarly, a study focusing on four low and middle-income countries found that, despite being completely untargeted, a Universal Basic Income (UBI) funded by the revenue gains from a broader VAT base would create large net gains for poor income households and reduce inequality and poverty, even if only 75% of additional VAT revenue was disbursed as UBI payments.[45]

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[38] C. Heady, "Tax Expenditures: Definitional and Policy Issues" in L. Phillips *et al* (ed), *Tax Expenditures: State of the Art* (CTF, 2011). On reduced rates of VAT as tax expenditures, see P.P Gendron, "Canada's GST at 21: a tax expenditure view of reform" (2012) *World Journal of VAT/GST Law* 1(2), 125-148; and Y. Zu, "Reforming VAT Concessions: A Tax Expenditure Analysis" (2017) *British Tax Review* 4, 418-437.

[39] Y. Zu, n. xx above.

[40] M. Keen, "The Anatomy of the VAT" (2013) *National Tax Journal* 66(2), 423-446.

[41] D. Snell, "GST – Revenue and Business Risk", in R. Krever and D. White (Eds.), *GST in Retrospect and Prospect* (Wellington: Thomson Brookers, 2007), 423-430, at 426.

[42] OECD, n. xx above, at 59-61.

[43] T. Harris et al, n. xx above. Tax expenditure studies in France, Italy and Germany show equally large numbers, see B. Egert, "The Efficiency and Equity of the Tax and Transfer System in France" (2013) *CESifo Working Paper* 4210; J. Tyson, "Reforming Tax Expenditures in Italy: What, Why and How?" (2014) *IMF Working Paper* WP/14/6; and M. Thoene, "18 Billion At One Blow – Evaluating Germany's Twenty Biggest Tax Expenditures" (2012) *Fifo Discussion Papers* 12-4.

[44] R. de Mooij and M. Keen, n. xx above.

[45] T. Harris et al, n. xx above.

Beyond the revenue costs, the use of multiple VAT rates also carries significant spillover effects, not least qualification and interpretation problems. In Europe, these difficulties can be illustrated with a few examples. In *Belgium*, replacement of a front bicycle wheel is subject to a standard rate, whereas replacement of the back wheel is subject to reduced rate, because the labour component is greater. In *France*, the reduced rate applying to food products only applies to chocolate under certain very complex conditions, and products containing chocolate are subject to the standard or reduced rate according to their form, presentation, or actual composition. In *Ireland*, cold pizza is zero rated, whilst warm pizza is subject to 13.5% if sold as take-away. In *Portugal*, fresh fish is subject to a 5% rate; if it is cooked prior to being frozen, is subject to a 19% rate; and if it forms part of a ready meal to be taken away or consumed on the spot, it is taxed at a 12% rate. In the *United Kingdom*, raw and unprocessed nuts are zero-rated, and so are roasted and salted nuts still in their shells; fruit and nut mix can be zero-rated if the weight of the roasted nuts is less than a quarter of the whole; however, if nuts are shelled and roasted or salted, or if they have been coated with chocolate or yoghurt, the standard rate applies.

In *Australia*, an overwhelming level of detail is needed to determine the scope of application of the zero rate of VAT applicable to "food for human consumption" and "beverages".[46] Thus many similar examples to the European ones are evident: uncooked chicken or chicken meat purchased in a supermarket is GST-free, whereas a cooked (so-called "BBQ") chicken is subject to GST,[47] and fresh bread is not subject to VAT, unless it has a sweet filling or coating, or is sold in combination, such as sausage and onion on a slice of bread. The Australian Taxation Office reportedly spends vast resources just to maintain the list of groceries that fit the definition of zero-rated sales up-to-date, and on enforcement efforts to ensure grocers and other business are charging VAT appropriately.[48]

Also symptomatic of these definitional and interpretative difficulties are the high levels of existing litigation concerning the application of reduced rates of VAT. Within the EU, there is a growing number of cases on whether reduced rates of VAT should be applicable to specific – often new - products.[49] Amongst the most recent, and illustrative, cases are those concerning the treatment of non-physical books. At stake in these cases has been the interpretation of the word 'books', and whether the provision within the EU VAT Directive which allows 'books' to be subject to a reduced rate of VAT should be extended to similar products which did not exist at the time the Directive was approved, namely audio books, and e-books. In the first of this group of cases concerning non-physical books, namely audio books, the (3rd Chamber of the) Court of Justice of the European Union (CJEU) left the

[46] See s 38-4 *A New Tax System (Goods and Services Tax) Act 1999*.

[47] See *A New Tax System (Goods and Services Tax) Act 1999* Schedule 1 - Food that is not GST-free, Item 6.

[48] United States Government Accountability Office, *Value-Added Taxes – Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition*, Report to Congressional Requesters, April 2008, at 27-28.

