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VAT and Small Business:

European Experience
and
Implications for North America

by
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Canadian Federation of Independent Business

and

National Federation of Independent Business
Research and Education Foundation

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Preface

Persistent deficits and a chronic unwillingness to control spending have led many federal politicians in North America to once again search for more government revenues. Meanwhile, depressingly low savings rates in the United States, and politically grounded crazy-quilt systems of tax incentives, deductions and credits have forced others to seek more economically neutral, consumption based forms of taxation. And as if to snub both, a rebellious citizenry continues to push an increasingly greater share of economic activity underground, despite polls showing ebbs and flows over public willingness to pay for specific levels of expenditures and the desirability of "tax reform".

The perceived need for a solution to these problems—too little spending control, an economically irrational tax base and an uncooperative citizenry—has stimulated interest in a particular form of taxation known as the Value Added Tax (VAT). For years, VAT has held a fascination for tax authorities; it has been seen as the nearly perfect tax, one capable of generating enormous sums in an economically neutral manner and with least potential for evasion and public outcry. So long as that view held sway only in academia, the bowels of the Canadian Ministry of Finance and the American Internal Revenue Service, and among European governments then instituting such a tax, the North American public showed little interest in or concern over VAT. But now North American politicians have become more than a little interested in a Value Added Tax. In Canada, government officials have prepared a VAT proposal as a substitute for the existing Manufacturers Sales Tax; in the United States, variants of VAT have passed one House of Congress as the funding mechanism for Superfund and have taken the shape of serious legislative proposals such as the Business Transfer Tax (BTT).

With both Canada and the United States facing the prospect of at least an extended debate on a Value Added Tax, the Canadian Federation of Independent Business (CFIB) and the National Federation of Independent Business (NFIB)—unaffiliated, but organisations clearly with similar memberships and interests—determined to further the discussion by commissioning a study of VAT's direct impact on small, independent business. The organisations were uninterested in developing old issues not directly relevant to small business concerns, e.g. progressivity/regressivity, although their note proved unavoidable. Rather, CFIB and NFIB believed it important to offer a small business perspective which was often found to involve challenges to common wisdom about VAT.

A particularly useful way to examine many of these issues was to draw on European experiences. Many nations in Europe have employed VATs for a long time. While their experiences could never be totally replicated in either Canada or the United States, they do provide a useful model for North Americans to examine. We therefore engaged a European with considerable background in small business and public policy to outline the European experience with VAT as it impacts small business, noting relevant North American phenomena as appropriate.

Graham Bannock, the study's author, is founder and chairman of Graham Bannock and Partners Ltd., an economic consultancy and software company with associates in Europe, the Far East and the United States. Mr Bannock was Director of Research for the Committee of Inquiry on Small Firms (The Bolton Committee) which reported in 1971.

We are particularly grateful to Mr Bannock for producing such a comprehensive report under severe time constraints.

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Cedric Sandford and Stan Mendham read the penultimate draft at short notice and made valuable suggestions. John Kay of the Institute for Fiscal Studies and Ebbe Ording, who is studying VAT in Norway, gave generous advice. A number of organisations gave assistance, notably: the national tax authorities in Belgium, France, West Germany, Italy, The Netherlands, Sweden and the United Kingdom; the Commission of the European Communities, the National Federation of the Self Employed and Private Business, the OECD and Price Waterhouse.

The Forum of Private Business in the UK gave enthusiastic help throughout. I am grateful to the NFIB and the CFIB for providing GB&P with the opportunity to take a deeper look at VAT and small business and to Richard Wietfeldt and William J. Dennis Jr (Project Director) for their support and assistance. I alone am responsible for the views expressed.

Graham Bannock
London, January 1986

Introduction

Summary of Conclusions

In the form levied in Europe, Value Added Tax (VAT) is a tax on consumer expenditure, like the sales taxes in North America, but collected from most businesses, not just retailers, across a rather broader range of goods and services and at much higher rates.

Our main findings may, at some sacrifice of precision, be summarised very briefly:

- Although the introduction of VAT need not, in itself, result in higher taxes, those OECD countries with it have much higher tax ratios than those without it. Once the elaborate infrastructure has been laid down, few governments have been able to resist the temptation to increase the rate of VAT.
- In theory, VAT introduces a minimum of distortions into the pattern of consumer spending and the structure of production, and does not spill over into costs. In practice, it is far from economically neutral in most countries.
- Where levied at a uniform rate, VAT inevitably bears more heavily upon the poor than upon the more affluent. This regressivity can be offset by the use of multiple rates and exemptions but only at the cost of increasing the compliance burden and economic distortions. There are, however, other ways of dealing with this problem.
- Both the business costs of complying with VAT and the government costs of administration are regressive with respect to size of firm. Measures typically taken to counteract this seem to be wholly or partly self-defeating. VAT and small business do not go well together.

VAT is a complicated tax but its advantages over a sales tax really boil down to a certain administrative neatness for government and a plausible, but as yet undemonstrated, claim to a higher degree of security against evasion and fraud. The price for these advantages, which would probably only be relevant if it were intended to levy the tax at rates approaching the average 20 per cent level in Europe, is the imposition of a new and heavy compliance burden upon business and particularly upon small business, as well as a significant increase in the size and cost of the tax administration machinery of government.

A great deal of mythology has grown up around VAT. It is not evasion-proof, nor is its impact free from economic distortions. The distortions arise not in theory but in the translation of the concept into practical reality. Most governments either exempt some goods and services from the tax or use multiple rates to soften the impact of VAT on low income groups. The tax is also very difficult to apply at all in some sectors, such as banking, for technical reasons. Other modifications are invariably necessary to lessen the compliance burden on very small firms and firms in certain sectors such as retailing, or to reduce evasion. When all this has been done, VAT has no clear cut advantages over a well-

designed sales tax except (possibly) in terms of enforcement at high rates of tax, as already mentioned.

For some large businesses in Europe, the interest earned on VAT revenues before they need to be paid over to the authorities far outweighs the cost of collecting and administering the tax. In other words, they actually profit from VAT. For UK small firms, net compliance costs (the value of time spent on VAT administration after allowing for cash flow benefits, if any) are commonly between one and two per cent of turnover, quite significant in terms of the competitiveness of the business and its profitability.

The government's administration costs for VAT, although absolutely large are nonetheless small both in relation to the yield of the tax (18 to 42 per cent of central government revenues in the EEC) and in relation to the compliance costs for business. VAT also has other attractions for government.

Since most businesses are registered, it does mean that most of the tiresome problems of defining retailers and retail sales which arise with sales taxes are avoided. Under VAT, in principle at least, if you are a registered trader (a business that has to file VAT returns) you do not bear the tax but pass it on to your customers. Only the final consumer, or a business which is not registered, actually bears the tax or is supposed to. The additional business records which registration requires can also be of use in monitoring compliance with other business and personal taxes.

Small businesses in North America could be compensated for the additional burdens imposed upon them and, in our view, should be if governments there decide on a form of VAT. Compensation would not prevent the diversion of scarce real resources from more productive uses, however, and the decision will ultimately depend upon political judgments over the need to raise additional revenues and the merits of alternative methods of doing so. It is hoped that this report on the experience of value added taxes in Europe will be of some assistance in the debate.

Plan of the Report

Chapter 1 briefly reviews the international background to the diffusion of VAT and places it in the context of long-term trends in taxation. Chapter 2 sketches out its theoretical advantages and disadvantages and how these are modified in practice. However boring and abstract the reader finds this chapter (unless he is thoroughly familiar with the subject matter), it is essential preparation for the following three chapters (Chapters 3, 4, and 5) of the report which flesh out the theory with a detailed (but far from exhaustive) account of how VAT works in Europe and how it affects small business. Chapter 6, which pulls the threads of the preceeding chapters together to present the implications of VAT for North America, is followed by a list of references and seven appendices of reference material.

1. The Rise of VAT

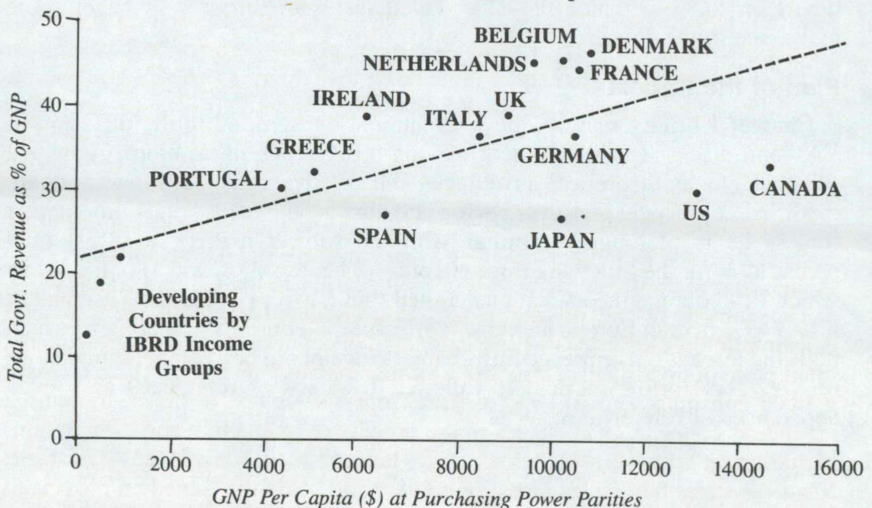
Taxation and the Growth of the State

One of the most striking features of the international economic scene during the past two hundred years or so, in addition to the spectacular growth in wealth and international trade, has been the increase in the role of government in economic affairs. The share of the Gross Domestic Product (GDP) accruing to employees of central and local government (but not including state industries) in Britain more than quadrupled from 3.0 per cent in 1907 to 12.9 per cent in 1973 (Bannock (1975)). Because of the growth of transfer payments (unemployment benefit and social security payments), the overall share of Government in national expenditure is much larger. In Britain, it increased from 12 per cent of the Gross National Product in 1790 to 53 per cent in 1982 (Sandford (1984)). We take Britain as an example, but government expenditure has risen everywhere and now accounts for between one quarter to one half of GDP in all the advanced countries.

The upward pressure on government expenditure has not been matched by as strong a pressure to keep taxes down. As a result, tax revenues as a percentage of national incomes have increased roughly in line with government expenditure. Chart 1.1 shows that today, looking at the whole range of democratic contries in the world economy, there is a clear tendency for taxes to rise with income per head. What has happened is that as countries have grown richer, governments have taken a larger share of the total. This relationship is not, however, a very close one; most of the richer European countries have a higher

Chart 1.1

GNP-Tax Ratio and GNP/Capita



Source: OECD (1984) (1985) and IBRD (1985). OECD GDP data (except Canada) are at current purchasing power parities. IBRD: Central Government Revenue as proxy for tax revenue.

tax ratio (averaging 40 per cent) than might be predicted from the general relationship between income and the tax-take, while North America, Japan and a few other countries not shown in the chart (Australia, New Zealand, Switzerland) have lower tax ratios (averaging around 30 per cent) than might be expected.

Table 1.1 shows the difference between average tax ratios in the EEC, the United States and Canada and their evolution since 1965. There has been an increase in these ratios in all these areas, but they have actually fallen recently in the US, and the gap between the EEC and North American tax rates has widened significantly over the period.

Table 1.1

Total Tax Revenue as Percentage of GDP

	1965	1980	1983
EEC	29.6	38.4	41.4
US	26.3	30.4	29.0
Canada	25.9	32.0	33.0

Source: OECD (1985) (unweighted averages)

Trends in Taxation

Table 1.2 shows the share of different types of taxes in total tax revenues in the EEC, US and Canada in selected years since 1965. Social security contributions have accounted for a rapidly increasing share of tax revenue in all three areas and now represent 29 per cent of the total in both the EEC and the US, though less than half that amount in Canada. The share of both taxes on property and taxes on specific goods (for example, excise duties) have fallen everywhere, while that of taxes on income and profits has fallen in the US but risen in the EEC and Canada.

We are discussing here shares in a rising total; both general consumption taxes and personal income taxes rose as a percentage of GDP in all three areas, though that of corporate income taxes fell sharply in the US and Canada.

The subject of the present study, value added tax (VAT), is a general consumption tax levied, as will be explained in detail in the next chapter, on the retail price of goods and services in a similar way to a sales tax (which is also a general consumption tax). VAT differs from a sales tax, however, in that the revenue is collected at all stages in the process of production and distribution, including the retail stage, whereas a sales tax is collected only at the retail stage. Most US states have sales taxes, of course, and so do the Canadian provincial governments. In the United States, general consumption taxes (sales taxes) have increased their share of total tax revenue quite considerably since 1965 and

Table 1.2

Groups of Tax Revenues in the EEC and North America as Percent of Total Taxation

	1965	1980	1983
EEC			
Taxes on incomes & profits	28.5	35.2	34.4
Social security contributions	24.4	27.8	28.8
General consumption taxes	13.0	17.2	16.7
Taxes on property	8.0	5.1	4.6
Taxes on specific goods & services	22.5	12.0	12.6
US			
Taxes on incomes & profits	46.3	47.1	42.6
Social security contributions	16.4	26.1	28.7
General consumption taxes	4.6	6.6	7.0
Taxes on property	15.3	10.1	10.6
Taxes on specific goods & services	14.6	7.8	8.6
Canada			
Taxes on incomes & profits	39.3	46.6	43.7
Social security contributions	5.7	10.4	13.1
General consumption taxes	18.2	11.5	11.6
Taxes on property	13.2	9.1	9.1
Taxes on specific goods & services	17.1	13.0	14.4

Source: OECD (1985) (Unweighted averages)

Note: Because of the method of averaging, omission and coverage, the percentages do not total 100.

indeed have been second only to social security contributions as the most buoyant sources of revenue. The same is true of the EEC. In Canada, where general consumption taxes were relatively more important as a source of revenue than in either the EEC or the USA in 1965, the Federal Manufacturers Sales Tax (levied at the wholesale stage) and provincial sales taxes have accounted for a declining proportion of revenue, although these general consumption taxes in Canada still yield relatively more than their counterparts in the USA.

It will be noted that in all three areas, the share of direct taxation (income and profits taxes and social security contributions) in tax revenues has increased while that of indirect taxes (taxes on expenditure) has fallen. Among indirect taxes, general consumption taxes are rapidly taking over from specific taxes on property, goods and services, especially in the EEC but also in the United

States. It is not surprising that federal governments in both the US and Canada have looked with interest at the contribution of VAT to the large and rising take from general consumption taxes in Europe. This interest is particularly strong in Canada where the Federal Manufacturers Sales Tax has accounted for a declining share of general consumption tax revenue which, in turn, accounts for a declining proportion of GDP. The United States, of course, has no federal general consumption taxes, but general sales taxes have accounted for an increasing share of total state tax revenues, (up from 19.3 per cent in 1949 to 31.3 per cent in 1984), as well as of total national tax revenue. These increases result partly from an increase in the number of states levying state taxes (45 now compared with 27 in 1949). In both the US and Canada, average rates of local sales taxes have increased several-fold in the post World War II period (Table 1.3), though the increase in rates has been much faster in Canada.

The Rise of VAT

In the EEC, VAT was introduced in Denmark in 1967, in Germany and in France (in its present form) in 1968 and had been adopted by nine member states by 1973. VAT has accounted for an increasing, in some cases rapidly increas-

Table 1.3

Average Rates of General Sales Tax,
Selected Years, 1949-85, US and Canada

		Per Cent
	US State Governments	Canadian (1) Provincial Governments
1949	1.3	n.a.
1953	1.6	1.3
1957	1.8	1.5
1961	2.3	3.5
1965	2.6	4.2
1970	3.5	6.1
1972	3.8	6.1
1974	3.8	6.9
1978	4.1	7.0
1981	n.a.	7.2
1982	4.2	n.a.
1984	4.5	n.a.
1985	n.a.	7.8

(1) Excludes Alberta, Yukon and the NWT

Source: Current Population weighted averages from Statistics Canada Catalogue 68-201; Provincial and Municipal Finances, Canadian Tax Foundation. Selected issues of *The Book of the States,* Council of State Governments.

ing, proportion of total tax revenues in all but two of the nine states (Table 1.4). Expressed as a percentage of central government revenues, the contribution of VAT is higher still, varying in the nine from 17.6 per cent in Luxembourg to 19.3 per cent in the UK, 34.7 per cent in Germany (a federal state) and 42.2 per cent in France (1983).

Table 1.4

VAT Revenues as Percentage of Total Tax Revenues in the EEC

	1965	1970	1975	1980	1983	1984 (est.)
Belgium	—	—	15.66	15.62	15.42	n.a.
Denmark	9.11*	18.77	16.90	22.19	21.10	20.50
France	20.07	25.41	22.97	20.74	20.22	21.50
FD Germany	—	17.40	14.62	16.64	16.99	17.00
Ireland	5.68*	13.10*	14.68	14.76	21.07	21.30
Italy	—	—	13.68	16.25	14.92	n.a.
Luxembourg	—	6.78	11.86	10.92	12.08	13.60
The Netherlands	—	14.61	14.36	15.85	14.79	15.80
UK	5.92*	6.52*	8.78	12.41	13.86	14.60

* = Sales tax subsequently replaced by VAT

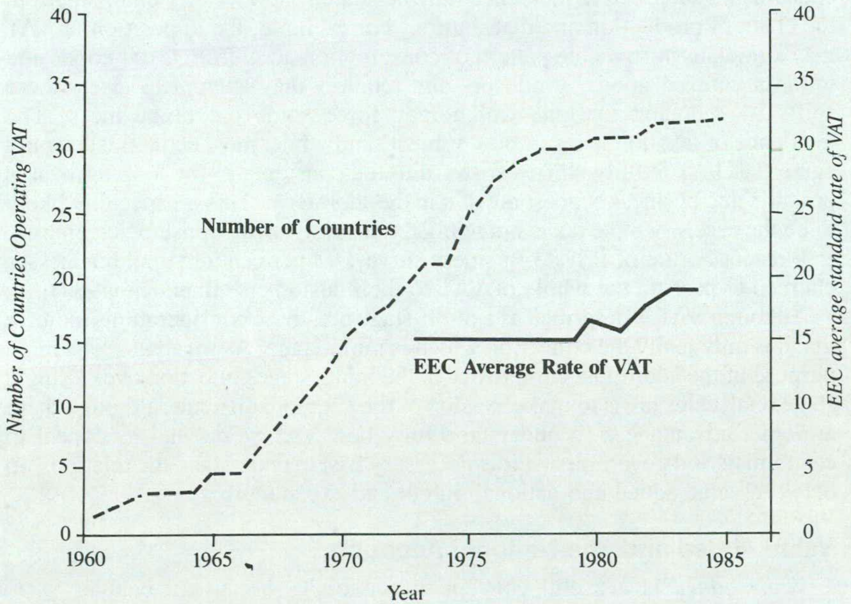
Source: OECD (1985)
1984 figures are GB&P estimates based on national sources.

VAT is levied at much higher rates than North American sales taxes and the tax base is wider, hence its great power as a revenue raiser. Chart 1.2 shows that the average standard rate of tax for the nine EEC states has increased from 15 to nearly 20 per cent since 1973. As will be shown in Chapters 3 and 4, the effective rate of tax is much lower than these standard rates (which are themselves not very precise indicators of changes in the burden of VAT) but there is no doubt that VAT rates, like sales tax rates in North America, have drifted upwards over a long period.

VAT is a complicated tax for both the tax authorities and the businesses which collect it, but its appeal as a source of revenue is obvious. VAT also has a number of theoretical advantages over other sales taxes which will take much of this report to explain and assess. Meanwhile, we may note that the spread of VAT has not been limited to the EEC. By 1986, VAT was in operation in 36 states around the world, surprisingly, for such a complex tax, many of them developing countries, and the diffusion of this tax shows little sign of slackening (Chart 1.2). Appendix 1 gives a full list of the countries with VAT. Although 15 of the 23 member countries of the OECD now have VAT, it is a striking fact that those that do not operate this tax, Australia, Canada, Japan, Switzerland, the United States, Turkey, and Greece (temporarily), are relatively low tax countries (tax revenues averaging 29 per cent of GDP in 1983) compared with those that do (41 per cent).

The actual causal relationship between VAT and high total taxes is less clear. It is true that most European countries with VAT were already high tax countries relative to the US, say, even before they adopted VAT. However, there is little doubt that in modern liberal democracies, public expenditures tend to rise to the limits of tax and borrowing potential. In this context, installing any new tax machinery, especially one as broadly based as VAT, will inevitably lead to higher overall taxation. The decision whether or not to introduce VAT needs to recognise these larger considerations just as much as the technical ones with which this report primarily deals.

Chart 1.2
The Rise of VAT



2. VAT in Theory and Practice

The Nature of VAT

VAT is a tax on final consumption which is collected at every stage of production and distribution rather than at the retail stage alone as with the sales taxes that are familiar in North America. VAT is levied on the difference between the sales of each firm and its purchases, that is, on the value it adds to these purchases. Traders who are registered for VAT are entitled to credit the tax they pay on their inputs against the tax they collect on their outputs and remit only the difference to the tax authorities. (If the input tax is greater than the output tax, they receive a refund).

Since traders do not bear the tax on their inputs and charge the output tax on their sales to their customers, the formal incidence of the tax largely falls on the consumer. The effective incidence may be shared, however, by other stages in the chain of production and distribution. For example, the imposition of VAT may stimulate shifts in the pattern of consumption away from taxed goods and towards untaxed goods. Producers and retailers may attempt to arrest these shifts by reducing margins which may force some out of business. The incidence of taxation is a complex subject, and whilst most economists would agree that VAT is fully shifted forward to the consumer in the long term, it is possible that business bears some of it in the short term. This is especially likely to be the case when the tax is not applied uniformly on all consumer spending. In a recent Forum of Private Business survey, 93 per cent of small businesses claimed to pass on the whole of VAT to their customers (Bannock (1984)).

Although VAT is described as a multi-stage tax, these considerations indicate that it is only really the collection which is multi-stage. As we shall see, a main purpose of the additional complexity of the multi-stage collection over a single stage retail sales tax is to make evasion of the tax more difficult, although there are other advantages. To understand fully how VAT works and its appeal to economists and governments, it is necessary first to understand the relationship between value added and national output and expenditure.

Value Added and The National Accounts

Value added is a useful concept in economics because it enables us to distinguish the unique contribution which individual firms or whole industries or sectors make to the national output. It is a necessary concept because these contributions are not measured by gross output or the value of sales or turnover. If we added up the sales of all firms in the economy, we should come to a figure which is several times greater than the value of the wages and salaries, rent, interest and profits paid by these firms; that cannot be right because for the economy as a whole or a sector of it, the value of output cannot be greater than the value of incomes or, for that matter, the value of expenditure plus savings. (We ignore the complications of investment and foreign trade which do not affect the point we are making).

The reason why the addition of the sales of all firms gives a larger total than their contribution to national output, income or expenditure, is simply that the

sales of each individual firm include the value of the inputs from its suppliers. The sales turnover of General Motors, for example, if added to the sales of its suppliers, would double count the value of the steel in its products several times over. First a steel company digs iron ore out of the ground and produces ingots and, after further processing, finally sells coils of sheet steel to, say, stockists or wholesalers. Then a small stamping company buys steel strip from the wholesaler and produces blanks for an electrical company which assembles these blanks into an alternator which it then sells to GM which installs it in a car. The car is sold to a dealer who, in turn, sells to the final consumer. The steel has been sold six times: once by the producer, once by the wholesaler, once by the stamper, once by the alternator manufacturer, once by GM and finally by the dealer.

At each stage in this process, value is added to steel, either by a manufacturing process as in the slitting of the coil into strip and the stamping of the metal blanks, or by the provision of a service, such as the stocking of the steel sheet by a wholesaler or the car by the dealer. The steel company is at the beginning of the chain as far as the steel is concerned, but it too will need to buy fuel for its blast furnace, electricity and lubricating oils for its strip-mill, and so on. The difference between the value of these purchases and the value of its sales is the value the steel company adds to its inputs, and the sum of the added values of all the firms contributing to the manufacture and distribution of passenger cars is equal to the total value of the new passenger cars bought by consumers.

The Gross National Product (GNP) is the sum of all values added in the economy and (if we ignore overseas trade and payments) is equal to consumer expenditure and saving and also to the total of what economists call "factor incomes":

Values Added in:	Disposal of Incomes:	Factor Incomes:
Output of consumption goods and services	Expenditure	Wages and salaries
+ Output of investment goods (capital goods and inventories)	+ Saving	+ Rent + Interest + Profit
= Gross National Product	= Gross National Product	= Gross National Product

A 10 per cent tax on the value added at each point in the chain of production and distribution, and including the public sector, would produce a yield of 10 per cent of the GNP.

Value Added and VAT

When we refer to a VAT, we can actually be thinking of one of three types of tax. The type of VAT just described is what is called a *Gross Product VAT*. In fact, this kind of tax is not used anywhere and is not under consideration for North America. The reason for this is that under a gross product VAT, value added would be calculated by deducting only purchases of raw materials and not machinery or other investment goods or the depreciation on those goods. This

would mean that capital goods would effectively be taxed twice, once when they were purchased and again in the depreciation element embodied in the products they were used to produce. An alternative type of VAT would be to allow the deduction of depreciation (an *income type of VAT*) but this would still involve the taxation of net investment and could lead to distortions in the choice of production methods.

Both the gross product and income types of VAT would also create administrative difficulties and in practice the VAT system used in Europe and under consideration in North America is of the *consumption type,* which means that value added is defined as sales minus purchases of energy, materials, semi-finished products, machinery and equipment and services (but not direct labour services).

The consumption type of VAT at a comprehensive and uniform rate of 10 per cent would produce a yield of 10 per cent of the total of personal consumption, which is equivalent to GNP minus saving. In theory it would, therefore, yield the same as a sales tax levied at the same rate on all final expenditure.

So far we have not considered transactions across national boundaries. Usually, VAT is not charged on exports because the consumer is outside that boundary. This means that the exporter claims back his input tax but charges no output tax. Imports are subject to VAT at the border on their landed value, that is including CIF charges (cost, insurance and freight) and customs duty, if any. The jargon for this type of tax treatment of foreign trade is that VAT is applied on the *destination principle*. It maintains domestic consumption as the tax base. If the tax were applied to exports but not imports then this would be the *origin principle*. Domestic production is the tax base under this system.

VAT does not cover all value added in an economy even on the chosen base. Certain industries are always exempted from the tax. There are two ways of treating the exemption of particular classes of expenditure from VAT. One is to grant exemption with credit for input tax which is invariably done for exports and the other is to grant exemption without credit for input tax. In both cases, the trader does not add the tax to his selling price. He is also entitled to reclaim the tax on the purchases he makes in connection with the sale in the first case but not in the second. In some countries, the term "exempt" is reserved for those instances where input tax is not credited; those where it is credited are referred to in these countries as "zero-rated".

A zero-rated trader is as much part of the VAT system as a standard rated one, filing tax returns and registered with the authorities. Exempt traders are completely outside of it and in the same position as final consumers. Very small traders whose turnover is below a defined limit or *threshold,* and for whom the administrative costs would greatly exceed the revenue, are usually exempted. So too is housing, where both new construction and rented accommodation are normally exempted because of the difficulty of otherwise taxing owner-occupiers and tenants on the same basis. The services of certain financial institutions, for which the calculation of value added presents special difficulties, are also usually exempted. There are many problems in applying VAT to the services of financial institutions. One difficulty is that some services (for example "free" checking accounts) are not explicitly charged for and therefore

the straightforward credit system is not operable. Insurance companies, to give another example, do not make a net charge for risk protection: in any individual case, value added cannot be calculated until claims made are subtracted from premiums paid. There are other instances of exemption which are discussed in the next chapter.

How VAT is Calculated

Just as, in theory, there are several types of VAT, there are also several ways in which the liability for the tax of each type may be calculated. So far we have simply described value added as sales minus purchases; this *subtraction method* is one way of calculating the VAT base to which the rate may be applied. Since, as we have shown, value added is the pool out of which all factor payments are drawn, it can also be calculated by adding up wages, interest, rent and profit made by firms. The *addition method,* as this is called, would, under a consumption VAT, require that profits be defined after writing off capital expenditure as it is incurred. It would, in effect, be a payroll and cash flow tax.

Tax liability in the VAT adopted in Europe and under consideration in North America, however, is assessed by a third alternative: the *invoice method*. What this means is that each firm invoices its customer for the value of its sale to that customer plus VAT (output tax) and receives an immediate credit against the amount of VAT it is due to pay to the government for the VAT paid on its own purchases (input tax). At the end of the accounting period (which may be monthly, quarterly, or even annually as we shall explain in Chapter 4) it pays the difference between the output tax and the input tax, if positive, or applies for a refund if its output tax is less than its input tax. Since value added is defined as the difference between purchases and sales, then the same rate of value added tax applied to purchases and sales will, if credits are given for the tax on purchases, yield the same net tax as if the same rate were applied to value added.

In fact, the VAT system in practice does not tax the true value actually added in any period at a particular rate, not only because depreciation is not allowed for but also because the tax has to be paid even if the producers are taking a heavy loss and not adding value at all. Moreover, since, in practice, input tax is not reclaimable on all inputs, value added is not accurately calculated by the invoice method.

Table 2.1 illustrates how VAT liability is calculated by the invoice method and how this reconciles with value added at various stages in the chain of production and distribution. For simplicity we assume that the first firm in the chain, as primary producer, has no purchases and therefore no input tax. He sells, say, wild fruit to a manufacturer for $20 plus output tax at 10 per cent = $22. The manufacturer processes the fruit and cans it and sells it to a retailer for $100 plus 10 per cent output tax = $110. The retailer sells the canned fruit to a consumer for $130 plus 10 per cent output tax = $143. The consumer has paid $13 in VAT. The primary producer has remitted $2 of this total to the tax authorities, the manufacturer $8 and the retailer $3. In each case the tax remitted is the output tax charged minus the input tax paid. The manufacturer, for example, paid $2 tax to the primary producer and collected $10 in tax from the retailer, the

difference of $8 being equal to 10 per cent of the difference between his sales (before tax) of $100 and his purchases (before tax) of $20.

This example is highly simplified since the primary producer in practice would have had some purchases—if only baskets to carry the fruit. VAT on these baskets would have been fully deductible from the output tax on his sales to the manufacturer and the cost of purchasing them would have reduced his "value added" in proportion. "Value added" would be reduced immediately by the full capital cost of the baskets, even though they will be used many times. Next time the primary producer sells fruit to the manufacturer, the value added would, in this case, be higher because the baskets will already be paid for, even though true value added would be the same. This brings out the fact the VAT levied in any period will not be strictly proportional to the value added in that period because of the way capital goods are treated in the consumption type of VAT.

It should be pointed out that the remittances of tax to the tax authorities indicated in the table will only all be made in any single tax accounting period if all the transactions take place within that period. In practice, the retailer will purchase the canned fruit from the manufacturer sometime before he sells it to the consumer and he will pay for the goods some time after he receives them. The manufacturer will be liable to remit the VAT on his sale to the tax office when it becomes due, whether the retailer has paid him or not, but he will also be able to deduct his input tax from his output tax whether he has paid his supplier, the primary producer, or not. As we shall show later, these features of VAT mean that the collection and remittance of the tax benefits the cash flow of some registered traders and has a negative impact for others. The precise cash flow impact of VAT on any individual trader will depend upon the frequency with which he has to make returns to the tax authorities, their timing in relation to the collection period to which they relate, and the length of the credit periods he gives to his customers and receives from his suppliers. The cash flow impact will also crucially depend upon the rate of tax charged on inputs which, for reasons to be explained later, in practice will necessarily be the same as the rate on outputs.

The Advantages of the VAT System

It is only possible to discuss the advantages of a tax system in relation to other alternative systems and in this section we compare VAT as adopted in the EEC with other alternative taxes, notably turnover taxes, excise taxes and general single stage wholesale and retail taxes.

Turnover taxes are taxes levied as a proportion of the price of goods on each sale in the chain of production and distribution. These taxes were common in Europe before the advent of VAT in the 1950s and were adopted at a federal level in Canada between 1920 and 1924 (Gillis (1985)). *Excise duties* are taxes levied on specific goods consumed in the domestic market, invariably "non-essential" goods, the demand for which is not very sensitive to price (those for which demand is inelastic), for example, alcohol and cigarettes. *Wholesale taxes* are single stage taxes levied on sales by manufacturers or importers like the Purchase Tax levied in the UK prior to 1973 and the Federal Manufacturers

Table 2.1

Simplified Example of VAT Input and Output Tax Liabilities At Various Stages of Production and Distribution (In Dollars)

	VAT Rate 10 Per Cent		
	Primary Producer Sells to Manufacturer	Manufacturer Sells to Retailer	Retailer Sells to Consumer
1. Purchases	–	20	100
2. Input tax	–	2	10
3. Tax-inclusive purchases (Line 1 + 2)	–	22	110
4. Sales	20	100	130
5. Output tax (Line 4 × 10%)	2	10	13
6. Tax-inclusive sales price	22	110	143
7. Value added (Line 4 − 1)	20	80	30
8. Net tax remitted (Line 5 − 2)	2	8	3

Sales Tax in Canada. *Sales taxes* are levied on retail sales and are applied by provincial governments in Canada and the states of the United States.

The theoretical advantage of VAT over these other forms of *indirect taxation* (indirect taxes are levied on expenditure, direct taxes on the income or wealth of individuals or companies) is that it can be completely neutral with respect to producers and consumers. Because purchases of firms including capital goods are not taxed, VAT does not spill over into the costs of firms and distort decisions on methods of production in the way that turnover taxes do. These are also called "cascade taxes" because they cumulate at each stage of the chain of production and distribution. The manufacturer pays turnover tax on his purchases from suppliers and charges tax on his gross sales to his customers so that some elements of his costs are taxed twice. By acquiring his suppliers he can save tax by eliminating a point in the chain at which the tax is levied. These taxes encourage vertical integration and negate the efficiencies of sub-contracting.

VAT is also neutral between exports and imports. Turnover taxes cannot be easily and precisely eliminated from export prices and in Europe deductions of turnover tax provided a convenient means for hidden subsidiaries to exports. Although wholesale taxes are not levied on exports, some tax element enters

into the costs of exporters which cannot be reclaimed by them. Wholesale taxes do not treat imported and domestically produced goods uniformly either, since, among many other things, they are applied at the time of importation and thus do not tax some distribution costs, such as delivery to the retailer and advertising costs, which may be included in the taxed wholesale price of domestically produced goods. Other problems with imports arise which, like this one, are neatly avoided by VAT (see Gillis (1985) for a discussion of the problems of the Canadian Manufacturers Sales Tax).

Another advantage of VAT is that it can be applied virtually across the board. Thus, it need not distort consumer spending towards any untaxed items.

While turnover taxes, which can be applied to services, result in double taxation and other distortions, wholesale taxes cannot be applied to many services where there is no wholesale stage—most services, such as dry cleaning or business consultancy, are produced and distributed at the retail stage. VAT can apply to the value added in services after allowing deduction of input tax on the purchases of cleaning fluids or electronic calculators used by service firms. This means that VAT at a uniform rate applied over the whole range of consumption will not introduce distortions into the pattern of either production or consumption which some other forms of indirect taxation seem inevitably to do. Moreover, there are problems under a wholesale tax of defining the wholesale stage and the wholesale price. Under modern systems of distribution where producers may sell to very large retailers at lower prices than they sell to wholesalers, similar goods may end up being taxed at different rates.

It will be noted that whilst the advantages of VAT over turnover and wholesale taxes are very clear, the advantages over a general retail sales tax are less clear. A sales tax is not levied on exports and is applied equally to the retail price of goods irrespective of their origin. Sales taxes can also be applied equally to goods and services and they do not enter into producer costs except to the extent that some producers and distributors purchase inputs, including services, at the retail level.

There are, however, advantages to VAT other than its neutrality. One desirable feature of the tax is that it treats all firms identically, irrespective of their industry, production stage or type of customer. Complex problems of classifying firms as retailers or wholesalers do not arise; under modern methods of distribution where sales to final consumers are often made at early stages of the production chain, this is an important advantage of VAT. Moreover, firms themselves do not have to distinguish between their business and non-business customers. They levy the same tax on all those to whom they supply.

It is commonly said that the VAT is self-policing because each trader will have a strong incentive to register so that he may receive credit for his input taxes. For the same reason, he will also want to ensure that he receives proper invoices from his suppliers and that he collects his output tax from his own customers. In this way, each trader keeps an eye on the firm above and below him in the chain of production and distribution. Because the collection of the tax is multi-stage, it is also said, evasion at one point in the chain can only affect part of the tax-take, though this patently does not apply to service industries. In practice, VAT is far from evasion proof. It may offer less scope for evasion than

a sales tax in some respects but opens up new opportunities for the fraudulent reclaim of input taxes (Chapter 4).

A further aspect of the appeal of VAT to government is that it forces smaller registered traders to keep more elaborate records than most of them would in the absence of the tax, and allows cross-checking of business income tax and VAT declarations which should lead to improved compliance with this and other taxes. It is clear that these advantages have been appreciated at least by the Canadian tax policy makers who have pointed out that VAT "provides an opportunity for one-stop audit, ie. both income tax and VAT audits could be carried out simultaneously" (Weyman (1985)). Like all indirect taxes, VAT imposes some taxation upon the expenditure of those who have evaded assessment for income taxes and upon non-residents visiting the country. This is considered to be an important advantage in a period when the "black" economy and international tourism and business travel are expanding activities.

It has also been asserted in Europe that the more elaborate records required for VAT lead to improved efficiency in small businesses. Although many accountants would agree with this, we consider it more likely that most registrable small business proprietors are able to decide what accounting systems are most cost-effective. At best, the additional benefits of VAT records will be marginal and they will not, for example, tell the businessman whether his business is profitable or not or what activities are profitable and those which are not.

Disadvantages of VAT

It is, of course, widely recognised that, like all taxes, VAT does present problems to both the taxpayer and the tax authorities. The most common objection to the introduction of a VAT is that a broadly based tax on consumers' expenditure will bear disproportionately heavily on those with lower incomes, that is to say it is *regressive* with respect to income.

Since people with high incomes on average spend a smaller proportion of their income (they save more, either before or after income tax), then a given rate of VAT on total consumer spending will tax a higher proportion of income of the poor than of the rich.

It is because of concern about regressivity that most VAT systems charge lower or zero rates of tax on expenditure on basic necessities such as food and housing. Some countries have more than two VAT rates; three European countries have four. Of 32 countries with VAT, only nine had a single rate system in 1984 (Tait (1984)), but none of these actually levied their single rate on all consumer expenditure.

The items which are VAT exempt because they present intractable problems to the designers of VAT systems account for a relatively small proportion of consumer expenditure—perhaps around 10 per cent on average in EEC countries. Items of expenditure, lower rated or exempt to offset regressivity, however, typically account for a somewhat greater proportion of consumer expenditure, usually nearer 30 per cent. Together, these special categories, however, are so important that all the theoretical advantages of the VAT in terms of neutrality

towards production and consumption and its clear superiority over single-stage wholesale or retail taxes go out of the window.

It is easy to understand why this should be so for neutrality of consumption since different rates of tax clearly distort consumer choice and the operation of market forces. The effects of differential rates on production, however, are more complicated. A producer who does not charge VAT on his output of exempted goods but is allowed credit for his inputs, for example, is receiving a subsidy from taxpayers while other producers that are not entitled either to charge VAT or reclaim it are paying a tax which is intended to apply only to final consumers. In a few cases, exempt (as distinct from zero-rated) exporters will be paying a tax in this way upon their exports.

More serious are the effects of multiple rates on the taxation of value added. Exemptions can give rise to either positive or negative effective rates of tax which are widely dispersed about the nominal rate. Where half of the costs of a restaurant meal is food and half value added and food is zero-rated, for example, then a 10 per cent rate of VAT on the whole cost of the meal is 20 per cent of value added, twice the nominal rate (Kay and Warren (1981)).

Kay and Warren calculated that effective rates of VAT in Britain are, for these reasons, different in virtually every sector of the economy and range from -27.5 per cent on the output of certain manufactured food products to 37 per cent on leather and leather goods. These particular extremes are not troubling from the point of view of regressivity, but it hardly makes sense to subsidise shipbuilding at -7.9 per cent and tax electronics and communications at 19.2 per cent through the VAT system.

Virtually all economists are agreed that multiple rates and exemptions should be kept to a minimum in the interests of avoiding distortions of these kinds. The regressivity of VAT systems in most countries is, in practice, mitigated or made more progressive by exemptions (OECD 1981) but at the cost of considerable distortions. These distortions are not inevitable with a VAT system: the effects of uniform rates on the distribution of income can be dealt with more efficiently by other means—for example by adjustments to income tax thresholds and social security benefits (Davis and Kay 1985), but their avoidance in practice has been a rare occurence.

There is, however, an even more intractable shortcoming of VAT and that is that it imposes heavy compliance costs upon small firms and requires an entirely new and expensive administrative machine in government.

The acquisition of the necessary knowledge and machinery to impose, record and remit the tax are largely a fixed cost and it inevitably follows that there are economies of scale in tax compliance as in other spheres of business-government relations (Faucett (1984)). Because the administrative resources of small businesses are limited, the burden tends to fall to a significant extent upon the proprietor whose time is the most precious resource in most small firms. Small businesses are also unable to spread the cost of in-house professional advisors over a wide range of activities and their data processing activities are computerised to a lesser extent. All this means that the compliance costs of taxation and VAT in particular are highly regressive with respect to size of firm. VAT is also expensive to collect from small firms so that government administrative costs as

well as business compliance costs are relatively higher for small firms.

As we shall show in Chapter 5, other indirect taxes are also regressive by size of firm, but because VAT involves the participation of all businesses, not just retailers as with a sales tax or manufacturers and importers as with a wholesale tax, and because it requires records of inputs as well as outputs, the total social costs and distortions of a VAT system are very much greater at the national level than with, say, a retail sales tax. For the same reason, the costs of administering VAT for government are also absolutely much greater than for other indirect taxes: more returns have to be processed, refunds have to be made as well as remittances received, and a major system of local offices staffed to audit traders' records and deal with queries as well as to perform the other functions of tax administration is necessary.

It will be shown in Chapter 4 that the government's administration costs probably average around one per cent of VAT revenues in the EEC at nominal standard rates of tax which range from 12-23 per cent. (Private compliance costs as a percentage of revenue are many times higher but neither compliance nor administration costs can be measured with precision). Where costs are effectively fixed, a doubling of the rate halves the administration costs as a proportion of revenue. Thus, fixed costs of one per cent of revenue would rise to 20 per cent of the total if the VAT rate were reduced from 20 per cent to five per cent, prohibitively high compared with a sales tax at a similar rate. This mechanism helps to explain why VAT, initially introduced at low rates in most countries, has been swiftly increased and has, so far at least, tended to climb more or less inexorably upwards (see Chapter 1).

There are also major start-up costs for a VAT system both for government and taxpayer and, as we shall see in the next chapter, troublesome, though containable, transitional macro-economic problems to do with the level of investment and inflation.

We have been able to show in this chapter that, theoretically, VAT is a good tax because it does not enter into the costs of producers of goods and services; if levied at a uniform rate on all consumption it will not distort the pattern of production and consumption; it is neutral with respect to imports and exports and it is perhaps less easily evaded than a retail sales tax. In practice, however, against these advantages have to be set the disadvantages that arise from the regressivity of VAT with respect to size of firm and the income and expenditure of consumers. In almost all countries, political pressures to minimise the burden of VAT on the less advantaged sections of the community have proved irresistable and, with the multiplication of rates and exemptions, not only are compliance costs pushed up still further but the neutrality of the tax towards the pattern of production and consumption has gone by the board.

As we shall see in Chapter 5, measures to lessen the impact of VAT on the smaller firm have introduced further distortions without significantly affecting the distortions in the size structure of economic organisation that VAT creates.

Finally, the inherent complexity of VAT and the way this complexity is multiplied by attempts to lessen regressivity of the two kinds identified mean that the administration costs for government are excessive at lower rates of tax.

We have shown that there are economies of scale in compliance by taxpayers,

there are also obviously economies of scale in administration of the tax. Once the heavy infrastructure of VAT has been laid down, major increases in tax revenue can be achieved by government at negligible incremental administrative cost.

3. VAT Rates and Coverage in Europe

The History of VAT

The consumption-type VAT now levied in the EEC was recommended by the Neumark Committee in 1962 (see International Bureau (1963)) five years after the Treaty of Rome agreement to form the customs union and affirmed as mandatory for member states in two directives in 1967. Douglas Dosser (in Peacock and Forte (1981)) wrote that the Committee "reported against a 'textbook background' that the VAT was the apotheosis of good indirect tax practice" and quoted the American academic, Carl Shoup (Shoup 1969), whose earlier work influenced their deliberations:

> "the turnover (cascade) tax, the manufacturer's sales tax, the wholesale sales tax, and the VAT .... each of these taxes discriminates less than its immediate predecessors among types of business and methods of doing business .... the VAT is the latest and probably the final stage in a historical development of general sales taxation at the national level that has eliminated the uneven impact of the turnover tax and the manufacturers and wholesalers sales taxes."

The Neumark Committee did not recommend that VAT should be applied at the retail stage. It seemed to be mainly concerned with the advantages of a more neutral tax than the cascade taxes then widespread in Europe. Actually, VAT is not neutral with respect to large and small firms unless net compliance costs are fully compensated for, nor is it neutral with respect to consumption and production unless it is applied comprehensively at a uniform rate. Dosser points out that the aspects of neutrality which appealed to the Neumark Committee were that it did not distort the structure of firms by encouraging vertical integration and could be easily applied on either the origin or destination principle so that the administration of the tax would not depend upon the continued policing of frontiers when tariffs were removed and VAT rates harmonised.

