PO-CH/NL/0058

PART A

Part A.

SECRET

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Begins: 1/11/83
Ends: 9/1/84.

PO -CH /NL/0058
PART A

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PART A

Chancellor's (Lawson) Papers:

EXTENSION OF THE VALUE
ADDED TAX BASE RATE

Disposal Direction 25 years

20/7/95.

CABINET OFFICE PAPER

The following Cabinet Office papers have been taken off the file. If you require access to these papers please contact the Cabinet Office.

Reference	Date Of Paper
ODE (83)	NOVEMBER 1983

- 2 NOV 1983

FROM: MISS J C SIMPSON
DATE: 1 November 1983

MR KNOX
CUSTOMS AND EXCISE

cc PS/Minister of State
Mr Middleton
Mr Cassell
Mr Monger
Mr Griffiths

Cx Chave this briefing pl.

VAT ZERO RATES

The Chancellor has asked, in the light of the briefing which you supplied for yesterday's meeting with Commissioner Tugendhat, whether there would be any possibility of the UK getting away with taxing non domestic construction, both new buildings and repairs, with domestic repairs moved from 15 per cent to zero rate? I should be grateful if you could provide a note for us on this, including also a note of the yield offset that would arise.

JS.

MISS J C SIMPSON

38-1-11

FROM: H M GRIFFITHS
3 November 1983

MR MONGER

MEETING WITH MR TUGENDHAT - VAT ZERO RATES

The draft note attached to Mr Knox's minute does nothing to dispel my worries about going to ODE on this issue now.

2. Paras 4 and 5 are likely to set the alarm bells ringing in other Departments, especially DoE and MAFF. In spite of the final sentence there must be a risk that other Ministers will ask for a meeting or at least demand reassurances.

3. There is a case for waiting at least until after the "reflection" meeting before reporting back to ODE. The meetings so far have been informal and it is not clear that Mr Tugenhdat has taken soundings among his Commission colleagues. I assume he will now do so.

4. If this note is to be circulated it is worth considering if it could be toned down in some places. First, in view of X in para 1 of Mr Knox's minute, is not the first sentence of para 4 of the note too alarmist? The reference to water and sewerage will worry DoE and fuel and power is particularly inflammatory. At the least could we not substitute "might" for "would" in the first line.

5. Secondly, the penultimate sentence of para 5 is surely calculated to arouse suspicion about the Chancellor's intentions. Could it not simply be dropped altogether? Earlier in the paragraph, it is surely over sanguine to suggest that Mr Tugendhat would "probably not have too much difficulty" in persuading his colleagues to hold off till after the Budget. I should have thought "may be able to" is as much as we can claim at this stage. By the time of the "reflection" meeting the chances may be clearer - another reason for delaying the report to DoE.

HG

H M GRIFFITHS

FROM: G W MONGER
DATE: 3 November 1983

MR MIDDLETON

F — VAT BASE

I understand that you will shortly discuss this with the Chancellor.

2. I agree with Mr Giffiths' comments. In particular I think passages like X and Y in the draft minute to ODE could raise questions about the Chancellor's intentions. And the result of an ODE discussion could be pressure to adopt a line that would embarrass the Chancellor - for example, daring the Commission to go ahead, with the result that Budget changes would then look like a response to their pressure. I spelt out some of these problems in my note of 28 October.

3. It might be possible to draft a more anodyne note but the best thing would be to postpone the report until after the next talk with Mr Tugendhat.

4. Another possibility, although I do not know what view the Chancellor would take of it, is that he could explain the problem to the Chairman of ODE, the Foreign Secretary.

G W MONGER

22 NOV 1983

CONFIDENTIAL

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Mr Middleton
Mr Monger
PS/Customs & Excise
Mr Knox C&E

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

FOREIGN SECRETARY

You will recall that I had an outstanding remit from OD(E) (OD(E)83 1st Meeting, 8 March) to explore with Christopher Tugendhat the possibilities of prevailing on the Commission to halt their threat of infraction proceedings against a number of the UK's VAT zero rates, and to report the results. I saw Tugendhat on 31 October. As a result of that conversation, he has now been given a further remit to hold similar talks with the Irish and Italian governments who, as you will remember, have been similarly threatened with infraction proceedings. It is most unlikely that the Commission will take any further action against the UK until they have had a chance to assess the results of these talks, which will probably not be until the new year. In the circumstances, I do not think that there is anything to be gained from an early OD(E) discussion of this issue; the Commission threat has receded for the time being, and we do not at present know in what form, if at all, it might re-emerge.

2. I therefore hope that this minute will be taken by the Committee as fulfilling the second half of my remit to report to them the results of my meeting with Tugendhat.

3. I am copying this to other members of OD(E), and to Sir Robert Armstrong.

N.

N.L.
18 November 1983

FCS/83/242

CHANCELLOR OF THE EXCHEQUER

F

VAT Zero Rates

1. Thank you for your minute of 18 November.

2. In the circumstances, there is clearly no need for a discussion of this subject at OD(E) and I therefore do not propose to put it on the agenda of that Committee unless there is a material change in the present circumstances.

3. I am copying this minute to other members of OD(E) and to Sir Robert Armstrong.

GEOFFREY HOWE

Foreign and Commonwealth Office

21 November, 1983

63 21-11

 25/11/83

VAT EXTENSION - NOTE BY DCEA

The attached paper covers the economic effect of extending VAT at 15% to newspapers, books and magazines, to children's clothing and footwear and to non-domestic construction and alterations and at 5% to fuel.

2. On books, newspapers and magazines, extension of VAT would add to previous real price increases. In the case of newspapers and magazines, but not in the case of books, this might be absorbed without a major loss in sales. tax on knowledge

3. The demand for clothing and footwear has been growing and real prices have fallen substantially in recent years. Extending VAT to children's clothing and footwear would only raise real prices to 1981 levels and would only have a small effect on total clothing and footwear sales.

4. The extension of VAT to non-domestic construction and alterations would reduce distortions by imposing some (depending on the extent of avoidance) tax on the financial sector and reducing the implicit subsidy to owner-occupied housing. The consequences on the construction industry depends on the extent to which the exempt sector would manage to avoid the tax and on the Government's response in relation to its own construction programmes. On a worst case - for the industry - where the exempt sector was unable to avoid the tax and the Government did not offset the effects the tax could have on its own construction programmes, the output of the industry as a whole could fall by some 4%. If on a more realistic assumption the impact of the tax were confined to alterations, the consequences for construction would be much smaller, although it would be concentrated on the smaller firms in the industry.

Extending VAT at 5% to all fuels would reduce but not eliminate the discrimination between different forms of consumer spending. But the key problem with energy pricing is the relative underpricing of gas, due to our failure to collect the economic rent. We estimate that gas tariffs are under-priced by some 20-25%. Even standard rate VAT (which would only bite on domestic tariffs), if imposed in addition to the gas levy, would not eliminate underpricing. VAT could never be more than a blunt instrument for collecting economic rent but if used for this purpose, this would point to extending it to primary fuels alone (the effect on coal would be very small as little is used by final consumers). But extension to primary fuels only would probably lead to pressure for a reduction in the gas levy, which is a better instrument for collecting economic rent. Moreover, it introduces a deliberate tax distortion between fuels which is economically undesirable, though there is a case for extending VAT to all energy when the present gross pricing distortions have been removed.

IB

I C R BYATT

ANNEX 1

ABOLISHING ZERO RATE 1984-85

		Full year revenue (£m)	First year revenue (£m)(1)	RPI impact effect (%)
		(1983-85 prices and incomes)		
Group 3	Books 85) Newspapers 225) Magazines 65)	375	275	0.3
Group 5 / Group 6	Newspaper advertisements) News services)	25	20	NIL
Group 7	Fuel and power 5%	460	335	0.3
	15%	1350	975	1.0
	(Primary fuels only) 5%	230	170	0.2
	15%	670	490	0.5
Group 8	Non-domestic construction neg purchased by exempt traders	0-275 (2)	0- 70 (3)	NIL
	All alterations	450 (4)	225 (3)	
Group 17	Children's clothing and footwear	250	180	0.2

2.5

Tax paid by central government (not included above)

Non domestic construction	275	200
Books etc	neg	
Fuel (15%) Gas	10	
Electricity	15	

(1) Assuming changes are fully implemented on 1 April, except where otherwise specified.
(2) 15% of relevant expenditure would suggest revenue of about £275m but in practice, avoidance may reduce this to virtually nothing.
(3) Assuming an implementation date of 1 July 1984 for alterations, and 1 October 1984 for non-domestic construction. If the implementation date for alterations were 1 October 1984, the revenue would be £110m.
(4) Includes £25m of tax "sticking" on exempt traders.

25/11/83.

ECONOMIC EFFECTS OF EXTENDING THE VAT BASE

1. This note considers the economic effects of standard-rating a number of items:-

(i) books, newspapers and children's clothing;

(ii) construction;

(iii) fuel;

2. For convenience the revenue and RPI effects are summarised in Annex 1. Revenue estimates are net additional indirect tax revenue including, where appropriate, consequential changes in tax receipts from other goods due to expenditure switching. RPI impact effects are also shown. Increases in the RPI would affect expenditure and tax receipts via indexation and uprating, but the costings do not allow for this. (A 1% increase in the RPI costs about £550m with conventional indexation.) More generally there would be pressure to compensate groups affected by the change (eg a rise in Child Benefit if children's clothing and footwear is brought into tax.)

Books, Newspapers, Magazines

3. The extra tax yield in a full year would be about £375m split up as follows:-

Newspapers	225	60%
Books	85	23%
Magazines	65	17%
	375	

This does not include revenue (possibly £25m) from newspaper advertisements and news services which for administrative reasons would probably be standard-rated simultaneously. (See C&E paper.) The first year yield would be about £275m, and the RPI impact effect about 0.3%. The revenue would come largely from the personal sector, but also from the exempt (notably universities). LA schools and libraries would presumably have their VAT rebated as at present.

4. The table below shows changes in real consumer expenditure and real prices over the past 10 years.

	Books		Newspapers		Magazines	
	Real Prices	Volume	Real Prices	Volume	Real Prices	Volume
1972-79	+1½%	+9%	+ 3%*	-9%	+ 3%*	-19%
1979-82	+9 %	-9%	+25%	-6%	+21%	- 6%
1982-83	+19 %	-	-1%	-	0%	-

*Combined newspapers and periodicals price index.

5. Books. Sales rose by 9 per cent in the 1970s in spite of a small rise in (real) price. Between 1979 and 1982 the price rise was much sharper and the volume of sales contracted by 9 per cent. There has been a further large rise in prices over the last year. We have no sales figure for this period. But experience since 1979 suggests that sales would suffer severely from yet a further price rise due to VAT.

6. It is more difficult to say how UK production would be affected. Between a third and a half of books are imported so that a significant part of the tax would fall on imports. And of course UK exports of books would not be affected by VAT. UK production remained static over the last three years.

7. Newspapers. This is the largest part of the market. The table shows that real expenditure fell by 9 per cent during the 1970s when (real prices rose only a little) - but the very large real price increases since 1979 have had a much smaller effect on sales (at a time when real incomes have been virtually static). This suggests there there may be other factors tending to raise sales which have become stronger in the last few years. If so, newspapers could stand an increase in price due to VAT better than books.

8. Magazines. The decline in sales during the 1970s was much sharper than for newspapers. But as with newspapers, magazine sales suffered much less from the more recent sharp increase in price. There have however been some very weak areas. Some (general interest) magazines suffered falls of 7-16 per cent in circulation between 1979 and 1981, while others were hardly affected.

Children's clothing and footwear

9. Revenue yield would be about £250m in a full year on personal sector (assuming no compensation on child benefit). First year revenue would be about £180m and the RPI impact effect about 0.2%.

10. Consumer expenditure on clothing and footwear was £10.8bn in 1982, and has generally been increasing in real terms (up 33% since 1972). Over this period, the real price of clothing and footwear fell by about 34%. About 15% of the total is believed to be on children's clothing and footwear (£1600m in 1982).

11. In recent years (1979-82) consumer's expenditure on clothing has grown more moderately (+7%). Yet the real price has continued to decline sharply (-22%). Over the period as a whole the price decline is probably due to growth in cheaper imported clothes and shoes.

12. Again we have little information on the elasticity, but taking an estimate of-0.5 (the 1979 review of VAT on children's clothing used a range of-0.36- 0.7) the standard-rating would decrease demand by only about 1% of total clothing and footwear sales if fully passed on in prices. But firms specialising in children's wear would of course be much harder hit. Not all the decrease in demand would fall on domestic production, though it is uncertain how competition from imports would respond to the change.

13. Given the expansion of this market and the continuous fall in real prices, it seems better placed to cope with standard-rating than (say) books. A 15% increase in price would only raise the prices of clothing and footwear to 1981 levels in real terms.

Non-domestic Construction and Alterations

14. 15% of the expenditure by central government and the exempt sector on new non-domestic construction amounts to about £550m. In practice the net yield will probably be substantially less because a tax on Government expenditure transfers no resources to the Government and the VAT exempt sector of the economy may well find ways of avoiding the tax. This leaves the tax on alterations which is much harder to avoid and which comes mainly from the personal sector (£450 million in a full year)as the principal source of revenue. There would be no direct impact on the RPI. The first-year revenue is uncertain since it depends on the date of implementation and any transitional arrangements.

(a) Effect on the central government purchases:

15. Central Government purchases of new non-domestic construction include the building of hospitals and roads. Unless the cash limits are adjusted there will be a reduction in the volume of construction. (Full compensation is over-generous because of the possibility of switching to less construction-intensive methods of providing services.) However, it is debatable whether public expenditure decisions should be based on VAT-inclusive prices. In general, taxes should not distort methods of production. Most of the private sector and local authorities can reclaim any VAT invoiced to them so their choices are based on VAT exclusive prices which correspond more closely to the underlying availability of the factors of production. VAT is at present charged on central government purchases. This encourages the use of non-VATed inputs, notably labour, in central government.

16. There is a special repayment mechanism to enable local authorities to reclaim the VAT on their purchases. This could be extended to cover central government purchases of new construction but it would take longer to include purchases which are already standard rated because of the disruption to existing spending plans which are based on VAT inclusive prices. (However, there would be substantial political difficulties because charities would certainly clamour for the same treatment - see C&E submission.)

17. It is likely that whatever method is used to cope with the tax on central government purchases total tax revenue and public expenditure will both increase as a proportion of GDP at market prices by around 0.2% . This is because all VAT payments by central and local governments are included in the total tax revenue even if they are subsequently refunded and all expenditure is recorded at VAT-inclusive prices.

