

# ADDRESSING VAT REGRESSIVITY

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## Título

Abordado el carácter regresivo del IVA

## Resumen

Los impuestos sobre el consumo, como es el Impuesto sobre el Valor Añadido (IVA), normalmente son considerados como impuestos regresivos. La respuesta tradicional a la pregunta sobre su regresividad ha sido la exclusión tributación de determinados productos –tanto mediante el uso de tipos reducidos como de exenciones sobre la presunción de que mediante esta exclusión se lograrían conseguir los objetivos redistributivos y sociales. Este enfoque sigue teniendo gran influencia en las políticas fiscales, estando ampliamente extendidas por todo el mundo tanto la utilización de varios tipos de gravamen como de exenciones. Todavía en las últimas décadas una abrumadora cantidad de pruebas legales y económicas se han erigido contra el uso de las exenciones en base. El objetivo de este artículo es contribuir al debate, presentando argumentos a favor de un IVA de base amplia. La conclusión es que un impuesto sobre el valor añadido con una base reducida, no es el resultado de criterios de equidad y eficiencia, pero sí de criterios políticos, y solo afrontándolos puede mejorarse el diseño del IVA.

## Palabras clave

Palabras clave: IVA, regresividad, exenciones, tipos reducidos, impuestos de base amplia, impuestos de base reducida

## Abstract

General consumption taxes, like value added tax (VAT), are commonly regarded as regressive. The traditional response to concerns over this regressivity has been the exclusion of certain products from full taxation –either through the use of reduced rates or exemptions– on the presumption that this exclusion will achieve social and distributional aims. This approach continues to heavily influence policy, with both multiple rates and exemptions still widely used worldwide. Yet, over the last decades, an overwhelming body of legal and economic evidence has built up against the use of exclusions from the base. This aim of this article is to contribute to this discussion, by presenting the arguments in favour of broad-based VATs.

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It concludes that narrow VAT bases are not the result of equity or efficiency considerations, but rather of the political ones, and only by addressing those can VAT design be improved upon.

Keywords

VAT, regressivity, narrow tax base, broad tax base, exemption, reduced tax rate.

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## 1. Introduction

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General consumption taxes, like value added tax (VAT), are commonly regarded as regressive.<sup>1</sup> The traditional response to concerns over this regressivity has been the exclusion of certain products from full taxation, on the presumption that this exclusion will achieve social and distributional aims. The argument is two-fold: first, non-taxation will increase consumption of products with positive externalities, so-called merit goods, such as cultural events, sport events and books; and, secondly, non-full taxation of essential products, such as food, healthcare and education, will diminish the natural regressivity of consumption taxes. Non-full taxation is achieved primarily through either exemptions or reduced rates, and both methods are widely used within Europe, as well as in many other countries applying a VAT. Yet, over the last decades, an overwhelming body of legal and economic evidence has built up against the use of multiple VAT rates or exemptions. Narrow VAT bases give rise to significant legal difficulties, creates economic distortions, and it is at best unclear whether it actually has the social and distributional effects that it aims to achieve.

The aim of this article is to demonstrate that, despite the intuition, using VAT reduced rates or exemptions is an inefficient method of achieving social and distributional aims. Part II provides an analysis of the traditional approach to addressing regressivity, by providing a cost-benefit analysis of VAT exclusions from the base; in Part III the evolution of the EU VAT base is analysed, showing that the determinant factors of the current base design were not equity or efficiency, but political in nature. Finally, Part IV concludes that a better designed EU VAT system is fundamentally dependent on understanding and addressing these political factors.

## 2. Addressing VAT Regressivity

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Despite the widespread perception of VAT as a naturally regressive tax, the question is not as straightforward as it initially appears, and the answer is far from settled. Although questions have been raised concerning the possible bias relating to the measurement of VAT regressivity generally,<sup>2</sup> the main source of contention relates to how regressivity is assessed. Namely whether it should be assessed relative to current income, or to current consumption.<sup>3</sup> VAT is particularly regressive if regressivity is assessed relative to income, but much less so when it is assessed relative to consumption, which is regarded as a better

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1 Whilst the article concentrates on VAT, most of its conclusions are applicable, *mutatis mutandis*, to other general consumption taxes, such as retail sales tax (RST) applicable in the US.

2 F. Gastaldi, et al., «Regressivity-Reducing VAT Reforms» (2017) *International Journal of Microsimulation* 10(1), 39.

3 R. de Mooij and M. Keen, «Fiscal Devolution and Fiscal Consolidation: The VAT in Troubled Times» in A. Alesina and F. Giavazzi (eds), *Fiscal Policy after the Crisis* (University of Chicago Press, 2013), 443-485.

indicator of lifetime welfare;<sup>4</sup> in 2014, an OECD report looking at 20 of its members, concluded that VAT systems were either proportional or slightly progressive when measured as a percentage of expenditure.<sup>5</sup>

It is undoubtedly true that, to the extent that all income is consumed, VAT is equivalent to a flat-rate, proportional tax, rather than a regressive one, and this will indeed be the case for those at the lower end of the income distribution. To the extent, however, that not all income is consumed and savings come into play, regressivity becomes a concern. Of course, it can be argued—and it often is—that savings are mere deferred consumption.<sup>6</sup> Yet, that argument does not fully convince, for two reasons. The first is that, whilst savings can indeed be seen to some extent as deferred consumption, they are much more than that, and can also be seen as, for example, further income generators and until consumption takes place individuals will extract significant benefits from their savings holding. The second, and perhaps more important, reason is that the higher the savings, the more deferred in time the consumption will potentially be, and *ad extremis* it can be passed on inter-generationally to a time when consumption is no longer taxed. It is therefore more realistic to argue that, whilst VAT is a proportional tax for the lowest income deciles, where all income is spent on consumption, it becomes regressive once part of that income is saved. Consequently, the higher the percentage of income saved, the more regressive the tax will be. The question is, then, how to address this regressivity.<sup>7</sup>

Reduced rates are one of two methods traditionally used to address vertical equity concerns—either to diminish the regressivity of VAT, or to increase consumption of perceived merit goods—the other being exemptions. Whilst the reasons for the use of reduced rates in older VATs are rather more prosaic,<sup>8</sup> early literature on optimal consumption taxation does provide backing for the use of differentiated rates.<sup>9</sup> Yet, the reduced rates in existing VATs do not follow the inverse elasticity rule suggested in early optimal taxation theory: first because, in practice, the information on consumers' behaviour needed to operate a differential tax regime that improves, rather than worsens, economic welfare is so extensive as to make such regimes impractical<sup>16</sup>; and, secondly, the traditional use of reduced rates by VAT systems to reduce the regressivity of the tax, tends

4 E. Caspersen and G. Metcalf, «Is a Value Added Tax Regressive? Annual Versus Lifetime Incidence Measures» (1994) *National Tax Journal* 47(4), 731. See also N. Warren, A. Harding and R. Lloyd, «GST and the changing incidence of Australian taxes: 1994-95 to 2001-02» (2005) *eJournal of Tax Research* 3(1), 114; G.N. Carlson and M.K. Patrick, «Addressing the Regressivity of a Value-Added Tax» (1989) *National Tax Journal* 42(3), 339; and S. Cnossen, «The Value-added Tax: Key to a Better Tax Mix» (1989) *Australian Tax Forum* 6(3), 265.

