



HM Treasury

# VAT and the Public Sector: Reform to VAT refund rules

---

August 2020



# VAT and the Public Sector: Reform to VAT refund rules

---



© Crown copyright 2020

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit [nationalarchives.gov.uk/doc/open-government-licence/version/3](https://nationalarchives.gov.uk/doc/open-government-licence/version/3).

Where we have identified any third party copyright information you will need to obtain permission from the copyright holders concerned.

This publication is available at: [www.gov.uk/official-documents](https://www.gov.uk/official-documents).

Any enquiries regarding this publication should be sent to us at [public.enquiries@hmtreasury.gov.uk](mailto:public.enquiries@hmtreasury.gov.uk)

ISBN 978-1-913635-62-6 PU 2996



# Contents

Executive summary		2
Chapter 1	Background	3
Chapter 2	Issues with the current rules	9
Chapter 3	Options for Reform	12
Chapter 4	Benefits and challenges to reform	14
Chapter 5	Delivering Change	21
Chapter 6	Conclusion	233

# Executive summary

Under current VAT rules, government departments, devolved administrations, the NHS and Highways England are eligible for VAT refunds under Section 41 of the UK VAT Act (1994) (Section 41).

Unlike commercial organisations, many public sector organisations do not carry out business activities and cannot, therefore, reclaim VAT incurred on the goods and services they buy. VAT is therefore a cost for departments and, in the absence of specific VAT refund rules, this must be funded through departmental budgets.

VAT could therefore act as a barrier to using more efficient and effective means of delivering a desired policy outcome. Section 41 was introduced to remove VAT from being a factor in decision making and enables the public sector to focus on making procurement choices that reflect true value for money for the Exchequer.

Work carried out internally within HM Treasury (HMT) and HMRC suggests that Section 41 in its current form is unduly complex, administratively burdensome and a barrier to effective financial planning.

The government is committed to improving the UK economy's productivity and to ensuring a robust and reliable tax system, capable of generating the revenue required to support our public services but also supporting economic activity. To achieve this, the tax system should be as simple and efficient as possible, creating the right incentives to deliver value for money and world class public services to the taxpayer. There is therefore a strong case to reform VAT refunds under Section 41.

HMT has internally reviewed several options for reform and is proposing to extend the scope of Section 41 to permit full refunds of the VAT incurred on all goods and services during the course of non-business activities for those organisations currently falling within the scope of Section 41 – this is the Full Refund Model.

Analysis suggests that reforming Section 41 to the Full Refund Model will improve tax neutrality in government procurement, encouraging policy delivery and procurement decisions which represent the genuine best value to the Exchequer.

The Full Refund Model is HMT's preferred option for reform to Section 41 at this stage, however the government is mindful of the complexity of implementing the reform, and welcomes views from any interested stakeholders on the timeline and impact of a reform and to better understand the issues described in this Policy Paper. For issues discussed in this Paper, we would appreciate views before 19 November 2020 to [HMTVATandExcisePolicy@hmtreasury.gov.uk](mailto:HMTVATandExcisePolicy@hmtreasury.gov.uk).