18. It is possible that there will be an increase in the PSBR of up to £70m in the first year because the tax is collected on average three months after the invoice date.

(b) Effect on the exempt sector purchases:

19. Taxable traders can at present reclaim the tax. It is difficult to make it stick on exempt traders alone, because there is probably substantial scope for avoidance through small legal changes (see Customs and Excise paper). The tax on some lease payments is probably harder to avoid but this will be comparatively small compared with the output tax on new buildings.

20. The long run effects on purchases by exempt traders are therefore likely to be small although it may take some time to organise the avoidance measures so there could be some disruption to the construction industry in the short run.

(c) Effect on alterations:

21. The revenue estimates for alterations are reasonably firm. They are largely based on the expenditure of consumers reported to the Family Expenditure Survey. Unlike exempt traders, consumers have comparatively little scope for legal avoidance and unlike central government they would make a genuine contribution to revenue.

22. The introduction of VAT on alterations would give builders an incentive to evade the tax on alterations but at the same time would make evasion harder. Currently, repairs and maintenance (which are taxable) can be incorrectly described as alterations. If both classes of work were taxable this would no longer be possible. However, on balance there could be some increase in evasion.

(d) Effect on the construction industry:

23. The industry is currently recovering from a fairly depressed phase. The recovery has been led by an increase in house building, particularly in the private sector. There has also been increasing activity in the commercial sector but the industrial building sector remains depressed. The latest NEDO forecast suggests that the volume of new work will increase by about 5 per cent between 1983 and 1982 and by a further 1 per cent between 1984 and 1983. However, output will still only be about 2/3rds of that in the early 1970s. Repairs and maintenance have held up and if anything increased.

24. The proposals cover about a quarter of the industry's total work (including repair and maintenance) and about half of all new construction. New construction includes alterations to non-domestic property.

25. In the worst case for the industry where central government departments were not compensated at all, exempt purchasers took no avoidance measures, and using a price elasticity of -1 as an upper limit, the output of the sectors directly affected would fall by 15%. For the industry as a whole the reduction would be nearer 4% and firms of all sizes would potentially be affected.

26. This is the worst case. In practice, the reduction in output may be much smaller. Government departments will be compensated at least partially, and the exempt sector may avoid much of the tax. If this happens the tax will fall mainly on alterations. In terms of the industry's total output the fall in volume could be small, say 1 or 2 per cent. (Alterations account for about 1/8 of total output.) But it would be concentrated in a sector where much of the work is done by small firms.

Fuel

27. In addition to raising revenue there are two broad arguments for levying VAT on energy:

(i) to minimise tax distortions by widening the tax base;

(ii) to help get energy pricing right.

Raising revenue and widening the tax base point to extending VAT to all fuels.

The effects of VAT on all fuels and energy

	First year revenue effect	Full year revenue	RPI impact effect
	£m	£m	%
5%	335	460	0.3
15%	975	1350	1.0

28. The effect on total energy demand would be small as demand is inelastic - with a price elasticity of -0.2 in the short run and -0.4 in the longer term. Lower demand will increase energy nationalised industry EFLs. A rough estimate of the immediate impact is of the order of £75-100m in a full year if VAT were applied at 5 per cent and £200-300m at 15 per cent. Thereafter it will fall as the industries adjust.

29. The appropriate level of energy prices continues to be a matter in dispute with the Department of Energy. We believe that the most serious degree of under-pricing is in gas tariffs ie in the domestic and commercial markets, where there is underpricing of perhaps 20 to 25%. We also have doubts whether electricity prices are at an economic level. There is an unexplained divergence between estimates of economic prices and the rate of return on capital - 1.4% and well below the RRR even though asset valuations have apparently been adjusted. If there is underpricing it would affect all - industrial, commercial and domestic - non-off-peak sales. Coal prices are broadly at market levels.

30. VAT can only contribute in a limited way to helping to get energy prices right:

(i) it can only effectively impact on the domestic sector, as most other users will be able to reclaim it. But -
(a) there is substantial underpricing of gas in the commercial market and we have doubts as to whether commercial and industrial electricity prices are fully economic;
(b) there is no reason to believe that prices for off-peak electricity, coal, or heating oils are below economic levels.

(ii) The size of gas underpricing bulks very large compared with what could be contributed by VAT. The real problem is economic rents. These total some £2bn of which about £600m are captured by the gas levy. Even with standard rate VAT only about $^1/_3$ of the outstanding rents would be captured (approaching £500m out of £1400m).

31. There is thus no simple way of effectively using VAT to get prices right. Multiple rates of tax would be complex and even so would only very approximately 'correct' relative prices.

32. One possibility would be to charge VAT at a single rate on 'primary' energy only. This would have many definitional rough edges, but on the positive side would leave off-peak electricity prices untouched and raise gas prices, which is where the major competition is within the domestic energy market. Again this is an extremely crude way of reducing the underpricing of gas. Moreover there is an economic case for extending VAT to all fuels when relative prices are got right. A VAT on primary energy alone does not help and may well make it more difficult to achieve this.

VAT on primary energy

	First year revenue effect £m	Full year revenue £m	RPI impact effect %
5%	170	230	0.2
15%	490	675	0.5

VAT on primary energy would increase BGCs EFL since gas sales will be diverted from the high price domestic market to lower price markets. But the extra demand for electricity will reduce the EFLs for the ESI and the NCB. Taking all three industries there would be a net reduction of roughly £80m with VAT at 5 per cent and £200-£250m at 15 per cent.

33. Although there will be some increases in social security benefits via the increase in the RPI (see para 2), these will work with a lag, and some groups will be affected more than average (as represented by the RPI weights). This could lead to pressure for higher increases and/or supplements for special groups to compensate for the increase in fuel prices, and of course would mean greater public expenditure.

EXTENSION OF VAT BASE: PUBLIC EXPENDITURE IMPLICATIONS

25/11/83

Note by FP

The Chief Secretary asked for a note on the public expenditure implications of the various options for extending the VAT base and the measures that might be taken to minimise them (Mr Gieve's minute of 3 November).

2. Public expenditure could be affected in a number of different ways by an extension of the VAT base:

i. the RPI effect will add to the cost of indexing social security benefits

ii. if VAT were imposed on children's clothing and footwear there would be pressure for a compensating increase in child benefit

iii. if VAT were imposed on domestic consumption of fuel and power it might be necessary to consider special measures to relieve the impact on poorer households

iv. there could be direct effects on the cost of Government purchases of goods and services

v. there could also be effects on nationalised industries' EFLs.

RPI effects

3. The extension of VAT to building alterations and non-domestic construction does not have an impact effect on the RPI, although there will be some effect on the RPI in due course to the extent that VAT on building costs feeds through in higher prices and ultimately affects rents and mortgage repayments. The impact effect on the RPI of the remaining elements of the Customs' package, assuming implementation on 1 April 1984, is about 0.5 per cent.

Social Security Benefits

4. The additional cost of indexing all social security benefits resulting from the implementation of the package will be about £175 million in a full year at 1984/85 prices. If the VAT changes are implemented on 1 April 1984 they will feed through into the May 1984 RPI figures, and will therefore be taken into account for the November 1984 uprating of benefits. The cost in 1984/85 will be about £65 million.

Child Benefit

5. If the uprating of Child Benefit announced next Spring were at or above the level of the RPI increase, after allowing for the effect of the VAT changes, it could be argued that no further action on Child Benefit was needed to offset this effect. There would, however, be pressure for a further specific addition to Child Benefit to offset the cost of bringing children's clothing and footwear into VAT. This is because the increase in CB resulting solely from the effect on the RPI of imposing VAT on children's clothing would amount only to about £8 million in a full year, whereas the additional VAT paid in a full year would be about £250 million.

6. About £50 million of the benefit of the current zero-rating for children's clothing goes to small adults rather than children, and so to offset the cost to children of the VAT change would require an addition to CB of about £200 million in a full year. There would be pressure to compensate for the cost of imposing VAT on children's clothing from the date of the change (1 April 1984) which would require an increase in CB from that date of 32p per week per child costing £200 million in 1984/85. Alternatively the same increase from November 1984 would cost about £70 million in 1984/85 but it would not compensate for the full effects of the VAT change in that year.

7. On the other hand, nobody would be able to say what the November 1984 CB increase would have been without the VAT change. This may allow some scope for reducing the effective cost. An increase of, say, 5 per cent to provide straight indexation would be 32p per week per child, and something in excess of this figure but less than the amount required for full VAT compensation plus RPI uprating might be sufficient.

8. All this, of course, only reflects the obvious fact that if losers are to be compensated for the cost of the changes, there will be no net benefit to the Exchequer.

Fuel and Power

9. Imposing VAT at 5 per cent on all fuel and power would have an impact effect on the RPI of about 0.33 per cent. Although this would be taken into account in the November uprating of social security benefits (costing about £45 million in 1984/85 and £120 million in a full year) there would probably be pressure for compensation from the date of the increase (say, 1 April 1984) which would make the 1984/85 cost the same as the full year cost. Alternatively or in addition there could be pressure for additional compensation for particular groups, eg poorer households, which have relatively heavy expenditure on fuel and power. It might be necessary to introduce special rebates similar to housing benefit for rates. At the very least there would be pressure for an immediate 5 per cent increase in the heating addition benefit which would cost about £20 million.

Government Purchases

10. The effect of imposing VAT on non-domestic construction would be to increase Central Government's expenditure by about £275 million in a full year at 1984/85 prices. (If fuel and power were also made liable to VAT the total would be about £300 million.) If the change in respect of construction were made on 1 October 1984, the increase in Government expenditure in 1984/85 would be about £140 million. This would have significant consequences for public expenditure and

departments' cash limits. There would also be an adverse impact on the PSBR in 1984-85 because at the year end some VAT payments will have been made by Government departments to their suppliers and not yet passed on by them to Customs and Excise. The introduction of a VAT refund mechanism for Government departments as envisaged in paragraph 15 of the Customs and Excise note would probably reduce substantially the effects on public expenditure and the cash limits. However, we would need to examine these implications in more detail before being able to come to a firm view.

Universities and Students

11. There would be pressure from universities for increased funds to compensate them for the additional VAT incurred on books, buildings, fuel and power. This could amount to about £60 million in a full year. Similarly, there would be pressure for increases in student grants to cover the additional VAT on books, fuel and power, and ultimately rents (as VAT fed through into construction costs). This could be of the order of £20 million in a full year.

Tax Thresholds and Allowances

12. The effect of the package would not feed through into tax allowances and thresholds until 1985/86 (when account would be taken of the December 1984 RPI figures). The cost of additional indexation as a result of the package would be about £100m in a full year. If fuel and power were also made liable to VAT at 5 per cent then there would be an additional cost of about £65 million due to indexation.

Effect of EFLs

13. Imposing VAT on all fuel and power would reduce demand by only a small amount, but the lower demand will increase energy nationalised industry EFLs. A rough estimate of the immediate impact is of the order of £75 to £100 million in a full year if VAT were applied at 5 per cent, and £200 to £300 million at 15 per cent. Subsequently the effect will fall as the industries adjust.

14. If, instead of applying to all fuels, VAT was imposed only on primary energy, the British Gas Corporation's EFL would increase (because gas sales would be diverted from the high price domestic market to lower price markets). However, the extra demand for electricity will reduce the EFLs for the Electricity Supply Industry and the National Coal Board. Taking all three industries there would be a net reduction of about £80 million with VAT at 5 per cent, and £200 to £250 million at 15 per cent.

15. If the imposition of VAT reduced price rises which would otherwise have occurred there could be additional effects on EFLs in later years.

SECRET

2% RPI

PM

E

F.

F.

P.

£2.3b

1.5 ypi

£ billions

25/11/83.

EXTENSION OF THE VAT BASE

INTRODUCTION

1. The Chancellor of the Exchequer's meeting of 26 October decided to pursue the possibility of an extension of the VAT base through the application of the current standard rate of tax to a range of currently zero-rated items. Annex 1 to this note lists the zero-rated Groups, and indicates those Groups, or part Groups, which remain candidates for taxation. This paper reviews the administrative and technical implications for HM Customs and Excise and for the businesses affected of applying the standard rate to the package identified by Ministers. It also seeks to establish a timetable both for further work on extension of the VAT base, including possible consultation with other Government Departments, and for the timetable for implementation by traders after any announcement of tax changes.

2. The paper also considers two other candidates for taxation: certain transport services and supplies of fuel and power.

THE PACKAGE IN DETAIL

3. Annex 2 looks in detail at the administrative and technical consequences of applying VAT to the package of Groups or parts of Groups which are clear candidates for taxation:

- Group 3 (Books, newspapers, periodicals, etc): whole Group
- Group 5 (Newspaper advertisements): whole Group
- Group 6 (News services): whole Group
- Group 8 (Construction of buildings etc): whole Group except new domestic construction
- Group 17 (Clothing and footwear): young children's clothing

most unwise

4. For books, newspapers, periodicals, etc (Group 3), newspaper advertising (Group 5) and news services (Group 6) we suggest that tax should apply to the whole of the coverage of all the Groups. There are no really substantial difficulties from a technical point of view in applying VAT to any of the Groups, but because of the close relationship between the goods and services that they cover, it would be preferable to apply the same tax rate to all three.

5. For construction of buildings etc, (Group 8) the underlying assumption is that the standard rate will apply to the whole Group with the exception of new domestic housing. This means that alterations of all buildings and all new non-domestic construction will become taxable. The taxation of alterations will remove the very difficult liability borderline between zero-rated alterations and taxable repairs and maintenance which has led to widespread confusion and administrative difficulties for our own staff and traders. We do not expect the imposition of taxation to lead to any serious administrative or technical difficulties, although any increase in taxation of the construction industry will encourage evasion and increase incentives to firms operating in the black economy.

6. Taxation of new non-domestic construction, on the other hand, will not necessarily increase VAT revenue, and for a number of reasons, there is little prospect of worthwhile receipts in 1984-85. The tax on supplies to fully taxable persons will, under the normal VAT mechanism, be offset against taxable outputs. The tax would, in theory, "stick" on supplies of construction to the exempt sector. But many concerns operating in this sector would be able to avoid the tax by obtaining their property through taxable companies that can recover most or all of the tax. The more widespread this practice turned out to be, the smaller would be the impact of taxation on both the exempt sector and the construction industry. There are two possible courses of action.