Both these considerations were rather specific to the EEC. All the original six members of the Community had, or had at one time, experienced cascade turnover taxes, and in Germany in particular there was great concern about the way this tax favoured industrial groupings. The cascade tax, like the Manufacturers Sales Tax in Canada today, was patently inferior to the proposed VAT. VAT also clearly had advantages in a customs union. Tait (1984) points out that most of the countries in the Latin American regional groups, the Latin American Integration Association and the Andean Pact have adopted value added taxes, in many cases to replace cascade taxes.

The origins of VAT go back much further than the Neumark Committee. According to the International Bureau (1983), proposals for a "refined turnover tax", which in its essentials was an income type VAT, were put forward in 1919 by a German businessman and government consultant, Dr Wilhelm von Siemens, while Thomas Adams, an American Professor at Yale, had made similar proposals for a business tax a year earlier. Neither of these proposals was

adopted at the time, but several countries used value added techniques in some form before the Second World War, including Argentina, The Netherlands and Finland.

The first modern consumption type VAT was introduced in France in 1954, but at first it applied only to the transactions of manufacturers and wholesalers and was revised and developed in 1968 and again in 1978. According to Tait (1984), several developing countries in former French colonial territories in Africa introduced VAT in the early 1960s. At least 37 countries now have valued added taxes or firm plans to introduce them, the latest being New Zealand and, with their accession to the EEC, Spain and Portugal. The state of Michigan in the United States also implemented Thomas Adams' Business Activities Tax (an additive type income-based tax).

Dates of introduction and other details of European value added taxes are given in Appendix 3. From 1986, all EEC countries except Greece (where introduction has been twice temporarily delayed) have value added taxes. Of the three countries which joined the enlarged EEC in 1973 and which did not participate in the decision to make VAT mandatory, all had single stage wholesale taxes prior to the introduction of VAT. Denmark had already introduced VAT in 1967. Ireland's VAT became effective from 1972.

The history of the introduction of VAT in the United Kingdom, where the tax was considered and rejected more than a decade before Britain became a member of the EEC, is of interest. From 1940 onwards the UK had a single stage wholesale tax called Purchase Tax, charged on manufactured consumer goods at multiple rates as a percentage of the wholesale price. In 1963, the government set up the Committee on Turnover Taxation (Richardson Committee (1964)) to consider the possible replacement of the existing wholesale tax (and profits tax) by VAT. The Committee decisively rejected VAT on the grounds that there was no logic in replacing a well established single stage tax, which the UK had at the time, with a cumbersome multi-stage tax requiring elaborate and extensive administrative machinery, when the object of the tax was simply to tax consumer expenditure. The difficulties arising from differentiating between basic necessities and other types of goods under a VAT were also pointed out.

The government did recognise the desirability of broadening the base of the system of indirect taxes, which also included excise duties, but which did not cover services. In 1963, as Robinson and Sandford (1983) record, however, the Conservative UK Chancellor (Finance Minister) had little enthusiasm for VAT and, with the dismissal of that tax by the Richardson Committee, nothing more was done. The next (Labour) government in 1966 introduced a per capita payroll tax, the Selective Employment Tax (SET), paid by all employers but refunded with a premium in manufacturing, refunded without a premium in the primary sector and transport, and borne in full by the construction, distribution and service sectors. SET was not costly to administer and raised substantial revenue, but was very unpopular amongst those employers who paid the tax and amongst trades unions.

The Conservatives who returned to power in 1970 were pledged to abolish SET and in 1973 replaced both SET and Purchase Tax with VAT. This was made

necessary by the accession of the UK to the EEC on the 1st of January 1973, though the government claimed that it would have introduced the tax even had Britain decided to stay out of the Community. Much use was made of the now familiar arguments for the neutrality of VAT, its value as a flexible regulator of demand and its favourable effect upon the balance of payments. (A report from the National Economic Development Office (NEDO 1969) had been much more favourable to VAT than the Richardson Report).

Exemptions and Rates

Although the broad shape of the VAT systems in the EEC are similar and determined by adherence to the directives of the EEC Commission (see Appendix 5), there are major differences in administration (see Chapter 4), the treatment of small firms (see Chapter 5), exemptions and rates. In these and many minor points of detail there are extensive differences and we could find no previous attempt to give an overview of variations in the system between member states.

The main features of the EEC VAT system are of course that it is of the consumption type with exports free of tax and imports taxed (for the most part) at national borders. According to the 6th Directive, banking, insurance and most other financial services are exempt from VAT and so are real estate, including lettings, educational, medical services, contributions to charitable organisations, works of art and a few other categories of consumption. In some cases, zero-rating (see below) rather than exemption is used for a few of these categories. Government services, such as postal services, generally are also exempt from VAT except where they compete with taxed services from the private sector.

Adherence to the 6th Directive is general but not absolute. For example, telecommunications are not subject to VAT in France and The Netherlands, nor are telegraph services in Italy. France also allows the liberal professions exemption from VAT with the choice of opting in. Some countries exempt authors and other cultural activities and the tax treatment of charitable organisations is not uniform. The European countries with VAT which are not members of the EEC generally operate similar systems. For example, the Austrian system is similar to that for Germany. There are a few important differences. Norway, for instance, allows input credits for investment goods but taxes registered traders at a special rate (50 per cent of the VAT rate) on these goods.

Most countries give favourable tax treatment to most foods, public transport and other basic necessities to reduce regressivity as well as to certain "desirable" goods such as books and newspapers. What goods are included in these favoured categories varies from country to country and the treatment may be either zero rating, exemption or, more commonly, a reduced rate of tax.

It will be recalled from the previous chapter that supplies of exempted goods (exempted without credit) and services are not allowed to reclaim input taxes, but suppliers of zero rated (exempted with credit) goods and services are. Most European countries, including non-EEC members with VAT systems, restrict zero-rating to exports and the transportation of exports, but three countries, the

UK, Ireland and Portugal, make extensive use of zero rating for the favoured categories of expenditure.

It will also be recalled that zero-rating actually results in a negative tax or subsidy for the domestic consumption of goods and services to which it applies. This complicates analysis of the rates used in VAT systems, but if we restrict our analysis to nominal positive rates rather than the effective rates discussed in the previous chapter, we can see that there is little uniformity in the numbers of rates levied (Table 3.1). Only four countries out of the 14 in Europe with VAT have a single standard rate, though the UK's extensive use of zero-rating for favoured goods distinguishes it from the three Scandinavian countries where, apart from exports, only newspapers (and in Sweden, fuels and medicines also) are significant consumption items to be zero-rated. Four countries have three rates and four have four rates.

Table 3.1

Numbers and Range of Positive VAT Rates
Levied in European Countries, March 1985

Name	No. of VAT Rates	Standard Rate	Other Rates: 2	3	4
United Kingdom	1	15.0			
Denmark	1	22.0			
NORWAY	1	20.0			
SWEDEN	1	23.5			
FR Germany	2	14.0	7.0		
Ireland	2	23.0	10.0		
Netherlands	2	19.0	5.0		
Luxembourg	3	12.0	6.0	3.0	
Portugal	3	16.0	30.0	8.0	
Spain	3	12.0	8.0	6.0	
AUSTRIA	3	20.0	32.0	10.0	
Belgium	4	19.0	25.0	17.0	6.0
France	4	18.6	33.3	7.0	5.5
Italy	4	18.0	38.0	9.0	2.0

Source: Appendix 2

Note: Non-member states of the EEC are in capitals.

Table 3.1 presents the picture as it was at the end of March 1985. It can be seen from Appendix 2 that several governments have experimented both with more and fewer rates, though most countries have the same number they started with. Only Ireland has fewer rates than when VAT was first introduced. The UK had two positive rates from 1974 to 1976, for example, while for a brief period in 1980, Italy had no less than 10 rates.

Table 3.1 also shows that there are wide variations in the levels of rates which, for standard rates (the general rate from which exceptions are made), range from 12 per cent for Luxembourg to 23.5 per cent for Sweden. Other rates range from 2 to 38 per cent, both these extremes being in Italy. Standard rates have generally moved upwards and in all EEC countries (other than Spain and Portugal where introduction is so recent) these rates are higher than when VAT was first introduced (Appendix 2). Reductions in the standard rate have taken place in five of the nine EEC countries on one or more occasions, but in most cases these reductions have been accompanied by changes in the base of the tax or in other rates so that the reductions have been more apparent than real. Certainly, as we saw in Chapter 1, VAT has yielded an increasing proportion of rising total tax revenues in seven out of nine EEC states. Only in Denmark where the VAT base is exceptionally wide and the single rate exceptionally high and in Italy, has there been any significant downward movement in the VAT/Total Tax revenue ratio since 1980. In the past decade the trend has been upward in all countries except France.

Some Measures of Coverage and Distortion

No comprehensive published estimates of the coverage of the VAT bases in relation to consumer expenditure in the EEC seem to be available and we have been obliged to construct our own.

Table 3.2 presents two alternative estimates of the VAT tax base as a percentage of total consumer expenditure. The first column uses the Commission of the European Communities notional tax base and expresses it as a percentage of total consumer expenditure from the national accounts. (The EEC Commission takes an interest in the VAT tax base not only because it needs to monitor adherence to the 6th Directive, but also because a major part of the EEC budget is derived from a levy of 1 percentage point of the VAT yield in member states. It does not, however, publish data on coverage). The second column isolates and totals those elements in consumer expenditure which are subject to VAT and expresses them as a percentage of total consumer expenditure.

There are large problems in measurement and definition that affect the construction of these estimates. One factor is that there are wide variations in the extent to which certain services are provided by the public sector. Where this is so and the provision remunerated but not taxed, the percentage coverage is lower; where these services are provided free, then consumer expenditure is lower and coverage higher. In Germany, for example, medical expenditure accounts for 13.5 per cent of consumer spending; in the UK it accounts for only 1.1 per cent.

The UK figure is also high in column (1) because the notional base includes the extensive range of zero-rated items. Our own estimates of coverage in column (2) are lower for the UK (and low for Ireland) because we have included in the tax base only taxed items of expenditure and both thse countries make extensive use of zero-rating. Our estimates of coverage are usually lower than those in column (1). This is partly because the national accounts consumer expenditure data are insufficiently detailed to allow for the intricacies of exempted expenditures from the tax base. We were, for example, obliged to

Table 3.2

Estimates of the VAT Base
As a Percentage of Total Consumer Expenditure,
EEC Member States, 1983

	EEC Basis (1)	National Accounts Basis (2)
Denmark	80	75
Italy	75	84
Belgium	77	74
FR Germany	89	71
Netherlands	84	72
France	81	70
Ireland	n.a.	58
UK	95	52
Unweighted Average	84	70

Sources: Total consumer expenditure: GB&P estimates from Eurostat.

(1) EEC National Tax Base: written answer by the Commission to a question in the European Parliament.

include all construction and letting expenditure, only some of which is untaxed in most countries. Moreover, exempt small producers are ignored in this analysis, but in fact they both pay some unreclaimable VAT and absorb some consumer spending on which VAT is not levied.

Despite all these qualifications it is clear that the notional VAT tax base is a very high percentage of total consumer expenditure in the EEC, at least 75 per cent excluding the British Isles. If the tax were to be neutral it would have to cover 100 per cent of consumption. Seventy-five per cent, nevertheless, is very high when compared with the coverage of other indirect taxes. The Canadian authorities estimate that the Federal Manufacturers Sales Tax covers 32 per cent of consumers' expenditure while, we believe, general state sales taxes in the United States cover less than two thirds of consumer expenditure on average.

In their efforts to lighten the burden of such a widely based tax by the use of multiple rates of tax, however, much of the notional tax base is, as we have seen, taxed only lightly or not at all. One crude way of illustrating this is to calculate effective tax rates and to compare them with standard rates.

Table 3.3 shows that the average standard rate of VAT is about 17 per cent in the EEC. (Of course the standard rate of tax is only a very rough indicator of the level of VAT actually charged since the proportion of goods and services taxed at the standard rate varies from one country to another, as does the number and spread of lower and higher rates in those countries with more than one rate). The gross effective rate (we use the term "gross" to distinguish this rate from the

effective rate on production value added used in Chapter 2), which is total VAT revenue as a percentage of total consumer expenditure, is only 65 per cent of the average standard rate. If the tax were to be neutral, then one uniform standard rate would be 100 per cent of the effective rate. Only in Denmark, France and Germany are both the coverage of the tax base and the effective rate as a percentage of the standard rate 75 per cent or more.

Table 3.3

Gross Effective and Standard VAT Rates, 8 EEC Member States, 1983

	(1) Gross Effective Rate %	(2) Standard Rate Per Cent	(3) Effective as % of Standard
Denmark	17.8	22.0	81
Italy	9.5	18.0	53
Belgium	11.0	19.0	58
FR Germany	10.3	13.5	76
Netherlands	11.8	19.0	62
France	13.9	18.6	75
Ireland	11.8	33.8	35
U.K.	8.9	15.0	59
Weighted Average	10.9	16.8	65

Sources: (1) Total VAT revenue form OECD (1985) as percentage of total consumer expenditure from Eurostat.

(2) Appendix 2 adjusted to calendar year.

Disallowed Expenditure

So far, for simplicity, we have assumed that unless a business enterprise is exempt (in which case it neither charges VAT nor re-claims VAT on inputs), it can reclaim all input taxes. However, in the interests of minimising the acquisition of certain goods free of VAT for personal use through a business, part or all of input taxes on certain goods are disallowed in most EEC states even though they may be wholly and properly incurred in the course of business. Thus France does not allow businesses to reclaim input taxes on hotel or restaurant expenses, even for subsistence purposes, on business travel or for motor fuels or passenger cars. The UK and Ireland do not allow any reclaims of input tax on cars (except for car dealers) while Belgium and other countries allow only partial relief for cars. Other common disallowances are expenditure on business gifts, business entertainment and company aircraft.

Exemptions without credits for banking and insurance, medical care and other activities, together with exemptions for small businesses below the

threshold and disallowed expenditures mean that credit for input taxes is not permitted for a significant proportion of business expenditures. The French authorities have estimated that only 71.4 per cent of net VAT revenues are collected from final consumers, 18.3 per cent from business enterprises and 10.3 per cent from General Government (Table 3.4). As shown, the extent of exemptions and disallowed expenditure varies between member states and the proportion of the tax collected from consumers is probably higher in other EEC countries, certainly in Germany and perhaps Denmark, where exemptions and disallowances are least important. This is not necessarily true in the UK and Ireland where, although the treatment of business expenses is more liberal, the threshold and therefore the number of small firms exempted is exceptionally high. The estimates in Table 3.4 suggest that even were the 6th Directive strictly adhered to in France, less than 80 per cent of VAT would be collected from households.

Table 3.4

Distribution of VAT Collection by Economic Sector, France 1978,
Under 1980 Legislation and
Under the Full Application of the 6th Directive

	Firms	Households	Financial Institutions	General Gov't.	Total
1980 Legislation	16.5	71.4	1.8	10.3	100.0%
6th Directive	8.6	78.3	2.1	11.0	100.0%

Source: Conseil des Impots (1983)

Note: These estimates were prepared using a VAT simulation model based upon input-output analysis.

It will be noted that although a significant proportion of VAT revenue is collected from firms and therefore enters into their costs, this does not necessarily mean that tax is not fully shifted forward to consumers. It does mean, however, that the distortions to the pattern of production and consumption arising from the differences in rates and coverage discussed above are further magnified and also that some at least of VAT paid enters into export prices.

Regressivity

We have shown that the motive for departing from the application of VAT at a single rate over the whole of consumer expenditure is to avoid placing a heavier burden upon the less well off. The poor spend a larger proportion of their income than the more affluent and suffer if all commodities, including basic necessities, are taxed at the same rate. In fact, the use of zero-rating or lower rates of tax for goods which weigh large in the budgets of lower income groups has been largely effective in offsetting the regressivity of VAT.

Table 3.5 summarises the results of studies co-ordinated by the OECD in which VAT liabilities were calculated for the patterns of expenditure of house-

holds in different income groups based on family expenditure surveys and expressed as percentages of household expenditure in each group. It should be noted that differences in coverage and method mean that inter-country comparisons are not valid, but it is clear that within each country, the VAT burden is a constant or rising proportion of consumption as incomes increase (ie. it is progressive). The exception is Norway which is the only one of the six European countries in the table which has a single rate of tax and makes no use of zero-rating for necessities. There VAT declines as a proportion of consumption as household income rises (ie. it is regressive).

Table 3.5

VAT as a Percentage of Household Consumption Expenditure By Category of Disposable Income

		Low (first decile) Consumption	Intermediate (fifth decile) Consumption	High (tenth decile) Consumption
Belgium	1973 (1)	9.16	9.36	9.58
France	1969 (2)	10.10	10.70	10.60
FR Germany	1975 (3)	6.03	7.00	7.01
Netherlands	1974 (4)	7.00	7.30	7.50
Norway	1975 (5)	14.90	14.60	14.00
U.K.	1977 (6)	2.90	4.42	4.95

Source: OECD (1981)
The data is not internationally comparable. Only some of the differences in coverage are listed below.

Notes:
(1) Employees. 1st quartile, 2nd quartile and 4th quartile.
(2) Couple with 3 children. 1969 consumption pattern, 1975 tax rate. Low = F3,000-10,000, Intermediate = F15,000-20,000, High = over F50,000.
(3) Low = 2 persons: pensioners and recipients of welfare. Intermediate = 4 persons: employees of average income. High = 4 persons: employees of higher income.
(4) Two person households. Low = under Fl.16,000, Intermediate = Fl.16,000-19,000, High = over Fl.44,000.
(5) Couple with 2 children.
(6) Four person household.

If the VAT burden is expressed as a percentage of income rather than consumption, the pattern becomes less clear with the tax remaining progressive in Belgium and the UK but regressive in The Netherlands. In either measure the differences in the proportional burden of the tax are, however, quite small, usually less than one percentage point. Other studies give similar results. In Sweden, for example, another country with a uniform rate, VAT is clearly regressive, while in Italy the tax is progressive whether related to either income or consumption (Aaron (1981)). In France an official study concluded that VAT was progressive with respect to consumption but regressive with respect to income (Conseil des Impots (1983)).

4. The Operation of VAT

Preparation

VAT is not a tax which can be introduced quickly. The process of study, consultation, legislation, education and installation of the necessary administrative machinery take a considerable time. How long it takes depends primarily upon the strength of the political forces generated and the effectiveness of the planning. It is common for writers on VAT to point out that introduction in Europe was facilitated by the existence of the administrative systems for cascade taxes and the familiarity of the business community with turnover taxes.

The EEC directives of April 1967 called for the introduction of VAT in all (at the time) six member states by January 1970, a lead time of 2 years and 8 months though of course the deliberations leading up to the decision gave ample warning. The actual dates of introduction and the time taken from April 1967 were as follows:

France	1 January 1968	8 months
FR Germany	1 January 1968	8 months
The Netherlands	1 January 1969	1 year
Luxembourg	1 January 1970	2 years 8 months
Belgium	1 January 1971	3 years 8 months
Italy	1 January 1973	5 years 8 months

In all cases some preparation had been done before the publication of the EEC Directive. This was certainly true for the two largest countries in the Community who were the driving forces behind the decision to go for VAT and the first to get it in operation. France had had a VAT in the industrial sector since 1954 and a law to extend the tax to nearly all economic activities had been passed in 1966; the real lead time therefore was well over two years and actually led back to the preparations for the industrial VAT 15 years earlier. Germany had introduced legislation to replace its turnover tax with a VAT of the income type, using the invoice method, in 1963 which was not passed, and the final law introducing VAT was not passed until May 1967.

The length of the delay in implementing the EEC directives in Italy seems to have been caused mainly by political problems. According to Antonio Pedone (in Aaron (1981)), tax officials were concerned about the difficulties of extending a turnover tax system to the highly fragmented retailing system, trades unions were concerned about the impact of VAT upon prices and its regressive effect upon lower paid workers, exporters were concerned that the exemption of input taxes on exports would result in lower rebates than those enjoyed under the existing turnover tax, while small businesses feared that VAT records would be used in the assessment of income taxes. At the same time, the capacity of the authorities to cope with the changes was limited by other contemporary reforms in direct taxation and in the finance of local government. Three postponements of the date of introduction were authorised by the EEC.

Difficulties of a similar kind are being experienced in Greece today which has twice been granted postponement of the introduction of VAT, though things seem to have moved more rapidly in Spain and Portugal which have just introduced the tax. European countries which introduced VAT after the pioneers in the original six EEC member states have, of course, been able to draw upon earlier experience.

The introduction of VAT in the UK, against the background set out in the previous chapter, was conducted like a well planned and successful military operation (see Johnstone (1975)), though the Chancellor's announced intention that it would be "the simplest VAT in Europe" was frustrated. Serious planning began in 1969 and a Green Paper was published in March 1971 committing the government to introduce VAT. The White Paper was published a year later and the enabling legislation became law in the Finance Act of July 1972. VAT was introduced on the 1st of April 1973, two years from the date of the Green Paper. Somewhat more additional administrative staff were required than expected, some 6,440 in total, but revenue at £1,425 million was 24 per cent more than expected.

Initial Economic Effects

We have already shown that fears about the distributional effects of the introduction of VAT have not, on the whole, been borne out in practice—although they would have been had not the theoretical neutrality of VAT been emasculated by exemptions and multiple rates of taxation. In those countries which have applied a single rate with few exemptions, VAT has proved mildly regressive with respect to consumption and more so with respect to income; however, in Sweden and elsewhere the progressivity of the income tax system was increased to compensate for this.

The effects of the introduction of VAT on the price level have generally been unfavourable—prices rose—but the extent of this effect has been impossible to determine with any precision because, as always with econometric analysis, all other factors affecting prices did not remain constant. The effects of the introduction of VAT on prices (or changes in VAT on prices) depends upon the extent to which the tax is shifted forward, the degree to which monetary policy is accommodating, the effect on wage settlements, the stage reached in the business cycle, the extent to which changes in other taxes compensate, changes in the pattern of consumption and other factors. Some of these factors will have immediate effects, for example, each 1 per cent on a uniform rate of VAT will immediately raise consumer prices by the extent to which the tax base covers consumer expenditure—generally by less than about 0.8 per cent assuming that no other taxes are reduced or eliminated. In practice, VAT replaced other taxes and the initial impact has never been great.

A number of econometric studies have been carried out (for some see Aaron (1981)) and although we have not reviewed them in detail, the general conclusion seems to be that VAT has been only mildly inflationary, particularly through its subsequent effects upon the wage price spiral in some countries. These studies lend little support to the view that VAT contributed to the upsurge

of inflation in the early 1970s which would, in our view, have happened anyway, even without the 1973 oil price shock.

There is even less evidence of other short-term macro-economic damage from the introduction of VAT. In those countries where VAT replaced turnover taxes which bore upon investment goods, there was concern that businesses would defer investment during the transition period. This potential problem was avoided in some countries either by introducing reliefs for investments under the turnover tax (for example Italy) or by the imposition of a temporary tax on investment after the introduction of VAT (Germany, Belgium). Some countries, (for example The Netherlands) had no transitional measures for investment goods.

One of the arguments in favour of VAT that we have not previously dealt with is that, because it is widely based and the rate easily altered, it can be used as an effective regulator of demand. The UK Treasury, for example, has powers to alter VAT rates by order without recourse to Parliament for just this purpose. However it is difficult to find cases where VAT has been used for purposes of macro-economic demand management. One exception was in Britain in 1974 when the standard rate of VAT was reduced to 8 per cent in an attempt to stimulate the economy and check the rise in prices following the oil price shock. However, as we have seen, most changes in VAT have been in an upward direction and to increase revenue.

Administration

It is a fair characterisation of VAT in its pure form that it provides economic efficiency at the expense of administrative complexity. We have seen how the economic efficiency of the tax has been undermined in virtually all countries in which it is imposed, but this has done nothing to alleviate the administrative burden; indeed, it has significantly worsened it. There can be no doubt that it is in administration that VAT looks least attractive, and it is to this subject we now turn.

VAT administrations need to perform four functions: first to arrange the registration of eligible traders (and their deregistration if they cease to be eligible for any reason), and to distribute explanatory material; second to despatch and receive tax returns, refund input taxes and receive tax payments; third to deal with the many queries (and disputes) that arise from new and established traders and fourth to carry out audits and enforce compliance with the tax.

These functions have some similarities with those for the administration of incomes and profits taxes, but are, in some respects, more onerous because of the frequency of the tax returns and the scale and regularity of tax refunds. About one third of VAT received by the authorities is repaid to registered traders. The proportion varies from country to country according to the foreign trade ratio, the extent of zero-rating and other factors. In 1979 the percentage of tax repaid was: Italy 25 per cent, The Netherlands 33 per cent, Sweden 38 per cent, UK 35 per cent. In France, where arrangements for the repayment of tax are much less favourable than elsewhere, the equivalent figure seems to have been only 7 per cent (see below).

Moreover, whilst the annual assessment of business income taxes involves the review of accounts prepared in the majority of cases by qualified accountants, VAT accounts are prepared in most cases by in-house staff who may find the complexities of tax difficult to handle, at least until several years' experience has been gained. These complexities, which arise mainly from exemptions and multiple rates and changes in the rates, require the availability of large numbers of officials to deal with queries on a daily basis and to visit premises to ensure that VAT regulations are being properly complied with.

The size of the VAT administrative machine is not of course necessarily greater than with the cascade turnover taxes operated by the original members of the EEC, but it would be very much greater than that required for a manufacturers wholesale tax or a retail sales tax. Value added taxes involve all or virtually all significant business units. In the UK for example, Purchase Tax (a single stage wholesale tax) involved 74,000 traders. The VAT which replaced it now involves over 1.4 million traders. (VAT also replaced SET (see Chapter 3) but that was collected through the social security contributions system).

The volume of administrative work for VAT is not simply a function of the number of registered traders. There are very large movements on and off the register each year as new firms start trading or pass the eligibility threshold, or go out of business or contract below the threshold. In 1983 in the UK for example, 176,549 firms registered and 134,549 deregistered (Ganguly (1985)). There are also a large number of other changes, for example, of address and legal status.

Administrative arrangements for VAT are not the same in all countries in Europe. Some countries have quite separate organisations as in Italy, others combine the administration of VAT and income tax as in Germany and Ireland though the VAT on imports is collected by Customs and Excise. In the UK, Customs and Excise are responsible for all VAT administration (they were also responsible for Purchase Tax) through a system of 90 main local offices, some with sub offices and central data processing. All countries have local offices, some have decentralised dataprocessing. In some countries the post office giro (electronic funds transfer) system is used for tax payments, in others bank giros or cheques are used. In Germany, the proceeds of the tax are shared between the Federal Government and the Lander (states). This is done on the basis of population not revenue and, since it is used to redistribute revenue between rich and poor states, causes considerable friction.

The Costs of Administration

Since there are major differences in the size distribution of businesses and industrial structures between countries and the turnover threshold is much higher in some countries than in others, the number of registered traders is not necessarily proportionate to the human population. The UK, for example, with a higher threshold and a more concentrated business structure, has only 40 per cent of the number of registered traders as Italy even though the human population is about the same. Table 4.1 shows the number of registered traders in selected countries together with the number of man-years which national administrations say are solely concerned with VAT (Particularly in countries

where the administration of VAT is combined with that of other taxes and where overhead facilities are shared, these numbers will be to some extent estimated. Even where VAT administration is separate, customs staff are involved in import taxation and the numbers should be treated with caution). It can be seen that each official deals with 115 traders in the UK and 267 in Italy.

Table 4.1

Number of Registered Traders, VAT Officials and Traders per Official, Selected Countries

	Belgium	France	Germany	Italy	Netherlands	Sweden	UK
Number of registered traders	565,555 1984	1,711,000 1983	1,752,358 1982	3,600,000 1980	455,000 1984	400,000 1979	1,433,100 1983-4
Number of VAT officials	4,000	11,500	N/A	13,500	2,400	1,705	12,451
Traders per official	141	149	N/A	267	190	235	115

Source: MIA Interviews with National Tax Administrations

The differences in numbers of traders per official do not necessarily reflect differences in productivity. Sweden handles more traders per official than Belgium or The Netherlands which could result from the simpler form of the tax in Sweden, while Italy, which has a more complex system, handles even more, which could, with its greater number of traders, reflect either economies of scale, laxer standards of enforcement or less concentrated industrial structure.

In the UK the average size of traders is very much larger than in the rest of Europe and each trader requires more attention (small firms which, as will be shown in the next chapter, account for the majority of traders in all countries, contribute relatively little revenue and receive less attention than large traders).

The UK also probably allows more scope for questioning decisions of the administration and has a system of VAT tribunals to arbitrate disputes; in other countries this is left to the judicial system.

A large proportion of VAT staff in all countries are concerned with field audits and other enforcement work. In the UK, 22 per cent of VAT staff are engaged in general administration and fraud work; in Italy, 37 per cent of the total are described as "financial police"; and in The Netherlands, 63 per cent are engaged in checking and audit. In Sweden, auditing units account for 60 per cent of total staff in the total number shown in the table but they also deal with other taxes. On a rough ratio basis to population, there are probably well over 70,000 officials engaged in inland VAT work in the EEC member states with VAT.

Even though VAT is a self-assessed tax it is quite labour intensive for the administration, as mentioned, particularly because of the the large numbers of

returns, payments and refunds and the requirement for audits on business premises. The Inland Revenue in the UK is able to deal with 387 individual income tax assessments per official employed, well over three times the number of registered traders per VAT official. (The UK does not use a self-assessment system and the Inland Revenue has a relatively low level of computerisation; North American productivity levels are much higher—see Chapter 6). High levels of staffing are associated with high levels of other costs, but high as these costs are in absolute terms, they are low compared with the revenue raised.

In the EEC, total government costs for VAT probably average about one per cent of the revenue collected. Table 4.2 provides figures for the UK; similar ratios of cost to revenue were mentioned by national tax authorities in Belgium, Ireland and The Netherlands. Germany has no data at federal level on the collection costs of VAT, but we were told that they were "very substantially less" than the total costs for all taxes as a percentage of revenue (around two per cent). In the UK, the cost-revenue percentage for income tax is 2.2, about twice that for VAT, though collection costs for Excise duties are estimated at only 0.3 per cent. Not only are the collection costs of VAT relatively low in relation to revenue, but they have fallen by about 50 per cent since 1977-78 as tax officials and businesses alike have become more proficient at operating the tax and as tax revenues have risen with economic growth and higher rates of tax. It should be noted that even if cost-revenue data were available on a comparable basis, differences in these ratios would not necessarily reflect differences in the efficiency with which the tax is collected. The relatively low nominal and effective rate and the extensive use of zero-rating in the UK should tend to raise the cost-revenue ratio compared with other countries. That it seems to be about the same suggests that the UK system is relatively efficient.

Table 4.2

Numbers of VAT Staff, Registered Traders and Total Administration Costs and Revenues, UK 1978-79 to 1983-84

	Number of Staff	Number of Registered Traders	Ratio of Traders to Staff	Total Cost of Administration £ million	Total Revenue £ million	Cost as % of Revenue
1978-79	12,914	1,286,200	100	99.4	5,218.1	1.9
1979-80	12,243	1,327,200	108	111.8	8,706.2	1.3
1980-81	12,302	1,338,000	109	137.8	11,450.4	1.2
1981-82	12,219	1,379,500	113	154.4	12,363.2	1.2
1982-83	12,255	1,398,300	114	165.7	14,413.3	1.2
1983-84	12,451	1,433,100	115	176.3	15,920.8	1.1
1984-85	12,656	1,458,900	115	193.1	19,280.0	1.0

Source: Commissioners of Customs and Excise (1985)

Note: Includes Car Tax, an additional tax yielding about £750 million.

Compliance Costs

The government's tax administration or collection costs are only part of the total social cost of operating the tax system however, and are in fact for VAT only a small part of those total costs. First of all, value added taxes, as we have shown, are not neutral, they alter relative prices and by doing so distort the structure of production and consumption in ways which will reduce welfare (in the technical economic sense of the word). There are also other ways in which value added taxes reduce welfare, for example, by discouraging firms to grow beyond the threshold. VAT may also stimulate tax evasion. Finally, as shown, VAT tends to work against the progressiveness built into the rest of the tax system and may promote inequality. We do not attempt to measure social costs which, though very important, are common to a greater or lesser extent to all forms of indirect taxation and are difficult, if not impossible, to quantify.

What probably is most important, although there have been few attempts to measure them, are the costs incurred by businesses in collecting the tax. (Among the few exceptions is the work of Cedric Sandford and his colleagues at University of Bath Centre for Fiscal Studies upon which we draw heavily in this section and in Chapter 5). These compliance costs are large in aggregate and much larger than the government's administration costs and moreover, as will be shown in the next chapter, introduce further distortions into the structure of production. Compliance costs consist mainly of the value of the time spent on keeping records, making tax returns and other matters solely for the purpose of meeting the requirements of the tax authorities. This time will be spent by proprietors and directors of businesses, their staff and their professional advisors. There may also be other costs, (stationery, telephone calls and possibly capital costs for equipment), but these will be a relatively small part of the total.

In 1978 the Bath centre arranged for the mailing of 10,000 postal questionaires to a stratified random sample drawn, with the cooperation of the authorities, from the VAT register. In addition to classification data on size and type of registration, questions were asked about the time spent on VAT, numbers of invoices processed, terms of credit, the nature of any benefits gained from complying with VAT regulations, sources of advice and visits from VAT officials. The response rate was 31.4 per cent, resulting in some 2,800 usable replies. The response rate was higher for larger businesses but quite adequate in all size ranges. Data was available from Customs and Excise to allow re-weighting of the response by size and sector to ensure that the results were representative of the population of registered traders as a whole. A large number of personal interviews with traders and their professional advisers were also carried out.

Respondents were asked to value the time spent on VAT compliance and to record related paid out costs such as fees paid to professional accountants. The grossed up results are summarised in Table 4.3. Total compliance costs for all registered traders were estimated at £392 million, which amounted to 9.3 per cent of VAT revenue in 1977-78 or over 4.5 times the government's administration costs in that year (which were 2.0 per cent of revenue). The question immediately arises: were traders exaggerating the time spent on VAT or over-

valuing that time on the fees paid out to professional advisers? It seems not. Objective analysis does not suggest that the time estimates were excessive and the average hourly rates used are in line with earnings in the sectors covered. It was possible to cross check professional fees questioning accountants in the personal interviews. Moreover, two specialist firms were found that would handle all invoices and purchase vouchers and complete returns, in other words carried out VAT administration for a fee. Their charges were 12-17 per cent less than the reported values, which is corroborative, allowing for the economies of scale and specialisation enjoyed by such firms and the fact that businesses using them would still need to spend some time on VAT affairs.

Table 4.3

Measurable and Compliance Costs of VAT, UK 1977-78
(In £ Million and Per Cent)

Nature of compliance cost	Normal Costs	Special Problems	Total	Per Cent
Value of time spent on tax compliance by:				
Proprietors and partners	155	7	162	41.3
Directors	59	3	62	15.8
Qualified accounting staff	29	9	38	9.7
Other staff	103	5	108	27.6
Fees to professional advisers	17	3	20	5.1
Other costs	negligible	2	2	0.5
Total measurable compliance costs	363	29	392	100.0
Per cent	92.6	7.4	100.0	

Source: Sandford (1981)

Were it not for the fact that we have frequently found in the past that many matters of vital importance to small business remain unresearched, we should have been surprised to find that there are very few other studies of the compliance costs of VAT and none carried out on the same scale and with the same rigour of the Bath Study. Sandford (1981) reviews the limited earlier work (one study in Germany and a number of studies of sales taxes in the United States, including a hypothetical study on VAT by P.A. Barker (1972)) and finds them consistent with his own work. He also reviews the more general literature on tax compliance, which is also very limited.

In the course of this study we have found three further relevant pieces of research. One study of the compliance costs for VAT in a sample of Dutch firms (Snijder (1981)) and another of sales taxes (Peat Marwick) are reviewed in the

next chapter. A third in Germany (Hamer (1979)) found that businesses' administration costs rose by 16 per cent on average following the introduction of VAT.

Managerial Benefits of VAT

"It is an ill wind that blows nobody any good" and there are some benefits of VAT. One, an improvement in accounting records, was mentioned in Chapter 2. In order to claim input taxes, registered traders need to keep meticulous records of purchases, certainly more detailed and better supported in a small firm than would normally be necessary. They also need records of sales and output tax charged, though the benefits to sales records is likely to be less marked. In fact, the Bath survey found that 32 per cent of respondents agreed with the statement that "my purchase records are better kept since VAT came in" and 26 per cent agreed that their sales records were better kept. The proportion agreeing that there was an improvement was significantly higher in smaller firms, but large firms also recognised an improvement. However, of all firms agreeing that their records were better, relatively few volunteered a positive value to the benefit. A few claimed that better records had resulted in lower accounting fees and others mentioned improved stock control. In the personal interviews with accountants, most took the view that the standard of bookkeeping of their clients had improved "but most qualified their judgement with expressions such as 'initially', 'a little', 'for some firms', 'for small traders' ", and said that there would be no reduction in their fee for accounting work. We can conclude that the benefits to firms of better accounting records are marginal, though the requirement for purchase records and supporting vouchers would benefit income tax audits by the tax authorities.

Payment Periods and Cash Flow

A much more important benefit for many registered traders lies in the improved cash flow resulting from output taxes received from customers and held pending payment to the tax authorities. Some traders, however, experience a deterioration in cash flow where their input taxes exceed their output taxes. A firm which exports 100 per cent of its output, or exclusively supplies other goods and services which are zero-rated, will charge no VAT to its customers but will be entitled to reclaim the VAT on its purchases. In the UK, where zero-rating is more extensive than in other EEC countries, about 30 per cent of registered traders (400,000 or so) qualify for regular repayment of tax. Traders will also find themselves in credit with the tax authorities on an occasional basis in periods when they have exceptionally large inputs (for example when purchasing major investment goods) or exceptionally low sales. The Bath survey found that 48 per cent of respondents were clear net payment traders as against 37 per cent who were clear net repayment traders, so very large numbers of small firms suffer a cash flow disbenefit from VAT.

Assessing the scale and incidence of these cash flow benefits or disbenefits is far from being a simple matter. Not only will they be affected by the extent to which traders are supplying zero-rated goods and the phasing of their inputs and outputs, but also by regulations about the frequency of returns, the timing of tax

liability and the delays in payments to and from suppliers, customers and the tax authorities.

Regulations about the timing of liability for VAT are not the same in all countries. The 6th Directive requires that VAT is due on delivery of goods or on invoicing of services (the tax points, in VAT jargon). In other words, VAT liability is incurred on an accruals rather than on a payments basis (Appendix 5). However, member states may, for certain categories of supply, determine tax liability on the date of payment rather than on the date of invoicing or the date of supply of the goods or services (France and Italy operate in that way). The purpose of these rules, which we will not elaborate in detail, is to prevent traders from deferring liability for the tax. The rules for imports may be different again. The formal tax point is the date at which the goods pass the frontier, though some countries require payments of VAT on entry, others allow a delay. (The UK Exchequer recently gained a useful windfall by changing the rules to payment at the frontier).

In principle, deduction of input taxes is immediate, that is, a trader may deduct from the VAT liable on his sales at any given date the full amount of input tax, whether actually paid or not. France is the only exception to this; there, input taxes are deductable only one month after the date at which they are due to the supplier.

The date at which a trader actually has to pay his net VAT liability (or receive a refund) will depend upon the frequency with which he has to make returns to the authorities and the "period of grace" allowed for settlement after the date to which the accounts made in the return relate. Nine of the 14 European countries listed in Appendix 3 require monthly returns; Ireland, Norway and Sweden require bi-monthly returns and in the UK and Denmark, returns are made quarterly, though most countries with the more frequent returns allow small firms to opt for less frequent returns. The UK allows regular repayment traders to make monthly returns.

The period of grace allowed for the filing of returns after the date to which the return is made up is 30 days in The Netherlands and the UK and 15-25 days in most other countries. Germany allows only 10 days, while France has different periods for different legal forms of business: sole proprietors are allowed the least time (15-17 days), public limited companies the longest (23 or 24 days). The French system is supposed to reflect the differential times required to prepare accounts in the various types of business, but it also has the advantage of spreading the arrival of returns at the processing centres. The UK requires returns from different sectors of the economy at different three month periods to spread the load on the tax authorities, though more recently it has allowed firms in any sector to opt for quarters which coincide with the traders' financial year.

In all cases, payments to the tax authorities are made with the return and where this is by cheque there will be several days further delay until the trader's bank account is debited. Repayment traders are expected to receive refunds of input taxes within 14 days in the UK; in Belgium it is about one month, provided there are no queries. The French authorities say that repayment "should not in principle exceed two months" (Conseil des Impots (1983)), but admit that delays are often greater than that in the Paris region. Neither in France, nor in

any other country that we are aware of, is interest payable to the trader on overdue refunds from the tax authorities, although there are penalties for late payments of tax. In 1980, over 80 per cent of VAT payments were received by the UK authorities after the due date and heavy penalties have now been introduced to correct this. Late payment is, of course, a further possible source of cash flow benefit to the trader.

The final set of factors affecting the cash flow benefit or disbenefit of VAT to the trader are the credit terms given to and received from his customers and suppliers. If his sales are made for cash and spread evenly throughout the month, and he makes monthly returns, then he will have the use of the VAT he collects for 15 days, plus the period of grace (say 20 days) and the time taken to cash his cheque (say 5 days), a total of 40 days. If his suppliers require payment of their invoices and his input tax on these amounts and which he will have deducted from his VAT liability after 40 days, then he will have the use of the whole of the VAT he has collected for that period. If the trader has to pay cash to his suppliers or pay within 40 days, then the cash flow benefit will be reduced. If his customers are given lengthy credit, then he may have no cash flow benefit at all and may have to pay VAT before he has collected it.

There are obviously many permutations of these different circumstances, but for those traders who are making net payments of VAT to the authorities, the value of their sales will be greater than the value of their purchases (they will be adding value to their purchases) and their output tax will exceed their input tax. If they give the same credit period for sales as they are allowed on their purchases, then they ought to be somewhat better off in cash terms with VAT than without it. This will still be true even if they buy inputs some time before they sell their own output, because the input tax is deductible from output tax as soon as the liability is incurred.

Some traders will, as mentioned, have to pay tax before they have received it from their customers. In France and Italy the tax authorities will make loans to traders for the purpose of meeting VAT liabilities, that is, delayed payment is allowed but charged for. In France, the period of these loans is normally up to four months and the interest rate is only half of one per cent over the bank base rate. The large minority of repayment traders whose input taxes actually paid exceed their output taxes are, of course, making a loan to the tax authorities until payment is received. However, if a repayment trader makes major purchases at the end of a tax period he may well receive refund of the input tax before he has paid his supplier.

Detailed calculations have been made of the benefits and disbenefits of VAT for the cash flow of registered traders in France and the UK and the results are summarised in Tables 4.4 and 4.5. In both countries, the overall effect of VAT on the cash flow of business is favourable, after allowance for commercial credit terms, though the absolute size of the "loan" from the tax authorities to traders is very much greater in the UK than in France. This is because, as shown above, VAT arrangements are less favourable to the trader in France (and were especially so in 1978 when VAT on UK imports was not required to be paid immediately), returns are made frequently and input taxes are not immediately deductible. Repayments also take longer in France than in the UK, but there are

fewer repayment traders because there is less zero-rating. It will be noticed that there are considerable differences between the sectors which benefit from VAT "loans" in the two countries. Retail distribution, where sales are to a large extent for cash, benefit heavily in the UK from quarterly tax payment periods, but suffer in France from the inability of retailers to deduct input tax immediately, and more frequent tax payments.

Table 4.4

Average VAT Cash Balances (+) or Deficits (−)
Held or Borne by Registered Traders, by Sector, France 1980

	Billion Francs
Distribution	− 0.1
Intermediate manufacturing	− 2.0
Capital goods	− 3.1
Agro-industry	− 1.0
Energy	+ 0.8
Consumer goods	+ 0.1
Transport & telecommunications	+ 2.7
Construction	+ 3.6
Services	+ 0.9
Total	+ 1.9

Source: Conseil des Impots (1983)

Table 4.5

Average VAT Cash (+) or Deficit (−) Balances
Held or Borne by Registered Traders, by Sector, UK 1977–78

	£ Million
Primary	− 8.0
Construction	− 11.9
Miscellaneous and public services	+ 114.7
Transport and communications	+ 2.6
Financial and business services	+ 7.2
Professional and scientific services	+ 24.8
Wholesale and dealers	+ 0.2
Retail distribution	+ 434.2
Manufacturing and utilities	+ 468.8
Total	+ 1033.0

Source: Sandford (1981)

We are not able to explain all the differences between the two countries which are complicated by differences in sector classification and may arise partly from differences in the methods of calculation and (at the time) treatment of imports, but we can conclude that overall cash flow benefits are less favourable in France than in the UK. These benefits may be less favourable still in Germany, so that they will differ not only according to the trader's individual positions and the sectors they are in, but also according to the country we are looking at.