# Chapter 1

## Background

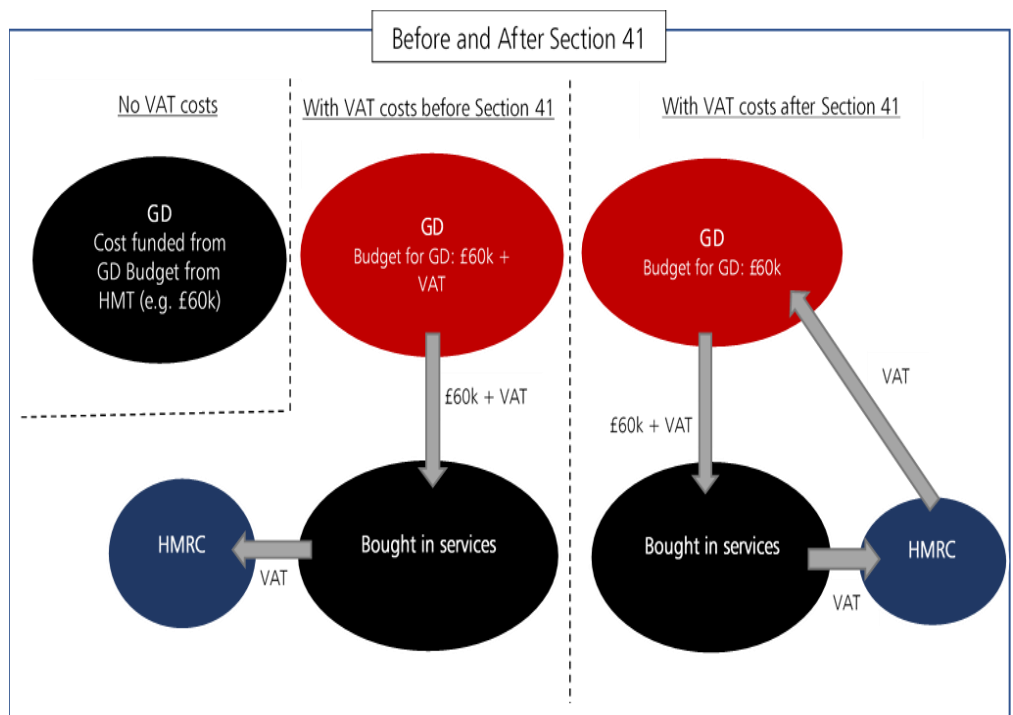
- 1.1 The government is committed to ensuring a robust and reliable tax system, capable of generating the revenue required to support our public services and supporting economic activity. Following the Office of Tax Simplification's (OTS) review of VAT, published in 2017, the government has continued to explore ways of simplifying the VAT system as much as possible for taxpayers. HMT is therefore exploring options for reform of Section 41.
- 1.2 This Policy Paper explores the issues affecting both private sector and public sector organisations in their interactions with Section 41 and set out the government's current position on the merits of a reform. HMT welcomes views on the merits and potential risks of this reform and strategy for implementation, to ensure that any reform is to the benefit of the public sector and the wider economy.
- 1.3 This Policy Paper is solely concerned with addressing the issues present within the Section 41 regime and therefore focusses only on those bodies currently within the scope of Section 41 and non-business activity.
- 1.4 There are no specific questions asked in this Policy Paper: the government is interested in any reactions or comments on this work. Where we are interested in a particular issue, the point is underlined in the below.

### Background to Section 41

- 1.5 VAT is a broad-based tax on consumption. VAT registered businesses collect the tax on the goods and services (supplies) that they make to consumers and may then recover the VAT that they have incurred during the course of making those supplies.
- 1.6 Public sector organisations, such as government departments and the NHS carry out public service functions and cannot reclaim VAT incurred on many goods and services they buy. VAT is therefore a cost for departments and, absent of specific VAT refund rules, this must be funded through departmental budgets.
- 1.7 While VAT costs for public sector bodies can be funded via departmental budgets, this extra cost and complexity can influence decisions on how public bodies operate and how public services are provided, in a way which VAT was never intended to do.



## Box 1.A: VAT and public bodies – before vs after section 41



- 1.8 As a result of this, in 1984 the government introduced Section 41,<sup>1</sup> a facilitation which allows government departments to recover VAT incurred on a limited list of services from HMRC. The aim of these rules is to prevent VAT from being a distortive factor in determining the provision of activities. It applies to government departments & their executive agencies; the NHS & its associated bodies and Highways England.
- 1.9 Without a VAT refund system, government departments would incur a VAT cost when sourcing external services, where they would not incur VAT if they performed those services internally. A VAT refund system ensures that VAT costs is not a disincentive for government departments to implement cost efficient activities and therefore save limited public resources.
- 1.10 Section 41 has been successful in removing VAT from many government procurement decisions; however, a number of issues have been identified with the current system. The government is committed to ensuring that the tax system is capable of meeting the needs of the modern economy and this review of the current system of VAT refunds aims to address these issues.