[49] For a comprehensive analysis of this jurisprudence see R. de la Feria, "EU VAT Principles as Interpretative Aids to EU VAT Rules: The Inherent Paradox" in M. Lang et al (ed.), *Recent VAT Case Law of the CJEU* (Vienna: Linde, 2016).

decision to the national court on whether applying a VAT reduced rate to hardcopy books, but not to audio books, violated the principle of fiscal neutrality.[50] Yet, barely six months later, in two other decisions on the same theme, the (4th Chamber of the) Court ruled that the principle of fiscal neutrality cannot extend the scope of reduced rates of VAT to the supply of electronic books.[51] These two initial cases have been followed by others, and the matter is, at present, not yet fully settled.[52]

National courts have struggled with similar difficulties, and in this regard, whilst other countries have also experienced a high volume of cases,[53] litigation levels in the United Kingdom are particularly telling.[54] One of the most (in)famous cases was *Jaffa Cakes*.[55] Jaffa Cakes is a food product comprised of three layers: a sponge cake base, a layer of solidified orange flavoured jam, and a top chocolate cover. For several years McVities, the producers of Jaffa Cakes, treated them as cakes, which – for historical reasons that are not fully clear, but appear to be related to their sale in traditional baking shops – are subject to a zero rate of VAT in the United Kingdom. In 1991, however, this classification was challenged by HMRC, in particular on the basis that Jaffa Cakes are the same size and shape as biscuits, which under UK VAT law are subject to a standard rate on the basis of having been regarded by the legislator at the time of the law's entry into force as non-essential food products. The case was brought before the VAT Tribunal, with a central question: what criteria should be used to class something as a cake, rather than a biscuit? Ultimately, the court concluded that Jaffa Cakes where indeed cakes, rather than biscuits, and should therefore be zero rated.[56] The decision had a massive impact in the food industry in the UK. Not only did it give raise to significant and ever more complex follow-up litigation,[57] but the criterion established by the court in that case – based on the consistency of the product once it becomes stale – remains to the present day the one applicable to distinguish zero-rated cakes from standard-rated biscuits.

Another (in)famous case concerned the classification of *Pringles*, a popular snack food, for VAT purposes. In the UK, although snack food is usually zero rated, potato crisps are specifically excluded from this rule, and are thus subject to the standard rate. Whilst the rationale for this distinction is not fully clear, it seems the legislator was guided primarily by health considerations. Following a dispute

[50] Case C-219/13, *K Oy*, ECLI:EU:C:2014:2207.
[51] Cases C-479/13, *Commission v France*, ECLI:EU:C:2015:141; and C-502/13, *Commission v Luxembourg*, ECLI:EU:C:2015:143.
[52] For a review of the so-called e-books cases see F. Cannas, "Reduced Rates and the Digital Economy" (2017) *EC Tax Review* 2, 96-108.
[53] M. Kukawska and M. Machinski, "Polish landscape in the area of VAT rates for foodstuffs from the perspective of the neutrality principle" (2014) *World Journal of VAT/GST Law* 3(3), 201-209.
[54] G. Morse, '*Proctor & Gamble UK v HMRC (Pringles Two)* – a very peculiar UK practice – the characterisation of food products for zero-rating' (2009) *British Tax Review* 1, 59–67; and I. Roxan 'Interpreting exceptional VAT legislation: or, are there principles in Pringles?' (2010) *British Tax Review* 6, 699–716.
[55] *United Biscuits (UK) Ltd v The Commissioners of Customs and Excise*, LON/91/160.
[56] 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.
[57] M. Devereux and R. de la Feria, "VAT – Unjust Enrichment" (2008) *Tax Journal*, 12 May, 13-15.

between Procter & Gamble (P&G), Pringles' manufacturer, and HMRC, the case was sent to the High Court, which concluded that Pringles could not be regarded as potato crisps, as in order to be classified as such, a product "must be wholly, or substantially wholly, made from the potato", whilst Pringles are made from potato flour, corn flour, wheat starch and rice flour, together with fat and emulsifier, salt and seasoning, with a potato content of only 42%.[58] Although the decision was reversed on appeal, the case highlights the distortions caused by these interpretative and classification difficulties: potato crisps were excluded from the scope of application of the reduced rates because the legislator deemed these products as unhealthy and thus non-meritorious, while similar products will continue to benefit from those rates. As a result, not only is the tax system *de facto* subsidising those products, to the detriment of competing products, but it actually encourages the production of arguably less healthy products, by creating an incentive for producers of potato crisps to reduce the potato contents in their products.

In addition to qualification and interpretative problems, multiple rates' systems give rise to planning, avoidance, and fraud opportunities; generally, the greater the number of VAT rates, the lower the degree of compliance.[59] Indeed, litigation indicates that VAT avoidance is often linked to exclusions from the base: of all the VAT avoidance cases decided by the CJEU in the last 20 years, for example, only two did not concern either reduced rates, or exemptions.[60] A paradigmatic example of the opportunities created by the application of reduced rates is the existing, and ongoing, litigation regarding composite supplies. The debate has two inter-related dimensions: the first concerns a qualification problem, namely how to treat a single supply of products some of which are subject to reduced rates, whilst others are subject to standard rates;[61] the second, however, is how and when should a supply with various components be regarded as single, and when should it be regarded as composite, and it is in this context that planning and avoidance can come into play, with either artificial merger, or artificial division of supplies.[62] In addition, certain types of VAT fraud are also linked to exclusions from the base,

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

[59] A. Agha and J. Haughton, "Designing VAT Systems: Some Efficiency Considerations" (1996) *Review of Economics and Statistics* 78(2), 303-308.

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

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

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

and would not be possible without those exclusions, such as misclassification of supplies, or certain claims for non-refundable input VAT.[63]

The compliance and administrative costs of the above are clear. The difficulty establishing the VAT rate applicable to a determined supply, amplifies companies' compliance costs In many cases, as acknowledged by the European Commission, the resort to external tax expert advice is unavoidable, creating significant additional financial burdens,[64] which for SMEs will often be Similarly as regards administrative costs: both classification and interpretative difficulties, and combating avoidance and fraud, combating aggressive planning too gives rise to extremely significant administrative costs, as demonstrated by the levels of litigation.