Net Compliance Costs

The net overall cash flow benefit (it will be remembered that many firms will experience a disbenefit) is most appropriately valued by applying an interest rate to the amount of the "loan" from the tax authorities to registered traders. For the UK in 1977/78, Sandford calculated that the cash flow benefits were worth £56 million at average bank minimum lending rates and this can be deducted from the compliance cost figure of £392 million in Table 4.3 to give an estimate of net compliance costs. The resulting figure of £336 million is 7.6 per cent of total VAT revenue in that year, below the gross figure of 9.3 per cent but nearly four times the administrative costs of government.

Sandford has recently updated his estimates to the year 1983-84 (Sandford (1985)). The UK government's administrative costs, as we have seen (in Table 4.2), had fallen to 1.1 per cent of revenue. Net compliance costs had also fallen because higher interest rates in this later period have boosted the value of the cash flow benefit to traders. Net compliance costs were, on the revised basis, 4.4 per cent, still four times the government's administration costs.

Evasion

Much of the claimed superiority of VAT over sales taxes (and other taxes) depends upon assertions that it is more evasion proof. The extent to which VAT is evaded in those countries which operate the tax is difficult to substantiate, but before looking at the evidence available we examine the logic of these assertions.

When it is said that VAT is self-policing it is usually meant that the retailer will ensure that he has a proper invoice from his supplier so that he may offset his input taxes against the tax charged to his customers; the supplier will have the same incentive to ensure that his suppliers invoice him correctly. In the same way, it is argued, each firm in the chain of production and distribution will ensure that it collects output tax from its customers because the act of supply creates a liability to pay that tax to the authorities.

The VAT system, then, helps reduce evasion in two ways. Firstly, the incentive to underdeclare output is tempered by the risk that the ratio of declared outputs to claimed inputs is low enough to arouse suspicion, or by the fact that the benefit of underdeclaration is only a proportion of value added, not final turnover. Secondly, it is felt that once a tax invoice is issued by a trader, it takes a greater effort of will to deny the tax due than if cash passes hands without any accompanying documentation.

However, in the absence of comprehensive cross-checking, the multi-stage system does not alter the incentive that exists under any form of sales tax to

underdeclare supply. A retailer who sells to a customer at a tax inclusive price and does not record the fact will still be better off by the amount of output tax due, even if he still pays input taxes. If he can find suppliers who will do the same then he has a better chance of escaping detection. If his inputs are relatively low and he is selling mainly to private individuals, as in the case of a plumber for example, he has an incentive to purchase those inputs retail at a tax-inclusive price and not to charge VAT at all. He can do this legally by not registering for VAT if his sales are below the threshold, and he will still be able to quote keener prices than his registered competitors. The temptation not to register and to conceal the true level of his sales will be high and may encourage him to opt out of the legitimate trading system and into the "black economy". If he is concealing his sales for VAT registration purposes, he is more likely to escape detection if he under-declares or does not declare his income at all for income tax purposes. Since marginal income tax rates in Europe will, on average, be 30 per cent or more and VAT around 20 per cent, the benefits of evasion are very high. In this way VAT has probably done much to stimulate the growth of the "black" economy which is causing concern to authorities in all European countries.

If any benefits do result from the incentives for customers to obtain receipts with purchases, they are restricted to transactions between registered traders. Those supplying directly to the public have no more reason to issue an invoice or receipt than they would under a sales tax. Where the authorities have reason to suspect fraud by a retailer, they can check with his supplier to compare the retailer's purchases with his sales—if he is purchasing more than he is selling then there is evidence of fraud if his stock position is inconsistent with his declared sales. If the supplier is in collusion with the seller then the fraud will only be detected by carrying out further inquiries. According to John F Due, checks with suppliers, when there is doubt about the sales of a retailer, is a routine feature of the administration of sales taxes in the United States. The strength of the VAT system is that it allows routine computer checks to be carried out of the ratio of input taxes to output taxes, which can pinpoint cases where these ratios are out of line and where there is a possibility of fraud. What it does not do is to allow the detection of fraud itself; this can only be done by a physical audit.

Automatic detection would only be possible if each trader recorded every purchase and sale on his return with the VAT number of his supplier so that the computer could cross-check that the claims tallied with one another. For obvious reasons the returns made to the tax authorities are not made in that detail and the more complex the structure of multiple rates and exemptions, the greater the normal range of variations in ratios will be and the less reliable guide they will give to the existence of fraud.

Another claim made for the strength of the VAT systems defences against fraud over a sales tax is that, because collection of the tax is multi-stage, then only part of the proceeds of the tax is lost if it is evaded at any point in the system. This is, of course, true but the corollary is that there are many more points in the economy at which scope for fraud exists. In a minor way it becomes easier for registered traders and their staff to acquire goods and

services for personal consumption free of tax than under a retail tax system. More important, because registered traders can reclaim input taxes under VAT, there is benefit to be gained from false invoices covering fictitious purchases which, if supported by fictitious invoices for zero-rated sales (especially exports of invisible services to associated overseas companies), are less likely to arouse suspicion under routine computer ratio checks. These and other possiblities for fraud do not exist at all under a sales tax system.

Reliable estimates of the extent of evasion are obviously difficult to make. One method is to compare the estimated yield of VAT from the national accounts with actual VAT revenue. This is not easily done because the breakdowns of consumption in the national accounts are difficult to reclassify on a basis to which multiple rates of tax and exemptions can be applied. A further difficulty is that the national accounts understate value added because of the existence of the "black" economy. Estimates based upon comparisons between expenditure-based and output-based national accounts indicate that output is typically understated, but since expenditure is also understated, calculations of this sort are unreliable. The circulation of large denomination banknotes and other indicators suggest that the "black" economy has grown substantially in Europe, and estimates of its extent range from 3 to 30 per cent of GDP. According to Pedone (in Aaron (1981)) in Italy:

> "Under any plausible interpretation, however, evasion is pervasive and large, reducing value added tax collections by as much as two thirds in some broad sectors and by two fifths overall. Only in the production of energy, which is a quasi-public enterprise, and in manufacturing, which is dominated by large firms that require modern accounting procedures and complete records to do business, is evasion below 40 per cent."

The problem of VAT evasion (and evasion of other taxes) is undoubtedly greater in Italy than in other European countries, but there is no doubt that it exists everywhere on a significant scale. Some indication of the extent of evasion can be gained from the results of control visits which are published in several countries. Control visits are made continually in Britain for all newly registered traders to ensure that the tax is being administered properly. Thereafter visits are apparently concentrated upon large firms where yield is greatest and upon those businesses where there may be reason (for example from computer checks) to suspect irregularities. In 1983-84, 350,000 visits were made amounting to 24 per cent of the total number of registered traders, but a large proportion of these visits, perhaps half, were to newly registered firms. The total number of visits to established businesses has been declining.

Tax assessments are issued following about one third of all audit visits. VAT is so complicated that innocent errors are easily possible, and the assessments relate both to under and overdeclarations of tax. In 1983-84, overdeclarations, however, at £6 million, were overshadowed by underdeclarations of tax or overdeclarations of repayment claims at £320 million, amounting to a net 2.0 per cent of total revenue. (Commissioners of Customs and Excise (1984)).

Given that only a third of traders are audited, we see that true evasion is probably nearer 6 per cent of revenue, and this is without taking into consideration those that fail to register at all, or undetected fraud by those audited.

According to the papers in *Aaron* (1981), the position was very similar in The Netherlands. In 1976, 20 per cent of registered traders received control visits and 34 per cent were found to have underdeclared tax. Recovery of tax underdeclared amounted to 1.2 per cent of VAT revenue in The Netherlands, while in Germany the corresponding figure was 1.4 per cent.

The French authorities estimate that losses of VAT revenue detectable by audit and investigation amount to 2.2 per cent of revenue (0.8 per cent of this is attributed to the work of the Customs authorities). A further 0.3 per cent could be attributed to detectable fraud in the "black" economy. Undetected fraud is estimated however, to raise total losses to between 6 and 10 per cent of total VAT revenue in France (Conseil des Impots (1983)). In a few countries, quite spectacular VAT frauds have been reported. In Belgium for example, there have been cases where fraudulent input tax repayment claims amounting to many millions of francs have been met from firms which had gone out of business some time previously (Wauters (1984)). Total evasion there is estimated at 8 per cent.

It seems to be the general experience that losses of revenue are relatively greater in small firms than in large, among service industries more than other sectors, and more in retailing than in manufacturing. Revenue authorities are understandably reticent about the methods of evasion used, particularly the more sophisticated devices. The French authorities, however, state that of detectable fraud, 43 per cent is accounted for by the omission of taxable transactions, 11 per cent by irregular deductions of input tax, 10 per cent by false exports, 5 per cent by early input claims (a problem largely peculiar to France) and 5 per cent by failure to pay tax on goods and services for personal use.

A government report on tax fraud in The Netherlands (Sijbren Cnossen in Aaron (1981)) revealed that: "although VAT fraud was slightly more frequent at the retail stage than at other stages of production ... less revenue was involved than at the other stages." Forty-four per cent of all reassessments "for tax evasion involved deliberately incorrect applications of the law, such as rules regarding deductions for prior stage taxes. Sixteen per cent had tried to postpone payments improperly. Thirty-eight per cent had failed to enter sales in their books or had kept incomplete accounts. Seven out of ten violations were committed by former offenders, perhaps because the penalties for violation tend to be rather low."

Enforcement Measures

The principal instrument of enforcement is the audit visit and one of the disadvantages of VAT is that it requires giving power to large additional numbers of officials to enter virtually all significant business premises in the country. In the UK, VAT officials have the right to gain access to business premises at any reasonable time and without search warrant although, except in some cases where fraud is suspected, appointments are made in advance. When in the premises, these officials have the right to examine all VAT bookkeeping

records and any correspondence or material relating to specific transactions.

Since delay in making VAT returns can be a useful source of finance for businesses, penalties are necessary for late returns as well as for failure to keep proper records or for fraudulent returns. Penalties for late returns are generally imposed administratively in EEC countries usually as percentage of the tax due, although those for other offences are left to the judicial system. There has been a distinct tendency for administrative powers and penalties to be increased over time. (For the UK see Committee on Enforcement Powers (1983) and Commissioners of Customs and Excise (1978) and (1984)).

In some countries, the methods used to enforce VAT compliance go far beyond audits on business premises. In several countries, inspections of goods in warehouses are regularly carried out and vehicles transporting goods are required to carry documents listing the buyers and sellers of the goods carried, with their VAT registration numbers. In Italy, since 1980 hotels and restaurants must issue VAT receipts, a copy of which must by law be taken off the premises by the customer who may be asked to produce it in the street.

5. VAT and Small Firms in the EEC

Small Business Attitudes

In his 1978 UK survey, Sandford asked respondents to agree or disagree with matched pairs of statements, one set pro-VAT and the other anti-VAT, for example:

"VAT is a simple method of collecting tax."
"As it stands, VAT is unreasonably complicated."

Pro-VAT responses were scored positively, anti-VAT responses negatively, while agreement or disagreement received a score of one and strong agreement or disagreement received a score of two. The responses of those who were indifferent (neither agreed nor disagreed) received a zero score. Had every score been very anti-VAT for any respondent, the score would have been -16; had every response been very pro-VAT, the score would have been +16.

The average result was -2 (slightly anti-VAT) and there were few large deviations. The least well disposed towards the tax were small and medium-sized retailers, and the sectors where the strongest anti-VAT views were expressed were retailing (though not among the largest firms), construction and professional and scientific services. Overall, the respondents broke down as follows, according to their attitude to VAT (per cent):

Very pro	0.6
Pro	15.9
Indifferent	47.0
Anti	27.1
Very anti	9.5
Overall	100.0

It is, at first sight, surprising that 47 per cent should be indifferent though 36.6 per cent were anti compared with 16.5 per cent pro. However, very few indeed can be expected to actually like taxes and one might expect to find that VAT compares unfavourably with other taxes.

Overall, there was evidence in the survey that in response to the statement "Most other taxes work more efficiently than VAT", there is a marginal preference for other taxes over VAT, but at an average result of barely -0.1, this anti-VAT response was actually less pronounced than for attitudes to VAT in isolation. When these average responses were calculated by size of firm, however, there was a very clear tendency for the rating of VAT, compared with other taxes, to improve with size of firm. In fact, the two largest categories of traders actually favoured VAT over other taxes (Table 5.1).

It is well known that small firms complain more than large firms about the burden of government taxation, regulation and paperwork. The reasons are simple ones: there are economies of scale in dealing with government; the proprietors of small firms have less administrative support (little or none in some cases) and are therefore bearing much of the paperwork burden person-

Table 5.1

Responses to "Most other taxes work more effectively than VAT"

Annual Taxable Turnover Category £ '000	Mean of Scores
0 - 9.9	−0.24
10 - 19.9	−0.14
20 - 49.9	−0.17
50 - 99.9	−0.05
100 - 499.9	−0.02
500 - 999.9	0.25
1000 & over	0.12
Overall	−0.06

Source: Sandford (1981)

ally. Attitudes to taxation itself (as distinct from the compliance costs of taxation) are also less favourable among small firms because taxes bear not only upon personal income, but upon the sources of capital for investment and expansion. Large firms have more easy access to the capital markets for both loan and equity capital than small firms, and therefore this aspect of taxation is of less concern to them (see Bannock (1981)). VAT is largely neutral to capital investment and is not borne to a major extent by the registered traders themselves. We saw in Chapter 4 that a proportion of VAT is in fact borne by business. Insofar as this results from the inability of exempt traders to reclaim input taxes, small businesses are discriminated against since virtually all exempt traders are small firms, except in financial services and real estate (though of course they can register voluntarily). However, the compliance costs do fall upon all registered businesses and particularly heavily, as will be demonstrated, on small businesses.

An international survey amongst small firms carried out in a number of countries in 1984 showed that, except in Japan, the combined problem of government taxes and paperwork received more mentions in response to the question "What is the most important problem facing your business today" than any other single set of problems (Table 5.2). Only in Japan was the basic problem of realising sales not overshadowed by the burden of government. This survey threw no light on individual taxes or regulations but certainly there is ample evidence in the UK that, of all aspects of the compliance burden of government activity, VAT is regarded as the most onerous.

The UK Forum of Private Business carries out regular surveys (brought together in Bannock (1984)) amongst its members and asks "Which act has the most adverse effect on your business?" and "Which act would you like to see changed?" As to the first of these questions, VAT came top of the list on every occasion in surveys carried out between March 1979 and March 1982, with percentage mentions running from 35 per cent to 57 per cent. In six out of the seven surveys in which these questions were included, VAT also came top of the

Table 5.2

Most Important Problems Faced by Small Business

	Per Cent of Mentions					
	Japan	USA	UK	Germany	Netherlands	Canada
Government regulations & paperwork	2.5	18.3	20.8	14.0	24.8	16.4
Taxes	9.2	12.5	15.8	8.6	10.2	9.2
Sub-total	11.7	30.8	36.6	22.6	35.0	25.6
Interest rates & financing	7.2	11.0	17.5	19.7	5.8	20.8
Realising sales	37.8	8.4	9.7	4.6	11.8	8.6
Competition from large business	11.9	9.7	10.8	13.7	11.8	8.9
Other	31.4	40.1	25.4	39.4	35.6	36.1
Sub-total	88.3	69.2	63.4	77.4	65.0	74.4
Total mentions	100.0	100.0	100.0	100.0	100.0	100.0

Source: SKIM (1984)

list as the Act which respondents would most like to see changed (14-43 per cent). In both cases, the trend of mentions has been broadly upwards over the period 1979-82 (ie. subsequent to the Sandford survey), even though the UK abolished multiple positive rates of VAT within the period.

Similar results were obtained in a more recent independent survey carried out for the UK Department of Industry (Table 5.3). Professor Bryan Carsberg carried out a survey of small firms and their auditors for the UK Institute of Chartered Accountants in 1984. He found that small business proprietors ranked VAT well above all other administrative requirements in terms of the cost, time and effort involved, including tax administration for employees, the preparation of annual accounts and social security administration (Carsberg (1985)). The auditors took a similar view and ranked VAT above the annual accounts and the provision of information for banks.

VAT Administration in Business

Before we go on to review the more detailed evidence on compliance costs by size of registered trader, it will be helpful to the reader unfamiliar with VAT if we give a picture of the practicalities of administration of the tax in a small firm.

The process starts with the routine bookkeeping and sales administration of the firm. Most small businesses, whether registered for VAT or not, will keep a record of major purchases with a file of purchase invoices. The purchase ledger or cash book will need an extra column for VAT however, and if the proprietor

Table 5.3

Government Burdens on Small Business
Per Cent of Mentions and Seriousness Rating

	Per Cent Mentions	Rating 1 = least serious 10 = most serious
VAT	39.0	4.7
Employment protection	29.0	4.7
Statistics	21.0	2.9
Local authority planning regulations	20.5	5.6
Employed/self employed tax treatment	13.5	4.5
Sick pay	13.5	3.4
PAYE Income Tax administration	12.5	4.1
Health and safety	11.0	3.5
Local authority building regulations	7.5	4.1
Environmental regulations	6.5	4.1

Source: Research Associates Survey in *Burdens on Business,* HMSO, March 1985

wishes to reclaim all the input taxes he pays, he will need to ensure that every entry is supported by an invoice or tax receipt giving the VAT number of his supplier. Credit card counterfoils and till receipts will not be sufficient for this purpose unless they bear the VAT number and, where appropriate, the rate of VAT charged. (This means for most cash purchases that he and his staff will need to remember to ask for a VAT receipt). In entering the input VAT in the ledger, he or his bookkeeper will need to distinguish between disallowed input taxes, including items for personal consumption (which may require an additional calculation if they are part only of the total on the voucher) if additional work is to be avoided when the VAT is totalled for the purposes of the regular return. For sales, the firm will need to ensure that VAT is charged at the appropriate rate and that all the necessary information (date of supply, VAT number, name and address of customer) is on the invoice. The amount and the VAT charged will also need to be entered separately in the books so that output tax can be totalled for the return to the tax authorities. Note that the tax to be paid is not just the VAT rate times sales because the tax is expressed on the net price. A 10 per cent VAT is 9.09 per cent of the tax inclusive price, and this calculation will need to be made frequently for both purchases and sales where the tax is not shown separately on receipts. For cash sales, a retailer may have to write out by hand a special tax invoice on a pre-printed form if requested. The more invoices a firm issues or receives, and the more complex the VAT rate structure, the greater the administrative burden will be.

At the end of the month or longer period, depending upon the regulations, the

firm will have to make a return showing its input tax, output tax and net tax payable or repayable. At its simplest, this may be a one-page form with just a few boxes to insert the numbers, and at its most complex it may be a forbidding document of several pages. An example of a simple form, that of the UK, is included in Appendix 7. The complex French form, which we could not obtain permission to reproduce here, fills three pages and 78 lines although every line clearly is not applicable to every trader. Complexity in the return is largely a function of the regulations—the more rates and special rules there are governing payments, the longer the form will need to be. As in other aspects of VAT, simplicity and fairness often conflict. Until recently no relief was allowed on bad debts in the UK for example. Since output VAT becomes liable on invoicing, subsequent refusal or inability to pay creates administrative hassle as well as financial loss. Where traders subsequently agree on different terms from those invoiced, credit notes may be issued. A similar procedure can be used (illegally) to circumvent the bad debt rule. For payment traders, the form will need to be accompanied by a cheque which requires further bookkeeping entries, although in Sweden the tax return also acts as the instrument for the transfer of funds via the post office giro system.

Who in the firm does all this will vary. According to Forum surveys, in some 60 per cent of small firms the proprietor himself completes the form, and in most cases he will need to check and sign it (Bannock (1984)). According to the SKIM survey (SKIM (1984)), 43 per cent of respondents also kept the books themselves and in a further 19 per cent of cases the books were kept by their spouses. In only 22 per cent of firms were the books kept by an employee, although this proportion was much lower than in other advanced countries. In Britain, about 30 per cent of small businesses have computers (Small Business Research Trust (1985)) (somewhat lower than in the United States) but even where bookkeeping is done electronically, the verification and inputting requirements for VAT are not lightened and we know of no small firm that prepares its VAT returns on the computer.

There are, however, several other elements in the burden of VAT administration which have not yet been described. The first of these is errors, queries and disputes. As a general rule, in a small firm only the proprietor and the bookkeeper will understand VAT. Customers and other employees may get things wrong (as they themselves will too on occasion). Failure to specify that a price quotation to an exempt trader does not include VAT will result in a query and possibly the loss of a sale when an invoice is issued. Incorrect rates may be applied—this is very common under multiple rate systems—and in some cases the distinctions between manufactured and non-manufactured foods, repairs and new construction, new and used goods and other borderline cases will require arcane knowledge of the regulations. (For example, frozen yoghurt and a hot sandwich may be subject to VAT, fresh yoghurt and a cold sandwich may not be subject to VAT). Other instances which create difficulties include the distinction between the purchase of a good or service when acting as a principal or as an agent (VAT will be liable in the former but not in the latter case), the supply of a service from overseas by telephone or other electronic means and its supply in person, trading between exempt and non-exempt organisations under

common ownership and the special VAT documentation requirement for exports and imports. In Germany, VAT is applied to sales to East Germany which in other respects would be treated as an export. Some of the misunderstandings, disputes and problems will be dealt with at the time, others will not be brought to light until months or years later when the VAT inspector calls to make an audit.

Secondly, dealing with the audits themselves is another element in the VAT burden, although it will be relatively infrequent, perhaps once every few years for a small firm. An audit will inevitably take up some of the proprietor's or bookkeeper's time, and, to the innocent and guilty alike, will create some anxiety. VAT is a self-assessed tax where the rules are so complex that in many cases the VAT inspector will need to seek higher authority for his interpretations, but where the small firm will pay a penalty, even if only in underpaid tax, if it gets it wrong. Although the tax is supposed to be borne by the end customer, the firm has no recourse to that customer if tax is incorrectly applied.

Thirdly, there is the necessity of keeping records of past transactions. In Europe, firms are required to maintain invoices and receipts for an average of seven years.

Anxiety about these matters is a part of the "psychic cost" of VAT which is not measurable but is nonetheless real. Sandford (1981) points out that income tax officials are normally happy, and indeed prefer, to deal with the taxpayer's accountant, but with VAT, the professional adviser cannot stand between the tax authorities and his client in the same way—although he may, of course, be present at audits where advance warning is given. There is also an obvious difference between the position of a senior employee in a large firm dealing with the VAT authorities and the proprietor of a small business whose personal pocket is at stake.

Another area of difficulty for some traders is "partial exemption". Firms, some of whose output is exempt and some of whose output is taxable (including zero-rated items), for example construction companies, are not allowed to claim tax back on all their inputs (for example the timbers they buy), but only on those that contributed to taxable outputs. Tax experts all agree that apportioning input tax between taxable and exempt outputs is the worst aspect of VAT administration, leading to many disputes between traders and authorities. Other areas of difficulty exist too. Sale or return items may be treated in a special way and bad debts need to be written off if permitted.

Finally, there is the whole question of VAT policy for the proprietors of small firms and, for that matter, the finance directors of large firms, to worry about. In all firms, the completion of VAT returns is not necessarily a simple matter of routine; it requires the attention of a senior person and in a small firm this is normally the proprietor. Since the date of the return is fixed and penalties for late returns significant, the proprietor needs to ensure that he and the necessary cash are available on the appropriate date. As we have shown, however, the maximisation of the cash flow benefit (or the minimisation of the disbenefit) requires conscious management decision. Bringing forward the delivery of a major capital item or postponing a major sale for a few days either side of a VAT

account period can make a very considerable difference to the cash flow in that period.

It should be added that what we have been describing here are the ongoing costs of VAT administration. When a small trader first registers for VAT (and the vast majority of new registrations are of small firms), he will have to invest a considerable amount of time in understanding the VAT system and then in training his staff, if appropriate, to maintain the new records and apply the tax (Mendham (1984)). As a start, he will need to read (in the UK) the *VAT Guide*, some 44,000 words and a number of other leaflets and booklets depending upon the trade he is in. There are a considerable number of official VAT leaflets and publications in Britain to choose from—over 100 in all—and even a regular publication, *VAT Notes*. These publications are, to say the least, not easily understood and some questions will probably have to be put to the local VAT office.

The Regressivity of Net Compliance Costs

All registered traders will bear the compliance costs of VAT, though not all will enjoy the cash flow benefits discussed in Chapter 4. As far as compliance costs are concerned, these may be expected to decline in relation to turnover for the following reasons given by Sandford:

- The larger the firm, the greater the scope for the use of specialist staff whose costs can be spread over a larger volume of sales—in a small firm the proprietor has to do much of the work and the cost of his time is normally greater than for specialist staff.
- The larger the firm, the greater the scope for computers, programmed point of sale registers, etc.
- "The number of invoices to be dealt with will not rise in proportion to size. Large firms are likely to buy in bulk and often to sell in larger quantities than small firms."

The Bath survey, described in Chapter 4, found in fact that compliance costs fell sharply with the size of firm, from 1.64 per cent of turnover for the smallest category of trader down to an average of only 0.04 per cent for firms with a turnover of over £1 million and over (Table 5.4).

What this means is that compliance costs are 40 times higher, *as a proportion* of turnover for the smallest category of firms in the table as for the largest. (Strictly speaking, the compliance costs discussed in this section are marginal costs since they do not include any allowance for overheads (office space, heat and light, etc.); were we to use average costs, then the regressivity might be greater still).

Moreover, the threshold for the largest category at £1 million ($ 1.438 million) was not high, even for 1978. There were 22,000 VAT registered firms with a turnover in excess of £2 million in 1983 (the equivalent threshold at 1978 prices would have been about £1.4 million) and for the very largest firms with sales of hundreds of millions of pounds, we can safely assume that compliance costs of VAT were well under 0.01 per cent of turnover. Checks on the influence of factors not related to size indicate that the mix of VAT rates (the number of

Table 5.4

Compliance Costs and Net Compliance Costs as a Percentage Of Taxable Turnover by Turnover Size Category, UK 1977-78

Annual Taxable Turnover £ '000	Compliance Costs	Per Cent Net Compliance Cost
0 - 9.9	1.64	1.69
10 - 19.9	1.23	1.13
20 - 49.9	0.74	0.68
50 - 99.9	0.54	0.50
100 - 999.9	0.24	0.22
1000 & over	0.04	0.03
Weighted overall mean	0.92	0.88

Source: Sandford (1981)

positive rates) is a determinant of compliance costs. Repayment traders had lower costs than payment traders, partly because of the special schemes for farmers, but also because zero-rated or exempt outputs involve less work. A number of large firms, particularly in retailing, undoubtedly make a large profit out of VAT when the cash benefit is allowed for. Incremental compliance costs for a highly computerised firm in this category are negligible.

A study on the compliance costs of taxation was also carried out in The Netherlands and the results were published at about the same time as Sandford's. Snidjer (1981) surveyed 286 firms and asked his respondents to value the time spent on VAT administration, fees to accountants and other associated costs. Recalculating his results onto a similar basis to Sandford's, we find that although as a percentage of turnover they are lower, they show a similar reduction with increasing size of firm: 0.59 per cent for traders with a turnover of between DG 250,000-499,000; 0.43 per cent (DG 500,000-999,999); 0.23 per cent (DG 1,000,000-1,999,999) and 0.19 per cent (DG 2,000,000-3,999,999). These calculations were made by assuming turnover was at the mid-point of turnover size categories and by omitting the open-ended lower and upper categories. We presume Snidjer's costs are lower for smaller firms than Sandford's, partly at least because he nets out the allowance for these costs given by the Dutch authorities (see Appendix 4).

It is now well established that the compliance costs of all forms of taxation are highly regressive and a recent study of the compliance costs of state sales taxes in the US gives a similar, though less steeply regressive, picture. Peat Marwick (1985), in a study of some 200 retailers, for 80 of which on-site measurement was carried out, found that net compliance costs (that is, after allowing for cash flow benefits) were more than three times higher for small retailers than for large retailers (Table 5.5). Overall, Sandford (1981) estimated the total value of

the "loan" from the tax authorities to UK registered traders at £56 million, about 14 percent of the estimated total compliance costs borne by these traders.

Table 5.5

Net Compliance Costs as a Percentage of Tax Collected By Compliance Element and Total Sales by Size of Firm, Representative US States

Compliance Element	Total Sales Turnover Category Small $1m & Under	 Medium $1m to $10m	 Large Over $10m
As % of Tax Collected			
Collection	2.996	2.382	1.637
Reporting	1.306	0.258	0.160
Payments	−0.401	−0.585	−0.599
Auditing	0.009	0.020	0.033
Miscellaneous	0.115	0.020	0.025
Total	4.025	2.095	1.256
As % of Taxable Sales			
Total	0.161	0.084	0.050

Source: Peat Marwick (1985)

This benefit does not seem to vary systematically with size. The main determinant of the cash flow benefit in proportional terms seems to be the economic sector, not the size of firm. The different pattern of commercial credit experienced by small and large firms seems to have little effect: although large firms are slower to pay their debtors, they also experience longer delays in receiving payment from creditors. Sandford did observe that the cash benefit of VAT was more appreciated by large than by small firms. Many small firms (and some large) did not perceive the benefit at all (or did not acknowledge it). Peat Marwick also found that the value of the use of sales tax funds was neutral to size. (This is not borne out by Table 5.5 because the payments item includes not only interest on tax held, but bank charges and other costs related to the handling of tax payments which do diminish proportionately to the volume of funds involved).

It is clear from Table 5.4 that the pattern of distribution of net compliance costs after subtraction (or addition) of the cash benefit (disbenefit) by size of firm is little different from that in the gross figures. What is striking about the US sales tax compliance figures in Table 5.5 is that they exhibit a very similar pattern but are about one tenth of the size of the corresponding data for the UK. Peat Marwick's data are based on a computer model using parameters derived from the survey and reflecting the conditions in a representative state where the

sales tax rate is 4 per cent. Since this rate is much lower than the UK VAT rate, which would tend to push up costs as a percentage of taxable sales, the magnitude of the difference is surprising.

We should expect the compliance costs to be lower for a sales tax than for VAT because retailers tend to benefit more than the average from the cash flow advantages and under a sales tax do not have the additional work of recording inputs or of dealing with multiple tax rates. The difference is greater than we should expect, however, and is clearly mainly attributable to the fact that in the US data, the turnover categories are at a higher level. "Small" US firms are bracketed under $1 million and have net compliance costs of 0.16 per cent of sales. This corresponds more nearly to the second highest bracket in the Sandford data ($144,000-$1.44 million) where compliance costs were 0.22 per cent of sales. This is 70 per cent higher.

Administration Costs by Size of Firm

Not only are the compliance costs of VAT regressive in terms of firm size, but so are the government's collection or administration costs. The vast majority of all firms in all countries are small firms, and this is also true of the number of traders registered for VAT. An extreme case is France, where there is no minimum threshold and where 73.2 per cent of registered traders had a turnover in 1983 of less than FF 1 m ($ 132,400) (Table 5.6). Even in the UK, where the threshold is relatively high, over 18 per cent of traders (some 262,000 firms) were below that threshold in 1983-84 (£18,000) ($ 25,880), but had voluntarily opted into the VAT system (Table 5.7).

The threshold (which has subsequently been increased) in fact only applied to newly registered traders whose actual turnover or expected turnover was £18,000 or more per annum. Existing registered traders had to remain on the register if their expected turnover was £17,000 or more. There are, therefore, different thresholds for registration and for deregistration. The limits refer to taxable turnover including goods and services which are zero-rated. A person whose taxable supplies are all zero-rated, however, may apply for exemption from registration even if those supplies exceed the limit. Firms whose taxable turnover is below the registration limit may apply for voluntary registration.

The net revenue yielded by these large numbers of small firms is a small proportion of total revenue. In the UK, the smallest 1.08 million firms (75.6 per cent of the total) together account for only 6.7 per cent of the VAT revenue, while the largest 6,000 firms (0.4 per cent of the total) accounted for 61.5 per cent of revenue (Table 5.6). In France, the largest 4.1 per cent of firms account for 77 per cent of gross VAT revenue.

The total costs of administering VAT in the UK in 1983-84 were £176.3 million ($ 201 million), which works out at £123 ($ 180) per registered trader. If we assume for a moment that the cost per trader is similarly distributed by size of compliance costs, then the administration costs for the 125,000 traders with a turnover of under £10,000 could be £7 million, compared with £10 million of revenue obtained from them. These figures are affected by the fact that small traders are often voluntarily registered and are thus likely to be claiming money back from the authorities rather than handing it over.

The same is true of some sectors, for example construction and primary (agriculture, forestry, fishing and mining), from which no net revenue is obtained at all (because output in these sectors is largely zero-rated). Substantial net refunds of tax are made at considerable administrative cost (Appendix 6).

Table 5.6

Numbers of VAT Registered Traders and Net Tax Receipts By Taxable Turnover Category, UK 1983-84

Annual Taxable Turnover £ '000	Number of Reg. Traders £ '000	Cum. %	Net Tax Receipts £m.	Cum. %
Up to 8.5	82	5.7	−5	–
8.6 - 10	43	8.7	15	0.1
10.1 - 12.5	39	11.4	20	0.2
12.6 - 15	64	15.9	35	0.4
15.1 - 17.5	34	18.3	25	0.6
17.6 - 20	142	28.2	80	1.1
20.1 - 50	424	57.8	380	3.6
50.1 - 100	256	75.6	465	6.7
100.1 - 500	260	93.8	1465	16.3
500.1 - 1000	41	96.7	710	21.0
1000.1 - 10000	42	99.6	2670	38.5
10000.1 and over	6	100.0	9360	100.0
Total	1433	100.0	15220	100.0

Source: Commissioners of Customs and Excise (1984)

Table 5.7

Numbers of VAT Registered Traders and Gross VAT Charged By Turnover Category, France 1983

Annual Turnover Francs thousands	Number of Registered Traders '000	Cum. %	VAT Charged	Cum. %
Under 1,000	1253	73.2	43	5.7
1,000-1,999	188	84.2	31	9.9
2,000-4,999	143	92.5	52	16.8
5,000-9,999	56	95.9	47	23.0
10,000 & over	69	100.0	578	100.0
Total	1711	100.0	751	100.0

Source: Ministere des Finances

In fact, the cost of collecting VAT from a small firm is, on average, probably somewhat less than for all firms, largely because fewer and shorter visits are made by tax officials, but this does not affect the general conclusion that the administration cost of VAT is regressive with respect to size of firm. In fact, Sandford (1981), on the basis of more detailed estimates on the costs of administration derived from the Bath survey, shows that administration costs are actually even more regressive than compliance costs. His overall estimates of operating costs (administration plus compliance costs) for 1977-78 are shown in Table 5.8. It can be seen from this table that for the first three size categories, covering 881,000 firms or 69.1 per cent of all traders, the total cost of operating the tax exceeded the net revenue by over 13 per cent. Incredibly, even for 96 per cent of the traders, operating costs accounted for nearly half of the revenue. It is only for the 4 per cent of larger traders that total costs fell to 15 per cent of revenue.

Table 5.8

Number of Registered Traders, Net VAT Revenue, and Net Operating Costs In Total and by Turnover Category, UK 1977-78

Annual Taxable Turnover	Number of Reg. Traders		Net Tax Paid	Net Operating Costs	Net Operating Costs as % of Net Tax Collected	
£ '000	'000	% cum.	£m	£m	%	% cum.
0 - 9.9	270.7	21.2	15	42	280.0	280.0
10 - 19.9	269.5	42.4	55	64	116.4	151.4
20 - 49.9	340.9	69.1	120	109	90.8	113.2
50 - 99.9	177.7	83.1	140	82	58.6	90.0
100 - 999.9	185.4	96.1	600	129	21.5	45.8
1000 & over	30.0	100.0	3305	69	2.1	15.0
Total	1274.2	100.0	4235	495	11.7	11.7

Source: Adapted from Sandford (1981)

As pointed out in Chapter 4, since 1977-78 a higher standard rate of VAT had been applied in the UK while higher interest rates will have increased the value of the cash benefit. These changes reduced estimated overall operating costs as a per cent of revenue from 11.7 in 1977-78 to 7.9 per cent in 1983-84, but the disproportion between large and small firms remains. (Sandford (1985)).

Are Small Firms a Problem?

Despite the known regressivity of compliance costs and the inefficiency of administration of VAT for small firms, authorities are apt to forget why it is that these are undesirable features of a tax. There are, in fact, three important reasons why they should be dealt with.

The first is that economic efficiency is enhanced by the removal of all distortions on production methods and form. Imposing a relatively heavy burden on small firms distorts production away from what might, in some cases, be its natural and most efficient unit. Distortions against small firms can impair not only present economic performance but also growth, given the important role of small business in innovation and change.

The second consideration is equity—it simply is not fair to impose differing burdens on different groups in society indiscriminately.

The third consideration is that all taxes involve compliance and administration costs. These costs are a net loss to society. When resources are poured into merely administering or complying with a tax, those paying them still suffer the loss but there is no offsetting social gain. It is as though, in our determination to distribute a bottle of champagne between ourselves fairly, we spilt much of it on the floor. When administrative costs are a significant proportion of revenue, it is difficult to believe that the value of the spending exceeds the cost of the tax.

The inequity of indiscriminately applying a social burden, the value of the costs of administering a tax and the distortions caused by an unequal application of the full tax burden are the reasons for concentrating on simplifying VAT for smaller traders.

Special Schemes for Small Business

All European countries recognise that VAT administration for the very smallest firms is an unfruitful burden for business and government alike, and this concern is reflected in a variety of forms of special treatment (see Appendix 4).

The simplest solution is to allow firms with a turnover below a certain level (threshold) to opt out of the system altogether. For firms which opt out, however, the compliance burden is exchanged for a tax burden. They are still obliged to pay VAT but are unable to reclaim input taxes while their registered customers cannot reclaim any of the tax element in the cost of supplies from them (except in Sweden where special arrangements apply). Unless the saving in compliance costs is greater than the tax burden, small firms below the threshold selling to registered traders will therefore suffer a competitive disadvantage unless they opt into the VAT system and, as mentioned earlier, many do so.

According to Commissioners of H.M. Customs and Excise (1978), following increases in thresholds in 1977 and 1978, only about one fifth of payment traders eligible to deregister did so. Some small firms opt into the system because they do not wish their customers to know how small their sales are; others may not appreciate the extent of the compliance burden.

Small exempt firms which have very low taxable inputs and sell directly to end consumers, as in many service industries, in contrast will gain a competitive advantage by remaining unregistered. Firms which are unregistered, may find it easier to evade income taxes but it is interesting that the UK, which has the highest threshold in the EEC, has kept the administration of income and value added taxes more independent of each other than in other member states. This may not last; experiments in exchanging information betwen the VAT and

Income Tax administrations have already been carried out in one part of the country.

To avoid these distortions and to keep as many businesses as possible within the VAT surveillance net, other European countries have other ways of treating small firms. There are a variety of flat rate schemes which involve setting VAT liability as a fixed percentage of sales or relating it to inputs. These schemes also result in distortions since they normally require the use of crude industry-wide margins, while attempts to tailor fixed rates for individual firms seem to result in higher administrative burdens for both government and business.

Another method widely used in the EEC for farmers is to exempt them from VAT registration and from charging the tax, but to allow their customers to deduct the farmers' notional input taxes from their VAT liability. In this way, the burden of administration is passed from the farmer to his customer, but this is only effective where all the farmer's sales are to registered traders. "Farmgate" and other direct sales thus become free of tax. This tends to encourage inefficient methods of distribution. A variant of this approach is to transfer the burden of administering VAT to the suppliers rather than the customers of small firms. This method works like a tax levied at the wholesale stage, but since it involves discriminating between different types of wholesale customer it greatly complicates administration for registered firms.

The other systems used to ease the burden of VAT on small firms involve compensating them for part at least of the compliance burden by allowing them to retain part of the tax collected. (Some US states and Canadian provinces allow the retention of a percentage of sales taxes, up to a ceiling, to compensate for compliance costs). This relief usually takes the form either of a VAT liability threshold below which tax need not be handed over to the authorities, or a tapered percentage relief varying with turnover size bands. All of these compensatory schemes involve some increase in the complexity of the system and therefore in the operating costs of both government and business.

Other alternatives exist. One method would be to allow small firms the option of being assessed for VAT on an annual basis, calculated from the annual accounts which have to be prepared anyway for business income tax purposes. The disadvantage of this approach is that, unless these accounts were to become more elaborate, the use of more or less arbitrary ratios of inputs and outputs would be necessary. Some form of regular payment would also be required, which would still leave some of the administrative burden.

Another alternative which has its attractions would be to eliminate all VAT payments between registered traders. Traders would be able to purchase tax free by quoting an exemption certificate number. Retailers would continue to charge VAT and their business customers would be entitled to reclaim taxes paid on retail purchases. This is the "ring system" of VAT operated in some Latin-American countries. Since VAT payments between registered traders do not contribute to net revenue collected there would, in theory, be no loss of revenue. At the same time, since the vast majority of all individually recorded VAT transactions are between registered traders, there would be a massive reduction in business record keeping and in the self-cancelling flows of tax revenues to and from the tax authorities.

Proposals to this effect were made by the Consultative Committee of Accountancy Bodies (CCAB) in the UK in 1978, but not adopted on the recommendation of an investigative committee which included representatives of the CCAB, the Confederation of British Industry (CBI), retailing and wholesaling bodies and Customs and Excise, but not small business as such (Commissioners of H.M. Customs and Excise (1979)). The tax authorities argued against the change on the grounds that only 28 per cent of registered traders predominantly supplied registered customers, while about 50 per cent sold regularly to both registered and non-registered traders, and their compliance costs would be worsened. The task of enforcement would also become more difficult so that neither most firms nor the tax authorities would find the administrative burden easier.

The tax authorities were mainly worried about the risk of increased evasion in the retail sector where "a disproportionate amount of VAT errors, underdeclarations and fraud occurs". It has been argued that under the CCAB proposals one major source of fraud (false input tax reclaims) would be eliminated (see National Federation (1982)). Not mentioned in the official report was the fact that by cutting input tax returns, a major tool in policing the system (through computer ratio checks) would be removed from the hands of the authorities.

Retailers, including small retailers, were against the change because it would increase their administrative burden (mainly because the special simplifying schemes operating in the retail sector depend upon input tax invoices) while the CBI and wholesale interests did not feel that the advantages of the CCAB proposals would offset the adverse effect upon cash flow that would result. It was also doubtful if the proposals were consistent with either the letter or the spirit of the EEC 6th Directive.

The debate over the CCAB proposals has been summarised at some length because it illustrates how, once a VAT system is in place, it is likely to remain. The arguments and investigation were certainly not exhaustive—for example, no serious attempt was made to measure the effect of the proposed changes on the compliance costs of business as a whole, nor was the following question faced: once VAT between registered traders is eliminated, what are the advantages of that system over other indirect tax systems? A VAT without tax between registered traders is, in essence, identical to a comprehensive sales tax.

All schemes for lightening the burden of VAT on smaller registered traders inevitably introduce further complexity and economic distortions or increase the opportunities for evasion or all three. The fact is that although better schemes might be devised, small business and VAT do not go well together.

6. VAT in North America

Towards Greater Realism in Tax Policy

Our review of experience of VAT in Europe has shown that, although on the surface it works smoothly enough, it is far in practice from the economically neutral and evasion-free tax dreamed of by so many economists and tax administrators 25 years ago when it first began to spread around the world. The same conclusion was reached at the conference of fiscal specialists held by the Brookings Institution in Washington DC in 1980 (Aaron (1981)), which demonstrated that the use of differentiated VAT rates to reduce regressivity among final consumers "inevitably complicate administration and compliance and destroy both neutrality and the advantages that uniformity may bring".

The present study, looking at VAT from a different perspective, presents an even more unfavourable picture of this tax by bringing out the fact that both the compliance and administration costs of VAT are highly regressive with respect to size of firm. In other words, VAT is bad for small business, and collecting the tax from small business is costly for government.

It has, of course, always been recognised by economists that taxes of all kinds can have profound effects upon economic structure and performance, and indeed the development of VAT systems owe much to the desire to minimise economic distortions. The conflict between economic efficiency and the design of a VAT system which will not bear more heavily upon the less advantaged members of society has, as mentioned, in most European countries resulted in the loss of much of the theoretical neutrality of VAT. But there are other dimensions to the economic neutrality of a tax system than its effect upon relative prices. Income taxes, for example, are generally believed to discourage risk-taking and effort and discourage saving more than taxes on expenditure (either type of tax can be made progressive in terms of income or expenditure). Income taxes, both corporate and personal, also, as mentioned in Chapter 5, tend to discriminate against small businesses, which are more dependent upon personal savings for investment than large firms which have greater access to capital markets. Payroll taxes, in general, also discriminate against labour intensive small businesses. For these reasons, a shift from taxation of incomes and payrolls to the taxation of consumer expenditure would be less detrimental to small business, but there is a danger that the removal of one set of distortions will be replaced by another.

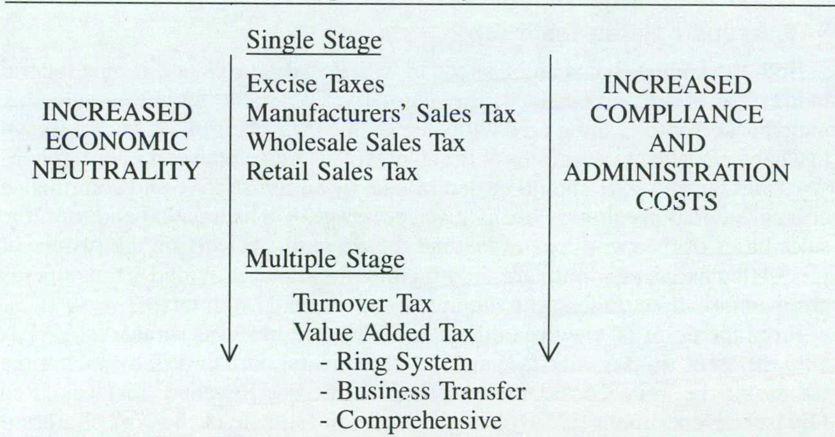
Complexity in any kind of tax system always discriminates against small firms because their administrative resources are so limited and they can rarely afford the best advice. Expenditure can be taxed at source by means of an expenditure tax which relieves all forms of saving from income tax—there is growing support for income tax reform along these lines in the UK—or expenditure outlays can be taxed, as they are through VAT and excise taxes in Europe and sales and other taxes in North America.