<sup>1</sup> Section 41(3) of the UK VAT Act, 1994 - <https://www.legislation.gov.uk/ukpga/1994/23/section/41>

## The scope of current rules

- 1.11 Goods and services supplied by a person who is, or is liable to be, registered for VAT are within the scope of VAT if carried out in return for consideration (an exchange of a supply for financial recompense) and by way of business. However, many supplies made by bodies which form a part of the public administration are removed from the scope of VAT provided that this outcome does not significantly distort competition.
- 1.12 Most of the activities of government departments are outside the scope of VAT, either because they are not carried out by way of business or are outside the scope of VAT as they are statutory in nature. Many of the activities of NHS bodies are also outside the scope of VAT because these bodies are publicly funded to provide free healthcare to the nation.
- 1.13 Section 41 only applies in these instances of non-business activity. Where the public sector is conducting business activity, it is treated as a business for VAT purposes in line with wider UK VAT principles. The treatment of VAT on purchases in this instance is determined under normal VAT recovery rules. Government departments may carry out some business activity, however this Paper does not comment on the classification between non-business and business activities and notes that in some instances this treatment can be complex to determine. As Section 41 applies only to non-business activities, this minimises competitive distortions with the private sector.
- 1.14 Section 41 therefore applies to certain public bodies, such as those listed below. Throughout this report, the following bodies may be referred to as central government organisations or government departments.
- UK government departments;
  - NHS England & its bodies;
  - Scottish Government;
  - NHS Scotland & its bodies;
  - Welsh Government;
  - NHS Wales & its bodies;
  - UK Parliament;
  - Health and Social Care in Northern Ireland (HSCNI) & its bodies;
  - Highways England
  - Some Crown Non-Departmental Public Bodies (NDPBs), for example the Advisory, Conciliation and Arbitration Service (ACAS).
- 1.15 The current VAT refund rules are administered through a list of Contracted Out Services (COS) headings which outline the services for which government departments may claim a refund on the VAT that they have

incurred.<sup>2</sup> The COS headings are outlined in an HM Treasury Direction and further detail is provided in HMRC manuals.

- 1.16 Whilst there may be other complexities for public sector bodies within the VAT system, this Policy Paper is focused on a reform to VAT rules and VAT accounting which will address existing complexities for those bodies already falling into the scope of Section 41.
- 1.17 UK VAT law is restricted by subsidy controls and competition law principles and these considerations are explored further in this Paper.

## Northern Ireland Executive and Local Authorities

- 1.18 Since the introduction of VAT, local authorities and certain other bodies have been able to recover the equivalent of the VAT incurred on purchases made to support their non-business activities. They can also recover VAT incurred on purchases relating to any exempt supplies they make, provided that the amounts involved are insignificant in relation to the total VAT incurred.<sup>3</sup> This was introduced to ensure that VAT costs are not funded through local taxation.
- 1.19 There is a broadly similar scheme for the Northern Ireland Executive, recognising the significant role that the Northern Ireland Executive plays in the delivery of local services.<sup>4</sup>
- 1.20 These bodies are therefore not included within the scope of Section 41 or this Policy Paper.

## National and International Comparisons

- 1.21 In understanding potential reforms, it is also important to note that, the reform proposed in this Policy Paper (the Full Refund Model) will broadly align the government's treatment of VAT for central government with that of local authorities.
- 1.22 We have also looked at the experiences of countries such as Austria, Denmark, Finland, France, Netherlands, Portugal and Sweden, which maintain refund solutions similar to that of the UK. Some have limited these schemes to supplies from certain sectors. This targeted approach reduces some of the complexity in the tax system, however certain borderlines will remain.
- 1.23 All of these approaches have merit; however, the government is keen to simplify the UK's VAT system as much as possible and maximise the neutrality of the tax in government procurement.