The first option would be to accept avoidance as inevitable, and, with it, a much lower revenue yield than is in theory available from taxation of this Group. The impact of taxation on the construction industry would be limited. But there would be difficulties of presentation in the Budget Speech and revenue estimates.

The second option would be to seek to devise anti-avoidance measures that would make the tax stick on the exempt sector. We are not confident of our ability to find ways of stopping avoidance, but the more successful we were, the greater would be both the revenue yield and the impact of taxation on the industries concerned. If the second option is pursued, it would be possible either to present the anti-avoidance measures as part of the Budget - which would call for consultation with other Government Departments before the Budget (see paragraph 20) - or to announce only the general intention to tax non-domestic construction and to decide after the Budget in the light of open consultation how best to maximise revenue yield. The latter course would have implications for timing but there are in any case transitional considerations which are likely to erode substantially the first year yield (see paragraphs 23 and 25).

7. In the case of young persons' clothing and footwear (Group 17) there are no important administrative obstacles to taxation and the application of VAT would remove a troublesome and time-consuming administrative borderline. As indicated in Annex 2, Group 17, all or some of the effect of taxation could be offset, if Ministers so wished, by an increase in Child Benefit, which is a better targeted relief since all dependent children qualify. The same Group happens to include protective boots and helmets; there are no technical objections to taxing these, but Ministers may wish to consider retaining zero-rating for them on the grounds that they are akin to the minor charitable and technical zero-ratings (e.g. talking books for the blind) which Ministers have already decided to preserve.

STAFFING IMPLICATIONS FOR HM CUSTOMS AND EXCISE

8. The main benefit for the Department in extending the tax to some or all of the items discussed above would be the removal of difficult borderlines the most awkward of which is between building alterations on the one hand and repair and maintenance on the other, where the need to answer enquiries and to try to police the borderline probably costs us some 20-30 man years of staff effort (say 25 for the calculation below). There would also be an increase in the overall cost-effectiveness of our operations, since the administrative machinery for zero-rating exists with the intention of collecting - precisely - nothing. This is demonstrated by the figures shown below for the marginal cost of collecting the additional revenue generated by an extension of the base.

9. There are of course offsetting costs. Some would be non-recurring, in answering enquiries and educating traders about their new liability position, and in registering or deregistering traders whose position was altered by the tax changes. Some currently unregistered traders in zero-rated goods and services would become taxable. On the other hand some traders with currently zero-rated outputs below the VAT registration threshold who have registered for VAT in order to claim back input tax would probably find it to their advantage to seek deregistration.

10. The most significant effect on staffing would result from the repayment traders that will become payers. Although the frequency of their returns would in many cases drop from monthly to quarterly, staff would have to ensure compliance by chasing up returns and payments, and where necessary making assessments and taking enforcement action to secure payment (with repayment traders the onus is of course on them to comply in order to obtain their refund). There would also be a new incentive for suppression of sales; generally

its effect would be slight, but we expect that it would require extra investigative work in relation to construction and clothing, and neither of these sectors are notorious for their high standards of compliance.

11. Against a register which currently has about 974,000 payment and 445,000 repayment traders, the changes we estimate are as follows.

(a) Books, newspapers etc and clothing affect some 125,000 traders: 350 would deregister and 12,500 would switch from repayment to payment.

(b) Construction affects about 220,000 traders; the net movement off the register would be about 2,000. It is very difficult to estimate how many of the 114,000 repayment traders would switch to payment, but we have assumed 50,000.

Thus some 62,500 traders would switch from repayment to payment. The total additional effort for collection, compliance and control work is estimated at about 120 many years, offset by 25 from simplifying borderlines - a net addition of 95.

12. To put these figures in context, the present staff effort on VAT is about 10,000 man years to collect £15½ billion at a cost of about 1.1%. The additional staff effort of 95, at a cost including overheads of about £1½-2 million a year, would be in respect of additional revenue in a full year of £1.1 billion - i.e. a <u>marginal</u> collection cost of under 0.2%. Ministers will also wish to note that no provision has been included in our 1984-88 manpower plans for an extension of the VAT base and we could not accommodate a staffing requirement of this order from within the targets we have been set. We would therefore need to make a claim on the national contingency margin to meet the increase in workload involved.

EC CONSIDERATIONS : IMPACT ON INFRACTION PROCEEDINGS

13. The rates of tax applicable in other EC Member States to the UK zero-rate Groups under consideration are summarised in Annex 3. The possibility of preventing the Commission from instituting infraction proceedings is not in itself an argument in favour of removal of existing UK zero-ratings. However, taxation of books and newspapers and related services, and in particular taxation of non-domestic buildings, would meet a large part of the Commission's case.

14. It should not however be assumed that taxing these products would result in the case being dropped. The Commission will be looking to see how we treat taxation of agricultural inputs and may continue to attach importance to fuel and power not supplied to the final consumer and (even) sewerage services and water. The UK would represent strongly to the Commission that major Budgetary action on zero-rating is sufficient to remove any reasonable ground for Commission action, but it cannot be guaranteed that the Commission would accept this. This might mean having to fight the Commission in the European Court over agricultural inputs or seeking to negotiate an administrative scheme which could replace zero-rating.

RELIEF FOR GOVERNMENT DEPARTMENTS

15. There are implications for the level of public expenditure which Ministers would need to consider. Application of VAT to the areas under consideration would impose a major additional expenditure burden on Government Departments, which we would estimate at about £300 million in a full year if the whole of the package were to be brought into tax. This does not however mean that public expenditure has to rise by any or all of that amount. One possibility of mitigating the effect would be to extend the arrangements already agreed for repayment of VAT on contracted-out services to a further range of Government

purchases. This mechanism would be similar to that already provided for local authorities who can obtain a refund of VAT in respect of purchases of goods and services so as to avoid burdening the rates with an additional charge. If however Ministers did want further consideration to be given to this option it would have to be borne in mind that any special measures introduced in favour of Government Departments would undoubtedly increase pressures (which have been strongly resisted in the past) from non-public sector bodies, in particular charities and other voluntary organisations, who cannot at present recover VAT on their non-business activities. There would also be little logic in restricting refunds to the items newly brought into the tax net as part of this package; the scheme would have to cover all VAT incurred by Government Departments. If Ministers wish, we and the Treasury can consider this question further in a separate paper.

THE ZERO-RATE GROUPS SUGGESTED FOR FURTHER STUDY : FUEL AND POWER AND TRANSPORT

16. Ministers asked us to study the possibility of extending taxation to these two Groups. Annex 4 examines them in detail.

17. For fuel and power (Group 7) we have assumed that either the Group would be dealt with as a whole or that electricity would remain zero-rated while the rest of the Group was brought into tax. Taxation would in either case give rise to transitional problems in relation to the probable need to apportion metered supplies of energy for tax purposes. The industries involved would also have to adjust their computer programs to take account of the rate change. There might be some liability borderline problems if electricity were to remain zero-rated, though there is no reason to suppose these severe. None of these technical difficulties is sufficient to make standard-rating

of fuel and power undesirable. However, if it was decided to tax them at a reduced rate in view of the social implications of standard-rating, this would raise the whole problem of a multi-rate structure, its scope, and the pressures to extend similar treatment to other items currently under consideration (or currently taxed at the standard rate).

18. Transport (Group 10) cannot be looked at as a whole. In the first place, many items are required for good reasons to be relieved under the EC Sixth Directive or would bring in virtually no revenue because they are invariably supplied to other businesses. Having set these items on one side, the main source of potential additional revenue under the Group lies with public transport within the UK. Because of the political difficulty of bringing the public transport services into tax, only to have to pay them higher subsidies to cover the increased costs, the scope of taxation would be limited to non-subsidised transport (in practice unstaged bus and coach services, air services and ferries and other boat trips). This would increase the existing disparity of treatment, most obviously between users of long distance coach services and British Rail passengers: and taxation of internal boat and air transport could be subject to particular political difficulties in respect of, for example, services to the Highlands and Islands, and the Isle of Wight. There would also be technical difficulties of apportionment of fares if we sought to apply VAT to the UK leg of international transport services, and we would also need advice on whether this would be consistent with our general international obligations in relation particularly to air transport. On the whole, we regard separating out this part of the Group as one of the least attractive options for taxation from an administrative point of view.

19. Fuel and power taxation would affect mainly nationalised industries, but there are a number of small firms. Of the total of 5,200 traders, we think up to 4,000, mainly coal merchants, would switch from repayment to payment. It is more difficult to estimate the administrative effects of taxing transport without knowing how far any change would extend. But assuming taxation of all internal journeys, whether or not subsidised, about 6,000 traders would be affected. Of these, 4,500 are repayment traders, and some 3,500 would switch to payment. The impact of these 7,500 new payment traders on our staffing levels would be to require a total additional effort of 15 man years.

CONSULTATION WITH OTHER GOVERNMENT DEPARTMENTS

20. The most complicated part of the package is non-domestic construction. If a scheme is to be devised which will prevent or minimise avoidance, it will be advisable to consult other Government Departments before the Budget in order to get the details right. This means talking to the Department of the Environment (on the implications generally of bringing non-domestic construction into tax) and the Inland Revenue (to tap their considerable expertise in this area).

21. If the package was extended to fuel and power, and transport, it could be necessary to consult more widely (e.g. DHSS and local authorities on benefit levels; Department of Energy on energy pricing and lead times for the introduction of changes; and Department of Transport on the impact on transport policy).

TIMING OF ANNOUNCEMENT AND DATE OF IMPLEMENTATION

22. If Ministers wish to aim for a Budget announcement of tax changes in mid-March we believe that a delay of about a fortnight (or possibly slightly longer) before implementation should be sufficient for most

traders in books and newspapers and clothing, which implies a starting date of 1 April for these items.

23. In the case of construction the picture is more complicated. For alterations a reasonably long lead time would probably be advisable to avoid protests from house-owners committed to substantial building jobs before the Budget announcement. 1 July would seem to be the earliest reasonable date, although there might be a case for a longer lead time (e.g. to 1 October). The political arguments would have to be weighed carefully against the first-year revenue implications. For new non-domestic construction some delay would be inevitable. First, a transitional solution would be needed to the problem of existing contracts; and second, there would probably be some advantage in holding open consultations with the various interests concerned, whatever the approach adopted to the question of avoidance (cf. paragraph 6). It would therefore be desirable to hold over taxation of non-domestic construction until at least 1 October, (cf. paragraph 12 of Annex 2, Group 8 note). Although it would be desirable administratively to aim for a single starting date for the whole construction sector, it might prove difficult to do so without foregoing some of the first-year revenue from alterations.

24. If the transport option was proceeded with, 1 April is probably a viable starting date. This would also be the case with much of the fuel and power Group. But metered supplies of gas and electricity would need special transitional arrangements, and there is also a case for delay in recognition of the fact that payments are generally made in arrears for fuel already consumed.

CONCLUSION AND TIMETABLE FOR MINISTERIAL DECISIONS

25. The timetable for Budget printing requires at least 6 weeks between final decisions and announcement of the changes. A Budget announcement in mid-March implies that decisions on the coverage of a standard rate package will need to be taken by the end of January. We think it desirable to consult the Inland Revenue and the Department of the Environment on certain aspects of the package. We recommend that discussions be initiated as soon as possible on a contingency basis, and would be grateful for an early decision on this aspect. If the fuel and power and transport options are to be pursued, it may be desirable also to institute appropriate discussions at an early date.

ANNEX 1

GROUP 1	Food	-	Retain zero-rate
GROUP 2	Sewerage Services and Water	-	Retain zero-rate
GROUP 3	Books, Newspapers etc	-	Strong candidate for standard rating
GROUP 4	Talking Books for the Blind	-	Retain zero-rate
GROUP 5	Newspaper advertising	-	Strong candidate for standard rating
GROUP 6	News Services	-	Strong candidate for standard rating
GROUP 7	Fuel and Power	-	Possible candidate for standard rating
GROUP 8	Construction of Buildings	-	Retain zero-rate for construction of domestic buildings; construction of non-domestic buildings and all alterations strong candidates for standard rating Why
GROUP 9	International Services	-	Retain zero-rate
GROUP 10	Transport (Internal)	-	Unsubsidised public transport a possible candidate for taxation
GROUP 11	Caravans and Houseboats	-	Retain zero-rate
GROUP 12	Gold	-	Retain zero-rate ?
GROUP 13	Bank Notes	-	Retain zero-rate ?
GROUP 14	Drugs	-	Retain zero-rate
GROUP 15	Imports/Exports	-	Retain zero-rate
GROUP 16	Charities	-	Retain zero-rate
GROUP 17	Young children's Clothing; Protective Boots and Helmets	-	Young children's clothing is a strong candidate for standard rating but there may be a case for continuing to zero-rate protective boots and helmets

GROUP 3: BOOKS, NEWSPAPERS ETC

PROPOSAL TO TAX

1. (a) Books, booklets, brochures, pamphlets and leaflets;
   (b) Newspapers, journals and periodicals;
   (c) Children's picture books and painting books;
   (d) Music;
   (e) Maps, charts and topographical plans.

TRADERS AFFECTED

2. These items are produced by general and specialist printers and sold through a very wide variety of retail outlets; some may be specialised (eg bookshops), but the great majority are likely to be traders who sell a (sometimes wide) range of other products which are liable to tax at the standard rate. For example, shops sell musical instruments and gramophone records as well as music; books are sold by shops, like W H Smiths, which also sell a wide variety of standard rated items such as stationery, stationery requisites, greetings cards and toys; newspapers, journals and periodicals are sold through newsagents, tobacconists, confectioners, which also sell a wide range of standard-rated products. The total number of traders affected is likely to be of the order of 60,000.

ADMINISTRATIVE REPERCUSSIONS

3. Most traders in this area are already likely to be registered for tax, and some are likely to be repayment traders if they specialise in publishing or retailing zero-rated items. A few traders may have registerd voluntarily in order to reclaim tax on their inputs and might wish to deregister; others would possibly be required to be registered.

4. Standard-rating would have some impact on the exempt sector, for example private schools and university libraries, since the tax could not be reclaimed. Local authorities would not be affected so far as their purchases for use, for example, in schools and libraries were concerned because they would be able to reclaim the tax under Section 20 of the Value Added Tax Act 1983.

5. Booksellers who deal in antique books would be able to take advantage of the special second-hand scheme for antiques, but the scheme would not apply to all rare books, some of which are of high value. There would likely be pressure to introduce a second-hand scheme for these.