Table 6.1 lists the available forms of outlay taxes in two groups. The first group, single stage taxes, are listed roughly in order of the magnitude of the total compliance and administrative burden they impose upon government and

business. A single stage tax is one which is imposed only at one point in the chain of production and distribution. The nearer that point is to the final consumer, the more business units there are involved in collecting the tax and, generally speaking, the greater the national cost of operating the tax. However, the nearer the tax point to the end consumer, the more nearly the tax comes (or can come) to approximate to a tax on total value added with minimum distortion to the pattern of production and consumption (provided the taxes are designed so as not to enter into business costs, which is possible with any form of single stage tax).

Table 6.1

Types of Outlay Taxes



The second group, multiple stage taxes, are levied at all stages in the chain of production and, in some cases, also of distribution. These are also listed roughly in order of total operating cost and are more costly to administer than single stage taxes. The turnover or cascade tax, as we showed in Chapter 2, cannot be prevented from cumulating at every stage in production, nor can it be at all accurately excluded from exports. Even if it is not levied at the retail stage, it has to be operated by very large numbers of businesses, though it is quite a simple tax to operate. VAT, which in its comprehensive form creates the minimum of distortion to the pattern of production and consumption, is, in absolute terms, very costly to administer and has an even higher compliance cost. Variants of the comprehensive VAT, the ring system and the business transfer system, each have somewhat lower total operating costs than the full VAT, but suffer from other disadvantages.

In the ring system, VAT registered traders charge tax only to traders or end consumers so that economic neutrality is unaffected with somewhat lower compliance costs, but it has more problems in policing than the full VAT. The business transfer tax (BTT) is the opposite of the ring system in that only

transactions between registered traders are taxed. In the BTT, the compliance burden is lifted from retailers at the expense of failing to tax value added at the retail stage. Even if state sales taxes remained in force, a federal BTT would, in the United States, probably favour retailers in terms of compliance burden at the expense of other businesses, while the ring system would do the opposite, as compared with a full VAT.

European experience can throw little light on the special difficulties of introducing a VAT into the federal systems in North America. Whilst West Germany is a federal state with VAT, the two North American countries face different conditions in the relationships between the levels of government than did Germany when it introduced VAT. Both federal constitutions, traditions of Canadian federal/provincial tax integration and state/provincial dependence on sales tax revenues, create a quite different set of circumstances.

VAT Versus a Sales Tax

Both the United States and Canada have state sales taxes and if new federal indirect taxes are to be raised, the alternatives available include a sales tax piggybacked onto or integrated with the existing state taxes or a VAT. As shown in Chapter 2, and at lower rates of tax at least, the choice between a comprehensive sales tax and VAT should be determined by administrative and compliance cost considerations alone. For any given coverage of consumer expenditure, the sales bases of the two types of tax and the economic effects on the pattern of production and expenditure are, in principle, the same, provided arrangements are made to allow traders to reclaim sales taxes paid on inputs.

From the point of view of both government and business, however, VAT is very different from a sales tax, and the incremental burden of introducing the tax would be very considerable. The US Internal Revenue Service (IRS) (Treasury Department (1984)) has published an estimate of the cost of administering VAT. It assumes that there would be some 20 million taxpayers (excluding farmers) and that IRS costs would amount to $700 million per annum by the time the system was fully operational. Twenty thousand seven hundred additional IRS staff would be required. The yield of VAT would depend upon the coverage of the consumption base. At 77 per cent of the base, which is about the average coverage in Europe, the yield of an effective 10 per cent rate of tax (again below the average in Europe) would be over $240 billion at the Treasury's estimated 1988 levels of expenditure (more than enough to cover the present budget deficit). Administration costs would be about 0.3 per cent of revenue on this basis. If net compliance costs for business were at the same 4.4 percentage of revenue that Sandford estimated for the UK for 1983-84, then the incremental compliance burden on business in the United States would amount annually to over $10 billion in 1988, much, if not most, of it borne by small business.

These figures are subject to wide margins of error since even if the VAT system adopted in the US were identical, productivity levels, interest rates, differences in the industry mix and size structure and other factors would lead to different compliance cost ratios. All the figures are intended to demonstrate is that the numbers are very large. The IRS costs given above are not the whole

costs since they exclude the costs of the US Customs Service which would administer import VAT. The IRS costs, at 0.3 per cent of revenue, also seem a little on the low side compared with European levels of around one per cent at a higher tax rate, even allowing for much higher productivity. The IRS estimates assume that there would be about 1,000 registered traders for each official, compared with 100-250 or so in Europe, ie. four to ten times more. The IRS has a somewhat larger manpower than the UK Inland Revenue, which has similar functions but does not operate a self-assessed tax system and is hardly computerised. The ratio of the US to UK population is about four to one.

Canada has not yet published estimates for the cost of VAT administration, but the number of registered traders there could hardly be less than 700,000 and could, depending on coverage, exceed 1 million, while costs for government and business should not be proportionately less than for the US.

We have seen no comparable estimates for the cost of introducing federal sales taxes in North America, but they would be a small fraction of the costs of a VAT system. Retailers in most states in the US and provinces in Canada are already handling sales taxes and both business and state governments have had up to 50 years' experience of sales taxes. Federal and state sales taxes could be collected on the basis of a single tax return (as is done with state and local taxes) and by reliance upon audits at only one level of government for both sets of taxes (as is done with corporate income tax). Some states already have arrangements to allow registered traders in some sectors to purchase goods free of sales tax, and these could be extended (Due (1973)). The incremental compliance costs for retailers would be very small (and could be compensated for), while other businesses would remain relatively unaffected. There would, no doubt, be political and administrative problems but they would, as far as we can see, be dwarfed by those of a full value added tax.

The only real practical objection to the introduction of federal sales taxes instead of VAT is that, at the sort of effective rates we are talking about, the incentive for evading sales taxes would be greater and the scope for controlling this more limited. There may be some force in this objection, but it seems inconceivable that the public costs of enforcing higher rates of sales tax would be greater than those of a VAT system, while the enormous saving in compliance costs would remain. In fact, there is no way of knowing what the consequences of generally higher rates of sales taxes would be, but since some US states and Canadian provinces seem able to cope with much higher than average rates of sales tax there is no reason to suppose that such rates are impracticable. The average nominal rate of sales tax in Canada is already nearly 8 per cent, while the highest rate is 12 percent (Newfoundland). In the US, the average rate is 4.5 per cent but Connecticut has a rate of 7.5 per cent.

The Sea Change

Whether an increase in the total level of taxation is desirable at all is a political issue although some economists, including ourselves, would argue that tax ratios in most European countries have long since passed the point at which they began to impair economic growth and flexibility.

The relatively slow recovery in Europe from the 1973-81 recession and its

sluggishness in adapting to new technologies and sources of competition compared with Japan and the United States (Canada, in economic performance, is somewhere between these two groups of countries), is leading to a reassessment of the role of high taxation, industrial regulation and employee protection in inhibiting economic change. At the same time, there has been a reaction against the simple-minded notions of "bigger is better", which characterised industrial policy in Europe in the 1960s. It is now accepted that but for the jobs created by small business, unemployment in Europe would be very much higher, while the dynamic role of small firms in American and Japanese economic development is being more widely understood (OECD (1985)). There are also signs, both in Europe and North America, of a desire to simplify tax systems and to reduce reliefs and allowances (tax expenditures) so as, among other objectives, to improve the functioning of capital markets. These changes were precipitated by the end of the long post-war boom which ended in the early 1970s and the difficulties encountered subsequently in maintaining the growth of public expenditure in the face of inflationary pressures and stagnant economic growth. They are of profound importance, and amount to a sea-change in economic and social affairs, which can be seen reflected everywhere, for example in a revaluation of the role of the entrepreneur and in ideas and values in architecture and urban redevelopment.

At a time when the general current of change in all the advanced industrialised countries is in the direction of reducing the burden of government on business and, in particular, promoting small business, proposals to introduce value added taxation in North America need very careful consideration. The tide may already be turning. Though New Zealand has just introduced it, Australia has recently decided against this form of taxation. Norway has set up a committee to re-examine the administrative burdens of VAT, and in Britain there is an active debate on how these burdens on small business might be lightened. Although the general tendency in modern tax theory is to favour some shift towards taxes on expenditure, practical experience of VAT suggests that it is an unnecessarily complex and burdensome tax for business. There is a risk, to put it mildly, that by the late 1980s VAT would, in North America, look as old-fashioned and unsatisfactory as the cascade taxes that it began to replace in the older bureaucratic traditions of Europe a quarter of a century ago.

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VAT and Small Business:
European Experience
and
Implications for North America

APPENDICES

Appendix 1

Chronology of Countries Adopting VAT

1960 1
Ivory Coast

1961 2
Senegal

1962 3
Morocco

1965 4
Colombia

1967 6
Brazil
Denmark

1968 9
France
FR Germany
Uruguay

1969 12
Madagascar
Netherlands
Sweden

1970 15
Ecuador
Luxembourg
Norway

1971 16
Belgium

1972 17
Ireland

1973 22
Austria
Bolivia
Italy
Peru
U.K.

1975 25
Argentina
Chile
Costa Rica

1976 28
Honduras
Israel
Panama

1977 29
Korea

1978 30
Nicaragua

1980 31
Mexico

1983 32
Dominican Republic
Guatemala

1985 33
Indonesia

1986 36
New Zealand
Portugal
Spain

Source: Tait (1984)

Updated by Graham Bannock & Partners Ltd.

Appendix 2

VAT Rates Applicable in the Member States of the Community

Country	Dates	Rates				
		Standard	Intermediate	Increased	Reduced	Zero
FR Germany	1.01.1968	10	—	—	5	—
	1.07.1968	11	—	—	5,5	—
	1.01.1978	12	—	—	6	—
	1.07.1979	13	—	—	6,5	—
	1.07.1983	14	—	—	7	—
Belgium	1.01.1971	18	14	25	6	Yes
	1.01.1978	16	—	25	6	
	1.07.1981	17	—	25	6	
	1.01.1983	19	17	25(1)(2)	6	
Denmark	3.07.1967	10	—	—	—	
	1.04.1968	12,5	—	—	—	
	29.06.1970	15	—	—	—	
	29.09.1975	15	—	—	9,25(3)	Yes
	1.03.1976	15	—	—	—	
	3.10.1977	18	—	—	—	
	1.10.1978	20,25	—	—	—	
	30.06.1980	22	—	—	—	
France	1.01.1968	16 2/3 (4)	13	20	6	—
	1.12.1968	19 (4)	15	25	7	—
	1.01.1970	23	17,60	33 1/3	7,5	—
	1.01.1973	20	17,60	33 1/3	7	—
	1.01.1977	17,60	—	33 1/3	7	—
	1.07.1982	18,60	—	33 1/3	7et5,5(5)	—
Ireland	1.11.1972	16,37	11,11	30,26	5,26	
	3.09.1973	19,50	11,11	36,75	6,75	Yes
	1.03.1976	20	—	35) (6)	10	
	1.03.1979	20	—	40)	10	
	1.05.1980	25	—	—	10	
	1.09.1981	25	—	—	15	
	1.05.1982	30	—	—	18(7)	
	1.03.1983	35	—	—	23(7)	
	1.03.1984	35	—	—	5/18/23(7)	
	1.03.1985	23	—	—	10	
Italy	1.01.1973	12	—	18	6	
	1.01.1975	12	18	30	6	
	18.03.1976	12	18	30	6	
	10.05.1976	12	18	30	6 and 9	
	23.12.1976	12	18	30	1/3/6/9	
	8.02.1977	14	18	35	1/3/6/9/12	Yes
	3.07 1980	15	18	35	2 and 8	
	1.11.1980	14	15 and 18	35	1/2/3/6/9/12	
	1.01.1981	15	18	35	2 and 8	
	5.08.1982	18	20(8)	38(3)	2/8/10/15(8)	
	19.04.1984	18	20(8)	30/38(8)	2/8/10/15(8)	
	20.12.1984	18	—	38	2 and 9	

(Continued next page)

VAT Rates *continued*

Country	Dates	Rates				
		Standard	Intermediate	Increased	Reduced	Zero
Luxembourg	1.01.1970	8	—	—	4	—
	1.01.1971	10	—	—	2 and 5(9)	—
	1.07.1983	12	—	—	3 and 6(9)	
Netherlands	1.01.1969	12	—	—	4	
	1.01.1971	14	—	—	4	
	1.01.1973	16	—	—	4	Yes
	1.10.1976	18	—	—	4	
	1.01.1984	19	—	—	5	
United Kingdom	1.04.1973	10	—	—	—	
	29.07.1974	8	—	—	—	
	18.11.1974	8	—	25	—	Yes
	1.05.1975	8	—	25	—	
	12.04.1976	8	—	12,5	—	
	18.06.1979	15	—	—	—	
Greece	1.01.1986	—	—	—	—	

Source: EEC Commission DG XV

Appendix 3

A Summary of VAT Regulations in Europe

Country:	**AUSTRIA**
Responsible Government Department:	Ministry of Finance
Date of Start:	1 January 1973
Rates and Coverage:	*Standard:* 20 per cent *Reduced:* 10 per cent on real estate, fresh foods, grapevines, professions, the arts, health, transport & swimming baths *Increased:* 32 per cent on cars, audio visual, furs and other luxuries
Exemptions:	
With Credit:	exports, transport to overseas, welfare organisations
Without Credit:	real estate, financial services, activities for the blind, education, authors and journalists, foster homes
Frequency of Returns:	Normally monthly, but quarterly if turnover in previous calender year is less than ASch 300,000
Special Schemes for:	
Small Firms:	Yes
Agriculture, Forestry, Fishing:	Yes
Others:	Yes—Travel Agents
Threshold Per Annum:	ASch 40,000

Country:	**BELGIUM**
Responsible Government Department:	Tax Administration
Date of Start:	1 January 1971

(Continued next page)

Country: *Continued*	**BELGIUM**
Rates and Coverage:	*Standard:* 19 per cent *High:* 25 per cent on vehicles, jewellery, watches, furs, firearms, ornaments, audio visual, perfumes, cameras, drinks *Intermediate:* 17 per cent on restaurants, building, fuels, the visual arts and footwear *Reduced:* 6 per cent on most foods, books, newspapers, tobacco, performing arts, tourist services, agriculture, cars for disabled persons
Exemptions:	
With Credit:	exports, diplomatic missions NATO, newspapers (daily or weekly), war cemeteries and memorials, legal services, health/medical, old age homes, nurseries, education, performing arts organisations
Without Credit:	real estate, business transfers, financial transactions
Special Schemes for:	
Small Firms:	Yes—simplification of record keeping
Agriculture, Forestry, Fishing:	Yes
Others:	Yes—for travel agents
Threshold per annum:	No threshold, but simplified record keeping at BF 20m per annum

Country:	**DENMARK**
Responsible Government Department:	Customs & Excise
Date of Start:	3 July 1967
Rates and Coverage:	*Standard:* 22 per cent
Exemptions:	
With Credit:	exports, international transport, newspapers published at least monthly with at least 15 per cent editorial content

Without Credit:	health services, social services, education, cultural and sports, public transport, real estate lettings, insurance, banking, lotteries, artists (except musical performers), travel agents, undertakers
Frequency of Returns:	Quarterly or shorter if desired by firms
Farming and Fishing:	half yearly
Special Schemes for:	
Small Firms:	No
Agriculture, Forestry, Fishing:	No
Others:	No
Threshold per annum:	DKr 10,000 Canteens and Cafeterias: DKr 30,000

Country:	**FRANCE**
Responsible Government Department:	Director-General of Taxes
Date of Start:	1 January 1968
Rates and Coverage:	*Standard:* 18.6 per cent *Increased:* 33.33 per cent on jewellery, photographic, audio equipment, vehicles, furs, tobacco *Reduced:* 7 per cent on hotel accommodation, meals in cafeterias, water, performing arts, public transport, medicines, books *Super-Reduced:* 5.5 per cent on water bought from utilities, most foods
Exemptions:	
With Credits:	exports and insurance/banking for exports
Without Credits:	real estate for low cost rental, housing bonds, charities, hospitals handicapped, war memorials and cemeteries, financial transactions
Frequency of Returns:	Monthly, Quarterly if under Fr 500 per month

(Continued next page)

Country: **FRANCE**
Continued

Special Schemes for:	
Small Firms:	Yes
Agriculture, Forestry, Fishing:	Yes
Others:	No
Threshold per annum:	None

Country: **WEST GERMANY**

Responsible Government Department:	Ministry of Finance
Date of Start:	1 January 1968
Rates and Coverage:	*Standard:* 14 per cent *Reduced:* 7 per cent for most foods, animal breeding, dental care, the arts, charitable supplies, health spas, transport by boat, bus/rail travel up to 50 km
Exemptions:	
With Credit:	exports and transportation of exports, NATO and BAOR, travel agents for travel outside the EEC
Without Credit:	real estate, financial transactions, railway system, radio services, post, telecommunications, old age homes, blind and youth activities, the arts, education, sciences
Frequency of Returns:	Monthly
Special Schemes for:	
Small Firms:	Yes
Agriculture, Forestry, Fishing:	Yes
Others:	Yes—travel agents services for individuals, Special arrangements for West Berlin
Threshold per annum:	DM 20,000 in previous calender year and DM 100,000 in current year

Country:	**IRELAND**
Responsible Government Department:	Revenue Commissioners
Date of Start:	1 November 1972
Rates and Coverage:	*Standard:* 23 per cent *Reduced:* 10 per cent on fuels, real estate, clothes, concrete, footwear, newspapers, vehicle hire & repairs, most agriculture, farm management, auctioneers *Special:* 2.2 per cent on livestock
Exemptions:	
With Credit:	exports and their transportation, foods, children's clothes & shoes, heating fuels, electricity, raw textile materials, medical equipment, transport repairs to ships and planes
Without Credit:	real estate rents & property developed up to 31st October 1972, business transfers, financial transactions, communication and transportation, welfare and non-profit organisations, education, health services, sport, school & hospital catering
Frequency of Returns:	Every 2 months
Special Schemes for:	
Small Firms:	No
Agriculture, Forestry, Fishing:	Yes
Others:	Yes—travel agents (exempt), construction (reduced rate)
Threshold per annum:	Irl£ 12,000 or Irl£ 25,000 where 90 per cent of turnover is from goods made from taxable materials

Country:	**ITALY**
Responsible Government Department:	Tax Administration
Date of Start:	1 January 1973

(Continued next page)

Country: *Continued*	**ITALY**
Rates and Coverage:	*Standard:* 18 per cent *Special Reduced:* 2 per cent on most foods, books, newspapers, building work, articles for the disabled *Reduced:* 9 per cent on certain foods, wines, records/tapes, telephones *Increased:* 38 per cent on furs, vehicles and other luxuries
Exemptions:	
With Credit:	exports and their transportation, goods for diplomatic missions
Without Credit:	letting of property, business transfers, banking, insurance, foreign exchange, shares, post, public transport up to 50 km, health and social services education, libraries & parks
Frequency of Returns:	Monthly, but quarterly if turnover is below Lire 480 m in previous year
Special Schemes for:	
Small Firms:	Yes
Agriculture, Forestry, Fishing:	Yes
Others:	No
Threshold per annum:	None, but simplified for small firms

Country:	**LUXEMBOURG**
Responsible Government Department:	Administration de l'Enregistrement
Date of Start:	1 January 1970
Rates and Coverage:	*Standard:* 12 per cent *Reduced:* 6 per cent on food, agriculture/ forestry, heating & lighting, goods for disabled, public transport, professional services *Special:* 2 per cent on meat, bread, milk products and pharmaceuticals

Exemptions:	
With Credit:	exports, imported aircraft and fuel, coins, postage stamps, equity capital, items in transit
Without Credit:	real estate except where construction will take place, medical services, old age homes, homes for young persons, education, arts and sports, non-profit making financial transactions
Frequency of Returns:	Monthly, but quarterly for smaller firms with turnover below LFr 18 m in previous calender year
Special Schemes for:	
Small Firms:	Yes
Agriculture, Forestry, Fishing:	Yes
Others:	Yes—tobacco, travel agents
Threshold per annum:	LFr 200,000 (1982)

Country:	**THE NETHERLANDS**
Responsible Government Department:	Ministry of Finance
Date of Start:	1 January 1969
Rates and Coverage:	*Normal:* 19 per cent *Reduced:* 5 per cent on foods, books, newspapers, public transport, items for agriculture, tourism, consumption tax on vehicles
Exemptions:	
With Credit:	exports and services to aid exports
Without Credit:	real estate older than 2 years, business transfers, financial transactions, broadcasting media, postal & telephone services, social services, dentists, scientific & cultural activities
Frequency of Returns:	Monthly, but quarterly if VAT liability is below DG 9,000 per quarter
Special Schemes for:	
Small Firms:	Yes

(Continued next page)

Country: *Continued*	**THE NETHERLANDS**
Agriculture, Forestry, Fishing:	Yes
Others:	Yes—travel agents
Threshold per annum:	None

Country:	**NORWAY**
Responsible Government Department:	Directorate of Taxes
Date of Start:	1 January 1970
Rates and Coverage:	20 per cent flat rate
Exemptions:	
With Credit:	exports, goods & services for North Sea oil rigs, dependencies for consumption on ships and planes, newspapers published at least weekly, ships, aircraft, oil rigs, fishing vessels longer than 15 metres
Without Credit:	real estate except construction, business transfers, financial transactions, public transport, artists, doctors, dentists, the arts, welfare organisations, postal services
Frequency of Returns:	Every 2 months
Special Schemes for:	
Small Firms:	No
Agriculture, Forestry, Fishing:	Yes
Others:	Yes—travel agents and construction
Threshold per annum:	NKr 12,000

Country:	**PORTUGAL**
Responsible Government Department:	Tax Administration
Date of Start:	1 January 1986

Rates and Coverage:	*Lower:* 8 per cent on manufactured goods, wine, energy, passenger transport, telecommunications, legal and medical services if opted for tax *Standard:* 16 per cent *Higher:* 30 per cent on spirits and aperitifs, luxury gifts, perfumes and cosmetics, furs, jewellery, precious stones and metals, aircraft other than commercial airlines, motorcycles under 125 cc
Exemptions:	
With Credit:	exports, fresh foods, newspapers and other publications, fertilisers, seeds, pharmaceuticals
Without Credit:	financial services, legal and medical services, education, postal services, real estate, authorship, burial services, medical equipment, works of art, sports centres, accountancy, consultancy & advertising services
Frequency of Returns:	Monthly. Quarterly if turnover below Esc 5 million
Special Schemes for:	
Small Firms:	No
Agriculture, Forestry, Fishing:	
Others:	
Threshold per annum:	Sole traders & partnerships only: Retail distribution Esc 8,000,000. Liberal professions Esc 500,000.

Country:	**SPAIN**
Responsible Government Department:	
Date of Start:	1 January 1986
Rates and Coverage:	*Standard:* 12 per cent inc. newly constructed commercial buildings *Lower:* 6 per cent on food and beverages, new and refurbished domestic accommodation, newspapers and other publications, live animals and animal foods, pharmaceuticals and medical equipment, hotels and catering below 5 star level, authorship, entertainment and art

(Continued next page)

Country: *Continued*	**SPAIN**
	Higher: 33 per cent on private aircraft & motor vehicles, leisure craft over 9m, jewellery, precious stones and metals, furs, 5 star hotels and catering
Exemptions:	
With Credit:	exports
Without Credit:	second-hand buildings, public postal services, medical and dental services, education, political bodies inc. trades unions, sports centres, financial services, rental of domestic accommodation & agricultural land, buildings, works of art
Frequency of Returns:	Monthly. Quarterly if turnover below Pts 1,000 (?)
Special Schemes for:	
Small Firms:	
Agriculture Forestry, Fishing:	
Others:	
Threshold per annum:	None

Country:	**SWEDEN**
Responsible Government Department:	National Tax Board
Date of Start:	1 January 1969
Rates and Coverage:	*Standard:* 19 per cent *including* VAT, i.e., *The effective* rate is 23.46 per cent Some lower effective rates in real estate, hotels and catering
Exemptions:	
With Credits:	exports, ships, planes, war materials subject to an arms arms embargo, medicines, fuels, newspapers (magazines published at least weekly), refuse and snow clearance, salvage operations on ships or aircraft

Without Credits:	real estate, business transfers, financial transactions, postal services, non-saleable periodicals (eg. firm in-house magazines), museum/theatre/concert catalogues or listings, public water supply, film for non-commercial use, wines, tobacco for personal use by travellers, cinema film showings, medical services
Frequency of Returns:	Every 2 months but longer for small firms
Special Schemes for:	
Small Firms:	No
Agriculture, Forestry, Fishing:	No
Others:	No
Threshold per annum:	SKr 10,000

Country:	**UNITED KINGDOM**
Responsible Government Department:	Customs and Excise
Date of Start:	1 April 1983
Rates and Coverage:	*Standard:* 15 per cent
Exemptions:	
With Credit:	exports, most foods, seeds and fertilisers, international transport, water, newspapers, books (but not advertising in them), items for the blind, fuels, construction services, medicines for the handicapped, charity goods, clothes and footwear for children
Without Credit:	real estate, insurance, postal services, letting, financial transactions, education, health, burials & cremations, non-profit trade & professional associations, sports competitions and works of art
Frequency of Returns:	Quarterly Monthly option

(Continued next page)

Country: *Continued*	**UNITED KINGDOM**
Special Schemes for:	
Small Firms:	No
Agriculture, Forestry, Fishing:	No
Others:	Yes—for retailers, travel agents
Threshold per annum:	£19,500

Source: International Bureau 1983 Updated
Spain and Portugal: Price Waterhouse

Appendix 4

Special Schemes for Small Businesses

Introduction

All the countries of Europe which have a value added tax in operation make some administrative recognition of the heavy compliance burden of the tax on small businesses. The forms this recognition takes are summarised in Table A4.1 below. Broadly, we may put them into two categories—schemes which attempt to compensate the small firm for bearing a disproportionatly large compliance burden, and schemes which attempt to actually cut that burden by simplifying the administration of the tax.

Table A4.1

Special Schemes for Small Business

		Information required of small business to participate in scheme	Countries in which scheme applies	Information required of small business to determine whether to be in scheme
A.	Designed to simplify administration of the tax for small firms at the expense of accuracy of assessment			
I.	Exemption of small businesses, defined by turnover	None	All but Belgium, France, Italy, The Netherlands, Sweden and Spain	Turnover
II.	Exemption of small businesses, defined by turnover, though allowing them to issue tax invoices	None	Sweden	Turnover
III.	Flat rate schemes by which value added is deduced from inputs	Value of inputs	Belgium	Turnover Industry margins relative to rest of industry
IV.	Flat rate schemes by which input is deduced from turnover	Value of turnover	Germany, Italy	Turnover Industry margins relative to rest of industry
V.	Flat rate schemes which apply to individual firms as opposed to individual industries	Full information	France, Belgium	Turnover

(Continued next page)

Table A4.1 *Continued*

	Information required of small business to participate in scheme	Countries in which scheme applies	Information required of small business to determine whether to be in scheme
B. Designed to compensate small firms for regressivity of compliance burden			
VI. Deductions in tax payable by small firms	Full information	Austria, France, Netherlands, Germany, Italy	Full VAT Accounts
C. Designed to pass compliance burden on to others			
VII. Tax compliance burden passed on to suppliers of small business (where all sales of small business are to non-registered sector)	None	Belgium	Turnover Industry margins relative to rest of industry
VIII. Tax compliance burden passed on to customers of small business (where all sales of small business are to registered sector)	None	Many countries with respect to farmers	Turnover Industry margins relative to rest of industry

Exemption

Exemption cuts both the tax burden on small firms and the compliance burden. Exempt traders have no need to fill out returns, keep receipts, claim back input tax or charge output tax. Exemption also reduces the administration costs of the tax without, as shown in Chapter 6, sacrificing much revenue. The registration thresholds currently in force throughout Europe are shown in Table A4.2.

However, although exemption helps some firms, there are many for whom it will pay to register despite the administrative cost of so doing. These are traders who

- sell output to other registered traders who can claim back the VAT they are charged
- have high input VAT liabilities which under exemption are unrefundable
- sell output at a lower rate than they buy inputs.

For traders which opt in, the exemption system neither compensates them for the compliance burden nor relieves them of it. It is not, therefore, a solution to the compliance problem. Moreover, exemption causes distortions in patterns of trade in favour of very small firms against small and medium sized firms. However, even if just to obviate the need for casual self-employed workers to enter the VAT system, some cut off point is desirable.

A distinction should be drawn between VAT systems which allow traders below the exemption threshold to opt for registration if they wish, and those that

Table A4.2

European Exemption Thresholds
Turnover below which VAT Registration is Not Compulsory, 1985

	Local currency	US $
Austria	AS 40,000	2,350
Belgium	None	–
Denmark	Dkr 10,000	1,120
France	None	–
Germany (1)	DM 20,000	8,090
Ireland	IP 25,000	32,630
Italy	None	–
Luxembourg (2)	LFr 200,000	4,030
Netherlands	None	–
Norway	NFr 12,000	1,600
Portugal	Esc 8 million	52,600
Spain	None	–
Sweden	SKr 10,000	1,330
U.K.	£ 19,500	28,040

Notes: (1) Tax-inclusive turnover
(2) 1982

do not. It can never fail to benefit the trader to be given the choice. However, VAT authorities in general dislike having to cope with the administrative burden of this permission. The EEC countries all allow voluntary registration for small firms, but many do insist that once they enter the system, they stay within it for a minimum number of years—in Germany it is five for example.

Exemption with Power to Issue Tax Invoices

In Sweden exempt traders are allowed to issue tax invoices, thus allowing their customers to reclaim VAT even though their supplier does not have to account to the authorities for the tax. This creates less distortion because the exempt trader receives compensation for the VAT he pays on his inputs in the form of the output tax charged, while registered firms trading with him can reclaim input taxes in the normal way.

Flat Rate Schemes—Value Added Derived From Input Data

The need for full VAT bookkeeping can be reduced by the use of industry-wide data on profit margins. Normally, traders must keep information on both their purchases and their sales. Under this scheme, traders keep records of their inputs and their inputs alone. To calculate output and total tax due, inputs are grossed up by some industry-wide coefficient which should be equal to the average ratio of output to inputs for the industry. Clearly, those with smaller than average margins will benefit from registering in the normal way for they will be allowed to claim back more input tax than the average firm and this is only possible in the normal VAT scheme. In a country where all traders in an

industry had exactly the same margins, the system would exactly match a full VAT system.

Flat Rate Schemes—Input Tax Derived from Turnover

As an alternative to deriving output tax from actual inputs, input tax can be derived from actual output. This saves the trader the need to keep receipts of invoices paid although he must now keep records of his sales. Again, those who run on low margins will benefit from registering in the normal way. The EEC Commission favours this as a method of helping small firms. As both this and the other flat rate schemes involve making the same simplifying assumption, the choice as to which is preferable should depend on whether it is easier for businesses to keep a record of sales or a record of purchases. This scheme is to be preferred on administration grounds for the authorities, as it allows them to cross-check that the customers of small firms have purchased all that they say they have.

Flat rate schemes provide a sensible balance between the interests of simplicity and accuracy, though their applicability is limited to narrow industries of homogeneous products.

Flat Rate Schemes—Separate Coefficients for Individual Firms

The French run a flat rate scheme which does not use industry wide data to calculate inputs or outputs, but past behaviour of individual firms. In essence, a careful study of each firm is conducted in which its ratio of outputs to inputs is calculated. That ratio is then used for all future tax calculations. The scheme swaps the distortion caused by divergent margins within industries for distortions caused by divergent margins across time. The scheme as operated in France actually requires firms to keep full VAT records anyway, and the fact that many traders choose to adopt it all the same is an indication that proprieters believe they can manipulate the assessment period to their advantage.

It is not even clear that if assessments are made frequently enough to be accurate, the burden on small firms is any less than it would be if the tax were administered normally, for the cost of an assessment is high to both a firm and the authorities.

Tax Compliance Burden Passed on to Suppliers

One way of alleviating the problems of small firms is to tax them at "source"—to levy the tax charge from them without actually requiring them to fill out tax returns. The first approach one might take on this path is to get the suppliers of small firms to levy a VAT charge in excess of the normal rate. For example, suppose all the small firms in a certain industry used one dollar of flour for every two dollars of output; if the standard rate of VAT is 10 per cent, under a normal system a small firm would buy, say, \$100 of flour (paying tax of \$10) and would sell \$200 of output (obtaining \$20 of tax) and would remit \$10 of tax to the authorities, who would also receive \$10 from the supplier. Under this scheme, the supplier would charge a special high rate of VAT—20 per cent—and the small firm would do nothing other than pay it on purchase of flour. The state would be equally well off, the supplier has a worse compliance task, the

small firm has a better one. What if the supplier in this case is another small firm?

Belgium operates such a scheme for a small number of retailers; however, it carries so many flaws within it, it could not be widely adopted. Firstly, it discourages suppliers from dealing with small firms at all. Secondly, it is extremely hard in practise to set premium rates of VAT that would reasonably approximately tax small firms by the right amount. Thirdly, it is administratively extremely complex. Multitudes of firms are all required to distinguish between their small firm or non-small firm customers. One of the administrative advantages of VAT is that all customers are treated alike and no separate accounts need be kept for different types. Finally, the scheme is only suitable for industries where all sales are to the non-registered sector, for otherwise unrefundable tax charges are passed up the production chain.

Tax Compliance Burden Passed on to Customers

In contrast to passing the burden of administration on to the suppliers of small firms, it is possible to pass it on to their customers. This can only work when all sales are to the registered sector, for the non-registered customers cannot be expected to pass tax on to the authorities. This is the basic method used in six of the EEC states with respect to small farmers. Under the normal scheme, farmers charge tax and their customers (being registered) reclaim it. Under the special scheme, farmers do not charge tax and their buyers do not reclaim it. But their customers are allowed to claim a deduction against their tax bill for the input tax paid by the farmer on his purchases. He is thus saved the bother of reclaiming it himself as he would under the normal scheme.

Graduated Relief Schemes

In the absence of measures to simplify the administration of VAT in small firms, some of the distortions created by the regressive compliance burden can be removed by compensating those worst affected by it. Many EEC countries have a form of graduated relief from the tax. As the tax liability has to be calculated in order that entitlement to relief can be established, this approach does nothing to lower the cost of administration. Relief can take one of several forms.

Firstly, there can be a VAT liability cut-off point below which VAT collected need not be handed over to the authorities. This is very similar to the Swedish "exemption with power to issue tax invoices" system, and is adopted in France in place of a turnover exemption threshold.

A second form is the deduction of a percentage of the total VAT bill. This is in force in Austria for example, where there are three turnover bands, each with a certain discount—a bigger discount for smaller firms (20 per cent for the smallest above the exemption threshold). The Germans have a maximum 80 per cent rebate falling by 1 per cent for every DM 500 of turnover in excess of the exemption threshold.

The Netherlands have a form of VAT allowance, withdrawn as VAT liability increases—the first DG 2,300 of VAT is ignored. Up to DG 2,500, tax liability is merely calculated tax minus DG 2,300. With liabilities above that, there is an

allowance of DG 1,650, withdrawn by a guilder for every extra tax liability of a guilder. This involves putting firms under the scheme on a marginal VAT rate twice that of other taxable units. When they make an extra sale, they must hand over output VAT on that sale and also hand over some tax that was previously being discounted from their liability. Whatever allowance remains is taxable under business income taxes.

It can be seen that no clear favourite system has emerged. Some states cut the marginal rates of small firms, others compensate them but raise their marginal rate. Given the desirability of having constant marginal rates for all firms, it may be that the optimum scheme is a combination of withdrawable allowance and percentage rebate, or perhaps a flat rate payment by government to all small firms in the VAT system. A graduated relief scheme does not benefit those who are net reclaimers any more than an a rise in income tax allowances benefits people who pay no tax anyway.

Retail Schemes

Mention should be made of the special schemes specific to retailers and which exist in each EEC member state. These schemes aim to cope with the special problems of retailers, who often sell a range of items taxed at different rates, and who cannot practically be expected to issue VAT invoices with all purchases.

Generally, these special schemes apply to all retailers, but Ireland, Italy and the UK operate exceptional regimes for small traders.

In Ireland and Italy, smaller retailers are allowed to apportion output tax payable on a range of items at several rates on the basis of the proportion of costs that each item represents. If two items are traded, therefore, and each accounts for half total input costs irrespective of the margins marked-up on each item, half of total sales turnover will be taxable at the rate of one item and the other half at the rate of the other. It will not pay retailers with low margins on highly rated goods to enter these schemes.

The UK runs nine retail schemes. Despite criticism of the complexity of the choice facing retailers, each does serve a distinct purpose. Scheme "C" is specially designed for retailers with a turnover below £75,000 in 1983 prices. Under this scheme, sales turnover does not need to be recorded. Instead, inputs of different rates are all grossed up by a flat rate margin (one for each type of retailer), which leaves an assumed turnover for each rate category of items sold. In effect, the authorities are both assuming that margins are uniform throughout each type of retailer and that purchases of goods each month accurately reflects sales in the same month.

Although the retail schemes do not remove the VAT burden from retailers, they make it a good deal easier than it would otherwise be for a group potentially particularly badly affected by the tax.

Appendix 5
The EEC 6th Directive on VAT

The EEC 6th Directive on VAT

The primary force behind the drafting of the 6th directive was a need for nine states to agree on all its components, and it is thus not surprising that the principles for implementing VAT which it outlined broadly conformed to existing practice in most states, rather than to an ideal VAT system. Even where states practices diverged, the Directive usually chose to leave issues open rather than directly opt for one system in preference to another.

The result is a document which, in a rather fluid way, describes the current VAT system in operation in EEC countries. A country not bound by the Treaty of Rome though, may choose not to structure the tax on identical lines to those outlined in the Directive.

1. The first issue the Directive tackles is who shall be taxable. This is not usually a controversial matter. Employees are not required to register for tax purposes (even when earning more than the exemption threshold) but all independent traders engaged in economic activity are.

   The Directive leaves open the degree to which businesses linked to each other can register as a single unit. It should not make any difference to tax revenues whether a country is tolerant to groups registering as one or as several traders, though evasion may be easier to detect in cases where firms producing different items submit separate returns.

   The Directive specifies that local government and other state authorities shall not be registered for tax, except in certain listed activities or where this would "lead to a distortion of competition". In principle, government bodies should be indifferent as to whether they are registered or not, for the pricing and budget policies of these bodies can be adjusted without the tax to match, in every way, the effects of having the tax. However, in practice, it is probably better to put government bodies into the VAT system. This removes any incentive for them to provide services "in-house" which could be contracted out but which would then incur an unreclaimable VAT charge.

2. The second issue the Directive tackles is what shall be taxable. This is taken to include virtually any supply made in return for a consideration.

   Goods taken out of a business for consumption purposes, used by the owner or given to the employees, qualify as taxable.

   The sale of a whole business is not considered a "supply for consideration"

3. The next issue considered is the location of supply. This is not important except in the context of exemption of exports. Goods are taken as located at the start point of their delivery while services are positioned at the office of the supplier or where the services are physically carried out. Certain services usually purchased by business users are considered

supplied at the location of the receiver—advertising for example.

4. The Directive then defines the "chargeable event"—the moment that tax officially becomes liable (putting aside delays in payment allowed). The tax rate charged is that in force at the time of the chargeable event.

   The point is deemed to be the first of, receipt of payment or delivery of supply. This is not convenient for those selling items on a sale or return basis.

   Imports are taxable when they enter the country. Some countries have, however, been running "postponed accounting" whereby importers are not liable for VAT on imports until their next return is filed. Importers then can both reclaim and declare the tax charge on imported goods simultaneously. This leads to a cash flow loss to the government, but, everybody agrees, simplifies the administration immeasurably.

5. The "taxable amount" is normally to be taken as the amount of the consideration obtained for the supply.

   Items consumed out of a business which are not paid for are taxable—at the purchase price (or, in the absence of a purchase price, the cost price).

   Taxable amount includes duties, levies and other charges. This will be an important issue in any state with a local sales tax.

   It does not include the VAT itself—the tax is expressed as an exclusive rate.

   Discounts offered in return for quick payment are not included in the taxable amount.

   States are left free to decide how to treat tax paid on goods returned, bad debts or discounts offered after supply has taken place.

6. Under the Directive, reduced and increased rates of tax are permitted. It is an issue on which virtually all tax experts agree—if you can avoid multiple rates, do so.

7. The Directive lists a set of exemptions from the tax which states are expected to make. Most of these exist for good reason and would be exempt under any VAT in or out of the EEC.

   Exports of goods are exempt with a refund of input VAT allowed—ie. the destination principle is in force. It might be logical to introduce a VAT which taxed exports and exempt imports—one would expect exchange rate movements to largely compensate for the trade effects of so-doing and administration would be more straightforward—however, not surprisingly, no country does so.

   Exports of services do not enjoy the tax free status of exports of goods, despite the fact that the logic of VAT is that they should do so. Instead, a schedule of listed service supplies made to foreigners is zero-rated so that in practice virtually all service exports would be free of tax. The reason that goods and services do not enjoy the same treatment is that whereas it is thought possible to tax imports of goods it is not as easy to do so of services which are, in principle, rather difficult to locate. Zero-rating all exports would probably lead to many service purchases avoiding tax in any country at all—hence the business services are exempt by specific

listing, while other services are taxed in country of supply.

There are exemptions relating to some international supplies. Transport, like shipping and aircraft for international use, is exempt—it would be a nuisance to tax and refund tax every time an aeroplane flew into the country. Gold held for central banks, defence equipment and items temporarily imported are also exempt.

Certain difficult areas are excluded from the tax—financial services, insurance, certain charitable institutions and the letting or leasing of land or buildings. The treatment of these items is a complex and widely discussed issue. It is certainly the case that VAT is peculiarly bad at coping with them.

Finally, there is a set of exemptions which is less necessary—postal services, health services, and education services. The reason for the last two is that they are usually provided in the public sector in EEC countries.

8. The refunding of input tax paid is made through the operation of the invoice system. There is no reason why a country introducing a new VAT need adopt this type of administration though it does make multiple rates possible.

   EEC members are allowed to remove the right to deduct tax on various "consumption items" such as entertainment allowances or cars.

   It is the declared aim of the EEC that VAT should be a consumption type tax with a full and immediate refund of tax paid on capital goods. It is permitted to introduce rules for refunding VAT on capital goods which limit the state's liability in the short term—for example, the French "buffer system" in which reclaiming on capital goods is only permitted against positive VAT liability.

9. Partially exempt traders—by far the most difficult to administer—are only allowed to deduct a proportion of VAT paid, set as the proportion of total turnover which is taxable. It seems sensible to introduce a de minimis rule so that traders with, say, less than 5 per cent of exempt transactions can reclaim 100 per cent of their input tax.

10. The Directive is flexible on the issue of how often returns have to be submitted. For traders, it is desirable that those who are net reclaimers should be allowed to claim back tax quite frequently, and for those paying tax it is important to balance the cash flow advantage of long gaps between returns with the administrative inconvenience of such gaps.

    It is possible under the Directive to have an annual tax period, and to demand interim payments.

    States are allowed to waive tax charges which are very small.

11. The Directive issues guidance on several special schemes for different groups of traders.

    On small firms, the Directive sets limits to the VAT exemption thresholds the states are allowed to impose and forbids members to introduce new graduated relief schemes.

    The registration limits are defined in terms of tax exclusive turnover of taxable outputs, not including capital disposals.

It stipulates that small firms must be allowed to opt for normal taxation if they want to—a provision against the interests of the tax authorities but in the interests of firms themselves.

The Directive also outlines the flat rate farmer scheme which effectively passes the compliance burden of the tax on to the buyers of farm products.

Travel agents are to be taxed only on the margin they add to the price of holidays they organise. For trips organised outside the EEC, the travel agent is taken as an exempt intermediary. These measures ensure that a travel agent paying foreign bodies who do not charge VAT will not be taxed on the full value of the trip organised. This is a measure that could be adopted for any trader with exempt inputs who, when taxed on the full value of output, is effectively paying a very high rate of tax as a proportion of value added.

Second-hand goods are an issue that the Directive raises but leaves unresolved. Traders in second-hand items should, like travel agents, only pay tax on their margin not on the full value of their sales. This is because they tend to buy their inputs from the personal sector and hence cannot reclaim any input tax back on their purchases.