## Government Accounting and Section 41

- 1.24 Tax liabilities incurred by government departments are funded through departmental budgets. As described above, this is also the case for VAT paid

---

<sup>2</sup> HMRC manual on COS Headings - <https://www.gov.uk/hmrc-internal-manuals/vat-Government-and-public-bodies/vatgpb9700>

<sup>3</sup> Section 33 UK VAT Act, 1994 - <https://www.legislation.gov.uk/ukpga/1994/23/section/33>

<sup>4</sup> Section 99 UK VAT Act, 1994 - <https://www.legislation.gov.uk/ukpga/1994/23/section/99>

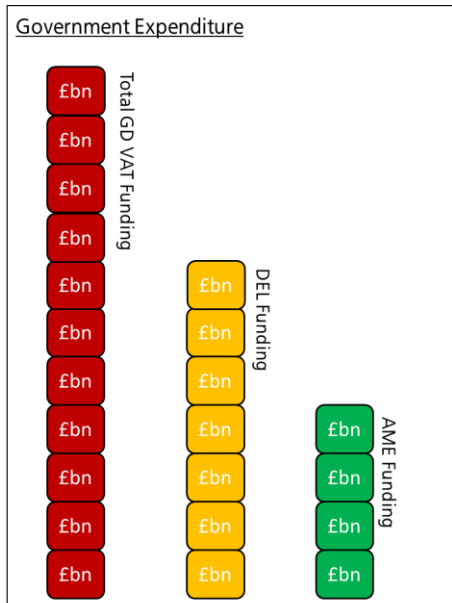
by government departments on purchases and these VAT costs are funded alongside other costs through Departmental Expenditure Limits (DEL).

- 1.25 DEL is the government budget that is allocated by HMT to, and spent by, government departments and other government organisations. This amount, and how it is split between government departments, is set by HMT as part of the Spending Review/Spending Round process. DEL will cover many of the VAT bearing costs that government departments incur, including the running of services to oversee schools or hospitals, IT projects and staff resources.
- 1.26 VAT refunds are not funded through DEL, since this VAT is not a cost to the spending department, and it may recover the VAT on eligible Contracted Out Services from HMRC through their VAT return.
- 1.27 In order to reflect the fact that some VAT costs for government departments are funded via refund mechanisms, VAT refunds are accounted for through Annually Managed Expenditure (AME). AME is typically demand-led (e.g. welfare, tax credits or public sector pensions) and it is spent on items that are not directly controlled by HMT or government departments.<sup>5</sup>
- 1.28 With respect to government tax receipts, the collection of VAT from VAT registered suppliers to government departments is netted off against the VAT refunds that HMRC pays to government departments under Section 41. Although VAT refunds lower the VAT receipts collected by HMRC, they also constitute VAT receipts received by the government department and are therefore accounted for as part of government VAT receipts. VAT refunds are therefore neutral from the perspective of total government VAT receipts.
- 1.29 On this basis, any change to VAT refund rules for government departments will automatically affect AME. If any reform to these rules is to be fiscally neutral it will have to be combined with a corresponding adjustment in DEL funding since government departments will be required to either fund greater or smaller VAT liabilities through their DEL budgets.

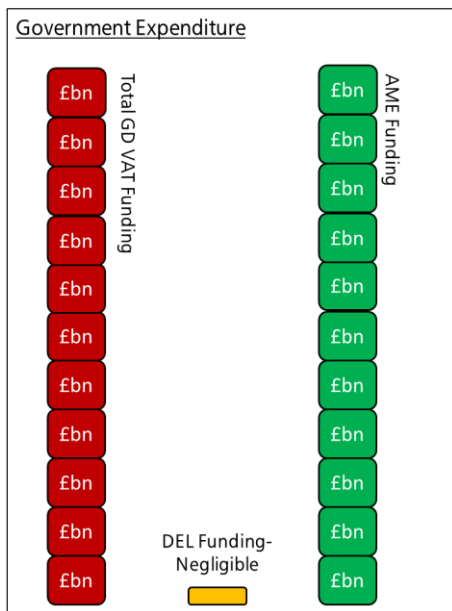
---

<sup>5</sup> Further information on the government accounts can be found here: <https://www.gov.uk/government/publications/how-to-understand-public-sector-spending>