INTERNATIONAL POSITION

6. The EC is a signatory to the Florence Agreement, which covers most of the items in this area, the basic aim of which is to ensure that the items are not subject to customs duties. There is, however, a let-out for internal taxes charged at importation provided that they do not exceed the charge made on internal supplies. The items covered are taxed in most EC Member States (see Annex 4).

GROUP 5: ADVERTISING IN NEWSPAPERS, JOURNALS AND PERIODICALS

PROPOSAL TO TAX

1. (a) The publication of an advertisement in a newspaper, journal or periodical.

(b) Various services supplied in connection with such a publication.

TRADERS AFFECTED

2. Taxation would directly affect advertising agencies, model agencies and others supplying services in connection with advertising, as well as a wide range of publications which would in any case become taxable if the present Group 3 relief were withdrawn. Some of these publications depend heavily on their revenue from private advertising for their existence (e.g. some newspapers, as well as Dalton's Weekly and Exchange and Mart). The total number of traders is of the order of 20,000 (including the large number also covered by the Group 3 relief).

ADMINISTRATIVE REPERCUSSIONS

3. Most printers and publishers are already likely to be registered for the tax, and some of them, because of the present relief for newspapers, journals and periodicals are likely to be repayment traders. These traders would in any case become payment traders if the Group 3 relief were withdrawn; the effect of withdrawing relief from advertising would be to apply standard rate tax to all their outputs.

GROUP 6: NEWS SERVICES

PROPOSAL TO TAX

1. (a) The outputs of news agencies such as Reuters, the Press Associations and Exchange Telegraph.

(b) The supply to newspapers of news items by freelance journalists.

(c) The general sale of information of a kind published in newspapers, collected by news agencies and similar organisations.

(d) Charges for use of the Prestel system.

TRADERS AFFECTED

2. Mainly news agencies and freelance journalists.

ADMINISTRATIVE REPERCUSSIONS

3. News agencies in general are likely to be registered for the tax as, in all probability, are many freelance journalists. The majority of large newspapers operate a self-billing system whereby they determine the liability of material supplied to them by freelance journalists. Figures on the number of registrations in this area are not available but it must be assumed that the majority are at present repayment traders. There would be a small cash-flow advantage to them and a corresponding cash-flow disadvantage to customers if relief were withdrawn.

GROUP 8: THE CONSTRUCTION INDUSTRY

PROPOSAL TO TAX

1. a. All supplies in the course of the construction, alteration or demolition of buildings or civil engineering works, other than the construction of new dwellings.

   b. The first time installation of double glazing, other than as part of the construction of new dwellings.

   c. The sale of a building, other than a dwelling, by the person who built it.

Materials and other goods used by a builder in building work would continue to have the same liability as the builders' services; and the relief for D-I-Y househuilders (refunds of tax on materials used) would remain.

ADMINISTRATIVE REPERCUSSIONS

Domestic and Commercial Alterations

2. There is one very significant advantage in changing the liability structure to tax these supplies. By removing the present distinction between alterations to existing buildings (which are zero-rated) and work which is not an alteration, or if it is, is also repair or maintenance (which is standard-rated), the single most difficult and time-consuming area of construction industry liability would be swept away. This is an area in which legislation is in any case necessary as we have reached the end of the road in trying to achieve a clear borderline through the Courts. If full benefit is to be gained from such a change, it is essential that there are no exceptions in the form of zero-rating for specific types of work, eg double glazing, energy saving work, housing improvement measures.

3. We think that the new dwelling/all other supplies distinction should be relatively easy to operate. We see no great difficulty in finding a suitable word to describe those buildings for which zero-rating will continue: "dwelling" is probably adequate but we can seek advice on this. A number of buildings, eg public houses, blocks of shops with flats above, are designed for mixed business and residential use. In these cases zero-rating should only apply to the construction and/or sale of the residential part. This will require apportionment but it should not be too difficult.

4. However so far as work on domestic property is concerned taxing alterations would further encourage the use of "black economy" traders to the detriment of legitimate small businesses. Small VAT-registered builders who can currently zero-rate alteration work (and the materials they use) may at the moment have a slight price advantage over the unregistered "black economy" trader who has to incur tax on his materials.

5. There would also be adverse effects on housing action programmes (including inner city initiatives) funded by Government or local authority grants to householders, housing associations etc unless the level of grants were increased to reflect the greater incidence of tax.

Substantial Reconstruction

6. At present we accept as zero-rated the sale of a "substantially reconstructed" building. This is doubtful in law, and we have been criticised by the VAT Tribunals for it, but has the sensible effect of putting reconstruction for sale on the same basis as contract reconstruction, which would be zero-rated as alteration. The relief is regarded by the housing and heritage interests as a valuable aid to the recycling of older property and the maintenance of the housing stock. It could be argued that substantial reconstruction is effectively as much a provider of new homes, particularly for less well-off first-time buyers, as the new housing market. There would therefore be some grounds for continuing the existing relief, and Ministers would doubtless come under considerable pressure to do so.

7. A decision would therefore be necessary on the future of the relief, and it is a matter on which Environment Ministers are likely to hold very strong views.

However, our advice would be against attempting to legislate for its continuation. In a regime where there is no relief for alteration or improvement generally, the case for special treatment of sale of reconstructed property is very much weaker. It is also a borderline which existing experience shows is very difficult to control in practice and is a fertile source for dispute. It would seem a retrograde step to allow relief for the speculative renovator for sale which was not available to the private householder, housing association or to landlords wanting to improve property for their tenants.

Sales of non-domestic Property

8. Under the present law, the supply by the builder of the freehold or a long lease (exceeding 21 years) of a building which he has constructed is zero-rated. The supply by the builder of a short lease on a new building is exempt, as is the supply of any interest in an existing building i.e. the sale or lease of second-hand-building.

9. Taxation of currently zero-rated supplies of non-domestic accommodation would have important consequences for purchasers and would risk causing some distortions in the commercial property market. If a firm seeking accommodation is taxable itself, it will normally prefer to receive a taxable supply of accommodation, so that it can recover tax under the input mechanism; an exempt supply will be to its disadvantage because of the burden of sticking tax which this implies. If the firm seeking accommodation is exempt, it would not be able to recover VAT under the credit mechanism and would therefore at first sight prefer to be in receipt of an exempt supply which would minimise its tax burden. However in practice we think that firms in the exempt sector would be able to avoid VAT on a taxable supply of property by channelling the purchase of the building through a taxable person in order that the tax falling on the construction of the building should be offset against taxable supplies before the building became available to firms in the exempt sector.

10. We do not at present know enough about the ramifications of the property market and property law to offer Ministers firm advice on whether avoidance of this sort could be prevented or on the best way of achieving this. We

feel however that some quite complex measures might be required, and it seems doubtful whether these would be successful in preventing a substantial revenue loss. The position is made more complicated by the interaction with the Sixth Directive, which requires Member States to tax sales of new buildings but provides for exemption of all leases and lettings of property, but with an arrangement available at the option of each Member State, whereby the parties to an exempt property transaction can be allowed to elect for it to be taxable. The Sixth Directive is an aspect which we shall need to consider very carefully if Ministers wish to announce a firm decision on commercial property in the next Budget and have any hope of securing a significant revenue yield from this source. One possibility would be to enter into immediate confidential consultations with officials at the Department of the Environment and the Inland Revenue who have more expertise on the workings of the property markets than we do. An alternative strategy would be to defer implementation of taxation until well after the Budget announcement so as to allow for a period of open consultation.

TIMING

11. Large building work involves a lengthy timescale for planning and execution. For VAT purposes, a tax point is generally created each time a payment is made or an invoice issued. Thus a sudden change in the VAT liability of non-domestic new construction would involve charging tax on payments made under on-going contracts, and on the sale (or long lease) of property which, when first conceived, was assumed to be zero-rated. This is less of a problem with building alteration work, although a sudden change would inevitably provoke loud protest from houseowners who were committed to a substantial building job eg extending their house.

12. Although any timing other than immediate implementation loses first year revenue and sets a precedent which can be invoked in relation to other goods and services, we think that there is no reasonable alternative to some sort of deferral. The simplest solution would be to introduce the change from say 1 October (on the assumption of a Budget announcement in mid-March) to allow reasonable time for adjustment and re-negotiation of contracts. This would appear to give only partial relief in respect of major commercial contracts which might take some years to execute, though there would be room for negotiation about phasing of payments which would help those concerned. The alternative is to relieve from the new VAT charge all contracts in force prior to Budget day. This would

allow building contracts to be completed on the terms envisaged when they were entered into. But there would be practical difficulties and ample scope for abuse in the form of back-dating or claims of firm oral contracts. It would also be necessary to make an exception in respect of rents currently zero-rated; otherwise the zero-rating could theoretically continue for hundreds of years. Our strong preference therefore is for a deferred date of change to apply to all payments after that date.

GROUP 17, ITEM 1: YOUNG CHILDREN'S CLOTHING

PROPOSAL TO TAX

1. Clothing and footwear designed for young children and not suitable for older persons. In practice relief is allowed to articles suitable for wear by an average sized child up to the fourteenth birthday.

TRADERS AFFECTED

2. Some 50,000 manufacturers, importers, wholesalers and retailers of clothing would be affected by the change. There is some specialisation, we believe, at the manufacturing stage, and there is a fairly wide variety of retail outlets ranging from departmental stores, through ordinary outfitters, to shops that specialise in goods for young children (eg Mothercare), other small traders and market stalls.

ADMINISTRATIVE REPERCUSSIONS

3. The great majority of traders affected sell goods which are at present standard rated and it is not likely that the relief for young children's clothing would result in many traders becoming repayment traders. Withdrawal of relief would result in administrative savings for most traders because it would remove a difficult borderline and result in them dealing only in goods subject to a single rate of tax. It is estimated that the change might result in 100 or so traders leaving the register.

4. The foot health lobby would be particularly vocal in opposing the change particularly bearing in mind that in 1972 the Munro Committee found that there was some evidence that the existing relief provided some incentive for the purchase of more sensible shoes.

5. Taxation would impose a burden on poorer families, but this could be broadly compensated by an increase in child benefit.

SECRET

ANNEX 3

VAT RATES IN THE EC ON POTENTIALLY TAXABLE GROUPS (20 OCTOBER 1983)

Standard rate:	Belgium 19%	Denmark 22%	France 18.6%	W. Germany 14%	Ireland 35%	Italy 18%	Luxembourg 12%	Netherlands 18%
Group 3 Books	6%	22%	7% (1)	7% (1)	0%	2%	6%	4%
Group 5 Newspaper advertisements	19%	22%	18.6%	14%	23%	18%	6%	4%
Group 6 News services	19%	22%	Exempt	14%	23%	18%	12%	Exempt
Group 7 Fuel and power	17% (2)	22%	18.6%	14%	5%	8%, 15% 20% (3)	6%	18%
Group 8 Construction of buildings (4)	17%	22%	18.6%	Exempt	5%	2%, 10% 18% (5)	12%	18%
Group 10 (6) Transport (internal)	6%	Exempt	7%	7% (7)	Exempt	Exempt (7)	6%	4%
Group 17 (8) Young persons' clothing and footwear	19%, 17% (9)	22%	18.6%	14%	0%	18%	12%	18%

NOTES

(1) Except pornography, which is taxed at the higher rate.
(2) This rate is for domestic fuel and power; motor fuel is taxed at 25%.
(3) 8% - gas and electricity, 15%-derv, 20%-Motor fuel.
(4) In every state except the UK, the same rate is charged on both new construction and maintenance/repairs.
(5) 2% - Public Residential buildings, 10% - low-priced dwellings; 18% - other.
(6) These rates are for the transport of passengers and not goods.
(7) Provided it takes place within a town (or between towns) of a distance of less than 50 k otherwise standard-rated.
(8) No Member State outside the UK distinguishes between young persons' and adult clothing/footwear.
(9) 19% - clothes, 17% - footwear.

ANNEX 4

GROUP 7: FUEL AND POWER

BACKGROUND

1. Ministers have indicated that they wished to consider the possibility of bringing all fuel and power into tax, or alternatively limiting the tax charge to primary fuels and continuing to zero-rate electricity.

ADMINISTRATIVE REPERCUSSIONS

2. Most traders in this sector are likely to be registered, but imposition of the tax may cause an increase in registration from small previously zero-rate traders who in the past have chosen to remain unregistered. Most registered traders are likely to be repayment traders, who would become payment traders if relief were withdrawn. We estimate that up to 4,000 (mainly coal merchants) could move to payment returns in this way.

3. The introduction of taxation may change cash-flow patterns for both the fuel and power industries and their customers. The precise extent of this will depend on the settlement times allowed within the trade, and their existing tax payment/refund arrangements.

TRANSITIONAL TAX POINT PROBLEMS

4. Suppliers providing metered supplies of fuel and power (e.g. the gas and electricity boards) would not be able to reach all meters on the day of the change in the rate. Under the VAT Regulations the tax point for this type of supply occurs each time a payment is received or a tax invoice issued. If this arrangement were left undisturbed the whole of the first bill after the date of the increase would be taxed at 15% even though it might relate to fuel consumed before the increase and even before the Budget statement. It would be possible to agree some form of apportionment with the supply boards for both standing charges and fuel charges, but we know nothing of their ability to implement it, or how much time they would need.

SOCIAL SECURITY BENEFITS

5. There are a wide range of such benefits. Many of them include an element for heating and lighting but any increase in fuel costs will affect benefits which are the main or supplementary source of income e.g. supplementary benefit, family income supplement and old age pension. The normal arrangement for increasing these benefits is for an announcement to be made in the Budget for the increase to be implemented in November of that year, but this only takes account of price increases up to previous May. If fuel costs were increased by the imposition of a positive rate of VAT at a date earlier than November there would be public demands for a corresponding earlier increase in benefits. There would be difficulties of timing both in the announcement of any increase in VAT and the uprating of benefits with different lead times being required by this Department and DHSS.

TIMING

6. The industry would no doubt argue for a long lead time to introduce the tax because of the time required to re-program computers and adjust pricing policy. Our only recent experience in this respect was the changes connected with the imposition of standard rate tax on lubricating oils which had been zero-rated. This change was first discussed with the oil industry on a confidential basis during the planning stage about six months before the Budget. The Order was subsequently laid on 26 March 1980 with an operational date of 1 May 1980.

GROUP 10: TRANSPORT

BACKGROUND

1. Ministers have decided that subsidised public transport should not be taxed because of the additional burden on public expenditure which this would impose. Most of the items currently zero-rated under the Group other than public transport are required to be relieved under the EC Sixth Directive, or would bring in virtually no revenue, because they are invariably supplied to other businesses. This note examines the possibilities of taxing unsubsidised public transport both internally and on the United Kingdom leg of international journeys, and of taxing salvage or towage services.