5 OECD, *The Distributional Effects of Consumption Taxes in OECD Countries* (Paris: OECD Publishing, 2014).

6 A. Thomas, «Reassessing the Regressivity of the VAT» (2020) *OECD Taxation Working Papers* 49.

7 Assuming it should be; some argued that progressivity concerns should not be concentrated in one single tax, see A. Auerbach, «Public finance in practice and theory» (2010) *CESifo Economic Studies* 56(1), 1.

8 As discussed in R. de la Feria and R. Krever, «Ending VAT Exemptions: Towards a Post-Modern VAT» in R. de la Feria (ed.), *VAT Exemptions: Consequences and Design Alternatives* (The Hague: Kluwer Law International, 2013), 3-35.

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

to result in precisely the opposite result to that suggested under that rule, namely the higher taxation of highly inelastic products, such as food and utilities. There is, therefore, limited support to be found in the literature on optimal taxation theory or otherwise,<sup>10</sup> for the use of differentiated rates as applied in older VATs, such as those in Europe. This is because, not only is there now extensive evidence that reduced rates carry significant costs beyond the obvious loss of revenue, there are also significant doubts as to their potential benefits, namely whether applying reduced rates truly achieves social and distributional aims.

## 2.1. VAT incidence and distributional impact

As a pre-condition for reduced rates to achieve the sought after distributional and social aims, the decrease in the tax rate must be passed on to consumers, in the form of price reductions. Theoretically, this should indeed be the case: in a perfectly competitive market, it is assumed that a decrease in taxes should result in a decrease in prices. Indeed, in policy circles it is almost universally assumed that indirect tax changes are fully and exactly passed through to consumer prices.<sup>11</sup> Markets, however, are often not perfectly competitive, and theory makes clear that pass-through may be less than complete (under-shifting), or more than complete (over-shifting).<sup>12</sup> For a long time, economic literature provided sound theoretical insights into the efficiency of consumption taxes, but the empirical work was not as widely developed.<sup>13</sup> For the last decade, however, there have been a wealth of studies on the incidence of VAT. Whilst these studies do not reach fully uniform results, and show instead varying degrees of pass-through to consumer prices, clear patterns have emerged that cast doubts, in policy circles, upon the full pass-through assumption.<sup>14</sup>

One of the first, and most significant, studies was the so-called «labour-intensive services experiment». Carried out across several European countries, and across a range of industries—from hairdressing to cleaning—the aim of the study, implemented in 1999, was to *test* the impact of the introduction of reduced rates of VAT on job creation. In 2003, a report from the European Commission confirmed that the impact of the new reduced rates on prices of labour-intensive services was minimal: when conducting price surveys, Member States found that reduced rates of VAT were reflected in consumer prices only partially or not at all, and that at least part of the VAT reduction was used to increase the margins of service providers; where the VAT reduction had been passed on to the con-

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10 P.B. Sorensen, «The Theory of Optimal Taxation: What is the policy relevance?» (2007) *International Tax and Public Finance* 14, 383; and H.J. Kleven, «Optimum Taxation and the Allocation of Time» (2004) *Journal of Public Economics* 88, 545.

11 R. Bird and P.P. Gendron, *The VAT in Developing and Transitional Countries* (Cambridge: CUP, 2007).

12 D. Benedek, et al., «Varieties of VAT Pass Through» (2020) *International Tax and Public Finance* 27, 890.

13 T. Kosonan, «More and Cheaper Haircuts After VAT Cut? On the Efficiency and Incidence of Service Sector Consumption Taxes» (2015) *Journal of Public Economics* 131, 87.

14 For a review of the latest literature see T. Buettner and B. Madharova, «Unit Sales and Price Effects of Pre-Announced Consumption Tax Reforms: Micro-level Evidence from European VAT» (2020) *American Economic Journal: Economic Policy* (Forthcoming)

sumer, Member States found that this was only a temporary measure and prices would subsequently increase.<sup>15</sup> Overall, the study concluded that, partially due to the lack of effect on prices, the aims of the experiment, namely to increase employment and to combat informality, had not been achieved.<sup>16</sup>

Around the same time, a second experiment to assess the impact of reduced rates on prices took place in Ireland. In 2001, struggling to contain high inflation, the Irish Government reduced the rate of VAT from 21 per cent to 20 per cent. In 2002, the Irish Government decided to raise the rate of VAT back from 20 per cent to 21 per cent, after the Government concluded that the lower rate of VAT had not been passed on to consumers.<sup>17</sup> Changes in European domestic VAT rates structures in the last decade have also opened up opportunities for empirical studies on the price incidence of the tax,<sup>18</sup> and there is now a significant body of literature exploring the topic, displaying clear trends and response patterns. The main take-away is in line with the results of the labour-intensive services and the Irish experiments: there is near unanimity in finding less than full pass through on prices. Prices tend not to reflect changes in VAT rates—or at least, not fully. The response to VAT changes is, however, heterogeneous, and depends on not only the type of change, but also the product type and firms' characteristics. Changes in the level of estándar rates are more likely to be passed on to consumers, than changes in the level of reduced rates or base-narrowing reclassification measures;<sup>19</sup> wide-ranging changes that affect a small consumption share are less likely to be passed on to consumers, than changes that affect around half of the consumption share;<sup>20</sup> and, as opposed to what tax incidence theory indicates, the response to rate changes is asymmetric, and increases are more likely to be passed on than are decreases.<sup>21</sup> Larger firms are also more likely to pass on rate reductions on prices than smaller firms;<sup>22</sup> reductions for products in more competitive markets are more likely to be passed on than those where there is imperfect competition;<sup>23</sup> reductions are more likely to be passed on as regards products where the market salience of the tax

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15 See Commission of the European Communities, *Report from the Commission to the Council and to the European Parliament: Experimental application of a reduced rate of VAT to certain labour-intensive services* (Brussels: 2 June 2003, COM(2003) 309 final); and Commission Staff Working Paper, *Evaluation report on the experimental application of a reduced rate of VAT to certain labour-intensive services* (Evaluation Report) (2 June 2003, SEC(2003) 622). For a detailed analysis of the «labour-intensive services experiment» see below, section II, «Narrowing the EU VAT base».

16 Evaluation Report, above fn.15, 28.

17 Evaluation Report, above fn.15, 26.

18 On the changes in European domestic VAT rates since 2018, see R. de la Feria, «Blueprint for Reform of VAT Rates in Europe» (2015) *Intertax* 43(2), 154.