Appendix 6

Number of Registered Persons and Net Tax Paid, by Sector, UK 1983-1984

	Approximate Number of Registered Traders at 31 March 84	Net Tax Paid or Repaid, 1983-84 £ million
Primary Industries		
Agriculture, forestry and fishing	181,700	−536.3
Mining and quarrying	1,400	−240.6
Manufacturing Industries	139,600	7,730.3
Construction	226,200	753.1
Utilities	200	392.7
Transport & Communication	61,600	768.6
Distributive Trades		
Retail distribution	267,600	1,125.3
Wholesale distribution	79,300	3,179.0
Dealers	30,700	507.2
Services		
Insurance, banking, and business services	70,900	1,061.8
Professional and scientific services	81,200	877.1
Miscellaneous services	291,500	2,461.9
Public administration and agencies	1,200	−834.7
Total	1,433,100	14,953.8

Source: Commissioners of Customs and Excise (1984)

Appendix 7

UK Quarterly VAT Return

H M Customs and Excise

Return of Value Added Tax

For the period
01 11 85 to 31 01 86

To be returned not later than 28 02 86

These dates must not be altered without the agreement of Customs and Excise.

For Official Use

Registration No | Period 01 86

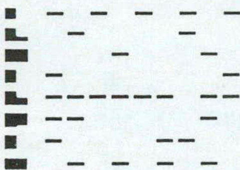
Please complete the whole of this form. The notes on the back and *Filling in your VAT return* will help you to do this. Return it, with any VAT due, in the enclosed envelope to the Controller, VAT Central Unit, H M Customs and Excise, 21 Victoria Avenue, SOUTHEND-ON-SEA X

Complete all boxes (writing "none" where necessary). If an exact amount of pounds is to be entered write "00" in the pence column. Do not put a dash or leave the column blank.

IMPORTANT

From this Autumn returns and tax payments received after due date may lead to surcharges. Please check your accounting and payment arrangements now.

FOR OFFICIAL USE



	Box	£	p
VAT DUE in this period on OUTPUTS (sales, etc), certain postal imports and services received from abroad	1		
Underdeclarations of VAT made on previous returns (but not those notified in writing by Customs and Excise)	2		
TOTAL VAT DUE (box 1 + box 2)	3		
VAT DEDUCTIBLE in this period on INPUTS (purchases, etc)	4		
Overdeclarations of VAT made on previous returns (but not those notified in writing by Customs and Excise)	5		
TOTAL VAT DEDUCTIBLE (box 4 + box 5)	6		
NET VAT PAYABLE OR REPAYABLE (Difference between boxes 3 and 6)	7		
Value of Outputs (excluding any VAT)	8		00
Value of Inputs (excluding any VAT)	9		00

Please tick only ONE of these boxes:

box 3 greater than box 6 — payment by credit transfer ☐ — payment enclosed ☐

box 6 greater than box 3 — repayment due ☐

How to pay the VAT due

Cross all cheques and postal orders "A/C Payee only" and make them payable to "H M Customs and Excise". Make credit transfers through account 3078027 at National Girobank or 10-70-50 52055000 for Bank Giros. You can get pre-printed booklets of credit transfer slips from your local VAT office. In your own interest do not send notes, coins, or uncrossed postal orders through the post.

Please write your VAT registration number on the back of all cheques and credit transfer slips.

Please tick box(es) if the statement(s) apply:

box 5 includes bad debt relief ☐ — box 8 includes exempt outputs ☐ — box 8 includes exports ☐

Retail schemes If you have used any of the schemes in the period covered by this return please tick the box(es) to show all the schemes used

A B C D E F G H J

Failure to make a complete return or to pay the full amount of VAT payable by the due date is an offence.

DECLARATION by the signatory to be completed by or on behalf of the person named above.

I, ... declare that the
(full name of signatory in BLOCK LETTERS)

information given in this return is true and complete.

Signed .... Date .... 19 ......
*(Proprietor, partner, director, secretary, responsible officer, member of club or association, duly authorised person) *Delete as necessary

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VAT 100 F 3790 (April 1985)

NOTES

'hese notes and the pamphlet, *Filling in your VAT return,* will help you to fill in this form. You may also need to refer to other VAT notices and leaflets.

f you need help or advice, or any of the answers overleaf gives a negative figure, please contact your local VAT office quoting your VAT registration number.

Box 1 You must show the VAT due on all goods and services you supplied in this period. This is your *output* tax.

Remember to include VAT due on:

- goods taken for private use
- gifts and loans of goods
- sales to staff
- sales of business assets
- imported services listed in *The VAT guide,* Appendix G
- postal imports where a full customs entry is not required.

Remember to subtract any VAT credited to your customers.

f you use a retail scheme the *How to work* pamphlet for your cheme will help you work out the output tax due.

Box 2 If any of your previous returns showed too little VAT ayable by you or too much VAT repayable to you, show the mount here—but leave out:

- adjustments notified in writing by Customs and Excise
- VAT declared on a previous return which you have not paid in full.

Box 4 You must show the amount of VAT deductible on any usiness purchases you have made, including imported goods und services and goods removed from bonded warehouse. This is your *input* tax.

this is your first return include any VAT you can reclaim on oods and services received before registration (see *The VAT guide,* paragraph 33)

Exclude any VAT on:

- goods and services not supplied for the use of your business
- business entertainment (except of overseas customers)
- motor cars
- second-hand goods which have been sold to you under one of the VAT second-hand schemes.

you are a builder see VAT Leaflet, *Construction industry,* about on-deductible input tax on fixtures and fittings.

Remember to subtract any VAT credited by your suppliers.

you have exempt outputs this may affect the amount of input ıx you can reclaim (see *The VAT guide,* paragraph 30).

Box 5 If any of your previous returns showed too much VAT ayable by you or too little VAT repayable to you show the amount ere.

Include:

- any VAT you are claiming back as bad debt relief under the conditions set out in the VAT Leaflet, *Relief from VAT on bad debts,* and tick the box on the front of this form.

xclude:

- adjustments notified in writing by Customs and Excise
- repayments of VAT claimed on a previous return but not yet received from Customs and Excise
- assessments already paid in this or other periods.

Box 7 If the amount to be entered is under £1 you must still fill in this form and send it to the VAT Central Unit. You need not send any payment, nor will any repayment be made to you.

Boxes 8 and 9 Show your total outputs in box 8. Include exports, exempt income such as rents, and other business income. Leave out the VAT. If exports or exempt outputs are included please tick the appropriate box(es) on the front of this form.

Show your total inputs in box 9. Include imports and other business expenses. Leave out the VAT.

For both boxes 8 and 9 you should show net figures after deducting any credits. Do not deduct any cash discounts. If your accounts are net of cash discounts you should add back a reasonable amount for any discounts given or received.

Some income and expenses must be left out of boxes 8 and 9. There are two ways to work these boxes out—Basis A and Basis B. Use the same basis for both boxes. Whichever basis you use always leave out:

- VAT
- wages and salaries
- PAYE and National Insurance contributions
- money put into or taken out of the business
- loans, dividends, grants, gifts of money
- compensation payments or insurance claims
- Stock Exchange dealings.

If you use Basis A also leave out:

Box 8

- sales of cars on which you paid no VAT (see *The VAT guide,* Appendix B, paragraph 10)
- exempt outputs excluded from any partial exemption calculation.

Box 9

- exempt purchases
- MOT fees and vehicle licence duty
- local authority rates
- purchases on which you cannot reclaim input tax (see *The VAT guide,* paragraph 28).

If you decide to use Basis B check if either or both of your outputs or inputs are above £50,000 on average (or £20,000 if you make monthly returns). If they are you must tell Customs and Excise by attaching a letter to the first VAT return that you make using Basis B, quoting "reference 2B/Basis B".

If you later decide to change to Basis A, you must inform Customs and Excise in the same way.

Remember, you must tell your local VAT office about any changes in your business circumstances. You will find details in *The VAT guide,* Section XI.

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SECRET

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

From: B H KNOX

Date: 8 January 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Ross Goobey
Mr Tyrie
PS/IR
Mr Graham (Parly Counsel)
Mr Coleby (Bank of England)

Ch

(1) Proposal is to tax all repayments ie interest + capital — taxing interest alone does cause problems, but this alternative seems odd to me.

(2) Reject advance credit card tax, so no revenue in 1987-88.

(3) V little discussion of presentation, or of how political difficulties over mortgages could be handled (pressure for pledges etc).

AA

CONSUMER CREDIT TAX

Introduction

1. At your meeting on 19 December you asked us to carry out further planning on a possible staged introduction of the tax (on credit cards, on mortgages and on other credit). You asked us subsequently to work on the basis of a 15 per cent tax on interest payments.

Internal distribution: CPS, Mr Jefferson Smith, Mr Wilmott, Mrs Boardman, Mrs Smith, Mr MacLachlan, Mr P V H Smith, Mr Butt, Mr Mier, Mr Bone, Mrs Hamill

SECRET

2. Annex A to this note contains a table of the revenue effects of a tax on this basis. Annex B is a paper that looks in detail at each of these three components of the tax base. This covering note brings out more general policy issues. Paragraph 12 explains the need to take decisions on these points by 16 January.

Tax revenue

3. A key assumption has been that a tax on consumer credit will help to redress current undertaxation of the financial sector. A 15 per cent tax on all consumer credit interest payments could raise gross revenue in excess of £6 billion a year, and net revenue of around £4 billion. We estimate this as perhaps three to four times what is needed to "top up" the taxation of this sector to the level of revenue that would be achieved if we could apply VAT to it (this takes into account the revenue already generated by "hidden" VAT on financial services). Moreover, tax at this level would exacerbate evasion and avoidance difficulties which (initially at least) we would be ill-equipped to deal with. It would raise interest rates appreciably, by around two percentage points for mortgage lending and four to eight points for other forms of credit. We lack hard information on which to base estimates of the distributional effects, but what data we have suggest that the rich pay less for credit and the poor pay most. Our conclusion is that as an initial revenue target £6 billion is too ambitious (but the advantage of taxing this sector is that ultimately it should be able to bear higher tax levels).

4. We suggest therefore that to assist in setting the rate, you need to give us a broad steer on the gross revenue target. This could, we suggest, be up to £2 billion. If the tax was to be on interest alone (including mortgage interest), this would imply a tax rate of about 5 per cent. After offsets, the yield would come down from an initial £2 billion to around £1.4 billion. If mortgages were excluded (and we recommend below that mortgages subject to mortgage interest relief should not be taxed), the same net yield could broadly be achieved with a rate of 15 per cent on other lending.

So presumably 5% on all except mortgages qualifying would yield c. £500 m.

The basis for calculating tax

5. Basing the tax on interest alone has disadvantages. Interest rates are volatile, and tying the tax to them would have perverse effects. For example, as interest rates fall, credit would become cheaper and increase in volume, whereas the tax yield, and its constrictive effect on volume, would decline. Because the tax would be proportionate to interest charges, it would increase absolute differentials between the costs of cheap and expensive credit, thus boosting the attraction of mortgage borrowing for consumer spending (this effect would be even stronger if mortgages were excluded from tax). Finally, there would be a strong incentive for lenders to minimise or avoid tax by reducing interest charges and boosting income from other, non-taxable, sources (such as hefty arrangement fees for credit agreements).

6. However, there are also advantages. In particular, using interest to "trigger" liability to tax avoids the problem of non-interest bearing credit (like the milkman's or newsagent's bills). We therefore recommend keeping interest payment as the criterion by which liability to tax is decided, while broadening the basis of calculation to lessen the perversities noted above. We can come up with no better way than charging the tax on total repayments (ie interest plus capital). This would reduce the problems caused by volatile and declining interest rates, improve the buoyancy of the tax, and cut the incentive to avoid tax by replacing interest by other payments (we say more about avoidance below). There could also be a beneficial effect on distribution. This basis of calculation could be criticised as leading to double taxation (insofar as capital repayments represented the consideration for goods bearing VAT), but since the tax would only be triggered by the supply of interest-bearing credit we think it should be possible to present it as a charge on this supply rather than on that of the goods. To aid presentation, too, the rate would be lower with the wider base: 2 per cent if mortgages were included, 3 per cent otherwise, both for a net yield of around £1.4 billion.

Coverage

7. Clearly the maximum revenue benefit, both at the outset and in later years, is obtained from the widest base, ie including all mortgages. But imposing any tax on mortgages at this stage of a Parliament is unattractive, and we assume that in planning for legislation in this year's Finance Bill mortgages should be excluded. If so, we suggest that the most logical borderline is that provided by mortgage interest relief; mortgages not attracting MIR should be subject to consumer credit duty. This should yield a small but useful revenue gain compared with the exclusion of all mortgages. With this exception the tax would cover all interest-bearing consumer credit.

Credit and charge cards

8. These cards pose a particular presentational problem, in that we suspect most consumers to have only the haziest idea of the distinction between credit and charge cards. Yet on the criterion suggested in paragraph 6 it is only the interest-bearing credit extended on credit cards that would be taxable (although overdraft facilities linked to charge cards would be taxable separately). This is, in our view, logical, and consistent with the assumption that credit arrangements not attracting discrete interest charges fall outside the tax. Any attempt to deem joining and "membership" fees for charge cards to be interest for the purposes of the tax could lead to anomalies and inconsistencies (how to treat, for example, once-off fees charged for arranging mortgages or other loans?). We suggest therefore that no special measures be taken to bring charge cards into the tax net except insofar as they already do so through the charging of interest (and here we may have to deem penalty charges for late payment to be interest, in order to close an obvious loophole).

What "paragraph 6" we lost here?

Avoidance

9. The credit and charge card issue illustrates a more general problem, that of avoidance. If the tax were charged solely on interest, lenders would have an incentive to minimise interest charges by shifting income into other forms like arrangement/joining/membership fees or (for credit and charge cards) into payments

?

by retailers. This incentive is reduced if total repayments are taken as the basis of calculation, because the gearing between interest cuts and tax avoided is lessened. Whereas with a tax on interest alone we might later find ourselves driven to deem various charges to be equivalent to interest (to protect the revenue) we think this is much less likely with the basis we now recommend. (Nevertheless, we think it wise to take a general power to deem "interest" to be any charge to the borrower calculated as a proportion of the debt.) The main risk with the new basis will be from lenders who try to eliminate interest altogether, to avoid triggering the tax. But, in present circumstances at least, we think this will be a difficult trick for most lenders to pull off without either seriously damaging their customer base (eg by charging hefty annual fees for the use of credit cards) or producing a scheme that we can tax as a proxy for interest (because it will result in charges proportionate to the debt).

Phased introduction

10. We see little attraction in a phased introduction of the tax (ie by dealing with credit cards in 1987 and other forms of credit in 1988 - a later extension to mortgages would be a different matter). The revenue advantages are very small (at a rate of 15 per cent on interest, credit cards would be unlikely to yield more than £90 million in 1987-88). But we would run all the risks of getting things wrong associated with a rushed introduction, and could see a possibly major part of the yield leak into untaxed forms of credit. The political fuss could be substantial - our limited experience of the credit card companies is that, although not especially popular, they would be aggressive and vociferous lobbyists, and would almost certainly stir up their card-holders (most of whom fall in the A, B and C1 socio-economic groups).

5p = 30m ?

Transitional measures

11. Something needs to be done about existing fixed-rate loans. We recommend no more than a provision allowing lenders to adjust the interest rate to accommodate the tax. If some or all mortgages are included in the tax base, there may be pressure for relief for existing loans. We would recommend strongly against this, as this would tend to lock people in to existing loans, introducing rigidities

into a sector that is just being loosened up, and possibly affecting people's mobility, with unattractive consequences.

Timing of decisions

12. We must give Parliamentary Counsel firm instructions by the end of this month. Since these will need careful preparation, our timetable will, we fear, be jeopardised if we do not have decisions on the points in this note (except those affecting the tax rate) by 16 January. We shall be making further submissions on more detailed machinery points in the days to come.

Summary

13. We make the following broad recommendations:

a. interest is the right "trigger" for the tax charge but is inadequate as a basis for the tax: we suggest total repayments to the lender.

b. taxing all mortgages is politically unattractive: we recommend excluding mortgages subject to MIR (but taxing others).

c. a 15 per cent rate on all consumer interest is too high (initially, at least): we suggest a gross revenue target of £2 billion (equivalent to about £1.4 billion net); that is, a tax rate of 3 per cent on total repayments of all non-mortgage consumer credit (as defined above).

d. we recommend against the early introduction of a separate charge on credit cards: the tax should be introduced on all taxable credit at the same date (April or July 1988).

e. we recommend against transitional reliefs in general, and in particular against tax exemptions for existing loans.

Bryce Knox

B H KNOX

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ANNEXE A

REVENUE YIELDS AND PSBR EFFECT [1]

(tax calculated as 15% of interest) £m

	87/8 [2]	88/9 [3]	88/9 [4]	89/90 [5]
Cards	90	170	170	190
Mortgages [6]	-	3100	2050	4750
Rest	-	805	535	1180
Gross yield	90	4075	2755	6120
Less IT allowances	-	- 95	- 60	- 140
Less Social Security Benefits	-	- 145	- 95	- 200
Less mortgage interest relief	-	- 865	- 575	-1330
Net PSBR effect	+ 90	+2970	+2025	+4450

(1) All revenue yields are exclusive of demand effects.

(2) 87/8 yield assuming card tax only implemented on 1 May - 9 months yield and excluding Christmas boom.

(3) 88/9 yield assuming full year's card tax and a 1st April start for the rest (9 months revenue).

(4) As for (2) but assuming 1st July start for the rest (6 months revenue).

(5) Full year's tax.

(6) Mortgages are the only form of credit reflected in the RPI. The impact effect of levying a 15% tax on interest alone would be about 0.55%.

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ANNEX B

INTEREST-BASED CONSUMER CREDIT TAX

1. This note looks in detail at the implications of introducing a tax charged, at a rate of 15%, solely on interest payments in respect of three main categories of consumer credit: cards, mortgages and miscellaneous loans.

CARDS

2. There are three main directly competing categories of cards and directly analogous forms of credit.

a) The more traditional "budget" account (mainly operated by retailers), which does not operate with a card, but in all other respects is analogous to either a charge card or credit card facility.

b) Charge card accounts which are mainly operated by retailers or by foreign-based card operators (American Express and Diners Club) and require card holders to pay off outstanding balances in full after a six-seven week delay. Charge card operators recover the costs of providing an average of six-seven weeks interest free credit in part from turnover charges to retailers and in part from enrolment and annual "administrative" charges which average out costs over all card holders. Increasingly, charge card operators are supplementing their card-based facility with a facility for card-holders to transfer outstanding balances to a separate non-card interest-bearing account when the card-holder does not wish to repay the whole of the balance incurred on his charge card within the period allowed.

c) Credit card accounts, the most important of which are operated by the British-owned Barclaycard and Access. Under these schemes, card-holders may either pay off their balance without incurring an interest charge in a similar six-seven week period to that provided by charge cards, or can obtain an automatic "extended credit" facility, subject to interest charges, without the need to transfer the outstanding amount to a separate non-card account. In the case of Barclaycard, the card also serves as a basic cheque guarantee card. Credit card operators recover the costs of both the basic 6-7 week period of free credit and of any "extended credit" partly from retailers and partly by imposing high interest charges on that proportion of their balances which go into interest-bearing "extended credit", at rates which are well above those for ordinary personal loans. Currently in the main bank credit card operators do not try to average out charges between all their card holders by means of "administrative" charges. This allows holders who normally use their credit card essentially as a cheque guarantee or as a charge card to do so without incurring the basic membership costs which they would with an ordinary charge card. In practice, DTI advise that at any one time as many as 40-45% of bank credit cards are being used in effect as charge cards. In addition, a growing number of credit cards are operated by retailers, some of which do impose small "administrative" charges on all card holders, in addition to high interest charges on "extended credit".

3. It will be apparent that:

(i) Card operators have a large number of alternative ways open to them of recovering costs in addition to card-linked "interest" charges. In no case is the basic 6-7 week period of "interest-free" credit actually "free"; but charge card and credit card

operators choose to recover its cost in different ways: by varying charges to retailers, supplemented in the case of charge card operators by averaging out costs over all card holders and in that of credit card operators by concentrating overall costs on those going into "extended credit".

(ii) Increasingly the facilities offered by the three categories in paragraph 2 are directly overlapping and competing. As a result, the distinctions between charge cards and credit cards, in particular, are probably blurred in public perception. It seems highly likely to us that the man in the street would regard the 6-7 week basic period as a form of credit (the costs of which are recovered in differing ways) rather than as merely "delayed payment".

(iii) Although the large majority of transactions are handled by a handful of card operators, there is a growing and substantial number of schemes operated by retailers, who would also need to be registered for any separate card tax. These account for perhaps 20-25% of the cards held, although probably a smaller proportion of interest paid.

4. The main effects of introducing, in isolation, a separate card tax levied solely on card-linked "interest" charges (as strictly defined), therefore, would be to:

a) Exclude retailer "budget" accounts and the mainly foreign-owned charge card accounts from the scope of the tax. Interest payments on "budget" accounts and on related non-card "extended credit" accounts operated by charge card companies would be caught by a broad-based tax, but not by one strictly

based on cards. In the view of the Department of Industry any separate card tax would therefore discriminate unfairly in favour of such directly analogous but non card-based types of loans.

b) Exclude the 25% of additions to credit card balances which do not incur interest.

c) Confine the tax base for any separate card tax, therefore, to the 75% of additions to credit card balances which give rise to interest charges. As a result, imposing a rate as high as 15% on card-based interest charges would produce a potential yield of only:

TABLE A

Rate of tax %	Full year yield (1) £ million	1987-88 yield (2) £ million	1988-89 yield £ million	1989-90 yield £ million
15	155	90	170	190

(1) At 1987-88 prices
(2) This is based on the implementation proposals in paragraph 7.

5. In the view of the Department of Trade and Industry, given the increasing blurring of the distinctions between charge and credit cards, it would be more equitable and less distortionary to include charge card transactions (and similar "interest-free" credit card transactions) within the scope of any tax. This would also slightly increase the revenue yield from one of the most bouyant areas of consumer credit. But in order to be consistent with any tax where liability to the tax was triggered by the supply of

interest-bearing credit it would be necessary to confine the tax to only interest-bearing credit extended on credit cards.

6. Inevitably this would increase the operators' opportunities for eroding the base of any card tax, particularly if cards were taxed in isolation; and if the tax charge was levied on interest alone, rather than on total repayments (interest plus capital). Since credit card interest rates are currently 25-30% a 15% rate would equate to a 4-4 1/2 percentage point increase in interest rates on credit cards. This would provide credit card operators with an incentive to recoup a higher proportion of their costs from sources other than card linked "interest" charges. This could involve their making higher charges to retailers, but more likely in the absence of any charge on charge cards they would try to move closer to the charge card model by, for example, choosing to average out a higher proportion of their costs in the form of "administrative" charges. Moreover unless the separate card tax was fairly quickly followed by a broad-based tax, or the scope of the card tax was widened to include non-card based accounts operated by card companies, credit card operators could also find strong attractions in introducing a facility (again on the charge card model) to allow card holders to transfer interest-bearing amounts to a separate non card-based account.

7. The actual yield from any separate tax on cards would depend crucially on:

a) how quickly it would be possible for card operators to introduce any such tax; and

b) how quickly, and to what extent, card holders and operators chose to switch from taxable card-based transactions. This in turn would depend on how far the tax base was extended beyond merely "interest", and on whether the separate card tax

was clearly seen as the immediate precursor of a broad-based tax.

8. Because of all the factual uncertainties noted in our submission of 15 December, it is difficult to predict how quickly a separate card tax could be introduced. A charge based on "interest" (as strictly defined) alone could involve fewer operators and be less complicated than the alternatives considered earlier, as it would be far nearer to a straight increase in interest rates. But significantly earlier implementation would only be possible if:

a) The tax applied only to "interest" charges as strictly defined. We would expect implementation to take longer if there was any attempt to extend the tax to alternative forms of consideration such as "administrative" charges.

b) There are no exemptions (eg for business holders, charities, local authorities etc).

It might then be possible to obtain nine months yield in 1987-88 by registering card operators during Autumn 1987 and requiring two payments from them during the first year (the first, in respect of 1 May - 31 October on 30 November, and the second three months later). However, because of the delay in consumer spending becoming interest bearing, these nine months would not reflect the normal pre-Christmas 1987 spending boom, and the first year yield would therefore probably be no more than three-fifths of the full year equivalent.

9. However, there would be a number of serious risks attached to any such timetable:

a) In advance of consultations with the industry, we do not know enough about their commercial systems to be sure that they could meet these deadlines.

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b) Any subsequent amendments to the legislative requirements during the passage of the Finance Bill could give rise to serious difficulties and embarrassment for both the card operators and the Government. Almost certainly there would be pressure for some form of exemption for, for example, business use. This would be very difficult to police and we think that all interest-bearing "extended credit" transactions should be within the tax. Implementing any such exemptions could involve significant work for card operators, by requiring them to establish the individual status of all their existing card holders.

c) The potential first year yield of £90 million from a 15% rate assumes that no erosion of the tax base would occur during the first year. In practice, as paragraphs 2 to 6 show, there would be a considerable range of non tax-bearing alternatives open to both card holders and card operators, particularly if the card tax is not seen clearly as a precursor of a broader-based charge. It is difficult to predict how quickly and how far card holders and operators would try to take advantage of these in order to avoid the tax. The opportunities for avoidance would be increased by the need to restrict the tax's scope strictly to "interest" charges (rather than alternative forms of "consideration") in order to ensure its early implementation. On the other hand, card holders are already paying interest rates which are well above mainstream commercial levels for personal loans, in return for the convenience of short term "extended credit" for occasional lump sums; and thus may not react greatly, at least over the short term, to a separate card tax, provided that the effective increase in interest rates was no more than 4-4 1/2 percentage points.. Moreover, those card holders who do not normally use their extended credit facility could be expected to react against any substantial increase in administrative charges if these went above the levels normally charged by

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charge card operators and this would limit the ability of card operators to switch to this form of consideration. Over the short term, therefore, we would not expect a separate card tax to make much impact on credit card operations. However, this would probably not hold good over the longer-term, in the absence of a broad-based tax, particularly if it did not prove possible to devise special anti-avoidance provisions to limit the ability of card operators, for example, to set up related non card-based "extended credit" accounts.

d) Because it normally takes up to 11-12 weeks for card purchases to give rise to "interest" entries on account invoices, any attempt at more or less immediate implementation could involve taxing commitments entered into before the Budget announcement. This would inevitably increase the complaints against singling out this area.

For all these reasons we continue to recommend strongly against imposing a separate tax on cards. If a separate tax is required, we consider that the earliest possible implementation date would be 1 May 1987; that this could only be met if all the provisions in paragraph 8 are adhered to; and that even then only at considerable risk.

MISCELLANEOUS LOANS

10. Paragraphs 11-16 consider the effects of imposing 15% on interest payments arising from all types of consumer credit other than cards and mortgages. In paragraph 22 we recommend that any broader-based tax should also cover any mortgages which do not receive income tax relief.

11. The range of facilities offered by the main types of consumer credit other than cards and mortgages varies considerably in terms of importance, interest levels, the size and number of lenders concerned, and the type of borrowers involved. The most important are bank overdrafts, personal loans, hire purchase and mail order.

A significant proportion constitutes fixed-interest loans, and there is a very considerable range of interest levels. In general terms interest rates in this category are higher than for mortgages, but lower than for cards; but at the extreme, some less reputable traders may charge interest rates of 500% or more. This miscellaneous category contains the vast bulk of the 50,000 traders who potentially may need to be registered for the tax; in order to minimise the resource efforts required, as many as possible of the smaller and marginal traders will need to be excluded by, for example, a de minimis limit. The type of borrowers using these categories of loans will also vary considerably. In general terms, they are likely to include more from Classes C (ii), D and E than either cards or mortgages.

12. The main macro effects of introducing a credit tax based on interest payments would be to:

a) Produce a potential yield as in Table B

TABLE B

Rate of Tax %	1988-89 yield 1/4/88 start £m	 1/7/88 start £m	1989-90 yield £m	RPI impact effect
15	805	535	1180	Nil

b) Produce a widely varying increase in interest rates, ranging from 3 percentage points in the case of bank personal loans to 100 + percentage points in the case of "back street" lenders.

c) Produce complex distributional effects within this category of loans. If looked at in overall terms, the main

burden of the tax would fall on Classes A, B, C(i) and (ii). But a higher proportion of loans in this miscellaneous category will be held by borrowers in Classes C(ii), D and E, than in the case of mortgages and cards. Moreover, if looked at in terms of its comparative effects on individual loans, because in general the poorest borrowers tend to pay the highest interest rates, borrowers in Classes C(ii) D and E are likely to be hit most in absolute terms by any tax charge geared directly to interest charges.

13. An interest basis would help to exclude automatically from the scope of the tax a number of forms of lending which might otherwise be caught by virtue of their being made in the "course or furtherance of business", but which we would not in fact wish to catch because they are purely incidental to the trader's main business activity - for example the interest-free credit normally extended by milkmen and newsagents.

14. On the other hand, basing the tax charge solely on interest would increase a number of technical difficulties (as compared with a broader-based tax on both capital and interest payments):

(a) In particular, it would be necessary to define "interest" very carefully in the legislation, in order to minimise potential avoidance problems. There would be even more opportunities than for cards, for other forms of "consideration" to be used as interest substitutes in order to avoid the tax charge. For example, interest could be expressed as a lump sum (as in the Koranic system), or as a time-limited "discount", or in a related but separate agreement, or as an "arrangement fee". It would be necessary for the legislation to make it clear that these types of "consideration" would be caught by the tax at least insofar as they were proportional to the capital sum, and probably to provide for a general averment power (following existing precedents) under which an averment by the Commissioners in any process that interest or other additional consideration has been levied shall be

sufficient evidence that it is so, until the contrary is proved.

(b) More generally, it would be necessary to give considerable thought to the detailed rules governing factors such as valuation, time of supply and changes of rates. As far as possible, we would wish to legislate for these by Regulations, (possibly in the form of special schemes) which would need to be drawn up after full consultation with the industry.

15. Our submission of 15 December highlighted the potential avoidance problems arising from off-shore lending and the exemption for loans for business purposes. Clearly, any tax charge set at as high a rate as 15% of interest rates (equivalent to an increase in the interest rate of 3 to 8 percentage points) would increase the incentive for abuse. This would be particularly important in regard to this category, since it covers the majority of loans to businesses.

16. A charge of as high as 15% would also increase the difficulties envisaged in our submission of 15 December in relation to existing "fixed-interest" loans, almost all of which come within this category. In our earlier submission we recommended a provision on the lines of Section 42 of the VAT Act 1983 to allow lenders to adjust the interest charge under existing contracts so as to recover the new duty, should they so choose. On administrative grounds, we would still prefer this solution, but with an increase as large as 15% of interest charges, there would undoubtedly be greater pressure for a total relief for all fixed-rate contracts entered into before the 1987 Budget announcement in order to avoid either the lender or the borrower (or both) having to bear a significantly increased burden. On the assumption that the tax would be introduced on 1 July 1988, at a

rate of 15%, the potential cost of such a relief would be around £100 to 200 millions in 1988-89 (assuming 50% of a full year yield), about the same in 1989-90, but probably less than £100 million in 1990-91.

MORTGAGES

17. Table C shows the gross potential yield of a tax on interest payments on mortgages.

TABLE C

Rate of tax	1988-89 yield *		1989-90 yield *
	1/4/88 start	1/7/88 start	
%	£m	£m	£m
15	3100	2050	4750

* Gross of income tax.

The net yield would depend on whether the existing income tax relief for interest charges would automatically extend to the additional interest charge arising from the imposition of the tax. All our planning to date has assumed that it would. In that event, the gross yield in 1989-90 would be reduced by some 28% to £3.4 billion. Even after this, however, the revenue effect of imposing a consumer credit tax at rate as high as 15% of interest payments on mortgages would be to claw back from mortgages a sum equivalent to over 40% of the benefit arising from the existing income tax relief, at the cost of an impact effect on the RPI of just under half a percentage point in 1988-89. In absolute terms, this would impose a considerable additional tax burden on mortgages particularly over the lifetime of the mortgage as a whole. Looked at in relative terms, however, because mortgage interest rates are considerably lower in APR terms, than those of most alternative

forms of borrowing, an interest-geared charge would impose a lower percentage point increase in the APR rates on mortgages than on other forms of borrowing, thus increasing its relative attractiveness in APR terms.

18. As Table D shows, the potential effects on actual monthly payments on individual mortgages would vary considerably, according to whether the mortgage was on an endowment or repayment basis and to whether or not it was eligible for income tax relief.

TABLE D

	Borrower A £20,000 endowment mortgage. standard rate relief.	Borrower B £20,000 repayment mortgage. Standard rate relief.
Total net monthly payment of which:	£186	£180
(i) interest (net of income tax.)	£146	£119
(ii) capital/ insurance	£ 40	£ 61
Credit tax charge at 15%		
(i) gross of income tax.	£ 31	£ 25
(ii) net of income tax relief.	£ 22	£18

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TABLE D Contd

	Borrower A £20,000 endowment mortgage. standard rate relief.	Borrower B £20,000 repayment mortgage. Standard rate relief.
New net monthly payment (assuming income tax relief)	£208	£198
Percentage addition to monthly payment:		
(i) with income tax relief	12%	10%
(ii) without income tax relief	17%	14%

Note: Figures assume a commercial mortgage interest rate of 12 1/3%.

19. As Table D illustrates, holders of endowment mortgages would suffer higher monthly increases than holders of repayment mortgages, as a result of the greater proportion of their existing monthly payments which interest represents. An interest-based tax would thus increase the existing higher sensitivity of endowment mortgage payments to changes in commercial interest rates. By contrast a tax charge based on total mortgage payments (ie both capital/insurance premiums and interest payments) would have a more neutral impact as between endowment and repayment mortgages.

20. As paragraphs 17-19 indicate, although the impact of an interest-based tax would be less for holders of mortgages than other borrowers because of their existing lower commercial rate and

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the effect of any extension of the existing income relief, the introduction of the tax at a rate of 15% would still result in sizeable increases to the monthly bills of the 35% of households which have mortgages. At current interest rates, a tax charged at 15% would equate to about a 1.85 percentage point increase in the mortgage rate. The impact would probably be resented most by existing borrowers, particularly those who had recently taken out mortgages. It could be argued that changes of 1 to 1.5 percentage points in the mortgage rate are not uncommon for commercial reasons. But it is likely that there would be pressure for some sort of relief for at least existing mortgages. We have therefore considered what form this might take. There are two main possibilities:

a) First, the tax could be applied to mortgages at a lower rate than to other forms of borrowing. This would involve substantial permanent revenue costs; applying a 10% rather than a 15% rate to mortgages, for example, would cost £1.5 billion in a full year. Although the main pressure for relief would probably come from existing mortgagees, any such lower rate would also increase the relative advantages in APR terms of new mortgages against other, more expensive, forms of new borrowing. On the other hand a differential rate for mortgages would be relatively easy to operate, and would increase the flexibility of the tax as an instrument of monetary control.

b) As an alternative, it would be possible to provide a relief purely for mortgages already in existence at the time of the 1987 Budget announcement. This could take the form of either a straight exemption, or a lower rate for existing mortgages. An exemption would be very costly in revenue terms, but would effectively limit the scope of the tax to new mortgages. As Table E, below shows the main effect of this

would be to delay the build-up of revenue receipts from the tax substantially for a period of perhaps 10 years.

TABLE E

Estimated build up of yield from a Tax on new mortgages only (89/90 prices)

	Yield (£b)	% of 89/90 yield from tax on all mortgages
1988/9 (Full year)	0.8	16
1989/90	1.4	30
1990/91	2.1	44
1991/92	2.7	56
1992/93	3.2	68
1993/94	3.7	78
1994/95	4.1	86
1995/96	4.4	92
1996/97	4.5	95
1997/98	4.6	98
1998/99	4.7	99

In addition, it could have a dampening affect on the housing market and on individual mobility, at least in the short term, by imposing a penalty on those wishing to trade in existing mortgages.

21. As the figures in the previous paragraphs show, any form of relief for mortgages would be extremely costly in terms of revenue foregone; and seems unlikely to negate all potential criticism. It

therefore seems questionable to us whether either of the alternatives in paragraph 20 would be worth pursuing, but we will need early instructions if either is to be pursued.

22. Should you decide to exclude mortgages from the tax, it will be necessary to consider whether this exemption should cover all mortgages, or be confined to those which already enjoy income tax relief. There would be technical and revenue advantages in including within the tax any mortgages which do not attract income tax relief (at a revenue yield of up to £200 million in a full year). It would also be consistent with current distinctions, in the tax treatment of mortgages, and might serve as some deterrent to the diversion of mortgage borrowing to general consumer spending; albeit not a very effective one. We would recommend, therefore, that mortgages which do not attract income tax relief should be included in any broad-based tax.

cc THOSE PRESENT
PS/CHANCELLOR
PS/CST, PS/FST, PS/EST
SIR P MIDDLETON
SIR T BURNS
MR CASSELL, MR SCHOLAR
MRS LOMAX, MR TYRIE
MR ROSS GOOBEY, MR WALTERS
PS/C&E, PS/IR

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NOTE OF A MEETING HELD AT 4.15PM ON THURSDAY, 8 JANUARY 1987, AT HM TREASURY

Present: Minister of State
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Knox - C&E
Mr Wilmott - C&E
Mr Bone - C&E

C/ MST agrees with you that this does not look a sensible starter for '87 Budget + he thinks never likely to be viable CL 9/1

A POSSIBLE INSURANCE PREMIUM TAX (IPT)

1. The Minister of State discussed Mr Knox's submission of 12 December, in the light of comments from his colleagues (minutes of 15 December from Ms Ryding and Mr Felstead). It was agreed to drop this for the 1987 Budget. The Minister of State thought this conclusion was likely to be a permanent one.

2. The Minister of State welcomed the opportunity to discuss Customs' research. The main argument against IPT was that it would disadvantage the British insurance industry, or push much business off-shore. He wondered whether the industry was benefiting from a hidden protectionist subsidy at present. Was Lloyds' pre-eminence in fact due to their skill and experience?

3. Mr Wilmott said the evidence on this was very indirect. As there had never been a IPT in the UK (in contrast with other European countries) it was difficult to estimate the effect of such a tax. He thought the success of the British insurance industry was due to it having a large home base, and a relatively entrepreneurial and open market. The French and German systems were, by contrast, very rigid. Mr Ilett agreed, referring to the French legislation on compulsory insurance and consumer protection, which made their insurance policies difficult to export.

4. Mr Bone said that the Dutch had a similar industry, but on a much smaller scale. Miss Sinclair added that historical/cultural factors were important.

5. Mr Cropper queried the justification for exempting financial services generally from VAT. Mr Wilmott said that it was very difficult to define the consideration for a supply of a service such as a bank current account. No EC Member State had ever tried to tax this sort of consideration, and so the EC had decided that it must not be feasible. Mr Wilmott added that these problems were less acute with insurance - some countries taxed premiums, despite the conceptual problems with this. Mr Cropper thought that a French equivalent of Lord Cockfield could have a field day with the financial sector: Mr Wilmott pointed out that he would have to persuade the 12 Member States to agree unanimously. But such a reform would be very damaging to the UK. The French were keen to put VAT on insurance premiums, because their IPT was so awful.

6. The Minister of State referred to the problems caused for VAT offices by the lack of paper records for many transactions. Mr Bone agreed that it made tracking much more difficult; financial services were more and more being reduced to a set of electronic impulses and this would not make taxes on financial services any easier to administer.

7. Concluding the meeting, the Minister of State said that it was agreed to drop IPT from the 1987 Budget. He thought the arguments against an IPT had a degree of permanance. (After the meeting, he commented that he had not yet had a reply to his letter of 17 November to the Canadian Minister of Finance: could Mr Wilmott let me know if this produces an interesting response, please?)

SPJ. 9/1

S P JUDGE
Private Secretary

29/3068

SECRET

FROM: DAVID PERETZ
9 January 1987

PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Grice
Mr Ilett
Mr Cropper
Mr Ross Goobey
Mr Tyrie
PS/IR
PS/CE
Mr Knox (C&E)
Mr Coleby (B/E)

CONSUMER CREDIT TAX

Could I offer a few quick comments on Mr Knox's submission of 8 January - mainly on the proposal that the basis for the tax should, after all, be total repayments to the lender.

2. First, there are certain advantages in having a tax linked to the rate of interest. These seem to me to outweigh the alleged perverse effects set out in paragraph 5 of Mr Knox's note. It would provide a useful, if modest, gearing up of the impact of any general change in interest rates on the cost of consumer credit. And it would mean that we would get some modest fiscal benefit, and fiscal tightening, when we tighten policy by raising interest rates.

3. Second, surely a tax on repayments would have some very odd incentive and distributional effects. For example a borrower would pay a very high tax charge on a temporary loan raised for a month or so, for example to tide over a period until some financial asset could be realised to pay for a purchase. It is not hard to think of other examples. And it would presumably tend to encourage borrowers to extend the period of their loans

as long as possible (thereby increasing the rate of growth of total credit outstanding).

4. Third, as to the separate credit card tax, I thought the arguments for this were not so much the short term revenue yield as the advantages we saw in it both as a signal that we are not indifferent to the rapid growth of consumer credit; and as a stalking horse for the wider tax. Of course both arguments would diminish if we were ready to announce a wider tax this year.

D L C PERETZ

1252/23

SECRET

FROM: A ROSS GOOBEY
DATE: 9 JANUARY 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Tyrie

PS/Inland Revenue

Mr Knox - C&E

Mr Coleby - B/E

CONSUMER CREDIT TAX

Mr Knox's paper of 8 January.

2. I don't think tying tax to interest rates is perverse (tying interest rates to tax might be, but that is not what is proposed). In fact it might have a pleasant automatic regulator effect: slack demand, lower interest rates, lower tax revenues, fiscal boost, higher consumer borrowing, higher activity etc etc.

3. I do not accept the argument for including repayments of capital particularly as I believe it possible to construct the tax in a way which skirts the avoidance problems.

4. Mr Knox identifies two specific cases of potential avoidance: "other payments" in lieu of interest and repayments of capital higher than the original amount lent.

5. Since the "other payments" consist of commissions, arrangement fees, card charges, higher payments by retailers, they should be subject to VAT. Any extended "interest free" credit will be

reflected in a higher price for the good supplied than would be available to a cash buyer and thus would bear VAT on the higher cost.

6. As to discounted capital repayments, the legislation should be drawn as to cover any difference between the price the good is supplied at or the amount of the loan and the amount repaid. In most cases this is interest but in some cases it will be some other payments.

7. A 5% rate including mortgages would be my preference with a yield of £2 billion reducing to £1.4 billion. A half point rise in mortgage rates seems a small price to pay for avoiding yet another incentive to borrow up to the £30,000 limit.

8. Mr Knox's paragraph 10 still does not convince me that some revenue would not be possible in 1987-88 on a broad-based tax. If you accept my view expressed above that there will be no untaxed forms of credit (other than offshore and we can use the Consumer Credit Act enforcement rules to deter that), then leakage will not be a threat, and I still do not see what is so complex about implementing this tax for our proxy-collectors, the finance companies, banks and building societies. Quick introduction would also avoid the possibility of a head of steam being built up by the anti-lobby.

Discuss

Consider 5% excluding mortgages. Yield quadrupling 7½ bn?

Discuss

ARG

A ROSS GOOBEY

JAN 1987

THE GREAT UNIVERSAL STORES P.L.C.

P.O. BOX 1BZ · UNIVERSAL HOUSE
251-256 · TOTTENHAM COURT ROAD · LONDON · W1A 1BZ
TELEPHONE: 01-636 4080
TELEX: 27652

MINISTER OF STATE	
REC.	13 JAN 1987
ACTION	MR JEFFERSON SMITH - C+6
	PS/CHANCELLOR
	MS SINCLAIR
	MR CROPPER
	PS/ C+6

MST

12th January 1987

The Hon. Peter Brooke M.P.,
Minister of State,
The Treasury,
Gt. George Street,
London SW1P 3AG

Dear Peter

V.A.T. - Small Business Review

As I think you know I have been connected with this Company for more than 25 years, and I am writing to say how shocked I am how Customs and Excise are trying to change the position on V.A.T. and are proposing to withdraw the present right for retailers to elect to have their VAT output tax calculated on the basis of collections and not sales with, amongst other things, a consequent loss of relief being given for bad debts.

This is likely to cost our Company many millions of pounds, and I cannot believe the Ministers intended the Revenue to act in this way.

Geoffrey

Sir Geoffrey Finsberg, MBE, MP

19 JAN 1987

SIR GEOFFREY FINSBERG, M.B.E., J.P., M.P.

HOUSE OF COMMONS
LONDON SW1A 0AA

PUP

15th January 1987

The Hon. Peter Brooke, M.P.
Minister of State,
The Treasury,
Great George Street,
London SW1P 3AG

MINISTER OF STATE
REC. 19 JAN 1987
ACTION Mr Howard
PS/Chex
Ms Sinclair
Mr Cropper
PS/CST
MST

Dear Peter

V.A.T. - Small Business Review

I am writing to amplify the letter I sent to you on the above subject on 12th January. The proposed changes by Customs and Excise appear to me to be a denial of natural justice in that it would involve companies selling on credit paying a higher rate of VAT than Parliament authorised and its theoretical application would be far too abrupt. The effect not merely on this company but numerous others will be that prices will increase to cover the extra cost which must have a deleterious effect on both inflation and employment in the end the customer or employee always pays.

I hope you will give this matter urgent attention and then instruct Customs & Excise to leave matters in this field where they are at present.

Yours
Geoffrey

PUP

SIR GEOFFREY FINSBERG, M.B.E., J.P., M.P.

