Tax briefing note
Value added tax

June 2025

What is it?

Value added tax (VAT) is a tax on the purchase price of most goods and services.

VAT was introduced in 1973 to replace purchase tax; a 33.3 per cent tax on goods classed as 'luxury' which was introduced in 1940 to discourage waste. The standard rate was cut from 10 to 8 per cent in 1974 when a higher 25 per cent rate (on petrol and some consumer goods) was introduced. This was halved in 1974 and the two were merged into a single 15 per cent rate in 1979. It was raised to 17.5 per cent in 1991 and again to 20 per cent in 2011 after a temporary cut to 15 per cent between December 2008 and December 2009. An 8 per cent reduced rate (mainly on domestic energy) was introduced in 1994 and cut to 5 per cent in 1997.

Businesses (including the self-employed) must register if turnover of non-exempt sales exceeds the threshold (£90,000 in 2025-26). VAT paid on firms' purchases is deducted from VAT charged to customers.

What's the problem with it?

VAT operates much like income tax but with two key differences: it doesn't tax savings/investment, and lower (and zero) rates are applied to types of consumption rather than people's incomes. In the same way that income tax reduces the incentive to work, so too does VAT. People's 'real incomes' (incomes after adjusting for prices) are reduced by income tax and value added tax alike. It doesn't immediately matter whether we make people poorer by reducing their after-tax incomes or increasing the after-tax prices of the things they buy.

VAT's consumption tax base means that it is more economically efficient (or, more accurately, less inefficient) than income tax. But the different rates applied to different types of goods and services distort consumption patterns and create the opportunity for tax avoidance. The famous legal case to determine whether a Jaffa Cake is legally a chocolate-covered biscuit (subject to standard VAT) or a cake (zero-rated) is an example of the problem.

Compared to a sales tax (a tax levied on retailers' sales), VAT places a much greater administrative burden on businesses for two reasons. First, all businesses along a supply chain must levy the charge, not just retailers. Secondly, businesses need to monitor their purchases as well as sales to deduct the VAT they have paid from their bills. The upside is that the incentive for retailers to evade tax is reduced by the extent of deductions. This tradeoff is why economies with high consumption taxes tend to favour a VAT while those with lower ones have a sales tax.

What should be done?

1. No increases.
2. No rates rises.
3. No item reclassifications.
4. Reform must be substantial to be worthwhile and the whole package must be revenue reducing to be acceptable.