19 Benedek, et al., above fn.12.

20 Benedek, et al., above fn.12.

21 Y. Benzorty, et al., «What Goes Up May Not Come Down: Asymmetric Incidence of Value-Added Taxes» (2018) *NBER Working Paper* 23849. See also R. Batista Politi and E. Mattos, «Ad Valorem Tax Incidence and After-Tax Price Adjustments: Evidence from Brazilian Basic Basket of Food» (2011) *Canadian Journal of Economics* 44(4), 1438.

22 Kosonan, above fn.13; and J. Harju, et al., «Firm types, price-setting strategies, and consumption-tax incidence» (2018) *Journal of Public Economics* 165, 48.

23 C. Carbonnier, «Who pays sales taxes? Evidence from French VAT reforms, 1987-1999» (2007) *Journal of Public Economics* 91, 1219.

is higher;<sup>24</sup> and firms operating in sectors with low profit margins are less likely to pass on VAT decreases, than are firms operating in sectors with high profit margins.<sup>25</sup>

How to explain these results? The most typical explanation for the lack of full pass-through of VAT changes on consumer prices is that it results from inelastic supply and demand or imperfect market competition.<sup>26</sup> Another possible explanation for the lack of effect on prices, particularly in the context of temporary changes such as the labour-intensive services experiment, is the assumption of fixed costs for changing prices.<sup>27</sup> Cognitive biases may, however, also play a role. Anchoring, whereby an individual depends on an initial piece of information to make subsequent judgements, may help explain the lack of pass-through if consumers make purchasing decisions on the basis of the pre-VAT reduction price (anchor). The low market salience of indirect taxes, resulting in consumers not always fully *factoring* in the price effects of general consumption taxes or excise duties in their purchasing decisions, seems also to contribute to the lack of pass-through.<sup>28</sup>

Whilst all these explanations can certainly help to partly explain the results, they do not do so fully—in particular, they do not explain the heterogeneous response of firms, depending on size or business structure, or the different pass-through rates depending on share of consumption affected by the reform. Regardless of the reason—or most likely reasons—for the lack of pass-through of VAT changes on consumer prices, we now know that consumers tend not to receive the benefit of reduced rates of VAT. This begs the further question of who does tend to benefit from this reduction in rates. Until recently there was limited concrete evidence on the main beneficiaries of reduced rates, although employees and a possible positive effect on (low-skill) employment had already been discarded;<sup>29</sup> a recent study, however, confirms the intuition that retailers—not consumers, employees or suppliers—are the primary beneficiaries of VAT reductions.<sup>30</sup>

The above mentioned studies cast doubt on whether reduced rates of VAT will be passed through to consumers. Yet, even assuming that, given the heterogeneity of the response to VAT reductions, reduced rates will indeed affect prices, there are still no guarantees that the envisaged distributional and social aims will be attained. Economic literature has been consistently sceptical of the

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24 F. Montag, A. Sagimuldina and M. Schnitzer, «Are Temporary Value-Added Tax reductions passed on to consumers? Evidence from Germany's Stimulus» (2020) *arXiv:2008.08511v1*, 19 August. On the distinction between market and political salience, further discussed in the Conclusion below, see D. Gamage and D. Shanske, «Three Essays on Tax Salience: Market Salience and Political Salience» (2011) *Tax Law Review* 65, 23.

25 Benzorty, et al., above fn.21.

26 D. Fullerton and G.E. Metcalf, «Tax Incidence» (2002) *Handbook of Public Economics* 4, 1787; Kosonan, above fn.13; and S. Delipalla and M. Keen, «The comparison between ad valorem and specific taxation under imperfect competition» (1992) *Journal of Public Economics* 49, 351.

27 M. Golosov and R.E. Lucas, «Menu Costs and Phillips Curves» (2007) *Journal of Political Economy* 115(2), 171.

28 R. Chetty, et al., «Salience and Taxation: Theory and Evidence» (2009) *American Economic Review* 99, 1145; and *a contrario*, Montag, Sagimuldina and Schnitzer, above fn.24.

29 Kosonan, above fn.13.

30 Y. Benzarti and D. Carloni, «Who Really Benefits from Consumption Tax Cuts? Evidence from a Large VAT Reform in France» (2019) *American Economic Journal: Economic Policy* 11(1), 38.

suitability of differentiated VAT rates to achieve distributional aims.<sup>31</sup> Such aims are generally regarded as better addressed under an efficient, and welfare enhancing,<sup>32</sup> single-rate system, with the yield then used to compensate lower-income households, either through welfare transfers, or progressive income taxes.<sup>33</sup> Only when there are no other means of compensating lower-income households, due to poor targeting capacity—as in the case of some developing countries—has an efficiency argument been made to justify the use of reduced rates of VAT.<sup>34</sup> This is partly because the most significant beneficiaries of the tax expenditure that result from the application of reduced rates of VAT are not lower-income households, but higher-income households.

Given the regressive nature of VAT, at least at the higher-income deciles, it seems intuitive that applying lower rates of VAT will protect low-income households and limit the regressivity of the tax. Yet analysis of consumption patterns, and distribution of VAT payments by income decile or quantile, seems to indicate that it is often the opposite: since consumption, even of essential items, is overwhelmingly by the highest income households, when there is a VAT reduction—assuming this reduction is passed-through—it is those households that primarily benefit from VAT decreases.<sup>35</sup> A recent empirical study found that in Ghana, the average estimated benefit received by the lowest consumption decile by the application of VAT reduced rates and exemptions was US\$16 per capita, compared to US\$190 per capita at the top end of the distribution.<sup>36</sup> The picture is even worse when high levels of informality are taken into account: a recent study found that the presence of large informal sectors in developing countries has a significant impact upon the distributional impact of general consumption taxes.<sup>37</sup> The large negative relationship between informal consumption shares—or from small businesses below the VAT registration threshold—and households' total expenditure means that applying reduced rates or exemptions will

31 Although there is some support in optimal tax theory for their application when it impacts on household production, see H. Kleven, W. Richter and P.B. Soerensen, «Optimal taxation with household production» (2000) *Oxford Economic Papers* 52(3), 584.

32 Even under imperfect competition conditions, see B. Bye, et al., «Welfare effects of VAT reforms: a general equilibrium analysis» (2012) *International Tax and Public Finance* 19(1), 368.

33 A. Atkinson and J. Stiglitz, «The structure of indirect taxation and economic efficiency» (1972) *Journal of Public Economics* 1, 97; A. Deaton and N. Stern, «Optimally Uniform Commodity Taxes, Taste Differences and Lum-sum Grants» (1986) *Economic Letters* 20, 263; I. Crawford, M. Keen and S. Smith, «Value-Added Tax and Excises» in J. Mirrlees, et al. (eds), *Dimensions of Tax Design: the Mirrlees Review* (Oxford: OUP, 2011); C.L. Ballard and J.B. Shoven, «The Value-Added-Tax: The efficiency cost of achieving progressivity by using exemptions» in M.J. Boskin (ed.), *Modern Development in Public Finance: Essays in Honor of Arnold Harberger* (Oxford: B. Blackwell, 1987), 109–129; and E.H. Davis and J.A. Kay, «Extending the VAT base: problems and possibilities» (1985) *Fiscal Studies* 6(1), 1.