### Box 1.B: Government expenditure under current Section 41 rules



### Box 1.C: Government expenditure under fiscally neutral Full Refund Model



# Chapter 2

## Issues with the current rules

### History of Central Government VAT refunds: 1984-2019

- 2.1 The introduction of the Section 41 refund scheme came about as a result of a number of inquiries led by Sir Derek Rayner into the Civil Service. The inquiries recommended that public bodies outsource certain services that could be performed by third parties at a lower cost. The culmination of these long-term enquiries was the report *Improving Management in Government: the Next Steps* (1988). The first stages of implementation saw departments analyse their functions and identify areas where executive agencies could be created to carry out these functions more efficiently.
- 2.2 The fact that third party suppliers would have to charge the public bodies VAT was a disincentive to take this route, so the Contracting Out Services (COS) refund scheme was introduced in 1984 (Section 41).
- 2.3 Original COS headings were specific to departments, reflecting the very different structures and natures of individual departments. For example, department 'A' could only recover VAT incurred on the purchases of services specified in the headings allocated to it; department 'A' could not rely upon the headings allocated to department 'B'.
- 2.4 In the early 1990s this changed to a single list of headings which all departments and NHS bodies could use, reflecting how the reforms of the previous decade had led to departments working in more similar ways to each other than had previously been the case.
- 2.5 Since the 1990s the way government departments operate has continued to evolve. Formerly self-managed organisations with the majority of policy delivered in-house, departments have become far more multi-faceted, interacting more often with the private sector. New structures and working models have taken working practices a long way away from how departments originally operated, with the creation of cost sharing arrangements, captive subsidiaries and use of multiple suppliers. There have also been dramatic changes in technology, affecting what departments can do and how they can provide their public services and, therefore, the way in which they operate.
- 2.6 All this change has meant that Section 41, which was originally intended as a narrow refund scheme, has become less effective and the changing landscape means that the COS headings require greater interpretation. For example, in the 1984 Direction, the Ministry of Defence had 11 COS

headings against which they could claim. By 1992 this had increased to 18. Other departments had similar growth, and now all departments have the potential to claim against 76 COS headings.

- 2.7 This evolution in the nature of government departments, the NHS and other bodies falling within the scope of Section 41, and the issues which have been identified above, have prompted the government to examine the scheme again. The options for reform set out in this Policy Paper aim to address these issues and deliver further benefits to public sector productivity.

## Current issues

- 2.8 The introduction of Section 41 has gone some way to facilitate government departments to deliver services that offer true value for money. It has also, however, introduced further complications and, in some cases, unfavourable incentives for government departments:
- 1 **Administrative burdens:** Section 41 is administered by HMRC through a list of services which are eligible for VAT recovery. The list is long and complex, and both HMRC and government departments require significant resource to deal with the administrative burden of interpreting the complex rules.
  - 2 **Productivity:** Government departments are unable to recover the VAT they have incurred on goods. The inability to recover this VAT creates an unwanted incentive to outsource services with significant goods costs. This may increase the number of inefficiencies in the system and improving this could yield benefits to public sector productivity.
  - 3 **Policy delivery:** The complexity of Section 41 may also interfere with policy implementation, including when central government forms partnerships and collaborates with local authorities, businesses and charities, who have different VAT treatments. This complexity may create financial uncertainty for both government departments and the Exchequer since it is difficult to predict the proportion of future VAT costs refundable under Section 41 and therefore the level of DEL funding required.
  - 4 **Legal disputes:** Government departments can be assessed by HMRC and find that they have substantial liabilities to pay, introducing uncertainty and making it difficult to plan for financial liability. This can lead to lengthy disputes with HMRC and create additional resource and financial pressures for project budgets.
  - 5 **National Crisis Response:** The COVID-19 pandemic has demonstrated the importance of flexible government and cross-Whitehall responses. This puts into sharp relief how Section 41 may interfere with the government's ability to react to the needs of individual public bodies, especially the NHS. Reforming the current rules would allow the government to respond more effectively to future problems by removing barriers to departments and the NHS working and collaborating more efficiently.