The case in support for differentiated rates of VAT, particularly as a method of reducing the regressivity of the tax or encouraging the consumption of meritorious products, is extremely weak. There is limited evidence that tax savings are passed on to customers, on the contrary, they tend to be absorbed primarily by retailers; even where they are passed on to customers, reduced rates tend to benefit overwhelmingly the richest households, as a result of global consumption patterns across the income distribution – in some cases resulting in increased regressivity. The costs of multiple rate systems, on the other hand, are extremely high. The revenue costs are very significant, which is particularly concerning, as public expenditure – either where it take the form of welfare benefits or of public services – tends to benefit most the poorest income households, and the spillover effects are both varied and large. The case in favour of approving, or moving to, a single-rate VAT system, or at least broadening the VAT base, is therefore overwhelming. Yet, both in Europe and in Australia the opposite has happened: not only has broadening the base proved impossible, but the tendency has been instead to narrow the base further.

III. Reduced VAT Rates in Europe

Within Europe, the use of reduced rates dates back to the introduction of VAT itself in 1967.[65] Although evidence regarding potential negative consequences of applying multiple rates may have been unavailable at that time,[66] difficulties soon became apparent for some decades. Accordingly, since the late 1980s, there have been several attempts to amend European rates rules, under the political guidance and legislative initiative of the European Commission. Yet, there has been unwavering resistance by EU Member States to any proposed amendments that might lead to a broadening of the

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

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

[65] The overview provided in the initial pages of this section is largely a summary of the analysis provided in R. de la Feria, n. xx above.

[66] As discussed in R. de la Feria and R. Krever, n. xx above.

VAT base., On the contrary, the most recent agreed upon amendments to the rates rules have narrowed the VAT base, with more goods and services being subject to reduced rates in Europe today than even as recently as fifteen years ago. Despite the impact of the financial crisis on the use of reduced rates of VAT, by 2011 the share of reduced rate goods and services was still on average 26%, ranging from a few percentage points in Bulgaria, Denmark and Romania, to more than 40% of total consumption in Greece, Poland, Portugal, and Spain.[67]

Failed Efforts to Broaden the VAT Base

The system put in place under the First and Second VAT Directives established only a basic framework, leaving full autonomy to EC Member States insofar as rates were concerned: they were free to establish their own rate structure, including the number and level of rates.[68] Reportedly for political and practical reasons, Member States used that freedom to largely mimic the rates structures applied under their previous turnover taxes.[69] With the approval of the Sixth VAT Directive in 1977, there was a significant increase in the level of detail contained regarding the tax base, and a decrease in the level of freedom granted to Member States.[70] Yet, despite the progress achieved in some areas of the system, as regards other areas such as the rates structure, reportedly the EC Council of Ministers found it impossible to reach agreement, and consequently further harmonisation was postponed to a later date.[71] The rules applicable to rates under the original version of the Sixth VAT Directive were therefore similar to those previously applicable under the Second VAT Directive, i.e. there continued to be total freedom given to Member States to determine their own rates.

In 1987, as part of a wider European integration initiative, the European Commission put forward a proposal for a new VAT rate structure.[72] This new structure was based on three basic principles, as follows: implementation of a dual-rate system, as opposed to the multiple-rate system applied in most Member States; limits to the use of reduced rates, by only allowing its application to six categories of goods and services, compulsorily allocated to each rate; and repeal of all temporary derogations,

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[67] F. Borselli *et al*, "Patterns of Reduced VAT Rates in the European Union" (2012) *International VAT Monitor* 1, 13-21.

[69] R. de la Feria and R. Krever, n. xx above. See also S. Cnossen, 'What Rate Structure for a Value-Added Tax?' (1982) *National Tax Journal* 35(2), 205–214, at 209; and V. Lenoir, 'April 1954–April 2004 – VAT Exemptions: The Original Misunderstanding' (2004) *European Taxation* 10, 456−459, at 456−457.

[69] R. de la Feria and R. Krever, n. xx above. See also S. Cnossen, 'What Rate Structure for a Value-Added Tax?' (1982) *National Tax Journal* 35(2), 205–214, at 209; and V. Lenoir, 'April 1954–April 2004 – VAT Exemptions: The Original Misunderstanding' (2004) *European Taxation* 10, 456−459, at 456−457.

[70] Sixth Council Directive 77/388/EEC of 12 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, OJ L 145, 13/06/1977, 1.

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

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

allowing Member States to apply reduced rates and zero rates to goods and services, where those rates had been in place before 1976.[73] The proposal was widely regarded as too ambitious,[74] and progress in Council discussions proved slow. By 1989, the Commission recognised that certain aspects of the 1987 proposal were curtailing the possibility of reaching agreement, and that a more pragmatic approach would be required. In 1991, the Council finally reached agreement on the essential characteristics of a new VAT rate structure,[75] which not only differed significantly from the Commission's original 1987 proposal, but also differed from the alternative rates structure proposed by the Commission in 1989.The new VAT rate structure, which would apply from 1993 onwards, was largely a product of political compromises. The price for reaching agreement was an extremely complex system (mostly if compared with the simplicity of the structure initially proposed by the Commission), filled with exceptions and derogations. Table 1 provides a comparative overview of the three VAT rate rules discussed during this period: the rules proposed by the European Commission in 1987; the alternative structure suggested by the Commission in 1989; and, finally, the structure which was ultimately approved by the Approximation of VAT Rates Directive.