34 M. Keen, «Targeting, Cascading, and Indirect Tax Design» (2013) *IMF Working Papers* WP/13/57; Bird and Gendron, above fn.11; M. van Oordt, «Zero-Rating vs Cash Transfers under the VAT» (2018) *Fiscal Studies* 39(2), 1; and C. Heady and S. Smith, «Tax and Benefit Reform in Central and Eastern Europe» in D. Newbery (ed.), *Tax and Benefit Reform in Central and Eastern Europe* (London: Centre for Economic and Policy Research, 1995).

35 This issue is further developed in R. de la Feria and A. Swistak, «The Progressive VAT», mimeo (forthcoming). See also A. Bozio, et al., *Fiscalite et redistribution en France: 1997-2012* (Institute des Politiques Publiques, 2012); and N. Ruiz and A. Tronnay, «Le caractere regressif des taxes indirectes: les enseignements d'un modele de microsimulation» (2008) *Economie et Statistique* 413, 21.

36 T. Harris, et al., «Redistribution via VAT and cash-transfers: an assessment in four low and middle income countries» (2018) *IFS Working Paper* W18/11. See also S. Boeters, et al., «Economic effects of VAT reforms in Germany» (2010) *Applied Economics* 42(17), 2165.

37 P. Bachas, et al., «Consumption Taxes, Redistribution and Informality» (2020) *IFS Working Paper* W20/14.

primarily affect either higher income households, whose consumption is concentrated in the formal sector, or larger businesses.

In practice therefore, reduced rates of VAT, to the extent that they are passed through in lower prices, effectively subsidise the consumption of the households at the higher levels of the income distribution. This in turn means that, contrary to intuition, reduced rates of VAT, as with any other exclusions from the base, do not necessarily reduce the regressivity of the tax,<sup>38</sup> but can, on the contrary, increase it.<sup>39</sup> This will be particularly the case where reduced rates of VAT apply to services where there is a choice between private and public services, as is often the case with medical services or education—as principally high-income households tend to opt for private services—or where they apply to meritorious items, such as books or cultural events—as principally high-income households consume these products.<sup>40</sup>

## 2.2. Revenue costs and spillover effects

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

The tax expenditures—defined as reductions in tax liability compared to the benchmark—<sup>41</sup> resulting from the use of reduced rates of VAT are likely to be extremely significant. Whilst it is not always easy to determine the exact size level of this tax expenditure,<sup>42</sup> c-efficiency levels—measured as the *ratio* of actual VAT revenues to the product of the estándar rate and final consumption—do provide some indication: in developed countries low c-efficiency tends to be attributable primarily to the VAT policy gap—that is, revenue loss due to exclusions from the base—rather than the compliance gap, as tends to be the case in developing countries.<sup>43</sup> It is therefore suggestive of the scale of the tax expenditure involved that European countries' VAT systems tend to rank below the OECD c-efficiency average, which stands at 52.9, whilst New Zealand, which amongst other broad-base features applies one single VAT rate, ranks at above

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38 Although they can, particularly in high-income countries, see Thomas, above fn.6.

39 Harris, et al., above fn.36.

40 de la Feria and Swistak, above fn.35.

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

42 Zu, above fn.41.

43 M. Keen, «The Anatomy of the VAT» (2013) *National Tax Journal* 66(2), 423.

90 points.<sup>44</sup> Similarly, the VAT Revenue *Ratio* (VRR), which also measures the effectiveness with which taxes are collected, also suggests that most VATs have significant tax expenditures, with between half and one-third of potential revenues lost due to exclusions from the base.<sup>45</sup> These results are in line with a recent calculation of the tax expenditure associated with exclusions from the VAT base in low and middle-income countries, which found that between 22 per cent and 55 per cent of potential VAT revenue was foregone as a result of those exclusions.<sup>46</sup>

The high levels of tax expenditure associated with reduced rates of VAT are all the more significant, because the foregone revenue has the potential to affect mostly those in lower-income households, as by the nature of consumption patterns, those are the ones who mostly benefit from public expenditure—whether by way of welfare benefits or others such as education or healthcare services. In the UK, for example, the distributional impact of eliminating reduced rates of VAT, whilst increasing the range of social benefits, was found to benefit mostly the three lowest-income deciles.<sup>47</sup> Similarly, a study focussing on four low and middle-income countries found that, despite being completely untargeted, a Universal Basic Income (UBI) funded by the revenue gains from a broader VAT base would create large net gains for poor income households and reduce inequality and poverty, even if only 75 per cent of additional VAT revenue was disbursed as UBI payments.<sup>48</sup>

Beyond the revenue costs, the use of multiple VAT rates also carries significant spillover effects, not least qualification and interpretation problems. In Europe, these difficulties can be illustrated with a few examples. In Belgium, a cycle repair of a puncture is subject to a lower rate than the rate applicable to the inner tube used for the repair, because of the labour component. In Portugal, fresh fish is subject to a 5 per cent rate; if it is cooked prior to being frozen, it is subject to a 19 per cent rate; and if it forms part of a ready meal to be taken away or consumed on the spot, it is taxed at a 12 per cent rate. In the UK, raw and unprocessed nuts are zero-rated, and so are roasted and salted nuts still in their shells; fruit and nut mix can be zero-rated if the weight of the roasted nuts is less than a quarter of the whole; however, if nuts are shelled and roasted or salted, or if they have been coated with chocolate or yoghurt, the estándar rate applies.

Also symptomatic of these definitional and interpretative difficulties are the high levels of litigation concerning the application of reduced rates of VAT. Within the EU, there is a growing number of cases on whether reduced rates of VAT

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44 D. Snell, «GST – Revenue and Business Risk» in R. Kreyer and D. White (eds), *GST in Retrospect and Prospect* (Wellington: Thomson Brookers, 2007), 423–430, 426.

45 OECD, above fn.5, 59–61.

46 Harris, et al., above fn.36. Tax expenditure studies in France, Italy and Germany show equally large numbers, see B. Egert, «The Efficiency and Equity of the Tax and Transfer System in France» (2013) *CESifo Working Paper* 4210; J. Tyson, «Reforming Tax Expenditures in Italy: What, Why and How?» (2014) *IMF Working Paper* WP/14/6; and M. Thoene, «18 Billion At One Blow – Evaluating Germany's Twenty Biggest Tax Expenditures» (2012) *Fifo Discussion Papers* 12-4.

47 de Mooij and Keen, above fn.3.

