

Should the UK lower its VAT threshold?

By Ben Lockwood

In the UK, businesses are required to pay VAT if their annual turnover is over £85,000. In 2018, the Government considered lowering this threshold to increase tax revenue. This move could be welcome in the wake of the economic shocks of Brexit and the COVID-19 pandemic. But would such a policy stifle the growth of small businesses?



Most countries use the value-added tax (VAT) as their primary indirect tax. It is standard to set a minimum registration threshold, usually based on annual turnover, below which businesses do not need to register for VAT. In the EU, a large majority of countries currently have a registration threshold while a few require all businesses to register for VAT. The UK also sets a registration threshold – the highest in Europe – at £85,000.

Until recently, policy in the UK has been to raise the VAT threshold roughly in line with inflation. However, after Brexit the UK Government investigated the possibility of lowering the threshold in order to raise more tax revenue. Following an in-depth investigation into the current design of the threshold by the Office for Tax Simplification, in the November 2018 Budget the VAT threshold was frozen at £85,000 until April 2022.

This outcome reflects a compromise between the need to raise revenue following the negative economic shocks of Brexit (and now the COVID-19 pandemic) on the one hand, and a concern that some

businesses were purposely keeping their turnover below the £85,000 threshold in order to avoid becoming eligible for VAT registration on the other. Such turnover restriction, or ‘bunching’ as it is sometimes called, clearly constrains the growth of very small businesses – many of them micro-businesses with fewer than ten employees – and thus affects the dynamism of the economy.

In our work, we use rich administrative data on UK corporations to investigate these important issues. We begin by documenting two stylised facts in the data: bunching and voluntary registration. We find substantial bunching below the registration threshold. Our precise definition of bunching is that a firm ‘bunches’ when it restricts its reported turnover in its corporate income tax (CIT) return below the VAT threshold to avoid having to register for VAT.

Figure 1 shows the extent of bunching for all firms in the UK with turnover between £40,000 below and £100,000 above the turnover threshold between financial years 2004/05 and 2014/15, about 3.5 million firms. We normalise turnover by subtracting the threshold value

from the turnover value so that the threshold is located at zero in any year. The blue line shows the actual distribution of firms around the threshold, and for clarity, the orange line shows the *counterfactual* distribution that we would observe if there were no bunching.

This figure shows quite clearly that some firms at least, restrict their reported turnover to avoid crossing the VAT threshold.

Next, we ask the question: do all or most firms do this? Our second finding suggests that this is not the case. Specifically, in any given year, a significant number of firms are registered for VAT even though their turnover is *below* the threshold in the current year. On average, over our sample period, 43% of firms below the threshold are in this position. Possibly, part of this may be due to rules of registration. In the UK, a business must register for VAT if its taxable turnover is likely to go over the threshold in the next 30 days, or if its taxable turnover in the previous 12 months was above the threshold. So, for example, a firm may register on the basis of the previous year’s turnover, and then its turnover may fall below the threshold in the current year.

However, there is considerable persistence in registration below the threshold. This is evident in Figure 2, which shows what happens to firms initially registered and below the threshold during fiscal year 2004/05. Almost half are still registered three years later, and over one third are still registered five years later. So, it is likely that registration below the threshold is a conscious decision by firms, rather than just due to inability to forecast turnover one year in advance, or inertia. This is known as ‘voluntary registration’. On the face of it, voluntary registration is quite a surprising finding, given that the costs of registering for VAT, and filing VAT annual or quarterly returns, are not trivial for micro-businesses.