Table 1: VAT Rates Proposals 1987-1992

COMMISSION'S 1987 PROPOSAL	COMMISSION'S 1989 ALTERNATIVE PROPOSAL	APPROXIMATION OF VAT RATES DIRECTIVE
Two-rate system (standard rate and reduced rate)	**Two-rate system** (standard rate and reduced rate)	**Five-rate system** (standard rate, three reduced rates and zero-rate)
Standard rate band (14% to 20%)	**Standard rate minimum**	**Standard rate minimum** (15%)
Reduced rate band (4% to 9%)	**Reduced rate band** (4% to 9%)	**Reduced rates minimum** (5%) in theory; in practice no minimum applies
6 items that may be subject to reduced rate	**6 items** that may be subject to reduced rate	**22 items** that may be subject to reduced rates
Compulsory nature of list of goods / services subject to reduced rate	**Compulsory nature** of list of goods / services subject to reduced rate	**Optional nature** of list of goods / services subject to reduced rate

[73] European Commission, *Completion of the Internal Market: approximation of indirect tax structures and harmonisation of indirect tax structure*, Global Communication from the Commission, COM(87) 320 final, 5 August 1987.
[74] See A.J. Easson, "The Elimination of Fiscal Frontiers", in R. Bieber *et al* (eds.), *1992: One European Market? A Critical Analysis of the Commission's Internal Market Strategy* (Baden-Baden: Nomos Verlagsgesellshaft, 1988), 241-260, at 260.
[75] Council Directive 92/77/EEC of 19 October 1992, OJ L 316, 31/10/1992, 1, known as the "Approximation of VAT Rates Directive".

Abolition of zero-rating	**Maintenance of zero-rating** for a limited range of products	**Maintenance of zero-rating**

Whilst temporary measures on VAT rates described above were supposed to be in place for a period of only four years after 1993, the Commission was unable to fulfil this time plan and it was not until the summer of 1996 that a work programme was presented for the adoption of the new VAT rules regarding the base.[76] Although formal legislative proposals were never put forward, the programme contained a detailed work plan extending through to mid-1999,which included the further harmonisation of VAT rates. Ultimately, this new attempt was also doomed to fail. The first setback came very soon after the presentation of the 1996 programme, as Member States failed to reach total agreement on the already tabled proposal regarding the establishment of a fixed band for standard rates of VAT. This included a minimum rate of 15% and a maximum rate of 25% and whilst Member States were able to agree on the minimum level, it was impossible to reach unanimity on a maximum level. Although the proposal was eventually approved, the final text contained no reference to the maximum level of standard rate.[77] With very little progress made, it soon became clear that the degree of envisaged harmonisation of VAT rates would not be achieved. Although unknown at the time, this was to be the last significant EU attempt to broaden the VAT base.

Over the years, it was always clear that Member States' resistance to VAT broadening measures was inextricably linked to political constraints. One of the most paradigmatic examples of these constraints, which has acquired the near mythical status within European circles, is the Irish Budget of 1982. In 1981, faced with a struggling Irish economy, the then Irish Minister for Finance, presented a range of tax reform measures aimed at dealing with the fiscal deficit. The measures included various VAT base-broadening measures, which would result in the application of the standard rate of VAT to several products that until then had been subject to zero-rate, such as children's shoes. Although the Budget included pay-back to lower-income families, so as to limit the potential regressive impact of the measure, the measures immediately became the target of strong controversy. Emotional political discussions were held on prime-time national TV, focussing primarily on the effect of the rate change on lower-income families.[78] Dependent on independent members of the Irish parliament to get the Budget passed, the coalition government of the time was particularly vulnerable to political controversy, and the Minister for Finance failed to get his Budget through when a number of independent members voted against it. The defeat of the Government over the Budget made a general election unavoidable,[79] giving

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

victory to the main opposition party.[80] Although the Irish General Election of 1982 was said to be brought about by "a unique set of circumstances",[81] the popular view, which has survived the test of time, was that the Government's fall was largely attributable to the VAT base-broadening changes, and particularly the imposition of a standard rate of VAT on children shoes.[82]

Narrowing the VAT Base

Since the approval of the Approximation of VAT Rates Directive, VAT rates, far from converging as might have been expected,[83] can diverge much more than under the legal framework set up in 1992. As reported by the European Commission in 2001, despite its tentative efforts to increase convergence, "when current rates are compared with those applicable in 1997, it is apparent that rates continue to vary considerably".[84] The first post-1992 narrowing of the Europe VAT base started in 1999, in the context of the so-called labour-intensive services experiment. The experiment allowed the application of reduced rates to certain labour-intensive services, such as hairdressing and window cleaning, with the aim of testing its impact on job creation and the combat informality.[85] Initially intended to last for three years, the experiment was consecutively extended,[86] despite its disappointing results, until it became permanent. In 2008, the European Commission put forward a new legislative proposal, which it designated as "a first action concerning reduced VAT rates" and as a "limited legislative proposal […] relating to urgent issues, which do not require any substantial additional study".[87] The proposal had two objectives, both allowing for narrowing of the VAT base: to make the possibility of applying reduced rates to certain labour-intensive services permanent, and to allow Member States the freedom to apply reduced rates to "locally supplied services", such as restaurant services. The proposal was approved not long after its presentation, with the final legislative document essentially following its wording – both

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

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

[82] Something denied by the then Taoiseach (Head of Government) Garret Fitzgerald, who in 2000 stated that it was a myth that VAT on children's shoes was the cause of the Budget collapse, in "How the myth over VAT on children's footwear still endures" *The Irish Times*, 9 September 2000.