These issues are significant enough to consider a substantial reform to Section 41, rather than tackling issues on a piecemeal basis. The government has explored various options for reform and this Policy Paper explores these issues in more detail and a proposal to mitigate them. As noted in chapter 5, any reform would be

managed sensitively to not put undue stress on government departments, including the NHS, given the current ongoing pandemic response.



# Chapter 3

## Options for Reform

- 3.1 There are broadly two models for reform of VAT refunds for central government departments – allowing full VAT refunds and removing VAT refunds entirely. These are explored further below.
- 3.2 It is worth noting that an alternative to VAT refund or funding schemes is to enable suppliers to zero rate any supplies made to central government organisations. This would remove the VAT cost at source but would represent a significant departure from current VAT rules and principles. Businesses would have to identify the appropriate VAT treatment for the purchaser, rather than the good or service being sold itself.
- 3.3 A zero rate could also increase the administrative burden for businesses interacting with the public sector, including SMEs. On this basis, this option is not under consideration at this time.

### Remove VAT refunds

- 3.4 One option for reform would be to scrap the Section 41 regime in its entirety, requiring government departments to fund their VAT liabilities directly from their budgets.
- 3.5 In order for this reform to be fiscally neutral, departments would require an increase to their DEL budgets to offset their increased costs.
- 3.6 This would address much of the complexity encountered by tax professionals across government. As previously set out, the current rules are complex and burdensome – tax professionals within central government must spend time administering them and occasionally allocating budgets to seeking external advice. The removal of the central government VAT refund regime would dramatically simplify this, bringing the tax treatment of VAT in line with procedures for other taxes.
- 3.7 While this may be a favourable option in minimising administrative burden for government departments, it is undesirable to reintroduce a tax system which does not encourage government departments to pursue activities which are cost effective. Seeking cost effective options has become an important element of public sector delivery and decisions on the best method of policy delivery are for government departments to make. Removing VAT refunds completely could force governments to choose in-house provision even when it is less efficient and does not offer legitimate value for money.

- 3.8 The aim of any reform to Section 41 should be to address the substantive issues with the current system, not create new barriers to government procurement and delivery options.

## The Full Refund Model

- 3.9 As is set out earlier, the Full Refund Model extends the scope of Section 41 to permit full refunds of the VAT incurred on all goods and services incurred during the course of non-business activities for those organisations currently falling within the scope of Section 41.
- 3.10 This model avoids the risk of reintroducing the artificial disincentive for government departments to pursue activities which are cost effective, that would likely occur if Section 41 were to be scrapped entirely. This is a priority in any reform as it is crucial that a tax simplification does not create barriers to policy options delivering value for money for the taxpayer.
- 3.11 Furthermore, this model would significantly reduce extraneous administrative burden on HMT, HMRC and central government in the long-term. A simpler set of rules for government VAT refunds also diminishes the pressure on these organisations to seek external advice when engaging with the complexity of the system. This can come at a significant cost to the Exchequer and these funds may be better utilised elsewhere.
- 3.12 Reducing complexity in this area of the tax system is likely to not only benefit central government but also the businesses, charities, local government bodies and other organisations who interact with government. Simplifying the system should remove many of the complexities and discrepancies that occur when central government collaborates with these organisations in developing and delivery policies.
- 3.13 Permitting full refunds on all goods and services provides departments with greater financial certainty, improving their and HM Treasury's capacity to financially plan. The government is committed to improving the UK economy's performance on productivity and analysis suggests that offering full refunds to bodies within Section 41 improves tax neutrality in government procurement and policy delivery decision making, encouraging productive delivery which represents the genuine best value to the Exchequer.
- 3.14 The Full Refund Model is HM Treasury's preferred option for reform to Section 41 at this stage, following initial positive feedback from across government, however the government welcomes views from any interested stakeholders.
- 3.15 The following chapters explore the potential benefits and risks of this reform and tests the feasibility of implementing the Full Refund Model in a manageable and beneficial way.