HOUSE OF COMMONS
LONDON SWIA OAA

19 JAN 1987 - 24

16th January 1987

Dear Peter

V.A.T. Small Business Review

May I at this stage request that if you are minded to accept the proposals of the Customs & Excise on this matter, before taking a final decision, I may X bring a deputation to see you ?

Geoffrey

The Hon. Peter Brooke, MP
Minister of State
Treasury
Great George Street
London, SW1P 3AG

For Urgent Advice on X Please

MINISTER OF STATE	
REC.	19 JAN 1987
ACTION	Mr Howard
	PS/Ch/Ex
	Ms Sinclair
	Mr Cropper
	PS/CST

MST

Rvp

FROM: S P Judge

DATE: 20 January 1987

MR HOWARD - C&E

cc PS/Chancellor
Mr Scholar
Miss Sinclair

PS/Customs & Excise

VAT - SMALL BUSINESS REVIEW

I think you now have three letters from Sir Geoffrey Finsberg on this subject to deal with - dated 12, 15 and 16 January! On the latter, the Minister has commented that he is of course prepared to see Sir Geoffrey on a without prejudice basis, unless we can persuade Sir Geoffrey that a meeting is not needed.

SPJ

S P JUDGE
Private Secretary

CONFIDENTIAL

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

From D J HOWARD
Date 23 January 1987

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Jenkins,
Parliamentary Counsel
PS/Inland Revenue

MINISTER OF STATE

VAT: SMALL BUSINESS REVIEW

This is an interim report on the consultation exercise which has recently been concluded. As promised in my minute of 16 January about the Chartered Institute of Management Accountants (CIMA) response, we shall let you have a full analysis after the discussions we shall be having shortly with the Enterprise and Deregulation Unit. This minute does not, therefore ask for firm decisions, although there is one point (paragraph 23) about the proposed division between primary and secondary legislation on which we should be grateful for your early view.

2. We had to allow a de facto extension of the consultation period of three weeks to cater for a number of important trade and professional representative bodies who did not manage to meet the

Internal distribution:

CPS	Mr Trevett	Mr Wilmott
Mr Knox	Mr Fryett	Dr McFarlane
Solicitor	Mr Goddard	Mr Hewett
Mr Jefferson Smith	Mr Hogg	Mr Holloway
Mr Butt	Mr Huband	

31 December deadline. The only major response still outstanding is that of the CBI but they have let us see a draft and we have treated it as firm for the purposes of this analysis. In total, therefore, we have received 183 responses: 72 from representative bodies and 111 from individual businesses. In addition, we have received 1,256 responses to the special questionnaire which we sent to a representative sample of 5,000 small businesses. The response rate of 25% is, we understand, well in line with normal market research expectations for this kind of exercise.

3. Annex A provides a brief summary, arranged by subject chapter headings, of the views of 21 of the most important representative bodies. Annex B contains a numerical summary of the responses to the detailed questions in the small trader questionnaire. For convenience, the main features are described in the following paragraphs.

General

4. Nearly all respondents have welcomed both the small business review itself and the opportunity to participate through the consultation exercise. In some cases, exemplified in my note of 16 January about the "Guardian" article, this has been expressed in unusually warm terms. Most recently, the CBI in its draft response has welcomed "the Government's intention of lightening the compliance burden that VAT imposes on small businesses". On the other hand, as you know, there have also been more negative responses, notably that from CIMA. The response from the Association of Independent Busineses (AIB) was also disappointing in tone.

5. In general, those proposals like cash accounting and extended time limits for registration which can clearly be perceived to help small businesses have been welcomed, while those such as compulsory deregistration which would withdraw existing benefits have, not surprisingly, been criticised. The most common reservation about the more beneficial proposals has been that they do not go far enough. This point has been made particularly in relation to the turnover limit for cash accounting. There has also been a

substantial degree of support for a much higher registration threshold than the £25,000 or so (35,000 ECU) noted in the consultation document as the draft SME's Directive proposal.

Responses on individual proposals

6. Cash accounting. The response has been almost entirely in favour of the availability of the option of cash accounting for small businesses although many respondents consider the proposed £100,000 turnover limit too restrictive. A range of alternative figures of up to £2 million has been offered and some respondents have argued for no limit at all. For example, in its draft response the CBI has plumped for £1 million but "questions whether there need be a limit at all". The Institute of Directors has suggested that, if cash accounting were to be restricted to a turnover limit of £100,000 in line with the draft SME's Directive, there should be a general scheme of bad debt relief for other businesses.

7. A number of suggestions and questions have also been put forward about the detailed operation of the scheme (mostly concerned with the accounting problems involved in entering and leaving the ring). There has been a broad consensus for simplicity in operational requirements; all such points are being examined. A few respondents have suggested an extension of the 30 days allowed after the end of an accounting period before VAT returns have to be rendered to Customs. This is seen as a possible alternative to cash accounting, although not surprisingly no respondent in favour has addressed the problem of the substantial revenue costs.

8. The responses to the small trader questionnaire suggest that the take-up of cash accounting may prove to be higher than we had previously estimated. Almost exactly one-half of the 95% or so of small trader respondents who answered the relevant question said that they would wish to use the cash accounting scheme; yet over 40% of all the 1256 respondents are already in the construction industry or are using a retail scheme, most of whom would have no need for cash accounting. Prima facie, the answers suggest that

the take-up could be as high as about 75% of those eligible compared with the 50% (on the same basis) we had previously estimated. The 75% figure may, however, need some discounting to allow for possible misunderstanding by respondents and perhaps also for a small degree of difference between the theoretical position and the real. Even so, we are now inclined to the view that a more realistic estimate of the potential take-up would now be two-thirds of those eligible.

9. On this basis, the estimates of cost provided in my minute of 16 December should be revised (with sensible roundings) as follows:-

Limit	Once and for all cost (£m)	Annual cost* (£m)
£100,000	50	5
£250,000	100	7
£500,000	150	10

(* excluding interest costs, as recently agreed on conventional grounds with the official Treasury.)

Assuming a 1 October 1987 start, which would be about the earliest practicable date to allow time for Finance Bill legislation, the necessary Regulations and both trader and staff education, the once-and-for-all cost would fall in the financial year 1987-88. We shall be providing separate advice on the turnover limit shortly.

10. Annual accounting. In general there has been a rather more lukewarm response to this suggestion. The balance of opinion among the major respondents is in favour of the scheme on the proposed optional basis, subject to requests that the turnover limit should be increased, pari passu, with that for cash accounting; but, overall, there is less enthusiasm than for cash accounting and some respondents have cautioned against annual accounting on the basis that the decline in record- keeping standards compared with the discipline of traders having to prepare accounts for VAT return purposes quarterly will be detrimental. Some, including the Institute of Directors have suggested that the risks of having to

make payments on account on a past turnover basis would be dangerous for businesses in volatile situations and that some form of Government "health warning" about the dangers of downturn would be appropriate. The VAT Practitioners Group has suggested, specifically a simplified VAT leaflet which would draw the attention of small businesses to the possible risks and disadvantages of annual accounting as well as the potential benefits. Again, there have been a number of more detailed comments which we are still considering. Just over 20% of small trader respondents would expect to use the scheme.

11. Maintenance and preservation of records. Some respondents have taken the opportunity to complain anew about the extension of the period for preservation of records from three years to six in the 1985 Finance Act. The CBI and others have suggested that traders should have a general dispensation to destroy records after a "satisfactory" VAT control visit; this, again, is a perennial point in correspondence.

12. Most respondents do, however, support the employment of an independent consultant (Peat Marwick McLintock have recently been appointed and commenced work), although a minority of smaller representative bodies have either denied the problems or even said flatly that the use of the consultant would be a waste of public money. Some concern has also been expressed that the terms of reference might be too narrow. However, we already have an understanding with the Enterprise and Deregulation Unit that, subject to the overriding need for consistency with our revenue needs, a measure of latitude may, if necessary, be allowed if the consultant himself felt it would be important to his findings.

13. Review of registration and deregistation requirements. These proposals, which have largely been the subject of earlier consultation, have for the most part been welcomed. However, a number of respondents have argued that the longer period of one month proposed for notifying liability to register and cessation of trading should become three months. (You will recall that this was suggested by Lord Young and his officials at the meeting on 15 October, but we then pointed out that each additional month allowed

would cost about £65 million a year in revenue forgone and would also leave us exposed to accusations of unjustified distortion of commercial competition from established businesses which had no interest in longer time limits.)

14. Although views were not explicitly sought on the point, a significant number of respondents have specifically sought a substantial increase in the VAT registration threshold, to either £50,000 or £100,000, while the Federation of Master Builders has taken the opportunity to reiterate its arguments for a "nil" threshold for construction industry businesses. Many, but not all, of those making such recommendations for a substantial increase have acknowledged the European Community dimension and have urged further initiatives and rejection of the draft SME's Directive proposals in this area. We shall be making a separate submission on the negotiating outlook in Brussels following the further discussion of the draft Directive in the Financial Questions Group which is scheduled for next week.

15. Most respondents have objected strongly to compulsory deregistration, although a small minority have suggested that it might be acceptable provided it did not apply to the food industry. The arguments deployed have generally been the predictable ones about loss of income from VAT repayments and its potential effect on competitiveness; loss of status; and, in some cases, the reduction of opportunity to do business with larger traders. MAFF, in a brief response, have said that compulsory deregistration would "have dire effects on small farmers and on agriculture and its many ancillary interests". A number of other respondents have summed up their views with the argument that traders must be assumed themselves to have concluded that the benefits of being registered outweighed any added compliance burden, and that it would be wrong to refuse to allow them to exercise this judgment. In some contrast, over 25% of those answering the small trader questionnaire were prepared to agree with the concept of compulsory deregistration.

16. It was clear from the outset that compulsory deregistration would be the single most controversial proposal in the consultation document. We consider that its inclusion has served its purpose to the extent of obtaining clear indications of view that the accounting and administrative burdens of VAT are rated as of lesser importance when the net financial effect is favourable to the trader, and that large numbers of businesses would be unlikely to choose to deregistger even if a substantial increase in the level of the VAT threshold was obtainable. We shall return to the point in our full report, after consultation with the EDU, but we suggest that there can now be little prospect of proceeding with compulsory deregistration at least for this year.

17. Retail schemes. There has not been a great deal of comment on this section of the paper and although some 170 respondents to the small trader questionnaire declared that they were using a retail scheme, there was an average of only about 60 answers to the questions about changes in the schemes.

18. In general, those proposed changes to the schemes which are beneficial to the trade have been welcomed, while the suggested new standard mark-ups have met with some criticism where they are less favourable to businesses than the present ones. We are examining the points made. None of the changes proposed in the consultation document would require changes to primary legislation.

19. Not surprisingly, the two most controversial suggestions have proved to be:-

(a) the proposed abolition of the standard method of calculating gross takings; and

(b) the suggested future limitation on the use of the schemes to genuine retail businesses.

The VAT Practitioners Group support (b) on grounds of equity, but businesses more directly involved oppose it. However, subject to further examination, including legal arguments advanced by the Law Society on which we are seeking the advice of our Departmental

lawyers, our initial reaction is that the objections to (b) are largely of a predictable nature and it is doubtful whether they provide any fresh insights or grounds for not proceeding. On the other hand, the arguments put forward against (a) have been much more forceful. You have received letters on the point directly from the Institute of Directors and from Sir Geoffrey Finsberg MP, on behalf of Great Universal Stores, a leading member of the Mail Order Traders Association. We ourselves received strong representations from the Association and others in response to the consultation document and this week have met the Association to hear their case at first hand. We shall be providing further advice in due course.

Abolition of VAT on credit transactions between registered traders.

20. This explanation as to why we were not proposing this reform which, as you will recall, was included as an annex to the consultative document at the suggestion of Lord Young, has not produced a great deal of response and most of that has been largely predictable. The National Chamber of Trade has reiterated its opposition and although, for example the CBI and the Retail Consortium constituent bodies have not offered a fresh view, we have no reason to believe that they have changed their mind. Of the trade and professional associations which participated in the joint Government industry working party in 1978, only the Consultative Committee of Accountancy Bodies were in favour of change. This time round the principal accountancy bodies, responding as individual associations, have with one exception remained silent on the matter, as have most other major respondents. The principal arguments in favour of the change have come from the NFSE (which has campaigned repeatedly in recent years), the Association of Independent Businesses and CIMA. On the other hand, one previous, if relatively minor, protagonist of change (the Antique Dealers Association) states that in the light of the explanation given the consultation document it does not now believe that the abolition of tax on inter-trade transactions would be beneficial.

Other matters

21. A number of other points, including some on the penalty system, has been raised in the responses to the consultation document. We shall cover these in our full report which will be submitted as soon as practicable.

Amendments to the law

22. The drafting of the necessary Finance Bill legislation in respect of cash accounting, annual accounting and registration/-deregistration (excluding compulsory deregistration) is in hand subject to firm decisions in the light of our full report and other necessary further advice. For registration/deregistration we shall need a series of brief technical amendments to Schedule 1 of the VAT Act 1983. For cash accounting and annual accounting Parliamentary Counsel has advised that only short clauses appear to be necessary, confirming and slightly extending our existing Regulation-making powers, and that the technical details of the schemes would then be appropriate to secondary legislation.

23. Parliamentary Counsel has also suggested that the simplest way of dealing with the turnover limits might be to include them in the respective Regulations too. We envisage that the proposed Regulations for cash accounting at least (because of its earlier proposed implementation date of 1 October 1987, as opposed to 1 July 1988 for annual accounting) would be made available to members of the Finance Bill Standing Committee in draft form; and, subject to the ruling of the Chair, it would appear then to be possible to debate the turnover limit prescribed in the draft Regulations in the context of Clause Stand Part. We should be grateful to know whether you would be content with this approach.

D J HOWARD

4466/16/PN

Already received J-Smith's minute

COPY NO 1 OF 17

FROM: K M ROMANSKI
DATE: 23 January 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Wilson
Mr Monck
Mr Sedgwick
Mr Odling-Smee
Miss Evans
Mr Tyrie

Mr Battishill - IR
Mr Isaac - IR

CUSTOMS PROJECT FIVE

I have been asked to circulate the attached paper by Mr Jefferson Smith dated 22 January about Consumer Credit Duty for the next overview meeting, to those who have not already received a copy.

K M ROMANSKI

BUDGET - SECRET

COPY NO. 4A/24 → Mr Romanski

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

From: P Jefferson Smith
Date: 22 January 1987

MINISTER OF STATE

cc PS/Chancellor
Mr Cassell
Mr Scholar
Mr Peretz
Mrs Lomax
Mr Ilett
Miss Sinclair
Mr Cropper
Mr Ross Goobey
Mr Painter (I/R)
Mr Graham
(Parly Counsel)

CONSUMER CREDIT TAX : SCOPE AND COVERAGE

1. At the Chancellor's overview meeting on 19 January, we were asked to provide a note on how we could exempt loans to charities whilst taxing lending by them. At that meeting it was recognised that it would also be necessary to consider the extent to which the tax should be applied to loans to or by other categories who are neither businesses nor individual consumers. You are to discuss these issues with us further on Friday in advance of our submitting to you detailed draft instructions to Parliamentary Counsel next week.

2. To date it has been decided that:

(a) The Finance Bill should set out the main reliefs, and provide scope for other, more detailed, provisions to be prescribed by Treasury Order following the post-Budget consultative exercise.

Internal Circulation:

CPS	Mr Butt	Mr Trevett	Mrs Smith
Mr Knox	Mr Howard	Mrs Boardman	Mr MacLachlan
Solicitor	Mr Wilmott	Mr Mier	

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(b) The tax charge is to be accounted for by registered lenders, it being left to them how and to what extent to pass it on to individual borrowers. One important consequence of this is that, if the charge of tax depends on the status of the borrower or any matter within the borrower's control, such as the purpose of the loan, the lender must be able to get the necessary information at the time the interest is charged.

(c) There is to be a general relief for loans for business use (except in respect of credit cards).

(d) The tax should apply to all loans to individuals other than any:

(i) for business use; or

(ii) which attract income tax relief for use in the purchase or improvement of a main residence.

(e) Loans <u>to</u> charities should be exempt; but loans <u>by</u> them should be treated on a par with loans by commercial lenders.

(f) Lenders should only be required to register if the total of their taxable business is above a de minimis limit to be prescribed by Order.

3. This note covers the implications of the decisions to date for the treatment of charities and for other private and public bodies which are neither mainstream businesses nor individuals; the extent of the exemption for business use; and the structure of the de minimis limit.

A. <u>Borrowers : the definition of "consumer"</u>

4. The first main issue is whether the right approach is to impose the tax basically on lending to all borrowers other than businesses, or to make its basis loans to individuals (other than for business use). This turns on whether borrowers who are neither businesses nor private individuals are to be inside or outside the tax. In the case

of VAT, the basic dividing line is drawn so as to allow only businesses to escape the burden of the tax by reclaiming VAT paid on purchases for business purposes. As a result, all non-business purchasers are treated as consumers, and have to bear the effects of the tax, unless any individual purchase benefits from a specific relief. The only exception to this is a specific relief which allows local authorities and certain other bodies in the public sector to reclaim VAT in respect of non-business purchases. This is simply to avoid an unnecessary financing burden.

5. Our previous approach had been to follow broadly this VAT approach. All lending would have been assumed to be taxable, unless the borrower could certify to the lender that the loan was for a business purpose or fell under some other specific relief. This would have meant considering legislating for relief for any categories of borrower which were neither businesses in the generally understood sense, nor individuals. As well as charities, bodies also falling to be considered would have been professional associations, political parties, trade unions, non-charitable associations, and local authorities. In view of the decision not to tax lending to charities, it seems to us that lending to all these other bodies should equally be outside the tax. Many of them have equal political clout and are equally able to claim that they are not really proper subjects of a tax on lending to consumers. Many of them have or could get charitable status, and this could give rise to hopelessly anomalous borderlines.

6. If we had to operate borderlines which involved differentiating between charities and non-charities, there would be serious problems of definition, both for us and lenders. It would not be sufficient to confine the relief to registered charities (the relevant legislation applies only to England and Wales, and does not cover analogous bodies such as churches). Any general VAT relief has always been refused on the grounds that it is extremely difficult to define charities, and impossible to distinguish between worthy

mainstream charities and more dubious fringe activities. In practice, we think that any relief for loans to charities will need to be drawn sufficiently wide to also cover churches, societies and organisations with philanthropic, educational or political aims, and clubs and organisations.

7. It therefore seems better to approach the matter the other way round. If the charge to tax related to loans to individuals, plus perhaps some categories very similar to individuals (discussed below). There would be the following advantages:

(a) A blanket decision would have been taken about the treatment of bodies which fall between businesses and individuals, rather than piecemeal decisions of great difficulty.

(b) The criteria for the tax would be sufficiently distanced from VAT to give a possible line of defence against charities which tried to exploit the precedent - in particular the argument that it would be administratively burdensome to give a VAT relief to charities would not be undermined.

(c) Compliance problems for lenders would be reduced, since they could accept that any lending to a corporate body would be outside the tax. Certification as a basis for exemption would be required only in respect of loans to individuals and similar categories brought within the tax.

8. The minutes of the overview meeting suggested that loans to groups of individuals or clubs could reasonably be taxed. We deal with groups of individuals below, and there might have to be anti-avoidance provisions against clubs formed for avoidance purposes. But we are doubtful about taxing bona fide clubs as such. Some are very like businesses, and are treated as businesses for VAT purposes. If they borrow on any scale they could form themselves into companies (they may do so in order to limit the liability of their officers or committee members). Some could become registered

charities; a civic amenity society for example can become a charity if its objectives are in part educational. There must be an enormous number of clubs which are neither companies nor charities; but apart from bank overdrafts, we doubt if they are borrowers on any significant scale. In view of the anomalies and scope for complaint that would result from taxing loans to those clubs which were unable or unwilling to constitute themselves so as legitimately to avoid the tax, we suggest that loans to clubs should normally be exempt.

9. Applied across the board, this approach would mean that all loans to individuals would be potentially taxable. But we see residual problems in three main areas:

(a) It would be necessary to ensure that individuals did not try to avoid the tax by, for example, establishing a trust for an individual or forming clubs or organisations solely for the purpose of avoiding the tax. Although in practice we do not think that this is likely to be done on any substantial scale given a relatively low rate of tax, the legislation would need to include powers to take anti-avoidance measures; for example, by deeming a type of organisation advocated for avoidance purposes to be essentially "individuals" or by defining "individual" further in secondary legislation.

(b) Any definition confining the tax charged to individuals would automatically exclude loans to partnerships. This would obviously be correct in the case of larger partnerships which in all other respects are on a par with a limited company. But smaller partnerships (eg between husband and wife) could give rise to similar opportunities as for the self-employed for "business" loans to be syphoned off to private use. We need to consider how far the provisions proposed below for certification of loans to individuals for business purposes should also extend to small partnerships.

(c) With the possible exception of partnerships, the self-employed individual would be singled out amongst businesses by having all their loans potentially taxable unless business use can be proved. We would need to require lenders to obtain certificates of intended business use from the self- employed before treating them as exempt. This would be relatively easy to do in the case of those loans which normally involve a written contract. But would be harder in the case of bank overdrafts or loans which involved many individual "over the counter" transactions (for example in the relatively few cases where traders have interest- bearing monthly accounts at a cash and carry). Self certification is unlikely to have much more than a deterrent effect, but we see no alternatives other than allowing the self-employed a free-for-all, or wholly excluding them from the general business relief.

B. Lenders : The business/non-business borderline

10. We envisage putting an obligation to register and account for tax on all persons making taxable loans. Such a comprehensive definition of "registrable lenders" would be considerably wider than the provisions under VAT (where taxable supplies must be made in the course or furtherance of "business") or the Consumer Credit Act. But it would avoid creating inequities between, for example, charities and commercial organisations providing loans for home repairs or the purchase of equipment for the disabled. (At the overview meeting, it was thought reasonable to tax lending by charities.) In practice, the position of charitable and other non-commercial lenders would be mitigated by the operation of the de minimis limit, and by the fact that many of their loans would be made at below commercial rates. Problems would also be avoided in relation to lending by local authorities, which would be brought within the tax without the need for any specific provision. We would therefore favour a comprehensive definition of registrable lenders. This could probably be

legislated for most easily by applying the tax to all loans to individuals except where specifically relieved. But to avoid an obvious anomaly, the specific reliefs would need to include an exemption for individuals lending to other individuals solely in a non-business capacity (eg to blood relatives).

11. The main exemption for lenders, however, would be a provision exempting all loans made by a lender whose total taxable interest receipts were below a prescribed limit. The limit would have the general aim of reducing the number of registrable traders as far as possible to the 10% or so of lenders who are probably responsible for well over 90% of total lending, in order to minimise the control effort required and thus keep down the staff numbers and administration costs which would stem from an attempt to control up to 70,000 lenders. More specifically, if set at a sufficiently high level it could automatically exclude loans by many non-business lenders such as charities, clubs and associations and employers not normally in the lending business lending to employees.

12. The de minimis provisions would be modelled on those for VAT in that they would provide for:

(a) Separate registration and de-registration limits (in order to avoid lenders with a seasonal pattern of business dropping in and out of the tax).
(b) These limits to be varied by Treasury Order.
(c) Disaggregation measures like those enacted for VAT in the Finance Act 1986, enabling legally separate businesses to be treated as one in order to combat avoidance.

13. We have done a considerable amount of work on the level at which the de minimis limit would need to be set in order to achieve the maximum revenue for the minimum control effort. But there is not sufficient published data on which to base any conclusion in advance of the public consultation. There is no obvious VAT analogy, since VAT is charged on a different basis; and in any case we are likely to

need to set any de minimis limit at a higher level than that for VAT in order to restrict the number of registrable traders sufficiently. Any figure is likely to be contentious; whilst much of the pressure will be for a high limit, the banks and larger institutions will favour a low threshold. We think that the published legislation should not include a figure, but that the announcement should make it clear that this will be a matter for consultation.

C. Credit cards

14. Throughout, this note has dealt with the position for the broad-based tax. Whatever decisions are reached for that, we continue to think that no de minimis limit or relief for business use should be applied to credit cards. Any such reliefs would endanger the chances of the card providers being able to operate the tax in 1987-88; and, by definition, they are likely to be in a substantial way of business. In practice, the opportunities for borrowers to abuse any exemption for business use are most acute for cardholders, and possibly least defensible.

D. Recommendations

15. (a) The basis of the tax should be loans to individuals, treating as exempt all loans to corporate bodies, including public authorities, professional bodies, charities and clubs.

(b) There should be a provision to safeguard against avoidance by individuals.

(c) Exemption of loans to individuals and possibly partnerships for business purposes should be backed by a system of certification by the borrower.

(d) All lenders should be potentially registrable except individuals lending to other individuals in a non-business capacity.

(e) There should be a de minimis limit related to the lender's potential taxable receipts. This should announced in principle and the level set after consultation.

(f) Interest-bearing loans on credit cards should be taxable whatever their purpose and without de minimis limit.

P Jefferson Smith

MR 9/25

BUDGET SECRET

BF 30/1

FROM: A C S ALLAN
DATE: 27 January 1987

MR JEFFERSON-SMITH C&E

cc: PS/Minister of State
Sir P Middleton
Mr Cassell
Mrs Lomax
PS/IR
Mr Painter - IR
PS/C&E

CUSTOMS PROJECT FIVE

At yesterday's Overview meeting, the timetable agreed was that you would provide advice urgently to the Minister of State on instructions to Parliamentary Counsel, and would as soon as possible thereafter produce the joint paper with Treasury and Inland Revenue on mortgages. The timetable envisaged at the meeting was for the paper on instructions to counsel to come forward on Wednesday, and the paper on mortages on Friday.

2. The Chancellor would be very grateful if you could ensure that the paper on mortgages is with him by Friday night at the latest, and if at all possible some what earlier.

ACSA

A C S ALLAN

M/S 9 FEB 1987 -8

C/ This has, of course been dropped for 1987 Budget & in MST's view - permanently. But might be interested to see this

Minister of Finance — Ministre des Finances

CANADA

CONFIDENTIAL

CR 11/2

JAN 27 1987

The Honourable Peter Brooke
Minister of State, Treasury
Treasury Chambers
Parliament Street SW1P 3AG
London, England

Dear Mr. Brooke:

In response to your request, I am pleased to provide you with information on insurance premium taxes in Canada.

Insurance companies operating in Canada pay income tax on profits pursuant to the provisions of the federal Income Tax Act in a manner similar to other types of corporations. In addition, each province levies a premium tax against insurance companies in the range of 2 per cent to 3 per cent of premiums received from residents in the province.

As you indicate, there is also a federal tax based on premiums which is imposed on persons resident in Canada who place property and casualty insurance on Canadian risks with an insurance company not authorized to transact insurance in Canada or with an insurance company authorized to transact insurance in Canada but through a broker or agent outside Canada. The tax is 10 per cent of the premium amount and is imposed pursuant to Part I of the Excise Tax Act. Revenue generated by this tax is currently about $1 million annually and therefore does not form a significant part of Government tax revenues.

I decided that the best way to provide you with detailed information on the provisions and the administration of Part I of the Excise Tax Act was to ask my officials to prepare a response to the questionnaire included in your letter. The completed response is enclosed.

If you have any additional questions, please do not hesitate to contact me again. Mr. R.M. Hammond, the Superintendent of Insurance, is the senior official responsible for the administration of Part I of the Excise Tax Act and he will be happy to answer any questions your officials may have regarding the response to the questionnaire. Mr. Hammond can be contacted at the following address:

PS/C&E
MST

MINISTER OF STATE	
REC.	-9FEB 1987
ACTION	Mr Wilmott C&E
	PS/Ch/EX
	Mr Scholar
	Miss Sinclair
	Mr Romanski

Ottawa, Canada K1A 0G5

Department of Insurance
7th Floor
Jackson Building
122 Bank Street
Ottawa, Ontario
K1A 0H2
Telephone: (613) 990-2183

In closing, I can appreciate your concerns about the sensitivity of the subject that you have raised and I can assure you that we will treat your enquiry as being very confidential.

Yours sincerely,

Michael H. Wilson

Encl.

Insurance Premium Tax - Federal - Canada

Description of Tax

Under Part I of the federal Excise Tax Act, a 10% premium tax is imposed on persons resident in Canada who place contracts of insurance, other than contracts of reinsurance, against Canadian risks with:

(a) an insurer not authorized to transact the business of insurance in Canada or;

(b) an insurer authorized to transact the business of insurance in Canada if the contract of insurance is entered into directly through a broker or agent outside Canada.

The Act specifically stipulates that the tax does not apply to contracts of life insurance, personal accident insurance, sickness insurance or insurance against marine risks. An extract from the Excise Tax Act showing the provisions of Part I is attached for reference.

Responses to Questionnaire

A. Basic Facts

1. When was the tax introduced?

   1922 for tax on insurance placed with unauthorized insurers.
   1963 for tax on insurance placed with authorized insurers through brokers or agents outside Canada.

2. Why was it introduced?

   To offset the loss of Canadian income tax that would have otherwise been payable if insurance were placed with authorized insurers or with Canadian brokers.

3. What other taxes are levied on the insurance industry (e.g., payroll tax)?

   Insurance companies are required to pay income tax pursuant to the federal Income Tax Act. In addition, each province levies a premium tax against insurance companies in the range of 2% to 3% of direct premiums written (i.e. excluding reinsurance premiums) in the province.

4. What was the reaction to the tax - from the industry, political parties, economic commentators?

   Information not readily available due to length of time the taxes have been in effect. However, they affect a relatively small proportion of the population and it is doubtful that there would have been strong resistance.

5. What is the tax base?

"Net premiums" which are defined in the Act as "gross premiums paid or payable under a contract of insurance, less dividends received or receivable in respect of the contract and less premiums returned on the cancellation of the contract."

6. Are there any exclusions; if so, why?

The tax does not apply to contracts of life insurance, personal accident insurance, sickness insurance or marine insurance. Similarly, it does not apply to insurance against nuclear risks to the extent that such insurance against nuclear risks is not, in the opinion of the Superintendent of Insurance, available within Canada.

Because Canada has a very strong life insurance industry, it was thought that there would not be sufficient life and accident and sickness business being placed outside Canada to warrant the application of the tax to this type of business. Marine insurance was exempted because of the international nature of the business and the fact that it is not regulated under federal insurance legislation.

Since 1973, there has been a provision in the Act which stipulates that the tax does not apply to any contract of insurance to the extent that such insurance is not, in the opinion of the Superintendent of Insurance, available within Canada.

The latter exemption is intended to provide relief for cases where the capacity of the authorized market is not adequate to complete coverage for large risks or where insurance for a specialized risk is not available with authorized insurers.

8. How often do the rates change?

Rates of tax have not changed since inception.

9. What is the yield?

Revenue currently amounts to about $1 million per annum.

10. Does the yield increase faster than inflation?

The amount collected tends to fluctuate in relationship to movement in premium rates and availability of coverage in Canada.

11. What proportion of government revenue from taxation does it represent?

Minimal.

12. How does the tax work?

    Brokers and authorized insurers are required under the Act to report cases subject to tax to the Department of Insurance not later than March 15 in each year. Persons or corporations so identified are subsequently contacted by the Department with tax being due not later than April 30.

B. <u>Mechanics</u>

1. How long was it between announcement and introduction of the tax?

   Minimal delay.

2. What consultations were there between tax authorities and the industry?

   Information not readily available. However, since the tax burden does not fall on the industry itself, it is unlikely that consultation would have been extensive.

3. What legislative difficulties were there (e.g., definitions)?

   No apparent difficulties.

4. How do tax authorities determine whether or not a particular type of insurance is subject to a particular rate?

   N/A

5. How do tax authorities treat

   (a) taxation of foreign insurance for domestic risks?
   (b) taxation of domestic insurance for foreign risks?

   (a) See description of tax.
   (b) N/A

6. What control and enforcement mechanisms are there?

   Legislation provides authority for Department to inspect books and records of insurers, brokers and agents to verify required returns. In practice, this authority has seldom been used.

7. How many staff are employed to administer and collect the tax?

   Two.

8. How does that number compare with

(a) initial estimates?
(b) the number required to introduce the tax?
(c) numbers employed on other taxes?

(a) Unknown.
(b) N/A
(c) Unknown.

9. What use do authorities make of computers to operate the tax?

Accounts receivable records and historical taxpayer records are kept on computer.

C. Effects

1. What effect has there been on the volume of insurance?

No significant effect.

2. What proportion of the tax falls on business/private consumer/other?

Major portion would fall on business.

3. Is there any estimate of the cost to the insurance industry of operating the tax?

No.

4. Are there any benefits to the industry, e.g., prolonged use of revenue collected before transmission to tax authorities?

Given the relatively small amount of revenue collected, any benefits such as those described would be minimal.

D. Problems

1. Are there difficulties in definitions and borderlines?

No.

2. Does the existence of variable rates make those difficulties worse?

N/A

3. What is the scope for tax avoidance?

As respects insurance placed with unauthorized insurers, if an insured or a broker does not report existence of the insurance it may go untaxed. However, it is expected that risks where the premium is

substantial, i.e., large risks, would tend to be handled by the larger brokerage firms, all of which are contacted each year by the Department. In general, it is thought that most cases are being reported and any revenue loss is small. Given the foregoing and the fact that an exemption from tax may be granted if it can be shown that the insurance was not available in Canada, an extensive inspection function does not seem warranted.

4. Is foreign insurance particularly difficult to tax?

   See response to (3) above.

5. How do tax authorities counter avoidance?

   See response to (3) above.

6. What other problems have been encountered?

   No significant problems.

7. What other problems may lie ahead?

   None foreseen.

Attach.

more than four years before the day on which the determination is made. R.S., c. E-13, s. 2; 1974-75-76, c. 24, s. 18, c. 62, s. 1; 1980-81-82-83, c. 68, s. 1; 1985, c. 3, s. 1; 1986, c. 9, s. 1.

(6) [Repealed, 1986, c. 9, s. 1]

PART I

INSURANCE PREMIUMS OTHER THAN MARINE

Definitions

3. In this Part,

"exchange"

"exchange" means a group of persons formed for the purpose of exchanging reciprocal contracts of indemnity or inter-insurance with each other through the same attorney;

"insurer"

"insurer" means any corporation incorporated for the purpose of carrying on the business of insurance, any association of persons formed upon the plan known as Lloyds whereby each associate underwriter becomes liable for a stated, limited or proportionate part of the whole amount insured under a contract of insurance, and any exchange;

"net premiums"

"net premiums" means the gross premiums paid or payable under a contract of insurance, less dividends received or receivable in respect of the contract and less premiums returned on cancellation of the contract;

"Superintendent"

"Superintendent" means the Superintendent of Insurance. 1952-53, c. 35, s. 15; 1956, c. 37, s. 1; 1962-63, c. 6, s. 1.

Tax on premiums in respect of insurance effected outside Canada

4. (1) Every person resident in Canada by whom or on whose behalf a contract of insurance, other than a contract of reinsurance, is entered into or renewed against a risk ordinarily within Canada at the time the contract is entered into or renewed,

(*a*) with

(i) any insurer not incorporated under the laws of Canada or of any province or not formed in Canada, or

(ii) any exchange having its chief place of business outside Canada or having a principal attorney-in-fact whose chief place of business is outside Canada,

that at the time the contract is entered into or renewed is not authorized under the laws

date qui ne peut précéder de plus de quatre ans la date de la désignation. S.R., c. E-13, art. 2; 1974-75-76, c. 24, art. 18, c. 62, art. 1; 1980-81-82-83, c. 47, art. 53, c. 68, art. 1; 1985, c. 3, art. 1; 1986, c. 9, art. 1.

(6) [Abrogé, 1986, c. 9, art. 1]

PARTIE I

PRIMES D'ASSURANCE AUTRES QUE L'ASSURANCE MARITIME

Définitions

3. Dans la présente Partie,

«assureur»

«assureur» désigne toute corporation constituée pour exercer des opérations d'assurance, toute association de personnes formée d'après le plan dit Lloyds, en vertu duquel chaque assureur associé devient responsable d'une partie déclarée, limitée ou proportionnelle de la somme entière assurée aux termes d'un contrat d'assurance, et toute Bourse;

«Bourse»

«Bourse» désigne un groupe de personnes, formé aux fins d'échanger entre elles des contrats réciproques d'indemnité ou d'inter-assurance par l'entremise du même fondé de pouvoirs;

«primes nettes»

«primes nettes» désigne les primes brutes payées ou payables aux termes d'un contrat d'assurance, moins les dividendes reçus ou recevables à l'égard du contrat et moins les primes remises lors de l'annulation du contrat;

«surintendant»

«surintendant» désigne le surintendant des assurances. 1952-53, c. 35, art. 15; 1956, c. 37, art. 1; 1962-63, c. 6, art. 1.

Taxe sur les primes relativement aux assurances contractées

4. (1) Toute personne résidant au Canada par qui ou pour le compte de qui un contrat d'assurance, autre qu'un contrat de réassurance, a été conclu ou renouvelé contre un risque ordinairement dans les limites du Canada à l'époque où le contrat est conclu ou renouvelé,

a) avec

(i) tout assureur non constitué en corporation selon les lois du Canada ou de toute province ou non formé au Canada, ou

(ii) une Bourse ayant son bureau principal hors du Canada ou ayant un principal fondé de pouvoirs dont le centre d'affaires est situé hors du Canada,

of Canada or of any province to transact the business of insurance, or

(*b*) with any insurer that at the time the contract is entered into or renewed is authorized under the laws of Canada or of any province to transact the business of insurance, if the contract is entered into or renewed through a broker or agent outside Canada,

shall, on or before the 30th day of April in each year, pay to the Minister, in addition to any other tax payable under any other law, a tax of ten per cent on the net premiums paid or payable during the immediately preceding calendar year in respect of such insurance.

Application

(2) Subsection (1) does not apply to

(*a*) any contract of life insurance, personal accident insurance, sickness insurance or insurance against marine risks, or any contract of insurance against nuclear risks to the extent that such insurance against nuclear risks is not, in the opinion of the Superintendent, available within Canada; or

(*b*) any other contract of insurance entered into after February 19, 1973 to the extent that such insurance is not, in the opinion of the Superintendent, available within Canada.

(2.1) [Repealed, 1986, c. 9, s. 2]

Residence of corporation

(3) For the purposes of this section, every corporation carrying on business in Canada shall be deemed to be a person resident in Canada.

Through whom contract made

(4) Where a contract of insurance is entered into or renewed through more than one broker or agent, or where payment of the premium or any part of the premium thereon is effected through more than one broker or agent, the contract shall, for the purposes of this Part, be deemed to have been entered into or renewed, as the case may be, through the broker or agent directly retained or instructed by the insured and not through any other broker or agent. R.S., c. E-13, s. 4; 1973-74, c. 24, s. 1; 1986, c. 9, s. 2.

Returns

5. (1) Every person to whom section 4 applies shall, on or before the 30th day of April in each year, make a return in writing to the

qui à l'époque où le contrat est conclu ou renouvelé n'est pas autorisée d'après les lois du Canada ou de l'une de ses provinces à faire des opérations d'assurance, ou

b) avec tout assureur qui à l'époque où le contrat est conclu ou renouvelé est autorisé d'après les lois du Canada ou de l'une de ses provinces à faire des opérations d'assurance, si le contrat est conclu ou renouvelé par l'intermédiaire d'un courtier ou d'un agent hors du Canada,

doit, le 30 avril de chaque année ou avant cette date, payer au Ministre, en plus de toute autre taxe payable sous le régime de quelque autre loi, une taxe de dix pour cent sur les primes nettes payées ou payables pendant l'année civile immédiatement précédente à l'égard de cette assurance.

Application

(2) Le paragraphe (1) ne s'applique pas

a) à un contrat d'assurance-vie, d'assurance contre les accidents corporels, d'assurance-maladie ou d'assurance contre les risques maritimes, ni à un contrat d'assurance contre les risques résultant de l'énergie nucléaire, dans la mesure où une assurance contre les risques résultant d'une telle énergie n'existe pas au Canada, de l'avis du surintendant; ni

b) à un contrat d'assurance conclu après le 19 février 1973 dans la mesure où une telle assurance n'existe pas au Canada, de l'avis du surintendant.

(2.1) [Abrogé, 1986, c. 9, art. 2]

Résidence de la corporation

(3) Aux fins du présent article, toute corporation faisant des affaires au Canada est réputée une personne résidant au Canada.

Par l'intermédiaire de qui le contrat a été conclu

(4) Lorsqu'un contrat d'assurance est conclu ou renouvelé par l'intermédiaire de plus d'un courtier ou agent, ou que le paiement total ou partiel de la prime y applicable est fait par l'intermédiaire de plus d'un courtier ou agent, le contrat est réputé, aux fins de la présente Partie, avoir été conclu ou renouvelé, selon le cas, par l'intermédiaire du courtier ou de l'agent que l'assuré a directement choisi ou constitué, et non par l'intermédiaire de quelque autre courtier ou agent. S.R., c. E-13, art. 4; 1973-74, c. 24, art. 1; 1986, c. 9, art. 2.

Rapports

5. (1) Toute personne visée par l'article 4 doit transmettre au Ministre, le ou avant le 30 avril de chaque année, un rapport écrit qui, à

Minister stating, with respect to each contract of insurance entered into or renewed by him or on his behalf during the immediately preceding calendar year and on which the net premiums are taxable under section 4,

(*a*) the name of the insurer;

(*b*) the amount of the insurance;

(*c*) the net premiums paid or payable during the immediately preceding calendar year; and

(*d*) if the contract was entered into or renewed as described in paragraph 4(1)(*b*), the name and address of the broker or agent outside Canada through whom the contract was entered into or renewed.

Return by broker or agent

(2) Every person who, acting as a broker or agent, obtains, effects or places or assists in obtaining, effecting or placing any contract of insurance entered into or renewed as described in paragraph 4(1)(*a*), and on which the net premiums are taxable under section 4, shall, on or before the 15th day of March in each year, make a return in writing to the Minister stating, with respect to each such contract so entered into or renewed during the immediately preceding calendar year, the name and address of the person resident in Canada by whom or on whose behalf the contract was entered into or renewed and the net premiums paid or payable during that year.

Return by insurer

(3) Every insurer that enters into or renews a contract of insurance as described in paragraph 4(1)(*b*), and on which the net premiums are taxable under section 4, shall, on or before the 15th day of March in each year, make a return in writing to the Minister stating, with respect to each such contract so entered into or renewed during the immediately preceding calendar year,

(*a*) the name and address of each person resident in Canada with whom or on whose behalf the contract was entered into or renewed;

(*b*) the net premiums paid or payable during the immediately preceding calendar year; and

(*c*) the name and address of the broker or agent outside Canada through whom the contract was entered into or renewed. 1956, c. 37, s. 2; 1962-63, c. 6, s. 1; 1986, c. 9, s. 3.

l'égard de chaque contrat d'assurance conclu ou renouvelé par elle ou pour son compte pendant l'année civile immédiatement précédente dont les primes nettes sont imposables en vertu de l'article 4, énonce

a) le nom de l'assureur;

b) le montant de l'assurance;

c) les primes nettes payées ou payables pendant l'année civile immédiatement précédente; et

d) si le contrat a été conclu ou renouvelé ainsi que le décrit l'alinéa 4(1)*b*), le nom et l'adresse du courtier ou de l'agent hors du Canada par l'intermédiaire de qui le contrat a été conclu ou renouvelé.

Rapport du courtier ou de l'agent

(2) Toute personne qui, agissant à titre de courtier ou agent, obtient, contracte ou place, ou aide à obtenir, contracter ou placer un contrat d'assurance conclu ou renouvelé ainsi que le décrit l'alinéa 4(1)*a*), dont les primes nettes sont imposables en vertu de l'article 4, doit transmettre au Ministre, le ou avant le 15 mars de chaque année, un rapport écrit qui, à l'égard de chaque contrat de ce genre ainsi conclu ou renouvelé pendant l'année civile précédente, énonce le nom et l'adresse de la personne résidant au Canada par qui ou pour le compte de qui le contrat a été conclu ou renouvelé, ainsi que les primes nettes payées ou payables pendant cette même année.

Rapport de l'assureur

(3) Chaque assureur qui conclut ou renouvelle un contrat d'assurance ainsi que le décrit l'alinéa 4(1)*b*), dont les primes nettes sont imposables en vertu de l'article 4, doit transmettre au Ministre, le ou avant le 15 mars de chaque année, un rapport écrit qui, à l'égard de chaque contrat de ce genre ainsi conclu ou renouvelé pendant l'année civile immédiatement précédente, énonce

a) le nom et l'adresse de chaque personne résidant au Canada avec qui ou pour le compte de qui le contrat a été conclu ou renouvelé;

b) les primes nettes payées ou payables pendant l'année civile immédiatement précédente; et

c) le nom et l'adresse du courtier ou de l'agent hors du Canada par l'intermédiaire de qui le contrat a été conclu ou renouvelé. 1956, c. 37, art. 2; 1962-63, c. 6, art. 1; 1986, c. 9, art. 3.

Examination of books and records

6. The Superintendent or any officer of his Department appointed by him may visit the office of any insurer, broker or agent and examine his books and records for the purpose of verifying any return required by this Part, and the Superintendent and such officer have a right of access to such books and records at all reasonable hours. 1956, c. 37, s. 2; 1962-63, c. 6, s. 1.

Penalty and interest for default

7. (1) Every person who refuses or neglects to make a return as required by subsection 5(1) or neglects to pay some or all of the tax imposed by section 4 is liable to a penalty of five per cent of the amount of tax unpaid at the expiration of the time for filing the return together with interest on the amount unpaid calculated at the prescribed rate from the 30th day of April in the year in which such amount is payable to the day of payment.