ADMINISTRATIVE REPERCUSSIONS

2. If unsubsidised transport is taxed and subsidised transport remains zero-rated there will be no problems of inequity and distortion of competition. This would become particularly apparent if for any reason a previously subsidised form of transport lost its subsidy since it would immediately have to suffer VAT for the first time as well (or if the legislation was drafted to enable the transport concern to keep its zero-rating the law would become increasingly anomalous and politically difficult to defend). Taxation of non-subsidised transport might also have an impact on privatisation plans eg for British airways.

3. Taxation of the United Kingdom leg of international transport could give rise to difficult apportionment problems to decide how much of the cost of transport was attributable to journeys within the United Kingdom or within the United Kingdom territorial waters or airspace (not much in terms of a journey from Heathrow to New York or even Brussels but this could be significant if the journey starts from Glasgow or on the ferry or hovercraft from Dover to Calais). None of these services are subsidised except for the rail part of British Rail trips to the Continent.

4. The VAT law in relation to the place of supply of services would need

amendment to catch foreign operators (but this is something we should have done under the Sixth Directive anyway) although this might cause some control/registration difficulties in respect of smaller operators. Some of this international traffic would be for business purposes but we would of course catch tourist journeys (outward and inward). This can be justified in terms of VAT as a tax on discretionary expenditure, but it would be criticised by British tourist interests. There would be no serious inequity if the subsidised part of British Rail continued to be zero-rated because British Rail has quite a small part of the total market. We would however have to consider carefully whether taxation of international journeys would infringe any international obligations both generally (for example in relation to cabotage agreements) and in respect of our EC commitments.

SALVAGE OR TOWAGE SERVICES

5. Taxation of salvage or towage services would bring in a very small amount of real revenue in respect of such services when supplied to pleasure boats, yachts. The bulk of the services are supplied either to foreign going vessels or British shipping companies able to deduct the tax.

SECRET

FROM: G W MONGER

DATE: 25 November 1983

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State
Mr Middleton
Mr Byatt
Mr Cassell
Mr Battishill
Mr Burgner
Mr Griffiths

Mr Knox - C&E

RPI

EXTENSION OF THE VAT BASE

At your meeting on 26 October you commissioned further work on a possible extension of the VAT base. Attached to this minute are:

a. a paper by Customs and Excise. This examines the administrative and technical implications and describes a timetable for further work.

b. an assessment of the economic effects, prepared by Treasury economists under Mr Byatt's direction, with a summary by Mr Byatt.

c. a note, as requested by the Chief Secretary, on the public expenditure implications.

COVERAGE

3. At your 26 October meeting you decided that it would be worth considering applying the standard rate to:

books, newspapers and periodicals
newspaper advertisements
news services
building alterations
non-domestic new construction
young children's clothing and footwear

All zero up to 5%

Annex 2 to the Customs and Excise paper looks in detail at the coverage of these items. The revenue effects in 1984-85 and a full year are in the table attached to this minute.

84-23-11

4. Do you agree that these are all condidates for inclusion in a standard rate package subject to further consideration of the issues concerning construction (see paras 7-9 below)?

5. As you requested, the Treasury paper (paras 27-33) examines the economic effects of extending VAT to <u>fuel and power</u>. In the light of of the assessment, and the possible repercussions from the introduction of a reduced rate of VAT, do you wish to pursue further the options of applying a 5 per cent rate either to all fuel and power or to primary fuels only?

6. Is there a case for applying VAT to <u>non-subsidised public transports</u>, or to any parts of it, such as unstaged bus and coach services?

CONSTRUCTION

7. A number of complex issues need to be considered in relation to construction as explained in paras 5-6 and Annex 2 of the Customs' paper.

8. So far as building <u>alterations</u> are concerned, the questions are:

a. whether there should be any exceptions for specific forms of work such as double glazing and loft insulation and

b. whether there should be legislation to continue the zero-rating of "substantial reconstructions". Customs' advice, with which we agree, is that any exceptions should be firmly resisted.

9. The major question in respect of <u>new non-domestic construction</u> is whether an attempt should be made to devise anti-avoidance measures that would make the tax stick on the exempt (mainly financial) sector. Without such measures any gain to the revenue seems likely to be small or short-lived.

TIMING

10. Customs recommend that tax changes for books and newspapers and clothing could apply from 1 April. Construction is more difficult

11. For alterations there is a case for a reasonable lead-time so as to minimise complaints that tax is being applied to work already in hand. Customs suggest either 1 July or 1 October for implementation. The latter would allow a longer lead-time but 1 July would bring in £110m more revenue in the first year.

12. As to non-domestic construction, there are three points on timing. First, a reasonable lead-time will be needed on account of work in hand. Secondly, deferring implementation for too long could run into severe problems with the EC. Thirdly, if an attempt is to be made to work out anti-avoidance measures, it is not yet clear whether internal consultation would be sufficient, or whether open consultation (with the industry and major consumers) would be needed after the Budget. This points to having urgent confidential discussions with DOE and Inland Revenue before a decision is taken on timing.

PUBLIC EXPENDITURE

13. So far as the public expenditure implications are concerned, the main issues are:

a. whether Ministers wish further consideration to be given to the possibility of refunding VAT on Government purchases eg of construction work;

b. whether an increase in child benefit should be considered specifically to compensate for an extension of VAT to children's clothing and footwear.

PSBR EFFECT

14. A full assessment of the PSBR effects of an extension of the VAT base would need to take account not only of the public expenditure consequences but also of the impact on direct tax revenue as a result of changes in output and profitability in industries affected by the VAT change. This would require simulation on the Treasury model.

EC CONSIDERATIONS

15. The substantial question here is whether taxation of non-domestic buildings, books and newspapers and related servcies would be an adequate response to the Commission's criticism of our zero-rates; or whether there would still be a risk of infraction proceedings (eg in respect of agriculatural inputs, and fuel and power supplied to industry).

NEXT STEPS

16. Since decisions will be needed by the end of January for an announcement in the Budget, you may wish to hold an early meeting to consider how this work should be taken forward.

G W MONGER

SECRET £% etc

boom

RPI constant

REVENUE AND RPI EFFECTS(1)

(£m 1984-85 prices and incomes)

½% no 71

Takeaway

'The Package'

	1984-85	Full year	RPI impact effect (%)
Books, newspapers and magazines	275	375	0.3
News services and news advertisements	20	25	Nil
Children's clothing and footwear +boom. cb.	180	250	0.2
Alterations(2)	225	450	Nil
Non-domestic construction(3)	0-70	0-275	Nil
Total	700-770	1100-1375	0.5

CA + VAT ½

Other possibilities

Food 5

		1984-85	Full year	RPI impact effect (%)
Fuel and power	5%	335	460	0.3
	15%	975	1350	1.0
'Primary' energy only	5%	170	230	0.2
	15%	490	670	0.5
Transport - coach services only		50	70	Neg

(1) Assuming implementation on 1 April 1984 unless otherwise specified.

(2) Assuming implementation on all payments after 1 July 1984; if the implementation date were 1 October 1984 the revenue would be about £110m. If the tax applied only to new contracts the 1984-85 revenue would be further rcduced.

(3) Assuming implementation on 1 October 1984 on all payments.

INDEXATION COSTS

(£m 1984-85 prices and incomes)

'The Package'

	1984-85	Full year
Social security	65	175
Tax allowances and thresholds	-	100

Fuel and power 5%

	1984-85	Full year
Social security	45	120
Tax allowances etc	-	65

Primary energy 5%

	1984-85	Full year
Social security	25	70
Tax allowances etc	-	40

SECRET

25 NOV 1983

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: B H KNOX

25 November 1983

CHANCELLOR

cc Minister of State
Mr Middleton
Mr Cassell
Mr Monger
Mr Griffiths

F

VAT ZERO RATES - CONSTRUCTION

1. You asked (Miss Simpson's minute dated 1 November) whether there would be any possibility of the UK getting away with taxing non-domestic construction, both new buildings and repairs, with domestic repairs moved from 15% to zero rate. You also wanted to know the yield offset that would arise.

2. The proposal discussed in my submission of today's date on extending the VAT base would do the following:

a. bring into the tax all alterations, both domestic and non-domestic - revenue yield +£450 million.

b. Bring into the tax non-domestic construction - revenue yield uncertain, for the reasons given in the submission.

c. Continue to tax all repairs and maintenance.

We assume that the alternative you have in mind would involve:

a. Not taxing domestic alterations and
b. relieving from the tax domestic repairs and maintenance.

Internal distribution: CPS
Mr Jefferson Smith
Mr Tracey

24-25-11

3. The effect of this on the revenue yield would be very substantial. £425 million of the revenue from alterations would come from the domestic sector, and you would be foregoing this. In addition, you would lose the revenue from domestic repairs and maintenance currently being collected, and this is estimated at about £175 million. This would involve a total turn-round of £600 million - ie you would not be getting £600 million in a full year which you could have got if you extended the tax in the way envisaged in the main submission.

4. As compared with the present yield from the tax, £175 million would be lost from domestic repairs and maintenance, and this would be offset by £25 million from non-domestic alterations and by a problematic amount from non-domestic construction. The difficulties and uncertainties over non-domestic construction are such that any net increase in revenue would be doubtful and there could even be a net loss.

5. There would also be EC objections. In our judgment, there would be no prospect of persuading the Commission to accept the extension of zero rating to domestic repairs and maintenance. Under the Sixth Directive we are allowed to maintain the zero rates in force at 31 December 1975 but it was agreed in the negotiations that marginal extensions could be made basically for technical reasons. It would be difficult to argue convincingly that an adjustment costing £175 million was only "marginal".

Boyce Knox

B H KNOX

FILE

Next 7 Annis (
Stock Relief - Inflation
CT/NIS

Corporate tax
- optimum basis
- much more economic work
- definite supply side advantage
- revenue neutral

VAT
- improve base
- VAT effect.

Brigethesion (same rate)
-RPI Constant

Savings + Investment (Pensions)
- meeting
- tax of pensions

Pension
SHS
TSG recco

Banks
- Building Socs ✓
- Composite Rate ✓
- Working Group on Bank Tax

30%

Small Firms
- Matters of presentation
pruning + simplification

differential rates

Stamp Duty (any of gifts)

Leasing of Houses

(1) Need to get ground cleared so
(i) more analysis
(ii) begin to look at packages.

(Mo droichean - Parlia day - average days)

Ch/Gx visits (Midlands business men)

FROM: MISS J C SIMPSON
29 NOVEMBER 1983

MR KNOX
Customs & Excise

cc PS/MST
Mr Middleton
Mr Cassell
Mr Monger
Mr Griffiths

f

VAT ZERO RATES - CONSTRUCTION

The Chancellor has seen, and was grateful for, your minute of 25 November analysing the proposal he made to relieve from tax all domestic construction, and tax all non-domestic construction.

2. He has now proposed another variant on this scheme; to leave the present tax position on domestic construction unchanged, bring into tax non-domestic construction and alterations. He recognises that the yield from such a scheme is likely to be small, but he wondered whether it would be sufficient to get the EC Commission to call off their infraction proceedings threat.

3. I think it would also be useful, for me if for no one else, if I could have a short note on the implications of the recent decision on Viva gas appliances.

4. On your main paper, we shall be setting up a meeting as soon as it can be arranged to discuss the whole issue. In the meantime, we should also be grateful for a note reminding the Chancellor (very briefly) why it is that we do not zero-rate those caravans that are not taxed, and also, what is the position on BR food.

JS.

MISS J C SIMPSON

10/29/11

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: B H Knox

5 December 1983

CHANCELLOR

cc Minister of State
Mr Middleton
Mr Cassell
Mr Monger
Mr Griffiths

PPS

VAT ZERO RATES : CONSTRUCTION

1. You have proposed (Miss Simpson's minute of 29 November) another variation on the construction theme. To leave domestic construction as it is at present and to tax all non-domestic construction - new buildings and alterations - would indeed remove the infraction threat so far as concerns zero-rating of construction. The taxation or non-taxation of domestic construction would be immaterial because the Commission are prepared to tolerate for the time being the existing zero-ratings covering supplies to private consumers. Whether taxing all non-domestic construction, together with whatever else was being done in the Budget, would be enough to persuade the Commission to drop their attack on the other non-domestic zero-rates is more debatable, since there would still be the risk that they felt bound to press their case on agricultural inputs; the answer would have to emerge from negotiations.

2. As you recognise, the revenue gain from this variant would be small, especially in 1984-85. Moreover, there are administrative reasons why we hope you would not leave the domestic construction side as it is.

Internal distribution:

CPS
Mr Jefferson Smith
Mr Tracey
Mr Taylor

49/5/12

3. We are putting separately to the Minister of State a note on the implications of the Viva Gas judgment (paragraph 3 of Miss Simpson's note). However, very briefly, the liability borderline between zero-rated alteration and standard-rated repair and maintenance has been a mess from the start of the tax and, following our upset in the Viva case, the position is now as bad, if not worse, than it has ever been. Moreover, it is in the domestic sector where the real money is and where most of the borderline problems arise. We would hope very much therefore that you would not pass up this opportunity to consider the VAT liability of construction in the round, i.e. not only from the EC infractions and revenue yield points of view but also from the point of view of having a sound and credible basis for taxation.

4. You also asked why some caravans are zero-rated and others taxed. Ordinary trailer caravans are liable at the standard rate as are lettings of all types of caravan when held out as holiday accommodation. Zero-rating applies only to those caravans which are too long or heavy to be towed lawfully on the public highway. These are mainly the large "mobile home" types of caravan which in practice rarely move from their permanent pitches. (There is a similar relief for houseboats used as places of permanent habitation.) This relief for large caravans (and houseboats) was introduced to fulfil Ian Macleod's 1969 undertaking that housing would be relieved of VAT. The caravans which are relieved are purchased mainly by less well off people as their only residence, and relief by zero-rating is considered to prevent inequity vis-a-vis purchasers of houses.

5. Finally, you asked about BR food, and it may be helpful to deal also with food supplied by airlines on domestic flights. Meals and snacks consumed at tables on BR trains are treated in the same way as catering in restaurants and taxed at the standard rate. For administrative convenience, food sold across the counter in buffet cars is aggregated with food supplied by station buffets. An

apportionment is made to take into account that although most of it is consumed "on the premises" (standard-rated), some is taken away for consumption elsewhere (zero-rated).