48 Harris, et al., above fn.36.

should be applicable to specific—often new—products.<sup>49</sup> Amongst the most recent, and illustrative, cases are those concerning the treatment of non-physical books. At stake in these cases has been the interpretation of the word «books», and whether the provision within the EU VAT Directive,<sup>50</sup> which allows «books» to be subject to a reduced rate of VAT should be extended to similar products which did not exist at the time the Directive was approved, namely audio books, and e-books. In the first of this group of cases concerning non-physical books, namely audio books, the (3rd Chamber of the) Court of Justice of the European Union (CJEU) left the decision to the national court on whether applying a VAT reduced rate to hardcopy books, but not to audio books, violated the principle of fiscal neutrality.<sup>51</sup> Yet, barely six months later, in two other decisions on the same theme, the (4th Chamber of the) CJEU ruled that the supply of electronic books cannot fall within the scope of the reduced VAT rates rule.<sup>52</sup> These initial cases have been followed by others, and the matter was only settled with the approval of new (amending) legislation.<sup>53</sup>

National courts have struggled with similar difficulties, and in this regard, whilst other countries have also experienced a high volume of cases,<sup>54</sup> litigation levels in the UK are particularly telling.<sup>55</sup> One of the most (in)famous cases was *United Biscuits (UK) Ltd (No. 2) v CC&E (Jaffa Cakes)*.<sup>56</sup> Jaffa Cakes are a food product comprised of three layers: a sponge cake base; a layer of solidified orange flavoured jam; and a chocolate cover. For several years McVities, the producers of Jaffa Cakes, treated them as cakes, which—for historical reasons that are not fully clear, but appear to be related to their sale in traditional bakery shops—are subject to a zero rate of VAT in the UK. In 1991, however, this classification was challenged by HMRC, in particular on the basis that Jaffa Cakes are the same size and shape as biscuits, which under UK VAT law are subject to a estándar rate on the basis of having been regarded by the legislator as non-essential food products at the time of the law's entry into force. The case was brought before the VAT Tribunal, with a central question: what criteria should be used to class something as a cake, rather than a biscuit? Ultimately, the Tribunal concluded that Jaffa Cakes were indeed cakes, rather than biscuits, and

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

50 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L347/1.

51 *K Oy* (C-219/13) EU:C:2014:2207.

52 *Commission v France* (C-479/13) EU:C:2015:141; and *Commission v Luxembourg* (C-502/13) EU:C:2015:143.

53 Council Directive (EU) 2018/1713 of 6 November 2018 amending Directive 2006/112/EC as regards rates of value added tax applied to books, newspapers and periodicals [2018] OJ L286/20 (14 November 2018). For a review of the so-called e-books cases see F. Cannas, «Reduced Rates and the Digital Economy: The Treatment of (E-)Books Highlights Some Possible Inconsistencies of the EU VAT System» (2017) *EC Tax Review* 26(2), 96.

54 M. Kukawska and M. Machinski, «Polish landscape in the area of VAT rates for foodstuffs from the perspective of the neutrality principle» (2014) *World Journal of VAT/GST Law* 3(3), 201.

55 G. Morse, «*Proctor & Gamble UK v HMRC (Pringles Two)* – a very peculiar UK practice – the characterisation of food products for zero-rating» (2009) *British Tax Review* 59; and I. Roxan, «Interpreting exceptional VAT legislation: or, are there principles in Pringles?» (2010) *British Tax Review* 699.

56 *United Biscuits (UK) Ltd (No. 2) v CC&E* [1991] BVC 818 (LON/91/160).

should therefore be zero-rated.<sup>57</sup> The decision had a massive impact on the food industry in the UK. Not only did it give rise to significant and ever more complex follow-up litigation,<sup>58</sup> but the criterion established by the Tribunal in that case –based on the consistency of the product once it becomes stale–remains to the present day the one applicable to distinguish zero-rated cakes (which harden when stale) from estándar-rated biscuits (which soften when stale). Many other everyday food products have been the subject of court cases in the UK to determine their VAT treatment, such as Marks & Spencer teacakes,<sup>59</sup> or Pringles.<sup>60</sup>

In addition to qualification and interpretative problems, multiple-rates systems give rise to planning, avoidance, and fraud opportunities; generally, the greater the number of VAT rates, the lower the degree of compliance.<sup>61</sup> Indeed, litigation indicates that VAT avoidance is often linked to exclusions from the base: of all the VAT avoidance cases decided by the CJEU in the last 20 years, for example, only two did not concern either reduced rates, or exemptions.<sup>62</sup> A paradigmatic example of the opportunities created by the application of reduced rates is the existing, and ongoing, litigation regarding composite supplies. The debate has two inter-related dimensions: the first concerns a qualification problem, namely how to treat a single supply of products some of which are subject to reduced rates, whilst others are subject to estándar rates;<sup>63</sup> the second, however, is how and when should a supply with various components be regarded as single, and when should it be regarded as composite, and it is in this context that planning and avoidance can come into play, with either artificial merger, or artificial division of supplies.<sup>64</sup> In addition, certain types of VAT fraud are also linked to exclusions from the base, and would not be possible without those exclusions, such as misclassification of supplies,<sup>65</sup> or certain claims for non-refundable input VAT.<sup>66</sup>

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57 The court ruling has become one of the most famous tax cases in the UK outside tax law circles, even becoming the subject of a short documentary in 2006 entitled *Half Cake Half Biscuit*, see «The Great Jaffa Cake Debate, Food: Identity Crisis», *The Sunday Herald*, 26 March 2006.

58 M. Devereux and R. de la Feria, «VAT – Unjust Enrichment», *Tax Journal*, 12 May 2008, 13–15.

59 *Marks & Spencer plc v CC&E (No.5)* [2005] UKHL 53; [2005] STC 1254.

60 *Procter & Gamble UK v HMRC* [2008] EWHC 1558 (Ch); [2008] STC 2650. See Morse, above fn. 55.

61 A. Agha and J. Haughton, «Designing VAT Systems: Some Efficiency Considerations» (1996) *Review of Economics and Statistics* 78(2), 303. See also T. Buettner and K. Erbe, «Revenue and welfare effects of financial sector VAT exemption» (2014) *International Tax and Public Finance* 21(6), 1028.

62 *RAL (Channel Islands) Ltd v CC&E* (C-452/03) EU:C:2005:289; and *WebMindLicenses kft v Nemzeti Adó- és Vámhivatal Kiemelt Adó- és Vám Foigazgatóság* (C-419/14) EU:C:2015:832.

63 *Talacre Beach Caravan Sales Ltd v CC&E* (C-251/05) [2006] ECR I-6269; [2006] STC 1671. See also G. Morse, «Restricting the composite approach in VAT: primacy of zero-rating and other categorising legislation: *Talacre Beach Caravan Sales Ltd v CEC*» (2007) *British Tax Review* 17.

64 T. Boulangé and L. Van der Noot, «The CJEU Confirms that Composite Services Cannot be Artificially Split in order to Benefit from a Reduced VAT Rate» (2018) *Intertax* 46(5), 450; G. Morse, «Separate or Composite Supplies for VAT: Assessing the Level of Generality: *Dr. Beynon and Partners v Customs & Excise Commissioners*» (2005) *British Tax Review* 190; G. Morse, «Identifying supplies. Further reflections on third party and multiple supplies: *Debenhams Retail plc v CEC and College of Estate Management v CEC*» (2006) *British Tax Review* 54; and D. Ladds and M. Chowdry, «*Debenhams Retail plc v Commissioners of Customs and Excise*» (2004) *British Tax Review* 26.