[83] This was in fact the European Parliament's opinion, see *Options for a definitive VAT system*, Working Paper, Economic Affairs Series, E 5, October 1995, at 87. This was also the view expressed by several authors and Member States' officials, see P. Guieu and C. Bonnet, "Completion of the Internal Market and Indirect Taxation" (1987) *Journal of Common Market Studies* XXV(3), 209-222, at 215.

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

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

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

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

factors a clear indication that negotiations had been relatively straightforward and that Member States were broadly in agreement with the new direction taken by the European Commission.[88]

Concurrent attempts by the European Commission during the same period to limit overall differentiation failed miserably. In 2003, the Commission presented a proposal with a view to "review and rationalise the use of reduced rates". The proposal left considerably more freedom to Member States to decide on their own VAT rate structure than under previous Commission proposals, namely the 1987 and 1989 proposals.[89] After years of discussions at the Council,[90] the proposal was finally approved in 2006 but at significant costs: the emphasis was no longer on rationalisation of reduced rates, or broadening of the base, but rather on the extension of the temporary rates provisions within the VAT Directive, as well as on the extension of the list of products to which reduced rates may apply. A legislative proposal that had intended to broaden the VAT had resulted in final legislation that had exactly the opposite effect of narrowing it.

By 2008, the level of VAT base erosion in Europe was therefore extensive. Amongst the older Member States, six (Greece, Spain, France, Ireland, Italy and Luxembourg) continue to apply a reduced rate lower than the minimum of 5% set out in the VAT Directive (a "super-reduced rate"); three (Belgium, Ireland and Luxembourg) still apply a reduced rate not lower than 12% (known as the "parking rate"); five Member States (Belgium, Denmark, Finland, Italy and Sweden) apply a zero rate on a marginal and restricted basis; while Ireland and the United Kingdom continue to make extensive use of this zero-rate derogation.[91] The situation is better, but not significantly so, within the newer Member States: six (Cyprus, Czech Republic, Estonia, Latvia, Malta and Slovakia) apply a zero rate of VAT, and nearly all have been granted authorisation to introduce / maintain the application of rates which derogate from rules set out in the VAT Directive.[92] The previous failed attempts to broaden the VAT base, and on the contrary, its progressive narrowing, seemed set to continue. Instead, however, the financial and

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

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

[90] The Council initiated its formal discussions on the Commission's proposal at the ECOFIN meeting of 7 October 2003 in Luxembourg (see *Preparation of Eurogroup and Council of Economics and Finance Ministers, Luxembourg, 6-7 October 2003*, MEMO/03/191, 06/10/2003). Although the Commissioner, Frits Bolkestein, was eager to have the proposal approved before the end of the year, the Council's initial discussions seemed to indicate that reaching Member States' agreement regarding this proposal might be difficult and lengthy (see *2530th Council Meeting – Economic and Financial Affairs – Luxembourg, 7 October 2003*, C/03/274, Pres/03/274, 07/10/2003 and *Results of the Council of Economics and Finance Ministers, 25th November 2003 – financial services and taxation*, MEMO/03/241, 26/11/2003). During 2005 a substantial push was given to this proposal by both Luxembourg and the United Kingdom – which held the Presidency of the Council during the first and second half of 2005, respectively – leading to its final approval in 2006, see *Results of Council of Economic and Finance Ministers, Brussels, 6-7 December 2004*, MEMO/04/289, 08/12/2004, and *Results of the 2688*th *ECOFIN Meeting*, Press Release 13678/05, Brussels, 8 November 2005, 21.

[91] The data is reported on the Commission's report on reduced VAT rates, COM(2001) 599 final, 22 October 2001, n. xx above. An analysis of the rates in force on 1 January 2009 shows that the situation has not improved and, if anything, it has worsened.

[92] Articles 123 to 130.

economic crisis of 2008/2009 hit, and, for a while at least, Member States approach to rate differentiation changed radically.

In the mist of the financial crisis, confronted with high budget deficits and limited (or negative) economic growth, whilst at the same time deprived of the possibility of currency devaluation and bound to a common interest rate, Member States – specifically those which are part of the Eurozone – turned to tax policy, and in particular to VAT, as their preferred means of macro-economic intervention. In line with research that indicates that tax reforms occur more frequently in periods of economic recession, and that VAT increases are amongst the most frequent measures,[93] between 2008 and 2014, many OECD countries increased their standard and/or their reduced VAT rate. EU Member States were no exception. Overall, a staggering twenty-three out of the twenty-eight EU countries changed their VAT rate structures during this period. At the same time, only nine EU Member States broadened the base – and in only a few cases substantially so – moving goods and services from reduced to intermediate rate, or from reduced and intermediate to standard rates.[94] Interestingly, the few Member States where wider broadening measures were introduced were those, like Portugal and Greece, where a bailout had been agreed with the so-called troika, and thus where VAT base-broadening measures were part of wider reforms agreed in the context of the bail-out agreements.[95]

Clearly keen to harness the political momentum,[96] the European Commission launched a public consultation in 2012 on the review of the EU legislation on VAT reduced rates.[97] The response to the consultation was not widely representative: there was a low number of submissions from academics, tax advisors and tax practitioners; and, by contrast, a very high number – more than half of all submissions – from national or European associations, the large majority of them representing sectors currently benefiting from a reduced VAT rate.[98] Unsurprisingly, the nature of the respondents reflected heavily on the contents of the responses: most were opposed to the abolition of the reduced rates and/or advocated for their extension. Soon after, the European Commission announced what can only be characterized as a monumental U-turn on VAT rates policy, by presenting a legislative proposal that

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

94 Details on these changes are provided in R. de la Feria, n. xx above.

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

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

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

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

would effectively disharmonise VAT rates,[99] thus opening the door to further narrowing of Member States' VAT base.