6. Catering supplied on domestic flights is treated as zero-rated so long as no separate charge is made and its value does not exceed 5% of the total cost of the ticket; otherwise it is taxable like any other catering. Bar sales are taxed at the standard rate.

Bryce Knox

B H KNOX

FROM: G W MONGER

DATE: 6 December 1983

PS/CHANCELLOR

cc PS/Minister of State
PS/Financial Secretary
Mr Middleton
Mr Cassell
Mr Griffiths
Mr Knox - C&E

F

VAT ZERO RATES: EXTENSION OF THE BASE

For the meeting which has been arranged to discuss this subject the Chancellor may find it helpful to have the following short table which gives the revenue yield at 1984-85 prices, split between domestic and non-domestic sectors, from applying VAT to new construction, building alterations, and repairs and maintenance. It must be emphasised that these figures represent broad orders of magnitude.

		Full year revenue (£m) VAT at 15 per cent	
	Current Vat rate	Domestic sector	Non-domestic sector (1)
New Construction (2)	0	500	0 - 275 (3)
Building alterations	0	425	25
Professional repairs and maintenance (excluding DIY)	15	175	25
DIY materials	15	300	-

(1) Excludes purchases by central Government.

(2) Excludes site values, but includes architects' and surveyors' fees.

(3) Range depends on extent of successful avoidance.

G W MONGER

21-6-12

File

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, HM TREASURY AT 3.00 pm ON THURSDAY, 8 DECEMBER, TO DISCUSS EXTENSION OF THE VAT BASE

Present: Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Mr Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Monger
Mr Griffiths
Mr Kerr
Mr Knox, Customs and Excise
Mr Jefferson-Smith, Customs and Excise

The discussion was centred around the papers circulated under Mr Monger's minute of 25 November and Mr Knox's of the same date on VAT and food.

1. General Approach

The Chancellor said there was a very strong case for doing something to extend the VAT base, and the obvious time to do it was in the Administration's first Budget. He therefore suggested that the present meeting should try to assemble a list of candidates from among the present zero-rated items which could be seriously considered for standard-rating. The Minister of State agreed with the idea of making substantial changes to the present VAT structure, but suggested that a much better option would be to tax all presently zero-rated items at 5 per cent. This would also give Ministers the option of reducing the tax on some presently standard-rated items by moving them to the reduced rate. He felt that this was a better way of getting a balanced package, and would also yield valuable revenue. He acknowledged that there would be considerable political difficulties with this, and that it might in the first year be necessary to provide off-setting adjustments within other parts of the tax or social security systems that would reduce the initial revenue yield, but also the RPI impact effect. He

91-8-17

estimated that the unadjusted revenue yield of an across-the-board 5 per cent VAT would be £2.3 billion, and the RPI impact effect 1.5 percentage points.

The Chief Secretary wondered how such a move would fit with the arguments the Government had deployed in 1979 about the advantages of having a single positive rate for VAT. It was, however, generally felt that this problem could, if necessary, be deflected by arguments that there were still only two rates of VAT, as technically speaking the zero rate was a VAT rate. Mr Knox said this would not cause any problems for Customs and Excise, but they would be very unhappy if they found themselves having to administer a rate structure including two positive rates as well as the zero-rate. The Financial Secretary said that he thought the option of taxing food generally had already been discarded, and he therefore felt that if it were accepted that food must continue to be zero-rated, it would make it very difficult to introduce a 5% rate for anything else. The Economic Secretary thought that financially the Minister's idea was extremely attractive, but he doubted if it would be politically possible. After further discussion, it was agreed that Customs and Excise should produce a paper analysing the possibilities for introducing reduced rate (not necessarily 5%), including the possibility of phasing/its introduction and measures for off-setting the RPI impact effect.

2. Books, Newspapers, News Services, etc

It was generally agreed that there should be no difficulty about taxing at 15% all the items in these groups *except* books. Proposals to tax books would inevitably produce cries about "a tax on knowledge". Although in many cases this would be unfounded, there was a serious problem with the question of educational books, many of which were bought by the final consumer or by bodies who were exempt and could therefore not deduct their input tax. The book trade was also unbuoyant. The Chancellor noted that most of the potential yield from these items came from those other than books, but he felt that for the time being he would

/like the

like the whole category, including books, to remain a serious candidate for taxation.

3. Children's Clothing

This was recognised as being politically much more difficult than taxation of books. It was recognised that a large amount of the initial impact could be off-set by increases in child benefit, and this approach found considerable favour. It would be possible gradually to reduce the off-setting element of child benefit, and thus increase the real revenue yield of the VAT. The Chancellor pointed out, however, that this would mean suffering the damaging RPI and public expenditure effects, as well as the inevitable public hostility, without initially having any revenue gain to show for it. Mr Middleton reminded the meeting that Anthony Barber had originally intended to tax all children's clothing and footwear, but had been forced to drop it after the first year. It was agreed that the option of taxing children's clothing should be dropped.

4. Alterations

The Chancellor suggested that it might be worth pursuing the option of removing the zero-rating from all building alteration work except such major works as loft conversions, cavity wall or loft insulation, or installation of central heating or indoor bathrooms. These were basically the items for which home improvement grants were available. Mr Jefferson-Smith pointed out that it was very difficult to calculate, without further consultation with the Department of the Environment, how much the potential revenue yield of £450 million would be lost by these exceptions, but Customs and Excise agreed to see what they could do from their own resources. It was suggested that the home improvement grant point was not an insuperable obstacle to taxing the whole range of building alterations. If desired, it would be possible to arrange things to provide suitable compensation, and it would be better to have a clear-cut policy

/that did

that did not produce a whole new serious of artificial borderlines. It was agreed, that the option of taxing all building improvements should be left in the list for the time being.

5. Non-domestic Construction

Mr Knox explained that Customs' examination of this question had revealed two particular potential difficulties. The first was that traders wholly in the exempt sector, from whom a great deal of the potential revenue yield would come, would almost certainly devise means of avoidance. The second was that within chains of basically taxable traders, there was often an exempt trader responsible particularly for property transactions. The second problem was the less difficult; there was a provision in the sixth VAT directive that allowed exempt traders in this position to be treated as if they were taxable, and six of the other member states in fact made use of this provision in exactly these circumstances. There was also a further complication in that a great deal of non-domestic construction was undertaken on behalf of the Government, who could not at present reclaim the VAT. It might therefore be necessary to consider extending more widely the provision which had been intended in last year's Finance Bill to relieve the VAT on contracted-out NHS services. Altogether, he felt that there would in the end be very little net yield from this item, nor a great impact on the construction industry; the great advantage of taxing this group would be the chance of deflecting EC infraction proceedings.

The Chancellor said that, although from a technical point of view this was an added attraction to taxing non-domestic construction, from the political point of view it was a distinct disadvantage. The Government would be expected to fight the EC, particularly in the present circumstances, and not simply give in to their demands. This view would be reinforced if it were

/generally

generally realised that the net revenue yield would be very small. The Economic Secretary felt that the option should be pursued, and that attempts should be to make it stick. Mr Knox pointed out that Customs and Excise could probably not do the necessary work on anti-avoidance provisions themselves; it would be necessary to talk to the Inland Revenue, who already had experience in this field. There would, however, be much less difficulty with this than there would be in talking to the Department of the Environment. The Financial Secretary suggested that it might be better to leave this for the second part of any package, and concentrate for this time on removing the liability problems on the alterations front. It was agreed that the option should be pursued, with active steps being taken to devise anti-avoidance measures.

6. Fuel and Power

The Financial Secretary said he did not want to rule out immediately the possibility of taxing primary energy at 15%, because of its large revenue effect. It was pointed out that this could create problems on the public expenditure front, and would also risk losing the gas levy. The Chancellor felt sceptical about the value of using VAT as a way of increasing gas prices, which he felt would be fixed according to what was judged feasible irrespective of this. The Chief Secretary also pointed out that this was an inauspicious time for the Treasury to be seen to be meddling in nationalised energy industry pricing. It was agreed the option should not be pursued any further.

7. Non-subsidised Public Transport

It was agreed that this was no longer a viable option for taxation.

8.. "Take-away" and "Junk" Food

(a) Take-away food. The Chancellor said he was very anxious to pursue this further. He was not convinced by Customs' arguments about

/the difficulties

the difficulties of finding a suitable border-line between taxed and untaxed food. Some concern was expressed at the political difficulty of taxing such traditional items of the British diet as fish and chips, and the Minister pointed out that the easiest border-lines to establish would almost certainly be condemned as discriminatory. It was also noted, however, that take-away food was a great growth industry, and therefore a buoyant source of revenue. The large service content in take-away food made a logical distinction between it and ordinary food bought for home preparation; this distinction was a much better one than the existing one between food served in restaurants and that served for consumption off the premises. The Chief Secretary entered a plea for the details of the tax schedule to be left to the Courts rather than attempting to embody it in legislation. It was agreed that the option should be pursued further.

(b) Junk food. The Chancellor pointed out that the existing list of taxed foodstuffs had been initially drawn up in 1972, and was very closely based on the purchase tax precedence. Since then, consumption and production patterns had altered radically, and he therefore thought this was a suitable opportunity to re-examine the list of taxed items to see whether it could be sensibly extended. The Financial Secretary felt that this would be likely to produce almost as large political difficulties as taxing the whole of food; the Government would be accused of making insensitive subjective decisions as to what

/should be

should be regarded as "proper food". It was pointed out that in many lower-income households, biscuits were an important part of the stable diet. The Chancellor said that he was not particularly wedded to the exact items which had been postulated in paragraph 11 of Mr Knox's minute of 25 November, but he did think that the natural extension of the categories could be devised, and asked Customs to go away and explore the options further. It was recognised that this was one case in which a detailed itemised schedule would be necessary.

9. Conclusions

It had been agreed that the following options should be pursued further:-

- books, newspapers, news services, etc.
- building alterations
- non-domestic construction
- take-away food

This would give a potential full-year revenue yield of £1 billion, with an RPI impact effect of 0.5 percentage points. The social security and other offsets were estimated at £275 million. Sir T Burns said that if the Treasury forecasts for the economy in 1984/85 were correct, an RPI impact effect of 0.5 percentage points would be quite feasible. It could be difficult if the more pessimistic forecasts proved to be correct, and it was also necessary to remember that revalorisation of the excise duties would also have an RPI impact effect.

The meeting closed at 4.25 pm.

JS.

MISS J C SIMPSON

9 December 1983

Distribution;

Those present
PS/Customs & Excise
Mr Battishill
Mr Lord
Mr Burgner

SECRET

19 DEC 1983

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: B H KNOX

16 December 1983

CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Mr Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Battishill
Mr Monger
Mr Griffiths

F

EXTENSION OF THE VAT BASE

... 1. Following your meeting on 9 December, I attach a paper on three options:-

- books, newspapers, news services, etc
- building alterations
- take-away food

2. Non-domestic construction is not covered, since we had thought that the conclusion of the meeting was that it was to be left on one side for the time being. Because of the nature of the work being taxed, there would have to be a time lag before implementation, so that little or no revenue would accrue in 1984-85. There is in any event a serious risk of avoidance, and unless there was sufficient certainty of

Internal distribution: CPS
Mr Jefferson Smith
Mr Wilmott
Mrs Strachan
Mr Harris

42-16-12

overcoming this to enable you to say that you expected a worthwhile yield from extending the tax to this sector, the change would be seen for what it was, an attempt to ward off EC infraction proceedings. If you want the option pursued, in order to work further on the avoidance issue, we must take expert advice on property dealings and in that case would be grateful for urgent authority to talk to Inland Revenue.

3. Paragraph 8(b) of the minutes indicates that you wanted some further exploration of junk food. I understand that you had in mind some extension of the present range of taxable food to bring in items which are closely similar and are not taxed because they have developed since the purchase tax charge was imposed.

4. These items were covered in paragraph 11(a) of my minute of 25 November. They are mousse and similar frozen dessert products, and savoury snacks similar to potato crisps, generally with a cereal base. We have no firm information about the potential revenue, but what information is available suggests that the revenue would not exceed £10 million. £60 million out of the £70 million forecast for the items in paragraph 11(a) would come from biscuits. Even a limited move to tax mousse and savoury snacks would open up argument on which foods should be taxed - it is often claimed that ice-cream is as much a food and part of the diet of ordinary families as those which are zero-rated. The sort of revenue yield which would be worth the controversy would only start to materialise if the tax were extended further into items such as biscuits, which the general view at your meeting was against.

5. We will be submitting separately a paper analysing the possibilities of a reduced rate as a general replacement for zero-rating.

Bryce Knox

B H KNOX

EXTENSION OF THE VAT BASE

POSSIBLE PACKAGE DISCUSSED AT THE CHANCELLOR'S MEETING ON 8 DECEMBER 1983

INTRODUCTION

1. At the meeting held on 8 December it was thought that a possible VAT extension package would involve taxation at the standard rate of the following currently zero-rated goods and services:

a) books, newspapers, periodicals etc; newspaper advertisements, news services

b) alterations to buildings

c) hot take-away food

This paper considers the practical and administrative implications of such a package (including those for the timing of any changes and for Customs and Excise staffing). It also gives estimates of its likely revenue yield and RPI impact effects. (These are also summarised in an Annex).

THE PACKAGE IN DETAIL

Books, newspapers, periodicals etc; newspaper advertisements; news services

2. There would be no substantial diffficulties in applying the standard rate to the whole of this group of goods and services. However, if it were decided to retain a relief for "books" in isolation, there would be a number of potentially serious borderline difficulties and anomalies.

3. There is no clear-cut definition of "book". Because the term has various shades of meaning, publications which at present fall more naturally to be described by other terms used in the zero-rating schedule (eg "booklets", "brochures", "journals") could often well fall to be regarded as books if these other more specific terms were deleted. Other items would continue to enjoy relief because they were produced in book format, eg children's picture or painting books, some music, and maps in atlas format, unless they were specifically made taxable.

4. A policy decision would therefore be required on what range of "books" should continue to be zero-rated. Despite the difficulties of distinguishing

at the borderline, we assume that Ministers would not want the relief to extend to brochures, pamphlets or leaflets, since these do not have a sufficiently substantial or permanent character. A borderline would also have to be drawn so as to exclude from relief all journals, whether or not published in book format. Once decisions have been taken on these issues, we would propose to deal with the borderline by zero rating "books" without definition, but specifically excluding from the zero-rating items which could be described as books but which it was decided to tax. Those could include brochures, pamphlets, leaflets, journals, periodicals, music, maps and topographical plans and childrens painting books. (Children's picture books would thus be zero-rated on books). This would be unlikely to produce a complete solution and would be a fertile ground for litigation, but it would seem to be the best approach available.