65 A. Hopland and R. Ullmann, «Pushing the Wrong Buttons: VAT Evasion by Misclassification of Meal Consumption Type» (2020) *European Accounting Review* 29, 975.

66 This point is further developed in R. de la Feria and A. Schoeman, «Addressing VAT Fraud in Developing Countries: The Tax Policy-Administration Symbiosis» (2019) *Intertax* 47(11), 950.

The compliance and administrative costs of the above are clear. The difficulty establishing the VAT rate applicable to a determined supply, amplifies companies' compliance costs. In many cases, as acknowledged by the European Commission, the resort to external tax expert advice is unavoidable, creating significant additional financial burdens,<sup>67</sup> which for Small and Medium Enterprises (SMEs) will often be onerous. Similarly as regards administrative costs: both classification and interpretative difficulties, and combatting avoidance and fraud are an unnecessary imposition. Combatting aggressive planning also gives rise to extremely significant administrative costs, as demonstrated by the levels of litigation.

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

### 3. Evolution of VAT Base in Europe

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Within Europe, the use of reduced rates dates back to the introduction of VAT itself in 1967. Although evidence regarding potential negative consequences of applying multiple rates may have been unavailable at that time,<sup>68</sup> difficulties soon became apparent. Accordingly, since the late 1980s, there have been several attempts to amend European rates rules, under the political guidance and legislative initiative of the European Commission. Yet, there has been unwavering resistance by EU Member States to any proposed amendments that might lead to a broadening of the VAT base. On the contrary, the most recent agreed upon amendments to the rates rules have narrowed the VAT base, with more goods and services being subject to reduced rates in Europe today than was the case even 15 years ago. Despite the impact of the financial crisis on the use of reduced rates of VAT, by 2011 the share of reduced rate goods and services was still on average 26 per cent, ranging from a few percentage points in Bulgaria,

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<sup>67</sup> Commission of the European Communities, *Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax* (Brussels: 23 July 2003, COM(2003) 397 final), para.42. As G. de Witt rightly points out «a complicated VAT system is good for lawyers and other advisers, but is bad for business»: G. de Witt, «The European VAT Experience» (1995) *Tax Notes International* 10(2), 49, 49.

<sup>68</sup> As discussed in de la Feria and Krever, above fn.8.

Denmark and Romania, to more than 40 per cent of total consumption in Greece, Poland, Portugal, and Spain.<sup>69</sup>

### 3.1. Failed efforts to broaden the EU VAT base

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The system put in place under the First and Second VAT Directives established only a basic framework,<sup>70</sup> leaving full autonomy to Member States in so far as rates were concerned. Reportedly for political and practical reasons, Member States used that freedom to largely mimic the multiple-rates structures applied under their previous turnover taxes.<sup>71</sup> With the approval of the Sixth VAT Directive in 1977, there was a significant increase in the level of detail regarding the tax base, and a decrease in the level of freedom granted to Member States.<sup>72</sup> Yet, despite the progress achieved in some areas of the system, as regards other areas such as the rates structure, reportedly the EC Council of Ministers found it impossible to reach agreement, and consequently further harmonisation was postponed to a later date.<sup>73</sup>

In 1987 the European Commission put forward a proposal for a new VAT rate structure.<sup>74</sup> This new structure was based on three basic principles: implementation of a dual-rate system, as opposed to a multiple-rates system; use of reduced rates limited to six categories of goods and services; and repeal of all temporary derogations, allowing Member States to apply reduced rates, where those rates had been in place before 1976.<sup>75</sup> The proposal was widely regarded as too ambitious,<sup>76</sup> and by 1989, the Commission recognised that certain aspects were curtailing the possibility of reaching agreement. In 1991, the Council finally rea-

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69 F. Borselli, et al., «Patterns of Reduced VAT Rates in the European Union» (2012) *International VAT Monitor* 1, 13.

70 First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes [1967] OJ L67/1301 (14 April 1967); and Second Council Directive 67/228/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes – Structure and procedures for application of the common system of value added tax [1967] OJ L67/1303 (14 April 1967).

71 de la Feria and Krever, above fn.8. See also S. Cnossen, «What Rate Structure for a Value-Added Tax?» (1982) *National Tax Journal* 35(2), 205, 209; and V. Lenoir, «April 1954-April 2004 – VAT Exemptions: The Original Misunderstanding» (2004) *European Taxation* 44(10), 456, 456–457.

72 Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes—Common system of value added tax: uniform basis of assessment [1977] OJ L145/1 (13 June 1977).

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

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

75 European Commission, *Completion of the Internal Market: approximation of indirect tax structures and harmonisation of indirect tax structure*, Global Communication from the Commission (5 August 1987, COM(87) 320 final).

76 A.J. Easson, «The Elimination of Fiscal Frontiers» in R. Bieber, et al. (eds), 1992: *One European Market? A Critical Analysis of the Commission's Internal Market Strategy* (Baden-Baden: Nomos Verlagsgesellschaft, 1988), 241–260, 260.

ched agreement on the essential characteristics of a new VAT rate structure,<sup>77</sup> which, not only differed significantly from the Commission's original 1987 proposal, but also differed from the alternative rates structure proposed by the Commission in 1989. The new VAT rate structure, which would apply from 1993 onwards, was largely a product of political compromises. The price for reaching agreement was not only an extremely complex system, but also one that was filled with exceptions and derogations.

Whilst temporary measures on VAT rates described above were supposed to be in place for a period of only four years after 1993, the Commission was unable to fulfil this time plan and it was not until the summer of 1996 that a work programme was presented for the adoption of the new VAT rules regarding the base.<sup>78</sup> Ultimately, this new attempt was also doomed to fail. The first setback came very soon after the presentation of the 1996 programme, as Member States failed to reach total agreement on the already tabled proposal regarding the establishment of a fixed band for estándar rates of VAT. Although the proposal was eventually approved, the final text contained no reference to the maximum level of estándar rate.<sup>79</sup> Unknown at the time, this was to be the last significant EU attempt to broaden the VAT base.

Over the years, it was always clear that Member States' resistance to VAT-broadening measures was inextricably linked to political constraints. One of the most paradigmatic examples of these constraints, which has acquired near mythical *status* within European circles, is the Irish Budget of 1982.<sup>80</sup> In 1981, faced with a struggling Irish economy, the then Irish Minister for Finance, presented a range of tax reform measures aimed at dealing with the fiscal deficit. The measures included various VAT base-broadening measures, which would result in the application of the estándar rate of VAT to several products that until then had been subject to the zero rate, such as children's shoes. Although the Budget included pay-back to lower-income families, so as to limit the potential regressive impact of the measures, they immediately became the target of powerful controversy. Emotional political discussions were held on prime-time national TV, focussing primarily on the effect of the rate change on lower-income families.<sup>81</sup> Dependent on independent members of the Irish Parliament to get the Budget passed, the Coalition Government of the time failed to get its Budget passed. The defeat of the Government over the Budget made a general

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77 Council Directive 92/77/EEC of 19 October 1992 supplementing the common system of value added tax and amending Directive 77/388/EEC (approximation of VAT rates) [1992] OJ L316/1 (31 October 1992), known as the «Approximation of VAT Rates Directive».