Given that there is evidence of both bunching and voluntary

Figure 1: Evidence of bunching by small firms

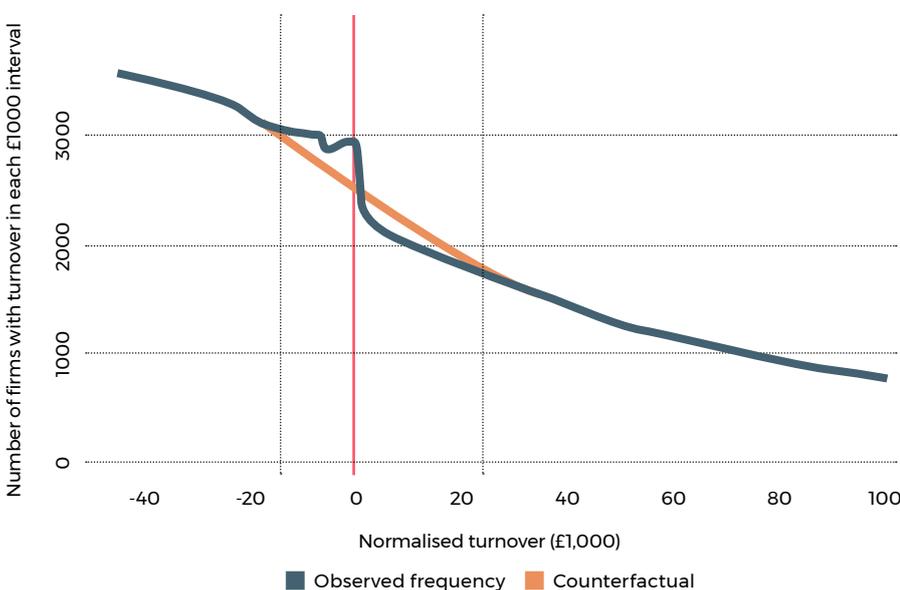
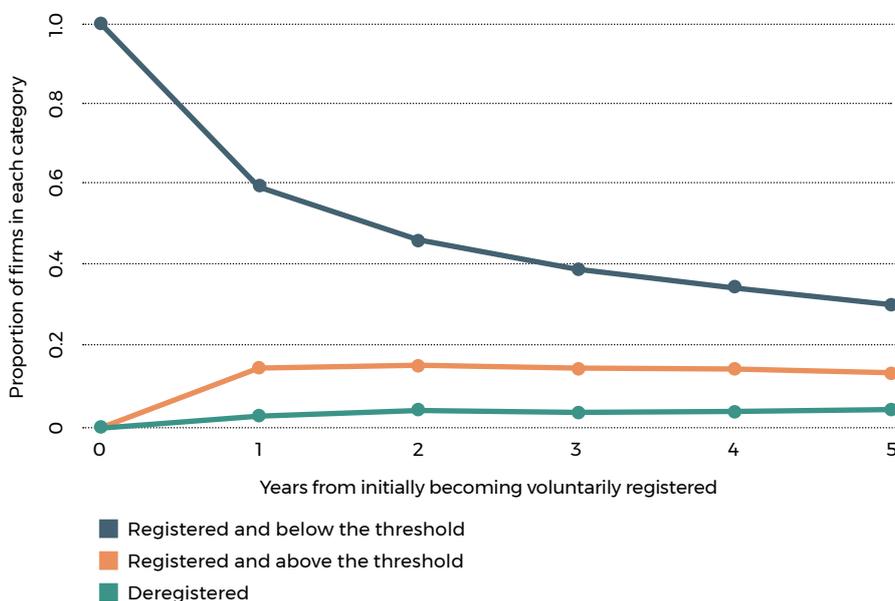


Figure 2: Evidence of voluntary registration by small firms



Around the threshold, firms are growing at an average rate of 8%, so the slowdown is quite substantial. However, statistical analysis shows also that on average, the acceleration after the threshold completely offsets the slowdown. We also find that the slowdown in growth for firms that are voluntarily registered below the threshold is much smaller, as we might expect. Finally, the same pattern of slowdown and acceleration is seen in the turnover of small businesses that are not incorporated i.e. sole traders. So, the policy take-away is that the threshold does not have any permanent effect on small firm growth, and there may be some scope for lowering the threshold in the UK. ◀

registration, one might then ask; why do some firms bunch, whereas other firms actually choose to register voluntarily, given the compliance costs of doing so? Basic economic analysis suggests three possible reasons. First, if the cost of inputs relative to sales is high, registration allows the small firm to claim back a considerable amount of input VAT. Second, business customers of a small firm can usually claim back any VAT charged, so a small firm that registers can pass on the burden of VAT charged on outputs to their customers in this case. Finally, if the market in which the small firm operates is less competitive, it is easier to pass on the burden of output VAT onto buyers even if they are final consumers, because prices are less likely to be undercut by other firms. In our empirical work, we find evidence that all three of these channels affect the probability of voluntary registration, and the amount of bunching, in the expected way.

Finally, we turn to the issue that is probably of most interest to the UK government: does the threshold affect small firm growth? In Figure 3, we plot the rate of growth of turnover against the distance of last year's turnover from the VAT threshold for that year.

We plot the average turnover growth rate of firms whose normalised lagged turnover (i.e. last year's turnover minus the threshold) is in a £1000 interval. We see that there is a noticeable slow-down in turnover growth as firms approach the threshold, and an equally noticeable catch-up when firms are about to pass the threshold. More formal statistical analysis shows that the slowdown in the growth rate is between 1 and 2 percentage points.

About the author

Ben Lockwood is Professor of Economics at the University of Warwick and a CAGE Associate.

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Figure 3: Evidence of slow-down in VAT growth as firms approach the VAT threshold