5. Even this, qualified, relief for books would be anomalous to the extent that relief or taxation would depend on the form in which a work was published, rather than its content. Books themselves are sometimes published as a series of part works, which cannot in themselves be regarded as books, and would therefore be taxed. In the other direction it would be argued, with considerable justification, that it was wrong to relieve popular fiction, some of which is in very poor taste, but to tax scientific and other learned journals and periodicals. It would not be possible to operate a relief based on a subjective judgment of the relative "worth" of particular publications; the only justifiable counter is to treat all publications in the same way. This is of particular relevance in the case of 'educational' books bought by universities, schools etc. Taxation of all books could lead to an increase in these institutions' spending of the order of £10m. But it would not be possible to operate a relief for 'educational' books alone, since this could only be delineated by reference to the books' content.

6. The revenue yield from taxing all goods and services in this group would be £290m in the first year and £400m (at 1984/5 prices) in a full year, with an RPI impact effect of 0.3. These figures would fall to £230m (first year), £315m (full year) and 0.2 if books were excluded from taxation.

Alterations to buildings

7. There would be no serious technical problems if all alterations were taxed. Our administration of the tax as it affects builders and specialist contractors would be greatly simplified and the possibilities of evasion by the misdescription of much standard-rated repair work as zero-rated alterations would be eliminated. The one technical problem we foresee relates to the liability of work involving the erection of a new building making use of an existing facade or when some of the walls of an existing structure are incorporated in an otherwise completely new building. Such cases will be relatively few in number and we think that we shall be able to devise a

suitable administrative interpretation of what constitutes the construction of a new building as opposed to the reconstruction or major renovation of an existing one.

8. There will of course be other non-technical repercussions of taxing all alteration work. There will be increased pressure for some public expenditure on house improvement grants and more noise from the charities' lobby in support of the campaign for a general VAT relief.

9. Taxation of all alterations would raise revenue of the order of £250m in the first year (assuming a starting date of 1 June - see paragraph 22) and £450m in a full year. Continuation of relief through zero-rating for specific categories of alteration could cut revenue to as little as £65m in a full year (see paragraph 10). Alterations do not figure in the RPI, so there would be no direct effect on the index.

10. Our preferred approach remains to tax all alterations to all kinds of property. However, if Ministers wish to consider retaining some relief, the following illustrative table shows various possible zero-ratings. The revenue estimates are very rough, being based on imperfect data.

	1984/5 full year revenue cost
	£m
(a) first-time installation in dwellings of =	
- central heating	100
- double glazing	90
(b) loft and cavity wall insulation and damp-proof coursing in dwellings	20
(c) alterations to dwellings to provide increased habitable space (room extensions, loft conversions))	
(d) first-time provision of inside bathroom/WC)	175
(e) first-time erection of private garage)	

Relief for these items could be justified on a mixture of social/basic amenity/energy conservation grounds. Some would be more deserving of relief than others. Double glazing was zero-rated as recently as 1982, and, with loft and cavity wall insulation, would perhaps have the highest claim to continuing relief. At the other end of the scale, the erection of a private garage is perhaps the least deserving. More generally, apart from the revenue cost, any relief package creates its own borderline difficulties and evasion possibilities and brings in its wake pressure for further concessions for reasoms of analogy or anomaly. Further, relief runs counter to the "received view" that VAT should not attempt to reflect every aspect of social policies but should restrict itself to broad priorities. In this context relief for the items mentioned above would inevitably be contrasted with the taxation of essential repair jobs such as a re-roofing or re-wiring. A final point is that some of these candidates for relief may be eligible for improvement or other grants - insulation, damp-proofing and the provision of bathrooms and toilets certainly fall into this category. We do not think that this necessarily strengthens the argument for relief; VAT is fundamentally a broad-based tax, and many taxable repair jobs, for instance, (eg those mentioned above) are already eligible for grants.

11. Taxation of alterations raises two further issues: that of garages, greenhouses and garden sheds added to existing houses (they are currently zero-rated), and the treatment of fitted furniture and kitchen equipment.

(a) Garages, greenhouses, garden, sheds etc

If these are detached structures, they count as buildings in their own right and the construction of them would continue to be zero-rated. On the other hand, if built on to the structure of an existing house (and that is a normal possibility only for garages), the work would be standard-rated as an alteration to an existing building. There would be a somewhat perverse fiscal incentive to have a detached rather than an attached garage. Also it would be indefensible (except to gardening enthusiasts and suppliers of greenhouses and the like) to allow zero-rating for greenhouses, sheds and other outbuildings when major extensions providing extra living space in the dwelling were taxed. Fortunately, however, the solution is fairly simple. We could exclude any building work in the grounds or garden of a dwelling from relief in the same way that we already do for the civil engineering work involved in the construction of private swimming pools, tennis courts or elaborate patios. We would, however, ensure that a garage constructed at the same time and under the same contract as a new house would be treated as part of the house and zero-rated.

(b) Fitted furniture and kitchen equipment

We should like to take the opportunity afforded by the withdrawal of zero-rating for general building alteration work to eliminate any possibility of further loss of VAT in respect of fitted bedroom furniture and of major consumer durables in fully fitted kitchens in new houses. When the tax started, the intention was to zero-rate as builders'fixtures the sort of goods that a buyer of a new house or flat would expect to be provided by the builder without extra charge. But builders are now supplying more and more fixtures and there has been a rapid expansion of fitted bedroom and kitchen specialists. We are now at the point where, without a change in the law, we will have to concede tax free fitted furniture in bedrooms. As regards kitchens, we have no wish to claw back on those cupboards and general purpose units/working surfaces that can be regarded as essential fitments in any new house. However, following a Tribunal decision, we have already had to concede zero-rating for built-in split level cookers and we may soon be at risk in respect of other cookers, fridges/freezers, washing machines and dishwashers when supplied as part of a "fully-fitted" kitchen. The withdrawal of zero-rating for general alteration work will mean that we will in future be at risk only in respect of fixtures in new houses but, even so, there is no justification for purchasers of new houses getting much of their bedroom furniture and kitchen equipment tax free merely because it is supplied fitted with the house. There is obvious distortion of competition with suppliers of free standing furniture and in principle all consumers should bear tax on major items of household equipment such as cookers, fridges, washing machines etc irrespective of the method of purchase. The loss of revenue is not large at present - of the order of £5-10m for fitted bedroom furniture and split level cookers - but it could increase substantially in the future if no action is taken. We therefore recommend that, as part of the Budget package, the law on supplies of builders' fixtures should be amended so as to exclude from relief fitted bedroom furniture and major items of kitchen equipment other than the usual kitchen cupboards and units.

Hot take-away food

12. The revenue yield from taxing this group would be £130m in the first year and £200m in a full year, with an RPI impact effect of 0.2.

13. We seriously doubt whether the problems of justifying and controlling the taxation of hot take-away food are any easier than those which would be associated with the taxation of take-away food generally, and indeed they would in some respects be much more difficult.

A definition on the lines of "hot food (or drink) suitable for immediate consumption" would catch all hot food, such as fish and chips, but there would be particular problems with mixed supplies which included both hot and cold elements sold at a single price (a hot sausage with French bread, and tea with a biscuit are simple examples). We think it would be necessary to provide that a mixed hot and cold take-away sold as a single menu item would be taxed as if it was wholly hot.

14. The main problems with taxing hot take-away food, based on a general definition, is that it would create numerous anomalies, possibly leading to distortion of trade and competition, and there would be significant scope for tax avoidance and evasion. These could be such as to bring the tax in this area into disrepute. Hot take-away food (such as hamburgers) is often in competition with cold take-away food (such as sandwiches and seafood) which is being sold from adjacent sources, for example, from vans outside football grounds. The service element may be no different in the two cases and neither the trade nor its customers would readily understand or accept the difference in tax treatment. Moreover, some take-away food can be eaten hot or cold (for example, sandwiches - which may be fresh or toasted, pies, pasties, sausages, buns and doughnuts); there could be problems - for example, a seaside pieman who starts his walk down the esplanade standard-rated and finishes it zero-rated. There would be considerable scope therefore for traders to avoid tax and it would have to be accepted that the revenue yield might gradually be eroded.

15. There would also be considerable scope for evasion, because it would be very difficult to prove after the event what had been sold hot and what had been sold cold. Although we would aim to agree an apportionment with traders, in the same way as we do at present for take-away food and food for consumption on the premises, we suspect that the demand for hot or cold food is much more flexible, and much greater scope therefore for initial underdeclaration and subsequent suppression of taxable takings. The infrequency of control visits would make evasion very difficult to detect and prove and there would be considerable scope for complaint from honest traders.

STAFFING IMPLICATIONS FOR H M CUSTOMS AND EXCISE

16. As with the package discussed in our paper of 25 November, the main staffing benefit derives from the elimination of the present awkward borderline between alterations and repairs/maintenance. The saving to be gained here will of course be eroded if the retention of reliefs for particular categories of alteration is contemplated. Compared with the previous package, the current proposals have lost non-domestic construction and children's clothing but have gained hot take-away food.

17. We estimate that the following changes in the VAT register would occur:

(a) books, newspapers etc affect some 75,000 traders: 250 would deregister and 9,500 would switch from repayment to payment

(b) alterations: there are 220,000 traders in the construction sector, of whom 114,000 are repayment traders. On the assumption of taxing all alterations, some 40,000 of these would switch to payment returns, the number depending very much on the scale of any continuing zero-rating. There could be a net movement off the register of about 1,500.

(c) take-away food affects some 29,000 traders. We expect 12,500 to switch from repayment to payment. Movements on and off the register should roughly cancel out.

Overall up to 62,000 traders would switch from repayment to payment. This is very nearly the same as under the previous package, and therefore our estimate of the total additional staff effort, after accounting for compensating savings, is the same (95 man years). If books and a range of alterations continued to be zero-rated this figure would fall by some 20-35, depending on the alterations chosen.

18. Nevertheless, the package would increase our cost-effectiveness, on the lines explained in paragraph 8 of our previous paper. The figures comparable to those quoted in paragraph 12 of that paper would be on the following lines:

additional staff effort	95
additional staff cost	£1½-2 million
additional full year revenue	£1050 million (1)
marginal collection cost	0.19%
overall collection cost	1.1%

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(1) assuming taxation of all alterations and books

EC CONSIDERATIONS

19. There are no obstacles under EC law to taxation at the standard rate of the goods and services in the present package. Taxation of newspaper advertisements, news services and alterations would meet the Commission's claims that these should not be zero-rated when supplied to business users. However, this will almost certainly not be sufficient to head off infraction proceedings on a number of items that would still be zero-rated (particularly non-domestic construction, agricultural inputs and supplies of fuel and power other than to final consumers). Indeed, the Commission may be encouraged to pursue infraction proceedings by the elimination of some zero-rates, considering that thus "The mould had been broken".

RELIEF FOR GOVERNMENT DEPARTMENTS

20. Application of VAT to the areas under consideration would impose a small but unquantifiable additional expenditure burden on Government Departments which is very difficult to estimate, but is unlikely to be significantly more than £25m. Such a burden would not in itself justify the introduction of a repayment scheme on the lines discussed in paragraph 15 of our paper of 25 November.

CONSULTATION

21. We do not think that the extension of taxation to any of the elements of this package will raise problems that will call for a major consultation exercise, either before or after the Budget. In any case, the timing of the introduction of taxation on alterations - see paragraph 22 below - would enable any consultation on minor issues to be carried out after announcement of the changes.

TIMING

22. As explained in our previous note, books, newspapers etc could be taxed from 1 April (assuming a mid-March Budget). We think that the best date for the taxation of alterations (and the proposed change in the law on builders' fixtures)would be 1 June. This would be the beginning of a tax period for most builders. That would be convenient for them. Also 1 June would allow roughly 2½ months for major alteration work in progress on Budget day to be completed with the benefit of zero-rating but without allowing too much time for avoiding the tax on work not already started by then. The normal

transitional provisions for dealing with VAT rate/liability changes will also mitigate any hardship that might otherwise be caused by a 1 June date. The builder can apportion the work so that only the amount of work done after the effective date of the change would bear tax and the customer can avoid the tax altogether if he is willing to pay for the work in advance of the effective date.

23. The taxation of take-away food would require the registration of significant numbers of currently unregistered traders. The need to carry out educational visits and to allow sufficient time for changes to traders' bookkeeping systems suggests that an implementation date of 1 May would be appropriate.

ANNEX

REVENUE YIELD FROM ABOLISHING CERTAIN ZERO RATES

	First year revenue	Full year revenue	RPI impact effect
	(£m, 1984/85 prices)		
Books, newspapers, periodicals etc; newspaper advertisements; news services	290	400	0.3
Alterations to buildings	250	450	nil
Hot take-away food	130	200	0.2
	670	1050	0.5

SECRET

19 DEC 1983

FROM: G W MONGER
DATE: 19 December 1983

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Economic Secretary
Financial Secretary
Minister of State
Mr Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Battishill
Mr Griffiths
Mr Lord

Mr Knox - C&E

f

EXTENSION OF THE VAT BASE

I agree with Mr Knox's submission of 16 December, and would like to add two points.

2. First, on non-domestic construction. The general feeling at your meeting was against inclusion of this group in the basic package, mainly on the ground that it would be vulnerable to avoidance. But taking non-domestic construction would have these advantages:

a. If effective anti-avoidance devices could be worked out, it would raise significant extra revenue, up to £275m in a full year.

b. It would have no direct impact on the RPI, or ordinary consumers.

c. It would deal with the biggest single disagreement with the Commission, and perhaps satisfy them entirely.

3. I wonder therefore whether it would not be better for every attempt to be made to identify suitable anti-avoidance measures before the idea is rejected. Could Customs be authorised to open discussions with the Inland Revenue (though not DOE) for this purpose before a final decision is taken?

4. As to the taxation of hot takeaway foods, the Customs have identified difficulties which are real if not insuperable. I wonder therefore whether it is worth also looking again at the case for the

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extensions of the present boundary earlier proposed by Customs to cover mainly biscuits, cakes and jams. This would have these advantages:

a. It would raise a significant sum - over £200m, about as much as hot take-away food.

b. It should not lead to substantial new boundary problems.

c. It might not appear as a major new policy. If chocolate biscuits are already taxed, then taxation of plain biscuits may not look like a revolutionary change.