78 European Commission, *A common system of VAT – A programme for the Single Market* (Brussels: 22 July 1996, COM(96) 328 final).

79 Council Directive 96/95/EC of 20 December 1996 amending, with regard to the level of the estándar rate of value added tax, Directive 77/388/EEC on the common system of value added tax [1996] OJ L338/89 (28 December 1996).

80 *Dail Eireann debate* (Wednesday 27 January 1982), Vol.332 No.2, Financial Resolutions, 1982 – Financial Statement, Budget, 1982, available at: <https://www.oireachtas.ie/en/debates/debate/dail/1982-01-27/22/> [Accessed 25 November 2020].

81 See *Today Tonight – Budget 1982*, broadcast on RTE Television on 27 January 1982, available at: <https://www.rte.ie/archives/> [Accessed 15 November 2020].

election unavoidable,<sup>82</sup> giving victory to the main opposition party.<sup>83</sup> Although the Irish General Election of 1982 was said to be brought about by «a unique set of circumstances»,<sup>84</sup> the popular view, which has survived the *test* of time, was that the Government's fall was largely attributable to the VAT base-broadening changes, and particularly the imposition of a estándar rate of VAT on children's shoes.<sup>85</sup>

### 3.2. Narrowing the EU VAT base

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Since the approval of the Approximation of VAT Rates Directive,<sup>86</sup> VAT rates, far from converging as might have been expected,<sup>87</sup> can diverge much more than under the legal framework set up in 1992. As reported by the European Commission in 2001, despite its tentative efforts to increase convergence, «when current rates are compared with those applicable in 1997, it is apparent that rates continue to vary considerably».<sup>88</sup> The first post-1992 narrowing of the Europe VAT base started in 1999, in the context of the so-called labour-intensive services experiment.<sup>89</sup>

The experiment allowed the application of reduced rates to certain labour-intensive services, such as hairdressing and window cleaning, with the aim of testing its impact on job creation and to combat informality.<sup>90</sup> Initially intended to last for three years, the experiment was consecutively extended,<sup>91</sup> until it became permanent. In 2008, the European Commission put forward a new legislative proposal, which had two objectives, both allowing for narrowing of the VAT base: to make the possibility of applying reduced rates to certain labour-inten-

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82 See *Election '82*, broadcast on RTE Radio on 27 January 1982, available at: <https://www.rte.ie/archives/> [Accessed 15 November 2020].

83 See *Today Tonight*, broadcast on RTE Television on 16 February 1982, available at: <https://www.rte.ie/archives/> [Accessed 15 November 2020].

84 See *Today Tonight*, broadcast on RTE Television on 16 February 1982, available at: <https://www.rte.ie/archives/> [Accessed 15 November 2020].

85 Something denied by the then Taoiseach (Head of Government) Garret Fitzgerald, see «How the myth over VAT on children's footwear still endures», *The Irish Times*, 9 September 2000.

86 Council Directive 92/77/EEC of 19 October 1992, above fn.77.

87 This was in fact the European Parliament's opinion, see European Parliament, «Options for a Definitive VAT System» (October 1995) *Working Paper, Economic Affairs Series*, E5, 87. See also P. Guiou and C. Bonnet, «Completion of the Internal Market and Indirect Taxation» (1987) *Journal of Common Market Studies* 25(3), 209, 215.

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

89 COM(2003) 309 final (2 June 2003), above fn.22; and Evaluation Report, above fn.15.

90 Council Directive 1999/85/EC of 22 October 1999 amending Directive 77/388/EEC as regards the possibility of applying on an experiment basis a reduced VAT rate on labour-intensive services [1999] OJ L277/34 (28 October 1999).

91 Council Directive 2002/92/EC of 3 December 2002 amending Directive 77/388/EEC to extend the facility allowing Member States to apply reduced rates of VAT to certain labour-intensive services [2002] OJ L331/27 (07 December 2002); Council Directive 2006/18/EC of 14 February 2006 amending Directive 77/388/EEC with regard to reduced rates of value added tax [2006] OJ L51/12 (22 February 2006); Council Directive 2004/15/EC of 10 February 2004 amending Directive 77/388/EEC to extend the facility allowing Member States to apply reduced rates of VAT to certain labour-intensive services [2004] OJ L52/61 (21 February 2004).

sive services permanent; and to allow Member States the freedom to apply reduced rates to «locally supplied services», such as restaurant services.<sup>92</sup> The proposal was approved not long after its presentation.<sup>93</sup>

Concurrent attempts by the European Commission during the same period to limit overall differentiation failed miserably. In 2003, the Commission presented a proposal with a view to «review and rationalise the use of reduced rates».<sup>94</sup> After years of discussions at the Council,<sup>95</sup> the proposal was finally approved in 2006 but at significant cost: the emphasis was no longer on rationalisation of reduced rates, or broadening of the base, but rather on the extension of the temporary rates provisions within the VAT Directive, as well as on the extension of the list of products to which reduced rates may apply. A legislative proposal that had been intended to broaden the VAT base had resulted in final legislation that had exactly the opposite effect of narrowing it.

By 2008, the level of VAT base erosion in Europe was therefore extensive. The financial and economic crisis of 2008–2009, however, provided Member States with an opportunity to—for a while at least—approach rate differentiation differently. Confronted with high budget deficits and limited (or negative) economic growth, whilst at the same time deprived of the possibility of currency devaluation and bound to a common interest rate, Member States turned to VAT. In line with research that indicates that tax reforms occur more frequently in periods of economic recession, and that VAT increases are amongst the most frequent measures,<sup>96</sup> between 2008 and 2014, a staggering 23 out of the 28 EU countries changed their VAT rate structures during this period. At the same time, only nine EU Member States broadened the base—and in only a few cases substantially so.<sup>97</sup> Interestingly, the few Member States where wider broadening

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

93 Council Directive 2009/47/EC of 5 May 2009 amending Directive 2006/112/EC as regards reduced rates of value added tax [2009] OJ L116/18 (9 May 2009).

94 European Commission, *Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax* (Brussels: 23 July 2003, COM(2003) 397 final).

95 The Council initiated its formal discussions in 2003, see *Preparation of Eurogroup and Council of Economics and Finance Ministers*, Luxembourg, 6-7 October 2003 (MEMO/03/191, 6 October 2003). However, the Council's initial discussions indicated that reaching Member States' agreement regarding this proposal might be difficult and lengthy (see *2530th Council Meeting – Economic and Financial Affairs – Luxembourg*, 7 October 2003 (C/03/274, Pres/03/274, 7 October 2003) and *Results of the Council of Economics and Finance Ministers, 25th November 2003 – financial services and taxation* (MEMO/03/241, 26 November 2003). During 2005 a substantial push was given to this proposal, leading to its final approval in 2006, see *Results of Council of Economic and Finance Ministers*, Brussels, 6-7 December 2004 (MEMO/04/289, 08 December 2004), and The Council of Economic and Finance Ministers, press release, *Results of the 2688th ECOFIN Meeting* (13678/05, Brussels: 8 November 2005), 21.