The reasons for such a surprising announcement were not immediately apparent. There are numerous potential triggers, from the need to adapt to modern technologies and new goods or markets and the wider changes proposed for the EU VAT system,[100] to the interpretative difficulties arising from the rates rules.[101] The truth is probably rather more prosaic: faced with decades of resistance and increasing pressure from Member States to allow further erosion of the base, the Commission finally broke the political impasse by ceding power in their favour. Whilst the potential consequences of this proposal, and even its constitutional validity, have been discussed elsewhere,[102] the political context of the European Commission's U-turn is particularly significant.

As the effects of crisis warned off, Member States started reversing the base broadening measures that had been adopted in the period between 2009 and 2014. One of the most notable cases in this regard was that concerning restaurant services in Portugal, where following a relentless campaign by the restaurant sector,[103] the decision was taken in 2016 to reverse the decision taken in 2013 to apply a standard VAT rate to those services, returning to the previously applied reduced rate.[104] More recently, political momentum has been gathering around the possibility of reversing the decision taken to apply the standard rate of VAT to electricity, again returning to the application of a reduced rate.[105] Concurrently, pressure mounted from other Member States to obtain derogations from EU rates rules, which would allow them to apply reduced rates of VAT to specific products. One of the most notable cases, and arguably the last straw for the European Commission, concerned what became known as the "tampon tax". The political controversy in the UK over the application of 5% reduced VAT rate, rather than the zero-rate, to women's sanitary products dates back to the late 1990s,[106] but it intensified significantly in the period that preceded the UK Brexit Referendum in 2016, with the topic becoming

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[99] European Commission, *Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax*, COM(2018) 20 final, 18 January 2018. On the details of the proposal see I. Lejeune and C. Herbain, "A revamped flexibility on VAT rates for Member States" (2018) *British Tax Review* 2, 161-165; and H. Kogels, "The Sweet Dream of a Simple VAT Rate Structure" (2017) *EC Tax Review* 6, 290-291.
[100] As argued by the European Commission, see R. de la Feria, "The Definitive VAT System: Breaking with Transition" (2018) *EC Tax Review* 3, 122-126.
[101] Discussed in Part II above.
[102] R. de la Feria and M. Schofield, "Towards an [Unlawful] Modernized EU VAT Rate Policy" (2017) *EC Tax Review* 2, 89-95.
[103] E. Miranda, "Não faz sentido baixar agora o IVA da restauração" *Jornal de Negocios*, 3 Fevereiro de 2015.
[104] VATlive, *Portugal restaurant VAT cut to 13%,* 1 July 2016. See also C. Teixeira, "Guia para perceber o que muda no IVA da restauração", *Visao*, 1 July 2016.
[105] A. Pereira and R. Pereira, "A lower VAT rate on Electricity in Portugal: Towards a cleaner environment, better economic performance, and less inequality" (2018) *Energy Policy* 117(C), 1-13. See also E. Miranda, "IVA – Um fato à medida do freguês", *Expresso*, 8 February 2020.
[106] Detailed analysis is provided in M. Schofield and R. de la Feria, "Section 126: VAT: women's sanitary products" (2016) *British Tax Review* 5, 611-618.

headline news, and one of the most highly politicised tax law issues of 2015.[107] The now re-named tampon tax was criticised in the media,[108] as well as being the subject of a petition with 320,000 signatories,[109] and a number of protests.[110] In March 2016, three months before the Brexit Referendum, the UK Prime-Minister David Cameron announced that he had secured agreement with his counterparts at the European Council to change the "far too inflexible" VAT system.[111] In effect, this assured the public that should the UK vote to remain within the EU, it would narrow the VAT base, including by decreasing the rate applicable to women's sanitary products. That same month, following an EU Council Ministers meeting, it was reaffirmed that the European Commission would provide options for Member States to zero-rate sanitary products.[112] The timing of the announcement seems to indicate therefore that the UK tampon tax weighted heavily on the Commission's decision to perform a U-turn on its traditional position on the VAT base – which is rather ironic given the result in the Brexit Referendum the following June. A few years later a similar public debate took place in Australia.

IV. GST Reduced Rates in Australia

One might have hoped that Australia's introduction of a value added tax in the form of the goods and services tax (GST) in 1999, would have benefitted from the experience of the longer established VAT systems. Although it did do so in many ways, and although the Australian approach is both novel and admirable in many respects, it has not escaped the anomalies that accompany the application of different rates. Fortunately Australia has only two rates – a zero rate in the form of its GST-free rules, and a standard rate of 10%. However it is in one significant aspect of the GST rates system that the influence of politics is most noticeable – the GST treatment of food.

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

108 See amongst others: H. Horton, "Tampon tax: Women show off their 'luxury' sanitary products online", *The Telegraph*, 29 October 2015; "MPs reject 'tampon tax' challenge in Commons vote", *BBC News*, 26 October 2015; D. Buchanan, "Periods cost £18,000? Here are five things I'd rather spend the money on", *The Guardian*, 8 September 2015; and contrast with, J. Hartley-Brewer, "The campaign to end VAT on tampons is one of the silliest the sisterhood has ever mounted", *The Telegraph*, 27 October 2015.