G W MONGER

FROM: MISS J C SIMPSON
DATE: 3 January 1984

MR MONGER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Byatt
Mr Cassell
Mr Battishill
Mr Griffiths
Mr Lord
Mr Knox - C&E

F

EXTENSION OF THE VAT BASE

The Chancellor has seen your minute of 19 December, commenting on Mr Knox's of 16 December, which he has also read with interest and was grateful for.

2. He is content that Customs and Excise should follow-up the suggestion made in your paragraph 3 that they should open discussions with the Inland Revenue to see if it is possible to identify suitable anti-avoidance measures which would make the taxation of non-domestic construction a viable proposition.

3. On the question of the taxation of take-away food, (paras 12-15 of the Customs and Excise paper) he has asked whether Customs and Excise are suggesting that some other basis of taxability than the distinction between hot and cold would be better, and if so what they have in mind.

JS.

MISS J C SIMPSON

SECRET

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: P Jefferson Smith

6 January 1984

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Battishill
Mr Monger
Mr Griffiths

f

EXTENSION OF THE VAT BASE : INTRODUCTION OF A REDUCED RATE

Introduction

1. At your meeting on 8 December it was agreed that we should produce a paper analysing the possibilities for introducing a reduced rate (not necessarily of 5%), including the possibility of phasing its introduction and measures for offsetting the RPI impact effect.

Potential Coverage of a Reduced Rate

2. A reduced rate could not be extended automatically to all existing zero-rate Groups. For the reasons set out in the paper attached to Mr Monger's note of 27 July (paragraph 14), some of the present Groups are zero-rated on technical rather than on social or political grounds. The main example is exports, where the zero-rate avoids burdening exported goods with any residual UK VAT, but similar considerations apply to international services, ships, aircraft and international travel. Different but equally technical reasons lie behind the zero-rating of bank notes and certain supplies of gold.

Internal distribution:

CPS
Mr Knox
Mr Wilmott

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3. Certain other Groups are zero-rated on mainly humanitarian grounds (e.g. talking books for the blind; drugs, medicines etc; some supplies by charities). We assume that these reliefs would be maintained.

4. The Groups (or part-Groups) of currently zero-rated goods and services which remain as potential candidates for a reduced rate are:

Group 1 - food
Group 2 - sewerage services and water
Group 3 - books, newspapers etc
Group 5 - newspaper advertisements
Group 6 - news services
Group 7 - fuel and power
Group 8 - construction
Group 10 - transport (part)
Group 11 - caravans and houseboats
Group 17 - young person's clothing and footwear

Some of these items would be standard-rated under the VAT extension package currently under consideration.

Level of the Reduced Rate

5. Under EC rules a reduced rate must be set high enough to ensure that there are no regular refunds of input VAT. It is difficult to calculate in advance what the minimum acceptable rate would be, since the position of individual trading sectors would vary mainly according to how far their inputs had borne VAT at the standard-rate. Food accounts for about half the consumer expenditure on the main currently zero-rated goods and services, and we think that here a fairly low rate (say, 2%) would satisfy EC rules. In other sectors with more standard-rated inputs (e.g. young children's clothing) a higher rate might be needed. We think it likely that a 5% rate would be high

enough to avoid significant problems in most areas. However, it is likely that the EC Commission would accept a lower rate, for a time at least, as evidence of a definitive move away from zero-rates. It is perhaps reasonable to assume that a 2% rate would be tenable, at least initially, though Ministers would be subjected to a great deal of probing at home and abroad about their future intentions.

Potential Yield and RPI Effects

6. Applying a 5% rate to all the items listed would yield nearly £2½ billion in a full year (1984/85). The total RPI impact effect would be just under 1½% (taxation of Groups 2, 5, 6, 8 and 11 would have negligible first round effects on the RPI). Other rates would have roughly proportional effects; e.g. a 2% rate would yield just under £1 billion with an RPI effect of 0.6%. If the items currently under consideration for taxation at 15% (books, newspapers etc; alterations; hot take-away food) were excluded, the yield and RPI effect of a 5% rate would be just over £2 billion and 1¼% respectively. The corresponding figures for 2% would be just over £¾ billion and just over ½%.

A Presentational Point

7. The introduction of a reduced rate could be criticised as complicating the present VAT rate structure. The advantages of the single positive rate have been proclaimed by previous Conservative Chancellors - by Lord Barber when VAT was introduced and more recently by Sir Geoffrey Howe when in 1979 he replaced the previous administration's two positive rates by the current 15% rate. Nevertheless, the UK VAT system can be regarded as always having had at least 2 rates: the standard-rate and the zero-rate (plus at times an increased rate). There would be advantages in presenting a new reduced rate as a replacement for the zero-rate rather than as an

addition to the system. The "technical" and "humanitarian" reliefs would need to be maintained; but the VAT legislation could be recast so as to present them, not as zero-rates, but as exemptions or exclusions from the scope of the tax, with refund of tax where appropriate. This would square better with the Sixth Directive and could well produce a considerable simplification of UK law in relation to international services. The zero-rate would thus cease to exist as a rate of tax.

Strategy for Introducing a Reduced Rate

8. Considerations of consultation and timing (see paragraph 18 below) appear to preclude implementation of a reduced rate immediately following the 1984 Budget. A change later in the year would be a possibility, though first year revenue would be foregone; otherwise a comprehensive package would have to await 1985. If Ministers decided on a VAT package for 1984 that involved taxing certain zero-rated items at the standard-rate, it would be clear that "the mould had been broken", and further moves in subsequent Budgets could be presented as a continuation of that action. Given the magnitude of a change involving abolition of the zero-rate, the reform would be seen as a major shift in the relative burdens of direct and indirect taxation. But a decision to follow up an extension of the standard-rate with a much wider reduced rate would have implications for the items to be included in the standard-rate extension package: it would be undesirable to move (e.g.) alterations up to the standard-rate and later move them down again.

9. A disadvantage of introducing a reduced rate would be increased pressure to move standard-rated items into it. Campaigns for extensions of the zero-rate can at present be resisted by pointing to the EC constraints. This prop would disappear if a reduced rate existed, and indeed one of the possibilities for offsetting the RPI effects considered later in this paper is to take items from the standard-rate into the zero-rate. But there would be serious danger that a reduced rate would open up argument from protagonists of all the worthy causes; if serious erosion of the revenue was to be avoided, a

robust line would need to be taken from the outset, that the move was part of a UK taxation strategy, which was not to be undermined by concessions, however deserving.

Offsetting the RPI Effects

10. Depending on the rate chosen, there would be RPI impact effects ranging from ½% (with a 2% rate) to 1½% (5%) or higher. If it was felt that the impact of a rate of say 5% on the RPI was too high, action could be taken to moderate it. There are two basic alternative approaches. First, the VAT-induced price rises could be directly or indirectly compensated for (i.e. action could be taken directly on those prices raised by the new VAT rate or indirectly on other prices to produce a compensating change in the RPI). Second, the overall RPI impact could be phased over a period, so that there was no immediate "lump" in the index attributable to VAT. Either approach could lead to accusations of manipulating the RPI.

11. Compensation would mean there was either no overall change in the RPI or the change was reduced to a level judged acceptable. But it would involve public expenditure (i.e. price subsidies) or a loss of tax revenue. Public expenditure not directed at holding prices down (e.g. an increase in child benefit) would have no effect on the RPI, even though it might offset adverse distributional consequences of the tax change. We assume that Ministers would not be attracted by the compensation-by-subsidy option, and it is not considered further.

12. Compensation through the tax system would necessarily involve only those taxes that impinged directly on prices (i.e. VAT itself and the main excise duties). To offset completely an RPI effect of 1½%

(a) the standard VAT rate would need to come down by about 3 percentage points (i.e. to 12%);

(b) or the reduced rate would have to be applied to a substantial part of the standard-rate coverage (to compensate for a 5% reduced rate, it would have to apply to about one-third of the present standard-rate coverage);

(c) or substantial reductions would need to be made in some of the excise duties (e.g. 20p off a gallon of petrol, plus 10p off 20 cigarettes, plus 10p off a pint of beer). The excise reductions would be too large to be made simply by foregoing revalorisation in a single year; with 5% inflation the duties would need to stand still for three years.

Full compensation by any of these means seems a non-starter: it would shift the balance of indirect taxation in a contentious way with nothing in absolute terms to show for it.

13. For partial compensation, to reduce the RPI increase to an acceptable level, the excise duties option is the least attractive. Unless all that was involved was a mere shading down which could be justified on other grounds, it could lead to accusations of taxing food (or housing, or fuel) while compensating drinkers (or smokers, or motorists). A reduction in the standard-rate of VAT would be less open to attack, but would make the tax less progressive. The preferable option would be to select VAT standard-rated items for reduction to the reduced rate. The prime candidates would be repairs and maintenance and adult clothing and footwear: reducing these to 5% would produce revenue and RPI offsets of £1 billion and 0.6% respectively. Other possibilities would be standard-rated foods and catering (£0.9 billion and 0.4%), but these would be harder to justify.

14. The object of phasing would be to stage the increase in the RPI over a period. Although the index would ultimately rise by the full amount, the effect on the rate of increase would be softened. The first move would raise the inflation rate by, say, ½%, but subsequent equal moves would not change it at all (of course, if the VAT changes

were made all in one go, the inflation rate would rise more sharply in the first year but would drop subsequently).

15. Phasing could be achieved in two ways. The tax rate could rise in stages, or the groups of goods and services subject to the reduced rate could be brought into tax in stages. The latter approach would probably be the more difficult to handle, in that pressure would build up both from people just included in the tax and from those who thought their turn was next. Controversy would extend over two or more Budgets, and it would be hard to adopt a fair and even-handed posture, as there would be a degree of arbitrariness in selecting the groups to be taxed first. The effect on the RPI would also be "lumpy", as the biggest group - food - would have to come into tax in one go if horrendous liability borderlines were to be avoided, and would carry with it over half the RPI impact of the whole reduced rate package. Gradual increases in the reduced rate, on the other hand, would avoid lumpiness and inequitable treatment of different groups. But again controversy over VAT rates could extend over a long period; there would be controversy over the future rate level, until such time as the rate had been raised to a level which was a sustainable long term resting place.

EC Implications

16. The general abolition of our zero-rate would remove the main area of potential or actual conflict with the EC Commission. Our VAT structure would be brought more closely into line with our partners' (Ireland would be left on a limb as the only Member State with major areas subject to a zero-rate). There would be no own resources implications, as zero-rated items are already included in the VAT base for this purpose.

Manpower Implications

17. We have not at this stage considered the manpower implications of virtually eliminating zero-rates. A general switch of repayment traders to payment returns would imply an increase in our control and enforcement effort. We think the total additional control effort could be of the order of 500 man years. However, this figure can only be a very rough guide to the manpower implications. If the introduction of any changes was staged, the additional staff would equally need to be taken on over a period (though not necessarily pari passu with the changes in the VAT coverage).

Timing

18. The extension of taxation to the groups listed in paragraph 4 would raise a number of potentially difficult problems that would necessitate extensive consideration and consultations with other Government Departments (and possibly wider). The deadline for structural VAT decisions for the 1984 Budget is 10 February (assuming Budget Day on 13 March) and it would not be possible to devise a scheme by then, for introduction shortly after the Budget, with any assurance that traders could cope with it, or that all the economic and commercial problems had been anticipated. The earliest a comprehensive package could be brought in would be in the course of the financial year, preferably after a period of advance warning to those likely to be affected.

Conclusion

19. There would be a few departmental technical or administrative difficulties in introducing a reduced rate as a general replacement for the zero-rate. Partial introduction, either as a phasing

operation or an end in itself, should not lead to unacceptable complications if existing borderlines are maintained (or sustainable new ones introduced); however, it would be highly desirable to recast the charging and relief legislation to dispense with zero as a tax rate. The main problems would be political - the sheer difficulty of introducing taxation where traditionally in the UK expenditure has not been taxed - and economic, commercial and technical for the sectors affected. There are so many implications to be explored that we do not think a reduced rate is a real starter for implementation immediately after the 1984 Budget; but it could well follow later, or even follow in subsequent years a 1984 extension of the standard-rate which would be seen as having broken the mould.

20. There would be ways of moderating or staging the RPI impact effect of a reduced rate. Complete compensation has little to be said for it, and if partial compensation was to be made, the best means would be to shift selected items from the standard to the reduced rate. Staging the introduction of the new rate would bring in the extra revenue over a period while minimising the RPI effects by keeping down the rate of change in the index, as distinct from its absolute level. We think either method discussed above - staging by groups of goods and services or by gradually increasing the rate - would be feasible, but the second is likely to be smoother.

... 21. There are many permutations, but the annexed table sets out what seem to be the main reduced rate options, using illustrative rates of 2% and 5%.

P Jefferson Smith

ANNEX

REDUCED RATE OPTIONS

			Revenue (full year) £m	RPI Impact effect %
1.	(a)	Extend standard-rate in 1984 Budget to books etc, alterations and take-away food	1,050	0.5 ✓
	(b)	Introduce reduced rate starting in 1985 Budget for items not affected by (a)		
		i. 5% (possibly with offsets)	2,015	1.3
		ii. 2%	810	0.5
2.		No extension of standard-rate, but introduce reduced rate at 5% with offsets	2,465	1.5
	(a)	Abatement of excise duty increase	various possibilities	
	(b)	Reduction in VAT standard-rate - for each 1% off	- 740	- 0.5
	(c)	Reduction in VAT from 15% to 5% on repairs and maintenance	- 135	- 0.1
		adult clothing and footwear	- 950	- 0.5
		taxed food and catering	- 920	- 0.4
3.		No extension of standard rate, but introduce reduced rate from mid-1984/85 or Budget of 1985 at 2% with increases (to be determined) in subsequent years	985	0.6

SECRET

FROM: MISS J C SIMPSON

DATE: 9 January 1984

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Battishill
Mr Monger
Mr Griffiths

MR JEFFERSON SMITH - CUSTOMS AND EXCISE

R

EXTENSION OF THE VAT BASE: INTRODUCTION OF A REDUCED RATE

The Chancellor was grateful for your minute of 6 January, which he found extremely helpful. He has commented that this option is clearly not a starter for 1984, but the work done on it has provided important background for the 1984 decisions.

2. The Chancellor would also like a more extensive note about public expenditure offsets for any increases in VAT revenue, and we should be grateful if Mr Monger could arrange for this to be provided.

JS.

MISS J C SIMPSON