# Chapter 4

## Benefits and challenges to reform

- 4.1 There are several areas where Section 41 can provide a benefit to central government. These benefits and challenges, and their interaction with the common current issues for Section 41, are outlined below.

### Administrative burdens

- 4.2 The government recognises that VAT can be a burden on businesses and aims to simplify the tax system where possible, ensuring the UK remains an attractive environment for enterprise.
- 4.3 At Autumn Statement 2016, the government commissioned the Office of Tax Simplification (OTS) to review the UK's VAT system and make recommendations on ways that it could be simplified. Since the OTS published its report in November 2017<sup>1</sup>, the government has continued to take forward the recommendations of the OTS in line with the Chancellor's response letter, published at Autumn Budget 2017.
- 4.4 One of the recommendations set out by the OTS was that:  
*'HMRC should look at ways of enhancing its support to other parts of government (for example in guidance) on VAT issues affecting their operations.'*
- 4.5 The government recognises that complexity in the VAT system has an impact on public sector organisations and that there is evidence that the current rules for VAT refunds is one source of this complexity. Officials have been taking forward this recommendation, however the government is keen to go further than set out by the OTS, simplifying the rules and reducing the pressures on other parts of government to need support on VAT issues.

### Administration for central government bodies

- 4.6 The landscape of government policy delivery has changed significantly since the introduction of Section 41 in 1984. It has also become apparent that the level of complexity, clearly present within the VAT refund regime, can create significant administrative burden for government departments. The long list of COS headings, which set out the services for which VAT may be refunded, is complex and contains various borderlines where there can be uncertainty whether a service is eligible for refunds.
- 4.7 While work is continually carried out by HMT, HMRC and government organisations (including the Tax Centre of Excellence) to ensure that the rules

---

<sup>1</sup> <https://www.gov.uk/government/publications/ots-report-on-routes-to-simplification-for-vat-is-published>

operate effectively, complexity still remains. It is also challenging to pre-empt future areas of complexity as a result of the rapid changes and advances that can be made in the service sectors.

- 4.8 It is possible that the complexity of the current rules may slow the process of implementing policies, as government departments must assess VAT rules when developing a business case and budget for a proposed policy.
- 4.9 This burden manifests itself in the time spent by tax experts in government departments to interpret the rules, changes that are made to them and their interaction with procurement practises and policies. Some stakeholders have suggested that external tax advice is required to understand the current rules. Whilst expertise of external advisors can be valuable to effective policy delivery and compliance with tax rules, simplifying the VAT refund rules could reduce costs for many government organisations. These funds may be better utilised elsewhere if tax rules can be simplified.
- 4.10 The time consuming and complex nature of decisions for government departments on VAT refunds can also lead to a significant number of errors. One government department can process millions of invoices during the course of the accounting year. These errors may be corrected internally, particularly where systems are automated, but may also be resolved later through HMRC's assessment regime.
- 4.11 In this context, significant resource is required from HMRC to support government departments in dealing with Section 41 and the issues that arise where errors have been made. Equally, differences in interpretation of Section 41 rules can result in disputes between HMRC and government departments.
- 4.12 A Full Refund Model could remove these complexities, to the benefit of the public sector, and allow government tax professionals to add value elsewhere in the government's activities. This may also expedite the process of building a business case for a policy option and reduce the pressures on the government departments to seek external advice.
- 4.13 These burdens suggest that a reform to Section 41 which results in a significant simplification, such as the Full Refund Model, would be desirable. We welcome the views of interested parties on the nature and scale of the administrative burden described, as well as the best way of minimising this.