Idem

(2) Every person who refuses or neglects to make a return as required by subsection 5(2) or (3) is liable to a penalty of ten dollars for each day of default or fifty dollars, whichever is the lesser. 1952-53, c. 35, s. 17; 1953-54, c. 56, s. 2; 1956, c. 37, s. 2; 1962-63, c. 6, s. 1; 1986, c. 9, s. 4.

PART II

AIR TRANSPORTATION TAX

Interpretation

Definitions

8. In this Part,

"certified air carrier"

"certified air carrier" means

(*a*) an air carrier that, pursuant to the *Air Carrier Regulations* made under the *Aeronautics Act*, is authorized by the Canadian Transport Commission to operate as an air carrier or as a commercial air service;

(*b*) a foreign air carrier that is authorized by the Canadian Transport Commission to operate international charter flights from and to Canada; and

(*c*) an air carrier, other than an air carrier described in paragraph (*a*) or (*b*), that itself or by its agent, sells in Canada transportation of a person by air that is to be provided in whole or in part by an air carrier described in paragraph (*a*) or (*b*);

Examen des livres et registres

6. Le surintendant ou tout fonctionnaire de son département désigné par lui peut visiter le bureau de tout assureur, agent ou courtier, et examiner ses livres et registres aux fins de vérifier tout rapport exigé par la présente Partie, et le surintendant et ce fonctionnaire ont droit d'accès auxdits livres et registres à toutes heures raisonnables. 1956, c. 37, art. 2; 1962-63, c. 6, art. 1.

Amendes et intérêts pour défaut

7. (1) Toute personne qui refuse ou néglige de faire un rapport ainsi que l'exige le paragraphe 5(1), ou néglige de payer une partie ou la totalité de la taxe imposée par l'article 4, doit payer une amende de cinq pour cent du montant de la taxe impayé à l'expiration de la période fixée pour la production du rapport, avec intérêt sur le montant impayé, calculée au taux prescrit, à compter du 30 avril de l'année pendant laquelle ce montant est exigible jusqu'à la date du paiement.

Idem

(2) Toute personne qui refuse ou néglige de faire un rapport ainsi que l'exige le paragraphe 5(2) ou (3) encourt une amende de dix dollars pour chaque jour de manquement ou cinquante dollars, en prenant le moindre de ces deux montants. 1952-53, c. 35, art. 17; 1953-54, c. 56, art. 2; 1956, c. 37, art. 2; 1962-63, c. 6, art. 1; 1986, c. 9, art. 4.

PARTIE II

TAXE DE TRANSPORT AÉRIEN

Interprétation

Définitions

8. Dans la présente Partie,

«embarquement»

«embarquement» ne s'applique pas aux embarquements ayant eu lieu à la suite d'une escale effectuée par un aéronef uniquement pour obtention de services au sol;

«taxe»

«taxe» désigne la taxe de transport aérien imposée en vertu de la présente Partie;

«transporteur aérien titulaire d'un certificat»

«transporteur aérien titulaire d'un certificat» désigne

a) un transporteur aérien que la Commission canadienne des transports autorise, conformément au *Règlement concernant les transporteurs aériens* établi en application de la *Loi sur l'aéronautique*, à exploiter une entreprise de transport aérien ou un service aérien commercial;

ial annual savings made in the early 1980s
ted £85,000 and £105,000 respectively to
Progress Report on the MDR to the Prime

ope for any further significant reduction
lity of vacating another floor of one HQ
unlikely in the foreseeable future as, at
ent is re-accommodating some London staff
on of another whole floor. The position
results of the recent occupancy audit are
doing an energy audit of COI HQ buildings
the results of this will give guidance for
ourse.

rtment occupying part only of two floors in
ve up a substantial amount of storage space
ld be virtually impossible to contract any
ven the installation of micro-computers.

GAD is attempting to use the available space
possible but it is not possible to give

BUDGET - SECRET

COPY NO. 1 /32

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

From: P Jefferson Smith

Date: 30 January 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Ross Goobey
Mr Tyrie
PS/IR
Mr Painter (IR)
Mr Johns (IR)
Mr O'Connor (IR)
Mr Graham
(Parly Counsel)

Many thanks. This is becoming more problematic & difficult, not less, as work progresses. Regretfully, I have concluded the time has come to shelve Customs Project 5. I am most grateful to the MST, CCU and others who have put so much work into it. N.L.

CUSTOMS PROJECT 5 : MORTGAGE INTEREST RELIEF

1. At a meeting on 15 January the Minister of State asked for further work to be done on the implications of the proposed consumer credit tax on mortgage interest relief and other interest reliefs operated by Inland Revenue. The overview meeting of 26 January asked for a joint Treasury/Inland Revenue/Customs paper. This paper has been prepared by Customs in consultation between the 3 Departments, and reflects the conclusions of a meeting chaired by Mr Cassell yesterday.

Internal Circulation:

CPS	Mr Howard	Mr Trevett	Mr MacLachlan
Mr Knox	Mr Butt	Mrs Boardman	Mr Mier
Solicitor	Mr Wilmott	Mrs Smith	

415/1/87

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Revenue

2. First, there has been a revision of the estimates of revenue yield which has a significant bearing on whether to include or exclude loans for house purchase or improvement. Paragraph 12 of my submission of 14 January showed the revenue building up to £½ billion in 1989/90. However, as a result of discussions with Inland Revenue we now estimate that the proportion of loans for house purchase and improvement not eligible for income tax relief is much higher than the proportion we had previously used. The exact extent is uncertain; but if these loans are kept in the tax, there would be an additional yield of at least £160 million, and we would tentatively estimate a total of £240 million. Against this, we have deducted 5% from the yield from "other" loans on account of the decision to exempt all loans to borrowers paying self-employed NICs. Taking into account both these factors, the total yield by 1989/90 would be about £680 million. In summary, the revenue is now estimated as follows:

	£m		
	1987/88	1988/89	1989/90
Credit Cards[1]	20	55	65
Loans for house purchase or improvement[2][3]	-	140	240
Other[3]	-	255	375
Total	20	450	680

(1) from 15 August 1987

(2) loans not eligible for income tax relief

(3) from 1 April 1988

Commercially Let Property

3. The figures above exclude loans for commercially let property, which has emerged in the course of this week's discussions as an area of considerable difficulty which requires resolution. There is income tax relief for interest on loans for purchase or improvement of property for letting, whether or not in a business capacity. Such

loans are outside MIRAS, so the income tax position is often outside the knowledge of the lender. Following the borderline adopted for distinguishing business loans from consumer credit for the purpose of the consumer credit tax, we would relieve loans for let property where the landlord borrowing was a corporate body, VAT registered or paid self-employed NICs; but this would bring within the tax other individuals acting as landlords, including employees and the retired. But to provide relief for them would re-introduce all the problems about evidence and certification which the self-employed NICs borderline was designed to avoid.

hmm...

Income Tax Relief

4. There is relief from income tax for mortgages and other loans applied to the purchase or improvement of property used as an only or main residence in the UK or the Republic of Ireland. The relief is limited to a maximum loan or loans to any one individual or married couple of £30,000. Most of the loans come within the arrangements for mortgage interest relief at source (MIRAS).

!

5. However, a significant number remain outside the MIRAS scheme. Some prescribed MIRAS lenders other than building societies or local authorities have not exercised their option to operate MIRAS on solely home improvement loans; they include a major clearing bank. Loans which are partly for home purchase/improvements and partly for other purposes remain by statute outside the scheme. After April 1987, MIRAS lenders will be required to operate MIRAS on all new house purchase loans exceeding £30,000 but it will remain optional for them to leave existing loans over £30,000 outside the scheme. There are also some loans from non MIRAS lenders. Relief on all loans outside the MIRAS scheme is calculated in the tax offices. Inland Revenue estimate that by 1988/89 only perhaps 5% of eligible loans by value will be dealt with outside MIRAS; but the total remaining outside MIRAS is nevertheless expected to be about

2 million loans and there will be some 350,000 non-MIRAS new loans a year.

Practical Problems of Aligning Consumer Credit Tax Exemption with Income Tax Relief

6. Ministers have decided that loans for house purchase which are relieved from income tax should also be relieved from the consumer credit tax. As the tax will be self-assessed and accounted for by lenders, they can only operate exemptions related to the borrower if they are in possession of the necessary information. A lender who operates the MIRAS arrangements should have no difficulty in indentifying the proportion of MIRAS loans which would be relieved from the new tax, since he would already be making such distinctions for MIRAS purposes. However we would have to accept that MIRAS is primarily a system of self-certification on the part of the borrower and neither the lenders nor Inland Revenue consider they have the resources to check whether borrowers are entitled to reliefs they have claimed. We believe that the revenue at risk through evasion in these circumstances is not such as would justify adding to resource burdens by requiring a tighter control for the purposes of the consumer credit tax.

7. The problems are considerably greater when the loans qualifying for tax relief are outside the MIRAS scheme. In the absence of MIRAS, the lender has no need to know the borrower's entitlement to relief, which would be established subsequently between the borrower and his local tax office. In order that the lender may calculate his tax liability, it will therefore be necessary for the borrower to provide some form of documentary proof that he is entitled to relief. This is likely to be unpopular with lenders, since it will add to their administrative burden: but it gives rise to other potentially serious difficulties.

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8. There would be problems in obtaining satisfactory documentary proof. One source would be the notice of coding or notice of assessment provided to some but not all borrowers by the local tax office. However these notices give no details of the loans or purposes for which interest relief has been given and there could be a considerable delay before they are available, particularly if there is a dispute about the borrower's tax liability. This gives rise to two problems.

9. Firstly, Inland Revenue are concerned that the new tax will add to the work of already overstretched local tax offices since many borrowers will be seeking documentary evidence or a piece of paper certifying that the loan qualifies for tax relief. In the first year the demand would be substantial because all existing loans would be brought within the scope of the tax. Many of the borrowers would not have ready evidence of tax relief and would apply to the Revenue.

10. Secondly, some means must be found of dealing with the correct treatment of the loan in the interim. You will note that the problem is much the same as that already identified in respect of "start-up" loans for new businesses in cases where the borrower does not have exempt status at the time of taking out the loan: how can a system operated by the lender on the basis of information known to the lender give relief in such a case? There are two possibilities, either allowing the lender to operate a temporary relief from consumer credit tax until evidence is available or requiring full payment with subsequent adjustment if the matter is resolved in the borrower's favour. Neither option is especially attractive. A borrower who had been granted temporary relief would have little incentive to provide information which would confirm or cancel it, and this would create difficulties for lenders and for the Department in attempting to agree the latters' liability. We prefer the second option, but recognise the unpopularity of requiring provisional payments of tax as well as the possibility that tax reclaimed by the lender might not be passed on to the borrowers concerned.

competition should help
+ useful incentive to do MIRAS loan

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Passing on Relief

11. There could be a presentational and political problem that, despite a decision to relieve house loans from consumer credit tax up to the £30,000 limit, the relief might not be reflected in the interest charged to the individual borrower. A lender might prefer to recover the tax by a uniform increase in all interest rates on his lending. This would result in the political criticism that borrowers below the £30,000 limit were bearing part of the tax burden, when Ministers had specifically intended to relieve them from it. We think that it would be very difficult to safeguard against this by legislation, and see no way in which we could cost effectively police any legal requirement on lenders to pass on the full effect of the relief to each entitled borrower. However, our view is that this is almost certainly an unreal problem, in that competitive forces would effectively discourage lenders from seeking to load the tax on to those who are not intended to bear it.

Alternative Solutions?

12. Thus, the difficulties of exactly aligning the consumer credit tax exemption with the income tax relief are so formidable that we would suggest that alternative solutions should be examined. We set out below two possibilities, each of which is capable of being applied more restrictively or more widely: roughly either to all relevant home loans whether or not they are above or below the £30,000 MIRAS limit or, again, roughly, to those below the £30,000 limit.

(a) One possibility would be to rely simply on the lender satisfying himself as to which of his loans were exempt from the tax. If the lender had satisfied himself that a loan was for home purchase or improvement that would be a sufficient reason for exempting him from the tax in respect of that loan. We would be asked for guidance as to what evidence lenders were expected to obtain; given the problems about involving the Inland Revenue this might in some cases have to be no more than a simple declaration by

BUDGET - SECRET

the borrower. Such self-certification would be costly and controversial to police, and if it were not policed would be wide open to abuse, and to criticism from the NAO and PAC.

(b) Another possibility - a rough justice solution - would be to restrict exemption from the consumer credit tax to loans operated under the MIRAS scheme. After April 1987, the proportion of lending eligible for income tax relief but not dealt with under MIRAS would be small in terms of value. There would still be a large number (at least 10%), either because the lender did not wish to operate MIRAS or the loan was a mixed one which could not be dealt with within MIRAS; but an effect of this borderline would be to give a very strong push to future lenders to get within the MIRAS system - a desirable development from the Revenue's point of view; and a strong push to borrowers not to have mixed home/non-home loans. In order to give time to do this, it might be possible to have a transitional arrangement whereby loans for house purchase or improvement would be eligible for relief from consumer credit tax even if outside MIRAS for a period up to say 31 March 1989; or a period during which it would be open to existing borrowers outside the MIRAS system to declare their loans to be for housing purposes so that they obtained relief in perpetuity on this basis, but all new loans would only get relief if they were within MIRAS. Eligibility would be determined by self-certification, the risk being accepted on the ground that it affected only one year's revenue.

13. This second option is not wholly attractive because it still involves either a good deal of trust or heavy compliance costs for lenders in the first year. It breaks the link with, and is more restrictive than the income tax relief. And it does nothing about the problem of loans for let property, which are outside the MIRAS system. But, ~~after that,~~ bearing in mind the desirability that any

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reliefs must be capable of simple operation by the lender preferably without the need for back-up by Inland Revenue, we suggest that this solution should have serious consideration.

A Different Borderline?

14. A decision is in any case needed on whether the exemption should be aimed at loans below the £30,000 limit or should go more widely to all home loans whatever their value. There are weightly arguments against the latter course: it would mean foregoing a substantial sum of revenue, perhaps about £240 million out of a probable total of £680 million before behavioural changes. We might expect substantial behavioural change, further increasing the revenue loss, as the lending market was distorted by this encouragement to dress up borrowing as being for home purchase or improvement purposes. But there may, clearly, be a political case for an extension on these lines.

Other Interest

15. The Minister of State also asked for consideration to be given to the treatment of other interest relieved from income tax. A list is attached of circumstances in which interest paid is allowable against income other than loans for purchase or improvement of property. Apart from the first item, none of these appears especially significant; but the general business interest relief does present a problem. In relation to individual businessmen the decision is that where they have a VAT registration or pay NICs as self-employed they will be exempt from the tax on all their borrowing, the apparent anomaly being defended as a small extra encouragement to the self-employed. But this borderline would shut out from relief those employees who have part-time self-employed activities. (An example might be a salaried music teacher giving lessons for fees in his or her spare time.) The effect of this decision is to break the simple link between the consumer credit tax and income tax relief.

business loan

Should the loan for his piano be exempt or not? Not simple

BUDGET - SECRET

16. As regards the other cases in the annex, in many cases there are similarities to loans for business purposes. As regards the other cases in the annex, there would be political pressure to grant relief, the income tax treatment being invoked as a precedent. Relieving these from consumer credit tax would raise much the same problems as with house loans, in that the relief would not really be policeable unless backed by Inland Revenue certification.

Summary

17. (a) Further work on the revenue estimates has indicated that the revenue from owner-occupied home loans not eligible for income tax relief is much higher than had previously been thought.

(b) Aligning an exemption for the consumer credit tax exactly with income tax relief on owner-occupied houses would give rise to serious problems in relation to those loans operated outside MIRAS.

(c) The difficulties, are such that we suggest that serious consideration is given to alternative solutions, either to rely wholly on self-certification or to allow relief only for those loans operated within MIRAS, coupled perhaps with some transitional relief for existing non-MIRAS loans based on self-certification by the borrower.

(d) It would not be possible to say that all other loans on which income tax relief is allowed would also be exempt from consumer credit tax, because the consumer credit tax would fall on business loans to individuals who were not VAT registered or paying self-employed NICs. There is a considerable problem to be resolved over the treatment of loans for commercially let properties.

P Jefferson Smith

BUDGET - SECRET

ANNEX

INTEREST QUALIFYING FOR TAX RELIEF

1. **Business interest relief**
Broadly speaking relief is allowed for interest paid if it is incurred wholly and exclusively for the purposes of the business.

2. **Interest on a loan to a partner to acquire interest in firm**
Relief is allowed on the interest if the loan is applied to buying the share of say a retiring partner or for the purpose of introducing new capital.

3. **Close companies**
Subject to certain conditions relief is allowed in respect of interest on a loan used to acquire an interest in or lend money to a close company.

4. **Employee controlled companies**
Relief is allowed on the interest on a loan to a full time employee used to acquire shares in an employee controlled company within 12 months from the time the company becomes employee controlled.

5. **Co-operatives**
Relief is allowed on the interest on a loan to an employee of a cooperative used to acquire a share in the cooperative or used wholly and exclusively for the purposes of the business.

6. **Purchase of plant or machinery by employees**
Relief is allowed for up to three years subject to certain conditions on the interest on a loan to an employee used to acquire plant or machinery including a car necessary to carry out his duties.

7. **Inheritance tax**

A limited relief is allowed in specified circumstances on loans to the personal representatives of a deceased person in order to pay inheritance tax.

8. **Life annuities**

Relief is allowed on a loan which is part of a scheme for the purchase of an annuity secured on land on the life of a person aged 65 or over.

ps8/2A RESTRICTED pup

FROM: A C S ALLAN
DATE: 2 February 1987

PS/MINISTER OF STATE

cc Mr Cassell
Mrs Lomax
Mr Scholar
Miss Sinclair
Mr Cropper

PS/C&E
Mr Howard - C&E
Mr Hewett - C&E

VAT: SMALL BUSINESS REVIEW

At the lunch at the Retail Consortium on Friday, the Chancellor was, as expected, pressed by the Mail Order Traders Association about the effects of the proposals in the Small Business Review. They did not raise any points about lack of proper consultation, but were concerned about the withdrawal of the "standard method" of accounting for gross receipts in the retail schemes.

2. Their concern was that this change would have a serious effect on them, reducing the extent to which they could get bad debt relief. They urged that other ways should be found to counter the avoidance problem of companies switching between the "standard" and "optional" method.

3. The Chancellor would be grateful if the Minister of State could look at this point in particular when he is considering the responses to the consultation document.

ACSA

A C S ALLAN

RA7.14 BUDGET SECRET

pwD

FROM: A C S ALLAN
DATE: 2 February 1987

PS/MINISTER OF STATE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Cropper
Mr Ross Goobey
Mr Tyrie
PS/IR
Mr Painter - IR
PS/C&E
Mr Jefferson Smith - C&E
Mr Wilmott - C&E
Mr Graham - Parly Counsel

CUSTOMS PROJECT 5

The Chancellor has seen the recent papers on this (and was very grateful for Mr Jefferson Smith's note of 30 January on mortgage interest relief).

2. He feels the proposal is becoming more problematic and difficult, not less, as work progresses. Regretfully, he has concluded that the time has come to shelve Customs project 5. He is most grateful to the Minister of State, to Customs and Excise and to others who have put so much work into it.

ACSA

A C S ALLAN

FROM: D J HOWARD

CONFIDENTIAL

DATE: 4 FEBRUARY 1987

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

c/ The latest position on cash accounting for VAT

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Jenkins
Parliamentary Counsel

Minister of State

CE 5/2

PRAYERS - DISCUSS.

SPECIAL SCHEMES FOR SMALL AND MEDIUM SIZED BUSINESSES: VIRES UNDER EC LAW

1. This note provides updated explanation of the position we have reached on European Community considerations following the Financial Questions Group meeting in Brussels on 29-30 January and Mr Trevett's informal discussions with Commission officials. It also provides (paragraphs 11-14) our overdue response to Ms Ryding's note of 22 December about a possible phasing-in of the turnover limit for cash accounting and annual accounting and includes some further discussion as background to the final report on the consultation exercise which we hope to submit next week following discussion with EDU officials.

2. The proposals contained in our consultation paper "VAT: Small Business Review" were drawn up to be consistent, as far as possible, with EC law. In the case of cash accounting, where the vires under the Sixth VAT Directive were unclear, we looked primarily to the draft Directive on small and medium sized businesses (SMEs). For the other proposals, eg annual accounting, we were satisfied that the 6th VAT Directive gave us vires for possible changes. On one item only was there serious fundamental

Internal distribution: CPS
Mr Knox
Solicitor
Mr Jefferson Smith
Mr Butt
Mr Trevett
Mr Fryett
Mr Goddard
Mr McFarlane
Mr Wilmott
Mr Hewett
Mr Holloway

doubt - compulsory deregistration. It is now, however, probable that we shall be looking to introduce legislation for a scheme of cash accounting before the draft SME's directive is agreed and adopted; and, following the consultation exercise, consideration is being given to the possibility of allowing businesses with a turnover higher than the 150,000 ECU (about £110,000 at the present rate of exchange) proposed by the EC Commission to use the scheme.

3. To clarify the EC vires for cash accounting and compulsory deregistration we wrote to the Commission in December (Mr Trevett's note of 23 December) asking for their opinion by the end of January 1987. We have not yet received a formal answer, but when in Brussels for further discussion on the small firms directive, Mr Trevett again saw the Commission and was given an unsigned copy of their proposed reply.

Compulsory deregistration

4. On this the Commission's proposed reply is unambiguous: it is not permitted by the Sixth Directive, nor under the draft Directive for small and medium sized businesses. We think we must accept this. To attempt to amend this latter directive to allow compulsory deregistration could prejudice the prospect of securing agreement to the "optional" maximum threshold of 35,000 ECU as proposed (now about £26,000); still more so if there is to be the slightest chance of going beyond that figure in accordance with our original negotiating aim. We see agreement on a maximum threshold figure as our prime objective if flexibility is to be achieved. The current position is that agreement in principle has been secured to the concept of a low mandatory threshold and a higher optional threshold, but there is no agreement on the figures. These will be for a political decision in COREPER or, failing that, by Ministers. We know that apart from ourselves and Ireland all the other Member States consider 35,000 ECU to be too high. Agreement on the maximum threshold will therefore not be easy.

Cash accounting

5. The Commission's proposed reply on this is less than helpful and we need to look separately at cash accounting for output tax and cash accounting for input tax.

6. On output tax the Commission's proposed reply is silent. However, it is clear that they agree with our view that Article 10.2 of the Sixth Directive permits output tax to be accounted for on the basis of payments received. This was further confirmed by the Commission at the meeting of the Financial Questions Group on 29/30 January.

7. On input tax we have proposed in the consultation document that credit for tax charged to a business using the cash accounting scheme may be taken only when payment for that tax has been made. This approach, which has met with little criticism, mirrors exactly the Commission's own proposal in the draft SME Directive. However, in reply to our letter, as to whether this diverges from Article 17.1 of the Sixth Directive - "the right to deduct shall arise at the time when the deductible tax becomes chargeable" -, the Commission have said "if the scheme which you intend to apply to small and medium sized enterprises diverges from this rule (Article 17.1), it will be necessary to ask for a derogation under Article 27 of the Sixth Directive". We regard this reply as disappointingly indirect: it appears that they, like we, are unable to understand fully the meaning and implication of Article 17.1 in relation to a scheme of cash accounting.

8. This is a point of considerable importance and we have asked the Commission to let us know more firmly, as soon as possible, whether or not in their view we need an article 27 derogation. Their immediate response was in theory "yes", but in practice "no", on the grounds, as they saw it, that a UK taxpayer was unlikely to challenge our scheme of cash accounting and take us to the European Court. This is an optimistic view which we cannot necessarily share and if there is any doubt we must expect a challenge, which without an article 27 derogation could succeed. Recent history in the case of Direct Cosmetics is a good example

of why in terms of EC law we must dot our Is and cross our Ts. This more cautious view on our part has been supported in off-the-record contacts with another Commission official with a legal background.

9. It is our opinion therefore that a derogation may be necessary, at least until adoption of the draft Directive on small businesses, and we have left a draft application with the Commission for their opinion. At this stage the draft makes no mention of the turnover limit, below which businesses would be eligible to use cash accounting, but only that it would be limited to small and medium sized businesses. In addition, and because of the Commission's doubts on this issue, we are, as a matter of urgency, seeking the opinion of the Law Officers on whether our proposed scheme would diverge from Article 17 of the 6th Directive; and if so, on the need for an Article 27 derogation, even if the Commission believe it to be unnecessary; and whether a turnover limit of £250,000 or £500,000 would affect their advice.

10. Discussion in the Financial Questions Group last week showed that, apart from ourselves and the Commission, cash accounting had surprisingly little support, although at least one Member State already allows its use for output tax. It was very apparent that the Member States wished to retain their existing plethora of special schemes and were not interested in introducing the Commissions'. Whether or not these existing schemes offer real simplification for the small business, rather than the tax authorities is, we suspect, in some cases open to doubt. Indeed the draft Directive proposes that where they do, in a manner which is no less favourable to small businesses, they may be retained. The hostility shown by some Member States towards cash accounting suggests that they fear that their present schemes will fail this test. This underlying theme no doubt prompted an illuminating statement by the Commission. This was that Member States should (without this Directive) implement the proposed simplified schemes, ie cash accounting and annual accounting, as an option to the simplified schemes they operated at present. The Commission suggested that this would enable Member States to judge whether small businesses really wanted them. This statement, and the one made to us by the Commission in the margins, that we were the only

Member State to understand fully the intention of cash accounting, suggests that, in principle, they ought not to oppose an application on our part for an article 27 derogation for its own sake. Leaving political considerations aside, their concern ought only to be with own resources on which, apart from a small once and for all loss in parallel with the revenue effect in the UK, cash accounting would have no effect.

Level of the turnover limit

11. We are sorry that we have previously overlooked the need to respond to Ms Ryding's minute of 22 December in which she recorded the Chancellor's question whether the turnover limit might not start at £100,000 and be raised to £500,000 in year 5, thus spreading the once-and-for-all cost.

12. We would advise against making any public commitment to such a course. As indicated in my submission of 23 January (interim report on the consultation exercise), the marginal once-and-for-all cost of each additional £100,000 on the turnover limit is, on average, no more than £25 million. Given that there is a strong lobby for a high turnover limit ab initio (most representations lying in the range of £500,000-£2 million), we believe it would be difficult to demonstrate convincingly that it was necessary to phase the scheme in over a five-year period and leave many prospective cash accounting traders dissatisfied in the interim.

13. A phased implementation from a base as low as £100,000 might also be inadvisable in the Community context. If, subject to the advice of the Law Officers on the risks of legal challenge, a turnover limit higher than the 150,000 ECU proposed in the draft SME's Directive is to be contemplated, it would be essential (against the background explained in paragraph 10) to introduce it as part of a UK scheme ahead of the proposed Community scheme, which is intended by the Commission to set minimum standards for the options to be available to small businesses. Given their attitude to date, we think that on the balance of probabilities it is unlikely the Commission would challenge a turnover limit of £250,000; the risk would be somewhat greater for £500,000 which might be viewed as unexpectedly high and involving a larger

once-and-for-all loss of own resources; and considerable for any higher figure which would be both expensive and well in excess of the limits applied by other Member States for their various special schemes for small businesses.

14. There are, of course, other considerations also to be taken into account in the choice of turnover limit. We are meeting officials in the Enterprise and Deregulation Unit later this week to discuss our proposed final report on the consultation exercise. At this stage we have not offered them a draft recommendation on the turnover limit (not least because of the Budget implications), but it will be surprising if they do not argue in support of the small business lobby for an improvement on the £100,000 offered in the consultation document provided we are satisfied that it would be consistent with European law. We shall probe the strength of their views, but also remind them that our original recommendation for broad consistency with the draft SME's Directive proposal was also influenced by control considerations and the need not to offer fresh incentives to VAT fraud on any significant scale. If you are content, we shall go into both the EDU's approach and our control concerns in more detail next week, as part of our final report, in which we can then include a provisional recommendation contingent on the advice of the Law Officers which is expected later in the month.

D J HOWARD

CC PS/CHANCELLOR
PS/CST, PS/FST, PS/EST
MR SCHOLAR
MS SINCLAIR
MR CROPPER
MR JENKINS - PARLY COUNSEL
PS/C&E

CONFIDENTIAL

NOTE OF A MEETING HELD ON THURSDAY, 5 FEBRUARY 1987 IN ROOM 50/2, HM TREASURY

Present: Minister of State
Mr Howard - C&E
Mr Trevett - C&E

CASH ACCOUNTING

Mr Howard explained that three ways had been identified to reconcile cash accounting with the Sixth VAT Directive:

a. to rely on Article 10 for output tax and Article 17 for input tax, with or without a derogation;

b. to allow it under Article 24 (Special schemes for small undertakings) eg flat-rates. This had the advantage of being subject only to the VAT Committee's consideration under Article 29;

c. as cash accounting might be considered too remote from either Article 10 or 17, to introduce the whole scheme as a derogation under Article 27 (Simplification procedures).

The Commission thought that all the vires for cash accounting were already in the Sixth Directive but Mr Howard said that there was still confusion. Mr Howard confirmed to the Minister that until the adoption of the SME's Directive the UK had to derive its powers from the Sixth Directive and the adoption of the SME's Directive did not fit the UK's timescale for the introduction of cash accounting. Mr Trevett said that he had received conflicting views from Commission officials about whether or not the UK should seek a derogation. Customs and Excise were therefore seeking the advice of the Law Officers.

The Minister of State asked how much higher a limit could be set, since to have a £100,000 turnover would require a derogation anyway. Mr Howard explained that the Commission were likely to be concerned by a scheme with a high turnover limit (following

an Italian precedent: the Visentini case). It was possible that the Commission would accept a limit of £250,000; Mr Howard felt that a lower limit would be much more acceptable because firstly presentationally it did not look so big, secondly it was not as high as the Italian limit, and thirdly an analysis pertinent to fraud and control suggested that the revenue at stake began to rise considerably with a higher limit. As there were quite a lot of traders in the £100,000-£250,000 turnover range, the Commission were likely to show concern about own resources. Mr Howard added that cash accounting would change the audit trail and people's bookkeeping needs; it would require a different approach from VAT officers to reconcile the books as they could no longer rely too heavily on tax invoices. He felt that a £500,000 limit would certainly require stricter control of traders and therefore probably additional resources, whereas with a £250,000 limit Customs could remain more relaxed.

The Minister of State asked about the timing of the announcement of these changes. Mr Howard said that, as the Law Officers' opinion was being sought (expected at the end of February), no announcement could be made before Budget day. The request for a derogation had to follow standard procedures. Mr Howard suggested that a firm proposal could be put to Brussels on the evening of Budget day. He hoped that, as a draft derogation had already been sent to the Commission, the derogation would be adopted within the minimum time: the UK would encourage the Commission to circulate the proposal to other Member States before Easter and therefore it should be adopted two months later. Mr Trevett said that he had never known a Member State to object to a derogation.

Mr Howard felt that Customs had done all they could informally. They were now awaiting a reply from the Commission about a derogation from Article 17. They would see the Enterprise and Deregulation Unit and then submit a final report on the consultation exercise with their recommendations to the Chancellor.

Deborah Francis.

MISS D L FRANCIS
Assistant Private Secretary

CONFIDENTIAL

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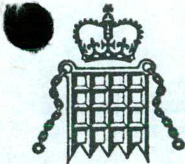

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From D J HOWARD

Date 6 February 1987

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

MINISTER OF STATE

VAT: CASH ACCOUNTING

When you discussed my minute of 4 February with us yesterday you asked for some figures in advance of our final report on the consultation exercise next week on the numbers of traders and the value of the revenue involved in each of the main turnover limit options.

2. Our revenue analysis by turnover bands is only undertaken retrospectively and we have had to use 1985 calendar year figures. However, we think that the results are sufficiently reliable to serve as broad indicators. We then need to distinguish between the total figures for each category and those which will relate more reliably to the potential market for cash accounting (paragraphs 4 and 5 below). The total figures for each category, on which we concentrated in discussion yesterday, are as follows:-

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Internal distribution

CPS	Mr Trevett
Mr Knox	Mr Wilmott
Mr Jefferson Smith	Mr Holloway

Turnover limit	Numbers of payment traders (1,000)	Tax paid (£bn)	Percentage of net VAT yield
n/e £100,000	645	1.4	7
n/e £250,000	840	2.8	14
n/e £500,000	920	4.0	20

3. The current total population of payment traders is about 1.18m and the grand total on the VAT register is about 1.49m. In percentage terms of the VAT-paying population the numbers of payment traders theoretically eligible for cash accounting can be expressed as:-

	Percentage of all payment traders	Percentage of total VAT register
n/e £100,000	55	43
n/e £250,000	71	56
n/e £500,000	78	61

4. As we have previously explained, however, it is unlikely that those traders using retail schemes, special construction industry schemes or with other special arrangements will be interested in cash accounting. Excluding such traders, we estimate that the potential market for cash accounting is:

	Traders (1,000)	Tax paid (£bn)	Percentage of net VAT yield (approx)
n/e £100,000	235	0.6	3
n/e £250,000	305	1.2	6
n/e £500,000	340	1.8	9

5. On the basis of responses to the small trader questionnaire we estimate that about two-thirds of those eligible are likely to avail themselves of the option (my minute of 23 January). In broad terms, therefore, we could say that close to 6% (£1.2bn) of the net VAT yield would be subject to an increased risk of evasion with a turnover limit of £500,000; proportionately less for the two lower limits.

for Shirley A. Woolber

D J HOWARD

cc PS/Chancellor
Miss Sinclair
Mr Cropper

PS/Customs & Excise
Mr Jefferson Smith) C&E
Mr Nissen)
Mr Michie)

On the basis of this, I will not be making any further offer.

NOTE OF A MEETING HELD AT 4.00PM ON TUESDAY, 10 FEBRUARY AT HM TREASURY

Present:	
Minister of State	Sir Dudley Smith MP
Michael Stern MP	Mr Fuller - Chairman, Brewers' Society
Mr Cropper	General Mangham - Brewers' Society
	Ms Hubbard - Brewers' Society
Mr Jefferson Smith - C&E	Mr Innes - Bass
Mr Nissen - C&E	Mr Stasfield - Grand Metropolitan
Mr Michie - C&E	Mr Kelly - Allied Breweries
	Mrs Friend - Bass

VAT INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

1. Sir Dudley Smith said that the Minister had shown in his letter of 19 December that he appreciated that there was a problem with tied houses. Pubs were a large revenue-raiser, yet taxes had gone up, not down, over recent years. The forthcoming Monopoly and Mergers Commission investigation, while not worrying the trade, did support their feeling that they were not getting the best treatment.

2. General Mangham said that the Brewers still felt that they had a special case on input tax, and should be allowed to deduct all of it. But he had noticed the movement in Customs' position, and had investigated whether their current proposal, allowing 85 per cent of input tax to be deducted (after allowing for cellarage costs), was acceptable to the industry. He was attracted by its simplicity.

3. Mr Fuller said that if small breweries - of which his was one - lost all their input tax, this would eat up about 2 per cent of their profits. Historically, they had many more tenanted pubs than the larger breweries, were more reliant on the beer trade as such, and were often concentrated in country areas. Country pubs were at risk. He could produce data to show that at least 90 per cent of their input tax should be deductible. (Ms Hubbard confirmed to Mr Jefferson Smith that this calculation did take account of cellarage costs.)

4. The Minister of State said that he realised that, by taking action against large-scale avoidance measures in other industries, they had created a problem for the Brewers - which he was keen to resolve. When he had last met the Brewers, on 4 December, they had expected to lose about £70 million. Under Mr Kelly's proposal, as modified by Customs, the cellarage concession would enable them to retain £20 million of that, and of the remainder only 15 per cent, or £7½ million, would not be deductible. He thought this was a substantial improvement for the Brewers. He would need hard proof that, taking the trade as a whole, 15 per cent was too high a figure. Customs were willing to discuss this, but if agreement could not reached, then they would have to reserve the right to look **de novo** at the issue, and possibly come up with a higher percentage.

5. Mr Jefferson Smith pointed out that an agreement with a trade association could not deprive individual traders of their legal rights; he hoped and believed that the Society would not make an agreement with Customs unless they were satisfied that it would stick with their members.

6. Mr Michie said that the proposed **de minimis** limit had not been discussed at the meeting on 29 January, although he had discussed it with Ms Hubbard subsequently. A Brewer with (non-attributed) expenditure on estate maintenance of £250,000 or less would be allowed to reclaim all input tax. Ms Hubbard confirmed that the cellerage concession had been taken into account here as well, and said that responses to date indicated that only one Brewery was small enough to benefit; many spent £250,000 on one pub alone. Mr Fuller said his company spent about £1 million on maintenance each year. Mr Kelly said that the **de minimis** rule would benefit brewers with less than about 20 pubs. Most small breweries had 100-150 outlets.

7. Mr Kelly said that the vast bulk of the industry valued Customs' offer, which would be simple for both parties to administer. In terms of turnover, about 90 per cent of the trade and about 75 per cent of individual companies would want to join

in. Ms Hubbard added that very few brewers favoured local agreements.

8. General Mangham said that it was clear that large breweries could live with Customs' proposal, as could the very small ones helped by the **de minimis** exemption. The problem was with the medium-sized ones inbetween. The Minister of State thought that it would be as difficult to fix a special method for medium-sized brewers alone as it would be to fix one for all: he did not favour a two-tier arrangement.

9. General Mangham said that his Executive and Council were meeting the next day, and he would take further soundings then. Mr Jefferson Smith confirmed that a special method would be agreed in writing, and made available to Customs staff; the Minister of State said that the method on offer would last for three years unless overtaken by external events (VAT infraction proceedings etc).

10. Ms Hubbard asked whether it would be possible to clarify loose ends after the main agreement was reached. Mr Jefferson Smith said it would, but pleaded that such tidying up should be kept simple; General Mangham supported this.

11. After the meeting, the Minister of State said that it was now up to the Brewers to sort out their own internal position; their larger members clearly understood the ground rules. Mr Michie said that it was silly to fine tune the broad brush formula that they had proposed, but that of course a two-tier method was possible. Mr Cropper agreed that the tone of the meeting had been relaxed, and the Minister of State congratulated Customs on progress to date. It was up to the Brewers to make the next move.

S.P.J. 11/2

S P JUDGE
Private Secretary

Papers PSO

FROM: APS/Minister of State

DATE: 12 February 1987

MR D J HOWARD - C&E

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

PS/Customs & Excise

Cathy

All the papers on this are still in apart from what I have attached.

Meena 12/2

VAT: CASH ACCOUNTING

The Minister of State was grateful for your minute of 6 February which he found very helpful.

Deborah Francis

MISS D L FRANCIS
Assistant Private Secretary

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

From D J HOWARD

Date 12 February 1987

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Jenkins,
Parliamentary Counsel
PS/Inland Revenue

MINISTER OF STATE

VAT: SMALL BUSINESS REVIEW

1. This note provides our full report on the recent consultation exercise and make recommendations as to decisions on most of the main points raised in representations. In brief, we recommend going ahead, subject to certain detailed modifications, with the proposals for cash accounting, annual accounting, changes in the time limits for registration and deregistration and alterations to retail schemes; but dropping, for the time being at least, the two most controversial proposals of compulsory deregistration and the withdrawal of the standard method of calculating gross takings for retail scheme traders. Our recommendations on the particularly sensitive issues of the turnover limit for cash accounting (and, by analogy, annual accounting) are at paras.9-10; and on the Finance Bill handling of the cash accounting proposal, pending formal Community approval, at paragraph 11.

Internal distribution

CPS	Mr Trevett	Mr Hewett
Mr Knox	Mr Fryett	Mr Holloway
Solicitor	Mr Goddard	
Mr Jefferson Smith	Mr Wilmott	
Mr Butt	Dr McFarlane	

2. As you know, the consultative paper, 'VAT: Small Business Review', was published on 24 October and at the same time a question and answer leaflet was sent to a representative sample of 5,000 small businesses, and to a small number of other businesses who requested copies. In total 183 responses were received to the consultation paper: 72 from representative bodies and 111 from individual businesses, and we have had 1,256 responses to the leaflet. Annex A contains a numerical summary of the responses, arranged by subject chapter headings. Annex B provides a detailed commentary of the main points raised by these and other respondents, again on a Chapter basis, and the recommended decision to take.

General reactions to the consultation exercise

3. The overwhelming majority of respondents have welcomed both the small business review itself and the opportunity to participate through the consultation exercise. In general, those proposals like cash accounting and extended time limits for registration which can clearly be perceived to help small businesses have been welcomed, while those such as compulsory deregistration and the abolition of standard method of reckoning gross takings which would withdraw existing benefits have been criticised. The Enterprise and Deregulation Unit (EDU) of the Department of Employment has commented that, with the exception of these two particularly controversial items, they believe the consultation exercise to have been very well received.

4. The most common reservation about the more beneficial proposals has been that they do not go far enough. This point has been made particularly in relation to the turnover limit for cash accounting. There has also been a substantial degree of support for a much higher registration threshold than the £25,000 or so (35,000 ECU) noted in the consultation document as the draft SME's Directive proposal.

The individual proposals: Cash accounting

5. Responses to the consultation. With only a few exceptions, the response to the consultation paper has been almost entirely in favour of offering the option of cash accounting to small businesses. As noted above, the main criticism, from a substantial number of respondents, has been that the proposed £100,000 turnover limit is too restrictive. A range of alternative figures of up to £2 million has been proposed and some respondents have argued for no limit at all. For example, the CBI has plumped for £1 million but "questions whether there need be a limit at all". The EDU has argued for a £500,000 limit as being a realistic compromise between the ambitions of some trade associations and the constraints of the draft Directive. In particular, they consider that this level is needed to help cash flow and give a positive expansion to the current scope of bad debt relief.

6. The response to the small trader questionnaire has also been encouraging in regard to cash accounting. Indeed, as I explained in my submission of 23 January, in view of the level of interest shown, discounted for the numbers of traders already using retail schemes or the special construction industry arrangements, we are now working on the assumption that the take-up of cash accounting could be as high as two-thirds of those eligible rather than the one-half we had previously estimated.

7. In the light of the excellent reception to the proposal we recommend firmly in favour of going ahead with the cash accounting scheme. Apart from the detailed operational aspects which attracted considerable technical interest in the consultation exercise, the main issues requiring further decision are those of the turnover limit and the further handling of the European Community aspects (both of which were discussed at the overview meeting on 9 February). We deal with these points in turn.

8. Detailed operation. A number of suggestions and questions have been put forward, mostly concerned with the accounting problems involved in entering and leaving the ring. There has been a broad consensus for simplicity in operational requirements;

detailed consideration to the main points is given in Annex B1. In particular, by comparison with the consultation document we propose significant alleviations in respect of simpler procedures for accounting for tax on leaving the ring and in regard to receipted tax invoices. On the other hand, we have suggested that the proposals to require any participation in the scheme to last for a minimum of two years and to limit the tolerance above the turnover limit to 25% for continued membership should remain, subject to later review in the light of experience of operation of the scheme.

9. Turnover limit. We have considered carefully the arguments which have been advanced for a limit of £500,000 or more. Hardly surprisingly, the respondents to the consultation exercise have concentrated on the benefits to business of a high turnover limit. There are also, however, significant considerations of cost; acceptability to the Community; and revenue control and the need to minimise the scope for fraud and evasion. Assuming that a cash accounting scheme applied equally to both output tax and input tax (an output tax-only scheme would probably be between two and three times more expensive as well as being particularly open to abuse), the key figures in relation to the potential market and cost are as follows:-

Turnover limit	Total number of payment	Likely cash accounting	Once-and-for-all	Annual cost
	1000	1000	£m	£m
n/e £100,000	645	235	50	5
n/e £250,000	840	305	100	10
n/e £500,000	920	340	150	15

As I explained in my submission of 4 February ("Vires under EC law"), we are seeking the Law Officers' Opinion to confirm the need for a derogation from the EC Sixth Directive for cash accounting on inputs and have also asked them to consider whether the different possible turnover limit would affect their advice. Subject to their opinion, the best judgment we can make at this stage remains that on the balance of probabilities it is unlikely that the Commission would challenge a turnover limit of £250,000 but there

would be a much greater risk of challenge if we were to go as high as £500,000. A short note on the revenue control considerations and fraud risks, which also influenced our original recommendation for a turnover limit of not more than the 150,000 ECU proposed in the draft SME's Directive, is attached at Annex C. As indicated in that Annex we are doing further work on theresource implications of the higher limits.

10. Despite the pressure for a higher limit, we still believe that there is a good deal to be said both in Community and revenue control terms in favour of the original proposal for a turnover limit of £100,000. At the other end of the spectrum under consideration we think that the Community risks and the scope for fraud and abuse militate strongly against going as high as the £500,000 suggested by EDU. However, as we discussed with you on 5 February, these arguments are perhaps proportionately less strong for a limit of £250,000. In cost terms the £250,000 limit is the one already illustrated in the scorecard and, if the Chancellor judges that he would like to offer a significant improvement on the consultation document proposal and that the total £100 million once-and-for-all cost is affordable, we think that we could live with a £250,000 limit operationally. Subject only to any further glosses by the Law Officers on the Community legal dimension, we therefore recommend accordingly.