109 *Stop taxing periods. Period. #EndTamponTax*, available at: https://www.change.org/p/george-osborne-stop-taxing-periods-period [Accessed 17 October 2018]: "This petition made change with 320,087 supporters!"

110 See P. Jackson-Edwards, "Two women 'free bleed' outside Houses of Parliament while wearing white trousers in protest over 'tampon tax'", *Mail Online*, 10 November 2015; and, N. Gutteridge, "EU denies MP's claim it has dropped Osborne's agreement to exempt UK from tampon tax", *Express*, 26 May 2016.

111 *Hansard*, HC, col 1245 (21 March 2016).

112 European Council press release, European Council conclusions, 17–18 March 2016 (2016, press release 143/16). See also the Twitter account of Commissioner Pierre Moscovici (@pierremoscovici) who wrote: "I've confirmed to @George_Osborne that @EU_Commission plans to make proposals this year for more flexibility on #VAT for sanitary products" on 26 May 2016; and on 7 April 2016 "EU leaders have made clear their commitment to VAT zero rating for sanitary products. We will deliver swiftly as part of VAT Action Plan."

The introduction of a GST in Australia had seemed, at the time of its introduction, a relatively remote prospect. The then Prime Minister was on record as having said that his party would "never ever"[113] reattempt to introduce a GST. The remark was made in the context of that party having just lost an election based on the introduction of the broad based consumption tax. This public position was, three years later, reversed when it was announced that the 1998 general election would seek a mandate for tax reform including the introduction of a GST as part of a broader tax reform.[114] A broad consumption tax had, in fact, been proposed in the Asprey report in 1975 and had become something of a political football with, as has been explained, the 1993 federal election having been lost by the Liberal party largely as a result of their proposal to introduce a GST.

Not surprisingly with such a background, the reappearance in 1999 of the proposal to introduce GST was not without political turbulence. Although Prime Minister John Howard had won the October 1998 election despite declaring that GST would be part of the proposed tax reform "...he did not have a Senate majority and the fate of the GST was reliant on the support of either independent senators or the Australian Democrats. The Australian Democrats ... agreed to support Howard's GST implementation on the proviso that it contained certain concessions."[115]

The political machinations became of national interest as the government focussed on key opposition politicians in order to secure the passing of the GST legislation. Early on the focus was on the Tasmanian Senator Brian Harradine who could be said to have held the balance of power in the Senate at the time.[116] The Senator ultimately did not support the GST, on equity grounds. As Kingston explains, the Senator announced:

> *But one thing can be guaranteed, and that is that the goods and services tax, once enshrined in legislation, will never be removed. Decisions we make now on this issue are not for the next three years; we are making decisions here that will affect generations. The question that I have to ask myself is whether I am going to be a party to imposing an impersonal, indiscriminate tax on my children, my grandchildren and their children for generations to come. I cannot.*[117]

The idea of equity and problems of regressivity dogged the political progress of the legislation at the next stage too. Having lost Senator Harradine to the GST cause the government then courted the Australian Democrats party. That party had already formed the view that most food should be GST-free

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[113] The comment was made in response to close questioning by a political journalist. See M.Grattan *Howard bans GST 'forever'*, *The Age* newspaper, 3 May 1995, page 5.

[114] See K. James "Comparative perspectives on the value add – four decades of value added tax reform in Australia, Canada and the United States." A full chronology 1975-1999 of the GST's introduction and various false starts and hurdles may be found at http://www.aph.gov.au/library/pubs/chron/1998-99/99chr01.htm (accessed October 2009).

[115] D. Jenkins "10 years of GST – The Trials and Tribulations: What has changed?" *Taxation Institute of Australia*, National GST Conference 3-4 September 2009 at 5.

[116] M. Kingston "Brian Harradine, man of honour" *Sydney Morning Herald* 24 June 2004. Accessible at http://www.smh.com.au/articles/2004/06/29/1088392648667.html.

[117] Ibid.

(zero-rated).[118] The party's view was that food should not be taxed because it was satisfied that: taxing food would make the GST regressive; the benefits of tax reform could be delivered with GST-free food; making food GST-free would help rural Australia as it would not inflate prices of (and thus would maintain demand for) food such as local horticultural products; GST-free food would improve public health standards (by taxing 'junk' food but not 'healthy' foods); making food GST-free would be more effective than compensating lower income individuals and families for taxes on food; and making food GST-free would not lead to a "compliance nightmare".[119]

In the course of its deliberations and submissions the Democrats considered the options available for defining what is meant by "food" and considered what it considered as "the British option" of GST-free status for food other than restaurant and take-away food; recognizing a need to minimize distortion between the takeaway and grocery sectors;[120] "the Dutch option" of taxing all food at the same concessional rate, acknowledging that this would create a larger revenue gap and affect many more suppliers of food;[121] and "the Irish option" of zero-rating all food aside from a list of essentially luxury or non essential products.[122]

What was ultimately agreed with the government was the current Australian model which taxes all but a relatively large category of "food for human consumption".[123] The details worked out in the legislation and the lists applicable are long, involved and prone to confusion and some distortion. Nevertheless it is very plain that had the concession to the Democrat party not been made Australia would probably still not have a GST.

