

Sunak's instincts are right. The Government should avoid slashing VAT on domestic fuel.

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You can understand the political reflex. Typical household energy bills could rise by £700 or more when Ofgem revises the price cap in April. MPs want to offset this pain using the levers they have available. So, they ask: why not slash the five per cent VAT rate on domestic fuel to zero? This would meaningfully dent the coming price rise, perhaps by as much as £90 for a standard household bill. And it would be a clear “retail” offer to the affected voters.

Labour has made hay over the Conservatives becoming a “high tax party” after the national insurance rise. Demanding a cut to VAT on domestic fuel emboldens that critique. The political opportunity is more delicious for them when you remember the idea was promoted by Vote Leave before the referendum. Indeed, Conservative Brexiteer backbenchers have wanted targeted VAT cuts on tampons, domestic fuel, and more for years as tangible Brexit wins, given that as EU members we were restricted from expanding the list of zero-rated items.

Yet as so often with tax policy, opportune politics makes for bad economics. New freedoms to vary VAT rates for individual products are freedoms best left unused. But not, perhaps, for the reasons we commonly hear.

The standard critique is that cutting VAT on household gas and electricity is not the most “progressive” approach to alleviating this crisis. A lot of the financial benefit of a VAT cut, say the Resolution Foundation, will go to “the rich” or “those with big houses.” If a Brownite belief in financial progressivity is your lodestar for any tax or spending change, the conclusion is obvious: abandon this idea and deliver targeted spending relief instead.

This is the correct conclusion, but from the wrong reasoning. A domestic fuel VAT cut is indeed a poorly targeted way of delivering relief to those who might need it. But this sort of argument – that each and every tax change must itself be “progressive” – is, in general, a barrier to sensible, pro-efficiency tax reform and part of the problem for our convoluted tax code.

If you abolished all current VAT exemptions or favourable rates, lower income households would find themselves with relatively higher additional VAT burdens than those in richer households, because the latter spend proportionately more on fully rated items. But the VAT system overall would be more coherent and robust politically. Then you could use more targeted tax or spending programmes (such as raising the NI starting threshold or universal credit) to alleviate poverty, with money to spare.

That's the key point: not every single tax or spending decision has to be “progressive.” What matters is the net effects of all taxes and spending. Free-market conservatives used to understand that the primary purpose of a tax system was to raise revenue for government activities in the

least distortionary way for economic activity. Social objectives can always be delivered more targetedly on the spending side. Yet years of instead carving out the VAT base to the notional benefit of the poor has led us astray, even before new fresh attempts to eat further into the tax base.

As a result, our VAT base has more holes in it than a block of Swiss cheese in a cage of hungry mice. Sports activities, most betting facilities, and museums are exempt. Most food, books, children's clothes and newspapers are zero-rated. A lower rate of five per cent is set for energy, sanitary products and other items. These are huge carve outs: the Institute for Fiscal Studies has estimated that, if all such "tax subsidies" were abolished, the headline VAT rate could be lowered from 20 to 16.3 per cent for the same revenue. Most of these 'tax subsidies' have been introduced to avoid "food poverty," "fuel poverty," or "child poverty."

Weird anomalies result. Famously, gingerbread men can be taxed at the standard rate if decorated with chocolate, but at a zero rate with just two chocolate dots. Emma Rawson has highlighted how bicarbonate of soda sold as a baking ingredient gets zero rated, but the same stuff sold in larger tubs for cleaning is standard rated. But it's not just foodstuffs. Bruno Prior explains that "wood pellets used in a pellet stove are eligible for the 5% domestic-energy rate, but the same bag of wood pellets sold as horse bedding incurs the full 20%."

These quirks might seem funny, but they are economically costly. They create distortions throughout the economy, with decisions slanted towards goods' tax favourability rather than true market-driven demands. As Prior says, "for some reason, many horse owners use a lot of wood pellets for heating." All this before we even consider the administration and compliance costs, including the court cases about products that fall into definitional grey areas.

True, this is a second-order concern to our current problem. But zero-rating domestic fuel would further distort the broader economy too by, in effect, subsidising home gas and electricity further relative to other goods at a time when the Government has knowingly used other policies to hike energy bills for environmental objectives. Is the policy goal household bill stability or reducing the effects of climate change? Perhaps the Government could tell us how it thinks about any trade-offs between the two.

By all accounts, Chancellor Rishi Sunak is wary of this idea, and he is right to be. Cutting domestic fuel VAT this year will create demand for such a policy to be maintained or used again in the future. More worryingly, opening up the VAT system in this fresh, post-Brexit environment will lead to a whole raft of new demands for VAT-based industrial policies. Campaigns we've seen for domestic tourism, fish and chips, and in-person retailers to be granted special VAT treatment as opportunities of Brexit will be re-emboldened, despite the absence of any robust economic rationale for this favouritism.

Once implemented, such policies create interest groups that make them irreversible. In 2012, remember, the Coalition attempted a modest base-broadening through levying VAT on food in takeaways supplied above the 'ambient temperature.' The so-called "pasty tax" was subsequently rejected and deemed "unfair" after a backlash. As an even more salient issue, zero-rated domestic fuel would be difficult to reverse.

These two objections: the undermining of economic efficiency and the political precedent for all sorts of special pleading from both taxpayers and industries, unite to the same lesson. Don't use

targeted VAT cuts as tools for social policy. “Broaden the base, lower the rates,” was the old supply-side mantra about taxes. It’s still right. If the government must provide relief it should do so transparently and honestly through a one-off spending programme. Let’s not further winnow the VAT base.

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