11. Handling. You said in a Parliamentary Answer to Mr Dennis Walters MP last week that the Government will announce its decisions on the consultation document proposals at the time of the Chancellor's Budget Statement on 17 March. We continue so to recommend, but we recognise that there could be some difficulty in steering the necessary Finance Bill clause for cash accounting through the House before an Article 27 derogation has been obtained. As we explained in the discussion with you last week, we think that the problems will be ameliorated to the extent that Parliamentary Counsel has already advised that the detailed legal provisions would be appropriate to Regulations, and the Finance Bill clause would, therefore, be essentially of the enabling variety. One possible way round the residual difficulty would appear to be to make the Clause itself subject to an Appointed Day

(or Commencement) Order to bring it into operation. There are precedents for implementing an enabling clause in this way and it would provide an assurance to the House that the Government did not intend to proceed illegally without the Community's agreement. We understand that the flexibility provided in this area by the Interpretation Act is such that cash accounting could be introduced on 1 October 1987 (as we have previously proposed) even if formal agreement by the Community were delayed as long as late September. If you agree, we shall explore this further in the legal drafting with Parliamentary Counsel.

Annual accounting.

12. Responses to the consultation document. In general, there has been a rather more lukewarm response to this suggestion. The balance of opinion among the major respondents is in favour of the scheme as an option for traders, subject to requests that the turnover limit should be increased, pari passu, with that for cash accounting; but, overall, there is less enthusiasm than for cash accounting. Indeed, the Forum of Private Business, (who conducted its own survey) suggested that there is insufficient demand to justify going ahead even on an optional basis. Other principal doubts expressed are that annual accounting could lead to a detrimental decline in record-keeping standards compared with the discipline of traders having to prepare accounts for VAT return purposes quarterly will be detrimental; that the risks of having to make payments on account on a past turnover basis would be dangerous for businesses in volatile trading situations and that some form of Government "health warning" about the dangers of downturn would be appropriate. Just over 20% of small trader respondents would expect to use the scheme.

13. Recommendations. On balance, while the overall tone of the support for this proposal has been somewhat mooted, we recommend that it provides a sufficient measure of support to justify going ahead with annual accounting on the proposed optional basis. We agree that the turnover limit should follow that for cash accounting. Other detailed comments made are considered at Annex B2. By comparison with the consultative document, we propose more

flexible procedures for agreeing the amount of monthly instalment payments. On the other hand, we do not consider that it would be practicable to allow newly registered businesses to use the facility; in addition to the probability that they will be in a repayment situation, there could be difficulty in agreeing the level of monthly payments so that financial problems were not created for them during or at the end of the first year. We continue to prefer, therefore, to offer them entry at the end of their first year's registration. As to the suggested inclusion of established repayment traders, we have explained to the National Farmers' Union that we shall have to recommend against this, since it would be imprudent to make regular repayments of revenue before vouched claims were submitted. However, we recommend that we should undertake further work on the possibility that after the introduction of annual accounting a system of annual returns and annual repayments could be offered.

14. EDU views. In our discussion with them last week EDU, while agreeing our main conclusions, also supported the limited representations made for businesses to use co-terminous accounting and VAT years. They accepted, however, that this benefit is more perceived than real due to the different timescales and that there could be considerable resource consequences for us if we were obliged to handle large numbers of returns at one time rather than staggering them, as we do at present, to achieve an even work flow. We finally agreed with them simply to use best endeavours for those cases where alignment would be reasonably practicable.

Maintenance and preservation of records.

15. Some respondents have taken the opportunity to renew their objections to the extension of the period for preservation of records from three years to six in the 1985 Finance Act. The detailed points and comment are at Annex B3, but none require detailed consideration ahead of the consultant's report.

16. Most respondents have, however, supported the employment of the independent consultant (KMG Thomson McLintock have recently been appointed and commenced work), although a minority of smaller representative bodies and individual accountancy firms have either denied the supposed burdens on businesses or even said flatly that the use of the consultant would be a waste of public money. Some concern has also been expressed that the terms of reference might be too narrow. We have suggested to the EDU that, subject to the overriding need for consistency with our revenue needs, a measure of latitude may, if necessary, be allowed if the consultant himself felt it would be important to his findings. We shall be having regular progress meetings with the consultant which will enable this to be done.

Review of registration and deregistration requirements.

17. Time limits These proposals, which have largely been the subject of earlier consultation, have for the most part been welcomed. However, a number of respondents have argued that the longer period of one month proposed for notifying liability to register and cessation of trading should become three months. This, together with other suggestions, is covered in Annex B4 where it is pointed out that each additional month allowed would cost about £65 million a year in revenue forgone. In addition, we would be exposed to accusations of unjustified distortion of commercial competition from established businesses which had no interest in longer time limits. We therefore recommend that we should proceed to implementation on the basis of the original proposals.

18. Registration threshold. Although views were not explicitly sought on the point, a significant number of respondents have specifically sought a substantial increase in the VAT registration threshold, to either £50,000 or £100,000, while the Federation of Master Builders has taken the opportunity to reiterate its arguments for a "nil" threshold for construction industry businesses. Many, but not all, of those making such recommendations for a substantial increase have acknowledged the European Community dimension and have urged further initiatives and rejection of the draft SME's Directive proposals in this area. The Government's

overall position remains, of course, that greater flexibility in establishing registration thresholds is necessary but, as I explained in my minute on 4 February on EC developments, we may have a hard fight to secure a maximum threshold of 35,000 ECU, let alone a higher figure.

19. Compulsory deregistration. It has been clear from the outset that compulsory deregistration would be the single most controversial item in the consultation document. Most respondents have objected strongly to the proposal although a small minority have suggested that it might be acceptable provided it did not apply to the food industry. The arguments deployed have generally been the predictable ones about loss of income from VAT repayments and its potential effect on competitiveness; loss of status; and, in some cases, the reduction of opportunity to do business with larger traders. In some contrast, over 25% of those answering the small trader questionnaire were prepared to agree with the concept of compulsory deregistration; and about 40% in the Forum of Private Business Survey.

20. The overriding view of traders is clearly that the accounting and administrative burdens of VAT are rated as of lesser importance when the net financial effect is favourable to small businesses, and that large numbers of businesses would be unlikely to choose to deregister even if a substantial increase in the level of the VAT threshold was obtainable. Moreover, the proposal has been found wanting in support from within Government and in Europe. The Secretary of State for Employment voiced his reservations at the meeting with you on 15 October, and recently EDU have reiterated that they share the acute concern voiced by the majority of respondents and agree with those who have argued that the trader should be allowed to make the commercially sensible decision. MAFF, in a brief response, have said that compulsory deregistration would "have dire effects on small farmers and on agriculture and its many ancillary interests". In addition, we have now been advised by the EC Commission that they would not regard the concept of compulsory deregistration as compatible with Community law. In all the circumstances we recommend that no further action should be taken on compulsory deregistration at this time.

Retail schemes.

21. Individual scheme details. Comment was very limited. In general, those proposed changes to the schemes which are beneficial to the trade have been welcomed, while the suggested new standard mark-ups have met with some criticism where they are less favourable to businesses than the present ones. Our detailed consideration is at Annex B5. In particular, the proposed amendment to Scheme B will now be optional, and mark-ups to be used will be critically reviewed in the light of comment received. We recommend that we should proceed to draft the necessary tertiary legislation (in the form of an amended 'statutory' Notice No.727, for implementation later in the year), having detailed discussions, where necessary, with the appropriate trade assocations.

22. General operation and use of schemes. Not surprisingly, the two most controversial suggestions of the retail schemes package have proved to be:-

(a) the proposed abolition of the standard method of calculating gross takings; and

(b) the suggested future limitation on the use of the schemes to genuine retail businesses.

23. Proposed abolition of standard method of calculating gross takings. In general, the arguments advanced against this proposal have been much more forcefully put. The proposal would mean that businesses who provided self-financed credit would no longer be able to claim automatic bad debt relief, thus putting them on a par with non-retail businesses, and it has been argued strongly that their profitability and hence expansion and employment opportunities would be badly affected. The Minister of State has received letters on the point directly from the Institute of Directors and from Sir Geoffrey Finsberg MP, on behalf of Great Universal Stores, a leading member of the Mail Order Traders Association (MOTA). Only this week Sir Fergus Montgomery MP has asked six Questions on the same theme. We ourselves received strong representations from MOTA and others in response to the

+ Retail Consortium [illegible]

consultation document and on 20 January we met the Association to hear their case at first hand. Many of the points raised, and figures provided, require detailed examination; but we accept that in the light of its poor reception the proposal needs further consideration and consultation, possibly as part of a broader review of the relationship between retail schemes and larger businesses. We recommend, therefore, that we should not proceed with the proposal at this time.

24. Proposed limitation on the use of retail schemes. This proposal was designed to end the anomaly whereby, over the years, permission to use retail schemes has been granted to a range of professional people, including estate agents and solicitors, who can scarcely be described as retailers. It has received support from the VAT Practitioners Group and individual accountancy firms on grounds of equity, but businesses more directly involved oppose it. The CBI, while not expressing a firm view, has suggested that this proposal, too, should be the subject of further, separate consultation. Our view is that the objections to this item are largely of a predictable nature and do not provide any fresh insight or grounds for not proceeding. The Law Society advanced, somewhat tentatively, legal arguments against the proposal (on grounds of "legitimate expectation") but our Departmental lawyers advise that these are without substance, and that our vires are clear. We recommend therefore that we should proceed with this proposal; the EDU is content.

Abolition of VAT on credit transactions between registered traders.

25. This explanation as to why we were not proposing this reform has not produced a great deal of response and most of that has been largely predictable. The National Chamber of Trade has reiterated its opposition and although, for example the CBI and the Retail Consortium constituent bodies have not offered a fresh view, we have no reason to believe that they have changed their mind. Of the trade and professional associations which participated in the joint Government industry working party in 1978, only the Consultative Committee of Accountancy Bodies (CCAB) were in favour of change. This time round the principal accountancy bodies,

responding as individual associations - the CCAB having been disbanded - have with one exception remained silent on the matter, as have most other major respondents.

26. The principal arguments in favour of the change have come from the NFSE (which has campaigned repeatedly in recent years), the Association of Independent Businesses and the Chartered Institute of Management Accountants. On the other hand, some individual accountancy firms have indicated specifically that they do not consider the matter worth further review, and one previous, if relatively minor, protagonist of change (the Antique Dealers Association) states that in the light of the explanation given the consultation document it does not now believe that the abolition of tax on inter-trade transactions would be beneficial. With EDU agreement, we do not propose that any further action should be taken at this time.

Other matters

27. A number of other points were raised and are reviewed at Annex B6. While we have not felt able to fully support any of the points, we consider that those relating to the Keith penalties should be fed into the review which, as proposed in "Building Businesses....Not Barriers", will take place before the 1988 Budget

Conclusion

28. We should be grateful for your agreement to the recommendations in this report, subject to the Chancellor's decisions where appropriate. We shall be glad to discuss if you would find it helpful.

D J HOWARD

RC6.98

FROM: CATHY RYDING
DATE: 13 February 1987

PS/MINISTER OF STATE

cc Miss Sinclair
Mr Cropper
PS/C&E
Mr Jefferson Smith - C&E

VAT INPUT TAX: ORIGIN AND SCOPE OF THE RIGHT TO DEDUCT

The Chancellor has seen your note of a meeting held on Tuesday 10 February.

2. The Chancellor has commented that on the basis of this, he would not be inclined to make any further offer.

CR

CATHY RYDING

CONFIDENTIAL

H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5.023....

Weeded
[illegible]

From: P G WILMOTT

Date: 16 February 1987

MINISTER OF STATE

cc PS/Chancellor
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Spence (IR)

CANADIAN INSURANCE PREMIUM TAX

Your Private Secretary's note of your meeting on 8 January concluded with the request that I report any interesting response from the Canadian Minister of Finance to your letter of 17 November. Mr Wilson replied to you on 27 January. below

2. In the circumstances I can be extremely brief. The most interesting thing about the Canadians' federal tax (10 per cent on premiums placed abroad or with unauthorised companies) is why they bother to impose it at all: the revenue amounts to just $1 million (roughly £500,000) a year. To be fair, the tax is not designed to raise revenue from consumption but is rather a proxy for income tax which would otherwise have been payable had the insurance concerned been placed with authorised Canadian insurers. We deduce that there is little insurance not so placed. (Or, if there is, it is not declared: the control processes do not look particularly rigorous. Unless their market is tightly closed, a maximum of $10 million a year in volume placed abroad seems implausibly low.)

Internal distribution: CPS, Mr Knox, Mr Jefferson Smith, Mr Bone

3. This is not the whole story of course. Mr Wilson tells you that each province levies a premium tax of between 2 and 3 per cent. The federal tax is presumably designed to plug a gap.

4. Given both the great constitutional differences between the two countries and, almost certainly, the differences in size and openness of the two markets, we do not find the Canadian example particularly illuminating. Nonetheless, it would be only courteous to thank Mr Wilson for providing the information. You might also care to inform him of your conclusions. If you prefer to leave the latter until after the Budget, the portion of the attached draft in square brackets may be omitted; we would then provide a further draft after 17 March.

P G WILMOTT

CONFIDENTIAL

The Honourable Michael H Wilson
Minister of Finance
Department of Finance Canada
Place Bell Canada
160 Elgin Street
Ottawa
Ontario CANADA K1A 0G5

INSURANCE PREMIUM TAXES

Thank you for your most helpful letter of 27 January with its very clear exposition of the federal tax on certain insurance premiums.

[My colleagues and I have now decided that we shall not be pursuing the matter any further here in the near future. Nevertheless I can assure you that the information that you provided formed a valuable addition to the background material which we assembled for consideration of such a tax.]

I am grateful for your discretion on the subject.

PETER BROOKE

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

From D J HOWARD

Date 24 February 1987

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

MINISTER OF STATE

VAT: SMALL BUSINESS REVIEW - RESOURCE IMPLICATIONS

1. I promised (Annex C of my "final report" submission of 12 February) a further note on the resource implications of the VAT small business package. This has proved to be quite complex since, leaving aside items which are negligible in resource terms, there are five separate changes (paragraphs 2-6 below) to be brought into the equation and in some cases we can offer little more than ballpark figures at this stage in advance of our PES 1987 submission. As shown in paragraph 7, which provides a summary on a year-by-year basis, only the first item is of possible significance for 1987-88.

2. Cash accounting: introductory costs

Briefly, we shall be faced with upfront administrative costs in the local VAT offices in vetting and handling applications for the

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Internal distribution

CPS	Mr Russell	Mr Wardle	Mr Holloway
Mr Knox	Mr Trevett	Mr Battle	Mr Bone
Mr Jefferson Smith	Mr Fryett	Mr Wilmott	

scheme, particularly as we are now working towards an introductory date of 1 October 1987 which excludes a computer solution. We shall rely mainly on overtime or the employment of casual staff, (although there may be problems in London), and the costs, assuming a two-thirds take-up and a turnover limit for entry of £250,000, will be in the order of £0.5 million-£0.6 million spread over a six month period from, say, 1 September. We shall do our best to absorb this cost within our running costs provision for 1987-88 but, as you know, we are already tightly budgetted as a result of the reductions in our bid made as part of the last year's PES settlement. If necessary, therefore, we should need to seek additional funding in the course of the financial year.

3. Cash accounting: continuing costs

In our initial paper for you on cash accounting (Annex A to Mr Knox's submission of 22 August 1986) we indicated that we foresaw revenue risks in the proposal, particularly since if we were either to increase the number or duration of control visits, there would be opportunity costs. As you know, we have since done further work on the fraud and revenue control risks, which were exemplified in Annex C to my minute of 12 February. We have concluded from this further work that it would in practice be dangerous not to increase the duration of control visits to those cash accounting traders where revenue is most likely to be at risk. This would involve, for example, reclassifying a large number of traders from receiving a visit of one-half of a day each eight years on average to a full day on the eight year cycle. In total, we estimate that for a turnover limit of £250,000 this will require 45 extra manyears of control officer time, including 15 for the particularly critical tranche of businesses with a turnover limit of between £100,000 and £250,000. We expect, however that we shall be able to contain any additional control visiting effort for the duration of 1987/88 and we propose, therefore, as part of the normal annual review of our needs to include the appropriate bid for 1988/89 and subsequent years in the 1987 PES exercise. Bearing in mind that the additional control staff will be required to be operational from the start of the year, we shall seek a full year's running costs for each of the additional posts.

4. Annual accounting: introductory costs

For the accelerated commencement date of summer 1988 we hope to issue an explanatory leaflet and a contribution to the periodic "VAT Notes" in the autumn of 1987,both containing an invitation to traders to register an interest in taking up annual accounting, which will then be followed by a specific, formal invitation to those traders to join the scheme. We think that introductory costs will then fall into two phases:

(i) Local VAT offices We hope to delegate the bulk of the intitial clerical and data keying work involved in the receipt and processing of applications to our local VAT offices. These offices are already to lose an average of two non-visiting staff each in the second half of 1987/88 when the benefits of the reduction in enforcement workload as a result of surcharge are expected to have worked through. It is possible that some of these savings may have to be deferred for a few months (with some perhaps overlapping into 1988/89); but some degree of reliance on overtime is also a possibility. We find it difficult to make firm predictions about the timing of the main workload at this stage: subject to review in the PES round, we suggest a provisional assumption that the manpower consequences will be contained within 1987-88, but that we should reserve the right to return to the question of funding, as with the introductory costs of cash accounting, later in the year.

(ii) VAT Central Unit, Southend We believe that there may be a temporary requirement for about 45 extra staff in VCU, Southend, to deal with the take-on of traders into the scheme and for the inevitable additional work in the teething period when we would expect, for example, a higher incidence of failed direct debits, problems with traders who did not fully understand the system and wished to change their instalments, and so on. We propose to bid for a full year's running costs in the PES round. There may also be some overlap into 1989/90 until the scheme has settled down.

5. Annual accounting: continuing effects

As we originally forecast (Annex C to Mr Knox's submission of 22 August 1986), annual accounting should lead to a small manpower saving in the longer-term. On our present central working assumption of 160,000 traders taking up annual accounting this would equate to 8 posts in Southend, probably from 1990/91.

6. Postponement of Keith III

The postponement from 1 July 1988 to the autumn of 1989 of the introduction of serious misdeclaration penalty and interest in order to facilitate the early introduction of annual accounting will lead to significant resource savings in 1988/89 and 1989/90. In broad terms about 150 extra posts which were included in PES 1986 will be deferred from 1988/89 to the second half of 1989/90 or later and a similar number from 1989/90 to 1990/91 or later. In the PES 1986 scenario many of these posts were to have been found from the enforcement savings deriving from surcharge. Under the new scenario there will be a more uneven profile in the workload and staffing of LVOs. We shall deal with the implications more fully in our 1987 PES bid.

7. Conclusions

Taken year by year, and subject to the full picture as it emerges in our PES bid, the position appears to be as follows:-

1987/88 Probably no change in total manpower needs, but a possible running costs problem as regards the introductory costs of cash accounting and annual accounting.

1988/89 Deferment of about 150 Keith III posts which would probably have been introduced evenly over the course of the year, offset by requirements for:

45 additional control posts for cash accounting

45 clerical posts in VCU for introductory work on annual accounting

with a full year's running costs in each case.

1989/90 No significant further net manpower saving for Keith III, but a significant saving, because of the holdover from 1988/89, in running costs on that account. Some unwinding of the additional VCU staffing for annual accounting.

1990/91 Keith III staff continuing to build up (fully operational in 1991/92). Any necessary completion of VCU unwinding, together with further savings of perhaps 8 posts, to be taken into account in constructing new baseline.

8. We should be grateful to have your agreement to the use of these assumptions in the Budget context.

D J HOWARD

CONFIDENTIAL

FROM: Minister of State

DATE: 26 February 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie (*)
Mr Ross Goobey (*)
PS/Customs & Excise
Mr Jefferson Smith - C&E
PS/Inland Revenue

(* with note of meeting on 24 February)

VAT: PARTLY EXEMPT BUSINESSES - REPRESENTATIONS FROM THE CBI

1. At their request, I saw on Tuesday a deputation from the Taxation Committee of the CBI about our VAT tax avoidance proposals. The deputation acknowledged the case for tackling tax avoidance and did not object to changes in primary law coming into force from 1 April. But they claimed that the main impact on their members would stem from the changes in the partial exemption regulations, also planned for 1 April. They sought a delay of six months for these.

2. The main plank of the CBI argument is that, with the final version of the regulations not yet published, there will be too little time to absorb the changes. Many small businesses are, the CBI says, unaware of what is going to happen and will have to work very rapidly, possible doing complex new calculations, to establish how to account for VAT under the new rules. Larger businesses will have to take important decisions on whether to maintain their existing VAT groups or split them up. In the time available they will not be able to reprogramme their computers to provide the data to support their VAT returns. Customs themselves, it is claimed, will not be able to cope with the deluge of applications for special partial exemption methods. The deputation had other points on which they criticise the new regulations, but they were insufficiently specific to be convincing. The real issue is whether there should be postponement.

3. In fact the CBI's main interest is not quite what it seems. They are trying to focus attention on small businesses, and do not acknowledge how far the revised rules go in removing burdens from those businesses which have a limited number of exempt transactions which the rules allow to be ignored, or where the input tax related to exempt supplies does not go above a generous level. The CBI's real concern is with the larger firms which stand to lose from abolition of the 1 per cent de minimis rule - the rule by which if not more than 1 per cent of turnover relates to exempt supplies, the whole of the input tax may be deducted. Clever grouping of companies for VAT purposes has made this a major source of avoidance. The big companies affected by this change have been aware of it since the end of December, and it is clear that they are already planning for it.

4. Customs and Excise plans for the change are well advanced. Drafts of the regulations are in the hands of all who responded to the original consultations. A leaflet will be with LVOs for distribution in the second week of March and its availability will be publicised. Negotiations with trade associations and indvidual businesses have resulted, or will shortly result, in agreements on accounting methods with the brewers and a number of major associations affected by the changes. Where special methods already exist, Customs have either confirmed that these can continue or have agreed small amendments. Only a very small proportion of the trader population will suffer the change of becoming partly exempt for the first time. Many of them are well ahead with their planning, and they have assurances that accounting will be based on their existing commercial systems which will not have to be changed. I am saving you immediate detail but I can expand on this if necessary.

5. But, although work is well in hand, it has to be conceded that 1 April is getting very near. There is also a legal problem of which the CBI is unaware. It had previously been thought that the new partial exemption regulations could be made under existing primary law, and therefore published about the beginning

of March. However, Customs now have legal advice that the present primary law is not adequate to support the regulations as they are intended, and the matter can only be put right by amending the primary law by Budget Resolution. This means that the new regulations cannot be made and laid until immediately after the end of the Budget Debates, which would be only a week before they come into force. However much comfort we may draw from the state of Customs discussions with trade associations and businesses at present, it could well be that, as March goes on and the regulations still do not appear, we could come under considerable pressure either to produce the regulations or postpone the changes. It might be said that we are expecting major changes to be introduced within only a week of the production of the final and authentic text.

6. Despite these dangers, my strong preference is to press ahead to a 1 April timetable. The whole matter originates in the embarrassment in which we were put during the Committee Stage of last year's Finance Bill when avoidance devices were first ventilated by the Opposition, and all that has been discovered in the consultation process indicates that they are much more extensive in scale and much more costly than ever the Opposition dreamed. Inevitably, postponement would forego revenue; for technical reasons the partial exemption change have to be introduced at the beginning of a calendar quarter, and the loss from deferral would be in the range of £75-100 million a quarter. Those who have planned their tax affairs suitably are enjoying a substantial benefit at the expense of the Exchequer over their competitors. The CBI's case for deferral is much less good than it looks; it is really a plea on behalf of big firms, while purporting to be for the smaller ones. Those who have grasped the nettle are well ahead with their planning: for the rest, I am sure that the firms and Customs can sort out at least provisional accounting arrangements in time. If we were now to postpone, it would send a weak and confusing message to those who have already settled with Customs. So far as I judge the tone of the meeting, the CBI are resigned to the 1 April start.

7. My conclusion is that there is a risk that we may run into stormy waters in March. But, on what I have heard so far, I think there would be more noise than substance. If we stick to 1 April, by the time we reached Committee Stage the new rules will be in operation, and it would be difficult to mount an effective challenge at least to the principle of the changes. On balance my judgement would be not to accede to the CBI request for postponement.

P.B.

PETER BROOKE

ph1.15

CONFIDENTIAL

FROM: CATHY RYDING

DATE: 27 FEBRUARY 1987

PS/MINISTER OF STATE

cc Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/C&E
Mr Jefferson Smith
PS/IR

VAT: PARTLY EXEMPT BUSINESSES - REPRESENTATIONS FROM THE CBI

The Chancellor was grateful for the Minister of State's minute of 26 February.

2. The Chancellor agrees with the Minister. However, on the point in paragraph 5 that the new regulations cannot be made and laid until immediately after the end of the Budget debate, the Chancellor wonders if the proposed new regulations could be published on Budget day, even though they cannot be made and laid until the following week.

CR

CATHY RYDING

834/044

BUDGET CONFIDENTIAL

Cathy
PPS in!
M.
2/3

FROM: K M ROMANSKI

DATE: 2 March 1987

Discussed in draft.

1. MISS SINCLAIR
2. MINISTER OF STATE

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Mr Cropper

VAT SMALL BUSINESS REVIEW - RESOURCE IMPLICATIONS

We have seen Mr Howard's minute of 24 February about the resource implications of the VAT small business package.

2. At this stage, the Customs figures are only very rough. Our main point on the paper concerns the conclusion for 1989-90 in paragraph 7. This says that there will be no significant further net manpower savings in that year. But, it appears from paragraph 6 that the delay to Keith III implementation will mean that the requirement for 150 additional staff will be deferred from 1988-89 to 1989-90, and the requirement for a further 150 additional staff which would previously been required in 1989-90 will be deferred to 1990-91. In both cases the staff, once taken on, are a continuing requirement. It follows that, under the earlier timetable, Customs would have had 300 staff working on Keith III in 1989-90; under the revised timetable they will only have 150 staff. We therefore conclude that this represents a net manpower saving on Keith III of 150 staff in 1989-90 (and Customs' Finance and Manpower Division agree).

3. Apart from that, the two main elements in the manpower figures are the 45 permanent staff needed for control of cash accounting, and the 45 temporary staff for introduction of annual accounting. On the information available to us, neither figure looks unreasonable. The 45 staff for control of cash accounting compare with some 200,000 traders expected to use the scheme, of whom

about 50,000 will have a turnover over £100,000. The 45 staff for setting-up annual accounting compare with some 175,000 traders who are likely to take advantage of this scheme (based on the replies to the Customs questionnaire sent to small traders, which indicated a likely take-up rate of 20 per cent).

4. On this basis, the manpower effect of the small business package will be as follows (the figures are not cumulative, but show the difference from previous plans for each year):

	As at 31 March		
	1989	**1990**	**1991**
Cash accounting	+ 45	+ 45	+ 45
Annual accounting	+ 45	+ 15*	- 8
Keith III	- 150	- 150	0
TOTAL	**- 60**	**- 90**	**+ 37**

* assumed, on basis of gradual rundown of staff needed for implementation of annual accounting.

5. So far as running costs are concerned, the only definite estimate is for the use of overtime and casuals for the implementation of cash accounting in 1987-88, amounting to £0.5 to £0.6 million. Customs say they will try to absorb this, and they should be told that they are expected to do so. In the later years, the running cost implications will not follow directly from the end-year manpower numbers, because of differing assumptions about staffing profiles. For instance, Customs say that the manpower changes in 1988-89 imply additional running cost requirements, because the 90 additional staff for cash and annual accounting are needed for the whole year, whereas, on average, the 150 staff for Keith III were to have been in post only for half the year.

6. We shall obviously need to scrutinise this, and all other aspects of the running costs implications of the package, and

the manpower requirements underlying them in this year's Survey. We shall also have to consider the scope for offsetting savings for any additional bids.

7. At this stage Customs are only asking you to approve these figures for their use in a Budget context, eg scorecard, briefing. Subject to the point in paragraph 2 above, we see no reason why you should not do so in that limited context. But we suggest that you should say that that does not imply your agreement to the figures for Survey purposes, and, in particular, that you expect Customs to absorb in 1987-88 the running cost implications of the start-up of cash accounting.

K M ROMANSKI

002/1283

BUDGET CONFIDENTIAL

2 of 10 copies

FROM: **M C FELSTEAD**
DATE: **3 March 1987**

PS/MINISTER OF STATE

cc:
Chancellor
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Romanski
Mr Cropper

VAT SMALL BUSINESS REVIEW - RESOURCE IMPLICATIONS

The Chief Secretary has seen Mr Howard's submission of 24 February and Mr Romanski's note of 2 March commenting on it.

2 The Chief Secretary has commented that he supports the conclusions in Mr Romanski's note, in particular that Customs and Excise should absorb in 1987-88 the running cost implications of the start-up of cash accounting.

M C Felstead

M C FELSTEAD
Assistant Private Secretary

RD

BUDGET CONFIDENTIAL

FROM: APS/Minister of State

DATE: 3 March 1987

MR D J HOWARD - C&E

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Romanski
Mr Cropper
PS/Customs & Excise

VAT: SMALL BUSINESS REVIEW - RESOURCE IMPLICATIONS

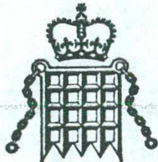
The Minister of State was grateful for your minute of 24 February.

The Minister is content for you to use the figures given in your submission in a Budget context. He has approved their use subject to the conclusion by both FP and FMD that, under the revised timetable, there will be a net manpower saving on Keith III of 150 staff in 1989-90. This does not imply any agreement to the use of the figures for Survey purposes, and the Minister expects Customs to absorb in 1987-88 the running cost implications of the start-up of cash accounting.

Deborah Francis.

MISS D L FRANCIS
Assistant Private Secretary

CONFIDENTIAL



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

From: P Jefferson Smith

Date: 3 March 1987

MINISTER OF STATE

Good!

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR

VAT : PARTLY EXEMPT BUSINESSES - REPRESENTATIONS FROM THE CBI

1. The Chancellor asked whether the proposed new regulations could be published on Budget day, even though they cannot be made and laid until the following week. There is no mechanism for advance issue of the formal printed version, but we could arrange for issue, including deposit in the Library of the House, of duplicated copies of the definitive text. We propose to proceed accordingly.

2. The CBI will be expecting a decision from you on their plea for deferment. You may like to write to Mr Willingale as attached.

P Jefferson Smith

Internal circulation:

CPS	Mr E Taylor	Mr Michie
Mr Knox	Mr Nissen	Mr Bone

30/3/87

DRAFT LETTER TO MR A E WILLINGALE, CHAIRMAN OF THE CBI TAX COMMITTEE

You brought a deputation to see me on 24 February to ask for 6 months postponement of the partial exemption changes due to be introduced on 1 April. I am very grateful to you and your colleagues for setting out the issues so fully and so clearly.

I have reported what you said to the Chancellor and we have looked at the matter very thoroughly. However, I am afraid that our conclusion is that postponement would unduly delay a necessary change. The amounts of revenue involved are substantial, and these are a measure not only of the loss to the Exchequer, but also of the distortion of competition between firms which have taken advantage of the present partial exemption rules, particularly as they apply to large VAT groups, and those which have not. In all the circumstances, we believe that the changes should go ahead from 1 April. I am sorry to send you a disappointing response, but can assure you that we weighed the matter up with great care.

PETER BROOKE

CONFIDENTIAL

FROM: S P Judge

DATE: 4 March 1987

MR JEFFERSON SMITH - C&E

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey

PS/Inland Revenue

PS/Customs & Excise

VAT: PARTLY EXEMPT BUSINESSES - REPRESENTATIONS FROM THE CBI

The Minister of State has seen your submission of 3 March, and written to Mr Willingale as suggested.

The Minister agrees with your proposal to issue duplicated copies on Budget day, and to deposit copies in the Library of the House. He would be grateful if this could be announced via an arranged PQ; I would be grateful if you could provide a draft by close on Thursday, 12 March.

SPJ

S P JUDGE
Private Secretary

Treasury Chambers, Parliament Street, SW1P 3AG

A E Willingale Esq
Chairman of the CBI Tax Committee
CBI
Centre Point
103 New Oxford Street
LONDON WC1A 1DU

4 March 1987

Dear Mr Willingale.

You brought a deputation to see me on 24 February to ask for 6 months postponement of the partial exemption changes due to be introduced on 1 April. I am very grateful to you and your colleagues for setting out the issues so fully and so clearly.

I have reported what you said to the Chancellor and we have looked at the matter very thoroughly. However, I am afraid that our conclusion is that postponement would unduly delay a necessary change. The amounts of revenue involved are substantial, and these are a measure not only of the loss to the Exchequer, but also of the distortion of competition between firms which have taken advantage of the present partial exemption rules - particularly as they apply to large VAT groups - and those which have not. In all the circumstances, we believe that the changes should go ahead from 1 April. I am sorry to send you a disappointing response, but can assure you that we weighed the matter up with great care.

Yours sincerely

Peter Brooke

PETER BROOKE

RP

FROM: S P Judge

DATE: 5 March 1987

MR JEFFERSON SMITH - C&E

cc PS/Chancellor
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey

VAT: PARTLY EXEMPT BUSINESSES

Michael Hirst MP, Conservative Member for Strathkelvin and Bearsden, telephoned me this morning. He asked when the partial exemption regulations were to be published: I said "soon", but did not reveal an exact date.

He asked me whether he should be getting concerned about the late appearance of the regulations, given that the new rules are coming into effect from 1 April. I explained that a large number of partially exempt traders already used special methods and would not be affected. I added that a major revenue loss was caused by clever VAT grouping by large companies; they had been well aware for several months of the likely changes and were planning accordingly.

I think my waffling was sufficient to put Mr Hirst off an immediate scent. But I did undertake to send him a copy of the draft regulations as soon as they are available. So I would be grateful if, in replying to my note of yesterday, you could enclose a dozen copies of the regulations.

I hope there aren't too many queries of this kind over the next ten days. But it might be useful if you could think up a line to take for Customs and Treasury press offices.

SPJ

S P JUDGE
Private Secretary

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

From: P Jefferson Smith
Date: 6 March 1987

PS/MINISTER OF STATE

cc PS/Chancellor
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey

VAT : PARTLY EXEMPT BUSINESSES

Your note of 5 March refers. On reflection, I do not see why we cannot give the direct answer that the draft Regulations will be available on Budget day. It will, after all, become more and more apparent that this is so! In answer to any further questions about the short period of time between the Budget and 1 April, we can say that the delay is inevitable, because the Regulations are linked with Budget Resolutions. And Customs have a guidance leaflet on the new system which is being distributed to local VAT Offices who will have it in the course of next week.

P Jefferson Smith

Internal Circulation:

CPS
Mr Knox
Mr E Taylor
Mr Nissen
Mr Michie

MR 11/91

CONFIDENTIAL

PUP.

FROM: CATHY RYDING
DATE: 6 March 1987

PS/MINISTER OF STATE

cc: CST
FST
EST
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR
Mr Jefferson Smith - C&E
PS/C&E

VAT: PARTLY EXEMPT BUSINESSES - REPRESENTATIONS FROM THE CBI

The Chancellor has seen Mr Jefferson Smith's minute to the Minister of State of 3 March.

2. The Chancellor has noted that there is no mechanism for advance issue of the formal printed version of the proposed new regulations, but that it would be possible to arrange for issue, including deposit in the Library of the House, of duplicated copies of the definitive text. The Chancellor was pleased to see that Customs proposed to proceed accordingly.

CR

CATHY RYDING

Papers PSe
RVP

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

FROM: P JEFFERSON SMITH

12 March 1987

MINISTER OF STATE

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Dyer
Mr Cropper

VAT : PARTLY EXEMPT BUSINESS (STARTER NO 6)

Your Private Secretary's minute of 4 March asked for a draft of an arranged PQ announcing that copies of the final version of the partial exemption Regulations would be placed in the Library of the House on Budget Day. We suggest the attached: if you approve, it should be put down tomorrow and answered on Tuesday.

P JEFFERSON SMITH

Internal distribution: CPS
Mr Knox
Mr E Taylor
Mr Nissen
Mr Michie
Mr Geddes

217/3/87

Tuesday
17 March

Draft arranged PQ

To ask Mr Chancellor of the Exchequer, pursuant to his Answer of 19 December 1986, Official Report, column 742, on the consultation document VAT Input Tax : Origin and Scope of the Right to Deduct, when he expects to publish the draft regulations which will provide the new rules for partial exemption.

HM Customs and Excise issued draft copies of most of the proposed new regulations in early February 1987 to those who had responded to the consultation document. Following discussions between Customs and certain interested trade parties, some changes were made and the proposed regulations are now in their final draft form: I have arranged for copies to be placed in the Library. The regulations themselves will be made and laid before the House on Tuesday 24 March, following approval by the House of the Budget resolutions.

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

From: P JEFFERSON SMITH
Date: 16 March 1986

MINISTER OF STATE

cc PS/Chancellor
Mr Scholar
Miss Sinclair
Mr Cropper

VAT PARTIAL EXEMPTION: PUBLICITY

1. We have had warnings from Mr Ray of the Building Employers Confederation that the BEC and the CBI are likely to try to inspire Parliamentary protests against the 1 April 1987 start date for the new partial exemption rules. Both bodies however well realise that the decision conveyed to the CBI following your meeting with them is final. Mr Ray appears to be the moving force, and we think that one reason is that (despite an informal reminder from us) he did not respond to the original consultation paper and he appears to have failed to advise his members of the implications for them. This is particularly unfortunate, as smaller builders with property interests probably form the main group of those beneficiaries who will be let out of the partial exemption net. Mr Ray is currently pushing us to mount a strong pre 1 April publicity campaign, including press advertising, so that no-one who could be affected can possibly remain unaware.

Internal distribution: CPS, Mr Knox, Mr E Taylor, Mr Michie, Mr Bone, Mr Rogers

2. The Budget Day press releases do of course cover this change. Moreover, a full scale press campaign would be absurd and likely to alarm quite unnecessarily the million plus traders who never need concern themselves with partial exemption, for the sake of being sure to reach all of the few thousand who are affected. But we think there is something in Mr Ray's suggestion. It would be well worth targetting further publicity, separate from the main Budget material, at those parts of the press which could be expected to pick it up and use it as advice to their readers. Unlike the Budget Day material, aimed at a wide audience, this could be directed specifically towards those who may be affected on 1 April.

X

3. I attach a copy of the news release we have in mind, and would be grateful for your approval, both as to contents and timing of release. We could issue it on Wednesday, Thursday, or Friday, but would rather not leave it any later. If there are criticisms of the 1 April start date in the Budget debates, you may want to respond when you wind up on Thursday. We would recommend issue on Wednesday, so that you could say that further publicity had already gone out.

P JEFFERSON SMITH

NEWS RELEASE

VAT: PARTIAL EXEMPTION: CHANGES FROM 1 APRIL 1987

HM Customs and Excise have published a revised edition of Notice 706 - Partial exemption giving details of the new partial exemption rules to be introduced on 1 April. Copies are available from local VAT offices.

VAT registered businesses incurring input tax relating to exempt supplies may be affected by the new rules in one of the following ways:

- Some businesses that currently have to restrict input tax recovery will now be able to recover all their input tax;

- Some businesses that have previously been treated as fully taxable will have to restrict their input tax recovery;

- Some businesses that already restrict their input tax recovery will have to change to a different method for working out how much input tax they can recover.

The changes to the existing rules follow a period of consultation on proposals outlined in Custom's consultation document "VAT Input Tax: Origin and Scope of the Right to Deduct", issued on 7 August 1986.

Although the changes will have a significant effect on the ability of certain businesses to recover VAT input tax, the number of such businesses will be relatively small: around one half of one percent of the total VAT trader population.

Both the old and the new partial exemption rules contain relieving provisions designed to free certain businesses from the partial exemption restrictions. One of the main features of the new rules is that they will apply more restrictively to large businesses whilst providing more generous reliefs for smaller businesses: it is anticipated that around 6,000 large businesses will have to apply partly-exemption restrictions for the first time and around 2,000 smaller businesses (including many builders) will cease having to do so.

How do I decide if I am partly-exempt and required to restrict my recovery of input tax?

- If you incur no input tax in relation to exempt supplies which you make, you will not be affected by the partial exemption restrictions;

- If yours is a small business and you have not had to apply restrictions in the past, even though you make some exempt supplies, it is unlikely that you will be affected: but read on;

- In deciding whether you are affected you can ignore input VAT relating to the following supplies unless you are in the business of supplying financial services:-

  any deposit of money;

  the granting of any lease or tenancy of or any licence to occupy any premises (where the input tax attributable to **all** such supplies is less than £1000 per year and subject to certain conditions - see below);

  any services of arranging insurance;

  any services of arranging mortgages;

any services of arranging hire-purchase, credit sale or conditional sale transactions;

the assignment of any debt in respect of a supply of goods by or services by the assignor.

A more detailed list of those businesses **not** entitled to ignore the input VAT in relation to such supplies is outlined in paragraph 10 of the new Notice. The further conditions relating to the exempt property supplies are outlined in paragraph 9 of the Notice).

- If your input tax attributable to exempt supplies is less than the following amounts, you may treat such tax as though it was attributable to taxable supplies.

  £100 per month on average; or

  both £250 per month on average **and** 50% of all your input tax; or

  both £500 per month on average **and** 25% of all your input tax.

What do I have to do if I think I may be affected by the changes?

You should contact your local VAT Office and ask for copies of Notice 706 "Partial exemption" and VAT Leaflet 706/2/87 "Partial Exemption: Transitional Arrangements For the New Rules". If, having read the Notice and Leaflet, you are unsure what to do or you need further help or advice, your local VAT Office will assist.

Coping with the changes

If you become partly exempt as a result of the new rules and are required to restrict your recovery of input tax, Customs will not

expect you to introduce significant changes to your computer or accounting systems. The Notice 706 outlines a standard partial exemption method to be used in order to calculate deductible input tax. If you find that you cannot operate this method you should contact your local VAT Office to agree a special method more suited to your individual needs. If necessary, Customs can agree to a 'provisional' method which can be subject to review at some later date.

Background note

"Exempt supplies" includes financial services, supplies of land and insurance.

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RD

FROM: CATHY RYDING
DATE: 17 March 1987

PS/MINISTER OF STATE

cc Mr Scholar
Miss Sinclair
Mr Cropper
Mr Jefferson Smith - C&E
PS/C&E

VAT PARTIAL EXEMPTION: PUBLICITY

The Chancellor has seen Mr Jefferson Smith's minute to the Minister of State of 16 March. The Chancellor has noted in paragraph 2 that Mr Jefferson Smith suggests that it would be well worth targeting further publicity at those parts of the press which could be expected to pick it up and use it as advice to their readers. The Chancellor assumes that this implies chiefly the trade press.

CR

CATHY RYDING

CONFIDENTIAL

cc PS/Chancellor
Mr Scholar
Miss Sinclair
Mr Brother
Mr Spence - IR
PS/C&E
Mr Wilmott - C&E

Treasury Chambers, Parliament Street, SW1P 3AG

The Honourable Michael H Wilson
Minister of State
Department of Finance Canada
Place Bell Canada
160 Elgin Street
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CANADA K1A OG5

17 March 1987

Dear Mr Wilson,

INSURANCE PREMIUM TAXES

Since I wrote to you on 17 February, you may by now have learned of the contents of the Chancellor of the Exchequer's 1987 Budget, presented today, in which there was no reference to any tax on insurance premiums.

My colleagues and I have decided not to pursue the matter for the present. However, I should like to repeat my thanks for your valuable assistance in our researches.

Yours sincerely

Peter Brooke

PETER BROOKE

RP

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KING'S BEAM HOUSE, MARK LANE
LONDON, EC3R 7HE

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5.023

From: P G WILMOTT

Date: 27 March 1987

Minister of State

cc Chancellor
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Spence IR

CANADIAN PAPER ON THE TAXATION OF INSURANCE

With his letter to you of 17 March the Canadian Minister of Finance sent you a paper prepared by Canadian economists and tax experts on the tax treatment of insurance under a value-added tax system. The paper concludes that it would theoretically be possible to apply VAT to insurance, or, more precisely, to the component of insurance premiums that represents the charge for the financial intermediation services offered by insurers. Although the Sixth Directive requires us to exempt insurance, we think it would nonetheless be worthwhile to study the Canadian ideas further. The French, for example, have been arguing for some time that VAT should apply to insurance, and that the Sixth Directive should be amended to permit this. A study of the Canadian paper

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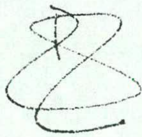
Internal distribution: CPS, Mr Knox, Mr Jefferson Smith, Mr E Taylor, Mr Bone, Ms French.

will provide an opportunity to consider whether there is any merit in supporting a French initiative (although we would not rate highly the chances of changing the law). In examining the study we shall, of course, need to look more closely at issues of administrative simplicity and equity towards the taxpayer than does the Canadian study, and this is where the attractions of the Canadian theories may pall. The study is also weak in dealing very superficially with the problem of insurance offshore. This will all take some time, and we suggest that in the meantime you may like to write to Mr Wilson to thank him for sending you the report. I attach a draft.



P G WILMOTT

DRAFT LETTER TO MICHAEL H WILSON, MINISTER OF FINANCE, CANADA

Thank you for your letter of 17 March enclosing the report of work carried out by the Department of Finance on the application of VAT to the insurance sector. It was good of you to remember our interest in this general subject. The report gives us a good deal to study and think about, in an area where, as you will have gathered, we think there may be scope for some reform of our taxation system.

PETER BROOKE