G. Jackson, The "tampon tax" is not a marginal issue — it's the force of structural sexism at work Guardian (Australia), Opinion, 25 July 2016, available at:

https://www.theguardian.com/commentisfree/2016/jul/25/the-tampon-tax-is-not-a-marginal-issue-its-the-force-of-structural-sexism-at-work

V. The Political Economy of General Consumption Taxes' Rates

The European and Australian experiences demonstrate the strength of political resistance to single-rate, broad-base VATs, both when amending an existing tax system, and when designing a new one: not only is it nearly impossible to broaden the base, but there is a constant and often systematic pressure to further narrow that base. Comparison between European and Australian experience shows that, as a result of these double dynamics, and despite narrowing pressures being present in every system, base

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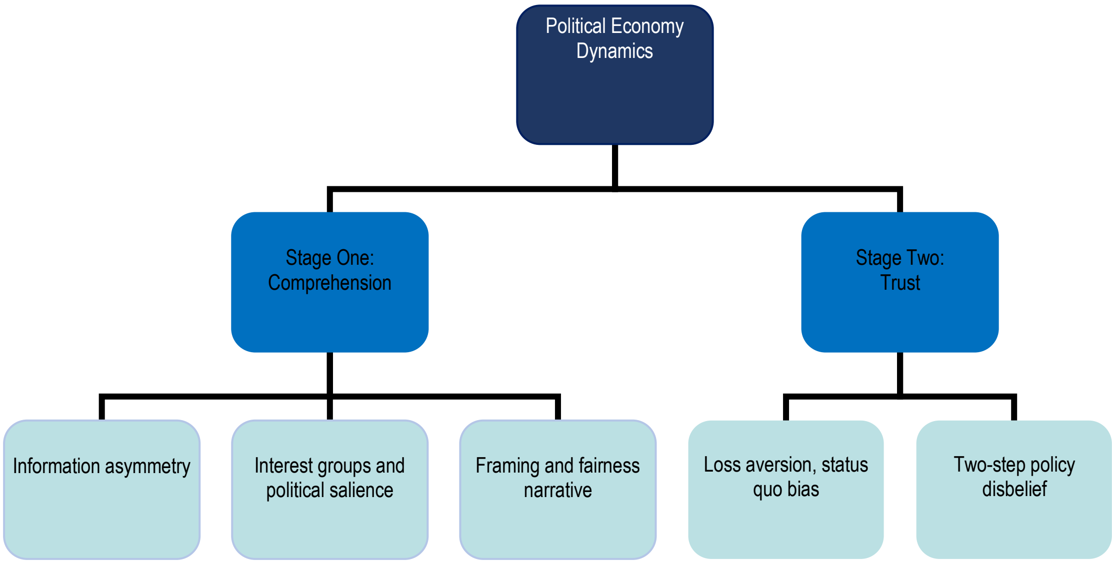
118 See *Main Report: Senate Select Committee on A New Tax System*, Commonwealth of Australia April 1999 at 371 and following pages,
119 Id at 371 – 378.
120 Id, at 374 -376.
121 Id at 376 – 377.
122 Id at 377 -378.
123 See *GST-free Food Guide "good news" for consumers*, Press Release of Australian Democrats, 14 June 2000 at http://www.democrats.org.au/news/index.htm?press_id=614&display=1 (accessed 2 November 2009).

erosion is significantly higher in systems that had a narrow base to start with – or put in another way, mistakes in VAT design are extraordinarily hard to correct.[124] The obvious question that emerges then is what determines these dynamics, and why resistance to broad base VATs is so prevalent, even in countries that, like European and Australia, have strong tax administrations and welfare-targeting capacity, despite strong evidence against the effectiveness of using reduced rates or exemptions to achieve social and distributional aims. Like other areas of the tax system where there is a gap between efficiency and fairness perceptions, the answer rests in the political constraints of tax reforms generally,[125] and of general consumption taxes in particular. Yet, whilst there is widespread awareness of this reality –[126] and even though there is a growing literature on political economy of taxation more generally – there has been so far limited research on the political economy dynamics of consumption taxes.[127]

It is argued that the political economy dynamics of consumption tax base can be separated into two sequential steps, both presenting obstacles to base broadening measures, and pushing for base narrowing ones, as follows: a first stage, when the main elements at play relate to the comprehension of the proposed tax policy; and a second stage, when the main elements at play concern trust in the proposed tax policy. The table below summarises the various dynamics at play.



The starting point would appear to be the information asymmetry between the general public, i.e. voters, and policy makers. Whilst analysis is often based on the assumption that voters and politicians have

[124] R. de Mooij and M. Keen, n. xx above, at 35.
[125] M. Castanheira et al, "On the political economies of tax reforms: survey and empirical assessment" (2012) *International Tax and Public Finance* 19(4), 598-624.
[126] OECD, n. xx above. It was even mentioned in former UK Prime Minister David Cameron's biography, *For the Record* (William Collins, 2019).
[127] For an early exception, regarding the introduction of VAT in Japan, see N. Hosaka, "The Political Economy of Consumption Tax" (1990) *Japanese Economy* 18(4), 19-47.

access to the same information, in reality it is too costly time wise for voters to collect extensive information about each policy, and voters should instead be "rationally ignorant".[128]

VI. Conclusion

It has been said that in a political system that is at once too responsive and not responsive enough, actual tax simplification is greatly limited and political compromises can create substantial complexity.[129] VAT base design certainly seems to be a paradigmatic example.

[128] A. Downs, "An economic theory of political action in a democracy" (1957) *Journal of Political Economy* 65(2), 135-150.
[129] See D. Shaviro, "Simplifying Assumptions: How Might Politics of Consumption Tax Reform Affect (Impair) the End Product?" (2006) *New York University Law and Economics Working Papers* 53, at 69-70.