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

97 Details on these changes are provided in de la Feria, above fn.18.

measures were introduced were those, like Portugal and Greece, where a bailout had been agreed with the so-called troika—a group composed of the IMF, the European Commission, and the European Central Bank—and thus where VAT base-broadening measures were part of wider reforms agreed in the context of the bail-out agreements.<sup>98</sup>

Clearly keen to harness the political momentum,<sup>99</sup> the European Commission launched a public consultation in 2012 on the review of the EU legislation on VAT reduced rates.<sup>100</sup> Whilst the response to the consultation was not widely representative, most respondents were opposed to the abolition of the reduced rates and/or advocated their extension.<sup>101</sup> Soon after, the European Commission announced what can only be characterised as a monumental U-turn on VAT rates policy, by presenting a legislative proposal that would effectively open the door to further narrowing of Member States' VAT bases.<sup>102</sup> The reasons for such a surprising announcement were not immediately apparent, and there are numerous potential triggers.<sup>103</sup> However, the political context of this U-turn is particularly significant.<sup>104</sup>

As the effects of the financial crisis wore *off* various base-narrowing pressures mounted. First, some Member States started reversing the base-broadening measures that had been adopted in the period between 2009 and 2014.<sup>105</sup> Secondly, pressure intensified from other Member States to obtain derogations from EU rates rules, which would allow them to apply reduced rates of VAT to specific products. The final pressure, and arguably the last straw for the European Commission, concerned what became known as the «tampon tax».

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98 A. Krajewska, «Fiscal Policy in the EU Countries Most Affected by the Crisis: Greece, Ireland, Portugal, and Spain» (2014) *Comparative Economic Research* 17(3), 5, 13-25. As regards Portugal, see also de la Feria, above fn.18.

99 R. de la Feria, «The 2011 Communication on the Future of VAT: Harnessing the economic crisis for EU VAT reform» (2012) *British Tax Review* 119.

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

101 European Commission, *Review of Existing Legislation on VAT Reduced Rates, Summary Report of the Outcome of the Public Consultation* (8 October 2012-4 January 2013, taxud.c.1. (2013) 708070, 12 April 2013).

102 European Commission, *Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax* (Brussels: 18 January 2018, COM(2018) 20 final). On the details of the proposal see I. Lejeune and C. Herbain, «A revamped flexibility on VAT rates for Member States» (2018) *British Tax Review* 161; and H. Kogels, «The Sweet Dream of a Simple VAT Rate Structure» (2017) *EC Tax Review* 26(6), 290.

103 R. de la Feria, «The Definitive VAT System: Breaking with Transition» (2018) *EC Tax Review* 27(3), 122.

104 R. de la Feria and M. Schofield, «Towards an [Unlawful] Modernized EU VAT Rate Policy» (2017) *EC Tax Review* 26(2), 89.

105 VATlive, *Portugal restaurant VAT cut to 13%* (1 July 2016). See also C. Teixeira, «Guia para perceber o que muda no IVA da restauração», *Visao*, 1 July 2016; and A. Pereira and R. Pereira, «A lower VAT rate on Electricity in Portugal: Towards a cleaner environment, better economic performance, and less inequality» (2018) *Energy Policy* 117(C), 1.

The political controversy surrounding the application of general consumption taxes to women's sanitary products did not start in Europe. There has been an ongoing debate in various countries, including Canada and the US, where pressure from constituents had already led to the decrease of the tax rate on those products in several states,<sup>106</sup> and Germany, where the rate has also been reduced with effect from January 2020.<sup>107</sup> The debate has been particularly consequential in the UK, however, where the debate dates back to the late 1990s,<sup>108</sup> but it intensified significantly in the period that preceded the UK Brexit Referendum in 2016.<sup>109</sup> The so-called tampon tax became one of the most highly politicised tax law issues of 2015, and three months before the Brexit Referendum, the UK Prime Minister, David Cameron, announced that he had secured agreement with his counterparts at the European Council to change the «far too inflexible» VAT system.<sup>110</sup> That same month, following an EU Council Ministers' meeting, it was reaffirmed that the European Commission would provide options for Member States to zero-rate sanitary products.<sup>111</sup> The timing of the announcement seems to indicate therefore that the UK tampon tax weighed heavily on the Commission's decision to reverse its traditional position on the VAT base—which is rather ironic given the result in the Brexit Referendum the following June.

#### 4. Conclusion

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The European experience demonstrate the strength of political resistance to single-rate, broad-base VATs, when reforming an existing tax system. Not only is it nearly impossible to broaden the base, but there is a constant and often systematic pressure to further narrow that base. The obvious questions that emerge then are: what determines these dynamics; and why is resistance to broad-based VATs so prevalent? This is the case even in countries that, like European countries, have strong tax administrations and welfare-targeting capacity, and despite strong evidence against the effectiveness of using reduced rates—or exemptions—to achieve social and distributional aims. As demonstrated above, and like other areas of the tax system where there is a gap between

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106 B. Crawford and C. Spivak, «Tampon Taxes, Discrimination, and Human Rights» (2017) *Wisconsin Law Review* 491.

107 N. Schmidt and S. McKenzie, «Tampons will no longer be taxed as luxury items, after landmark German vote», *CNN*, 8 November 2019.

108 Detailed analysis is provided in M. Schofield and R. de la Feria, «Finance Act 2016 Notes: Section 126: VAT: women's sanitary products» (2016) *British Tax Review* 611.

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

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

111 European Council, press release, *European Council conclusions*, 17-18 March 2016 (2016, press release 143/16).

efficiency and fairness perceptions, the answer can be found in the political constraints upon tax reforms generally,<sup>112</sup> and on general consumption taxes in particular. Yet, whilst there is widespread awareness of this reality generally,<sup>113</sup> there has been so far limited research or political interest in the political dynamics of consumption taxes. It is defended here that only by changing this approach can VAT systems start fulfilling their potential: ironically, and somewhat paradoxically, only by understanding these dynamics,<sup>114</sup> and by accepting that current VAT design is largely determined by them rather than by efficiency and equity considerations, will we be able to implement a VAT that is actually determined by efficiency and equity considerations.

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112 M. Castanheira, et al., «On the political economies of tax reforms: survey and empirical assessment» (2012) *International Tax and Public Finance* 19(4), 598.

113 OECD, above fn.5. It was even mentioned in former UK Prime Minister David Cameron's biography, D. Cameron, *For the Record* (William Collins, 2019).

114 Discussed in detail in R. de la Feria and M. Walpole, «The Impact of Public Perceptions on General Consumption Taxes» (2020) *British Tax Review* 67/5, 637-669.