## Administration for businesses

- 4.14 VAT is a tax that is collected by businesses in stages and paid to HMRC. The government is keen to ensure that it creates as little burden for businesses as possible and this includes rules for VAT refunds. Simplification of the tax rules for the public sector will likely have an impact on the businesses interacting with government departments, the NHS and Highways England.
- 4.15 The government is keen to ensure a robust and reliable tax system, capable of generating the revenue required to support our public services. But it is also important to ensure that it is a system which encourages and supports economic activity. This includes removing inefficiencies in the current system

and simplifying the interaction between the private and public sector where possible.

- 4.16 There is evidence that when negotiating contracts between the public and private sectors, detailed analysis of the VAT position must be taken by the department in building their business case. This can often involve the service provider, an unnecessary consideration for a business when supplying a normal consumer.
- 4.17 The OTS also identified instances, especially for grant funding, where:  
*'Frustration was expressed [by businesses tendering for public sector contracts or applying for grants] about a number of cases where the VAT position was unclear, or cases where an initial understanding of the position was challenged, with HMRC and government tendering departments having differing interpretations. Construction and infrastructure were two sectors mentioned to us as being particularly affected.'*
- 4.18 The Full Refund Model could remove this ambiguity on the refund position for departments, simplifying their relationship with those tendering for public sector contracts. The reform will not remove instances where there is a lack of clarity on whether a supply is taxable or if the behaviour of the department is business or non-business. However, reducing the burden on departments and businesses through Section 41 rules should free up resource to help address these other issues.
- 4.19 The recent report on growing the contribution of defence to UK prosperity by Philip Dunne MP<sup>2</sup> identified issues with the current system, in the context of approximately £1.5 billion in VAT refunded to the Ministry of Defence (MOD). As an illustration of the complexity, consultants employed to provide advice generate a refundable VAT liability, whereas consultants employed to design and implement a new vehicle trailer system generate an irrecoverable VAT liability for the department.
- 4.20 As the report summarised:  
*'All of this, especially the administration around Contracted Out Services, creates significant work and concern about the effective use of resources, the consequences of error corrections/penalties, with consequent delay and impact on prompt payment.'*
- 4.21 This burden could be resolved by the Full Refund Model, removing the need for businesses to alter their services to fit the categories of the COS Headings.
- 4.22 The government is also committed to avoiding trade distortions for smaller suppliers to win work in the public sector. Small businesses are the backbone of the UK economy, and play a key role in helping to build a strong, viable private sector that delivers value for taxpayers and jobs for millions all over the UK<sup>3</sup>.

---

<sup>2</sup> <https://www.gov.uk/government/publications/growing-the-contribution-of-defence-to-uk-prosperity-a-report-for-the-secretary-of-state-for-defence-by-philip-dunne-mp>

<sup>3</sup> <https://www.gov.uk/government/news/new-changes-to-encourage-small-businesses-to-apply-for-government-contracts>

- 4.23 The government currently spends approximately £5.6 billion directly with small businesses. There is, however, room for improvement and the government aims to achieve 33% of procurement spend through small businesses by 2022. Simplifying rules around VAT and procurement for government departments, the NHS and Highways England may make it easier for small businesses to interact with government and tender for contracts.
- 4.24 The Full Refund Model could help minimise the administrative burden of Section 41 for businesses as well as the public sector. The government welcomes the views of interested parties, particularly businesses interacting with central government on the impact of Section 41 rules and the merits of the proposed reform.

## Productivity

- 4.25 Raising the UK's public sector productivity is essential for maintaining control of public finances while meeting growing demands for world class public services.
- 4.26 With public services accounting for around 20% of the UK economy, public sector productivity plays an important role in the UK's productivity growth overall. Public sector productivity growth, however, has historically been poor. From 1997, when data started, to 2009, average annual growth in total public service productivity was negative 0.1%. From 2010 to 2017, the average annual growth rate was 0.7%. However, 2017 – the most recent year available – saw public sector productivity growth of just 0.3%.
- 4.27 Different rates of growth in public sector productivity have significant effects on public sector debt relative to GDP, according to modelling by the OBR. All other things being equal, a 1 percentage point increase in public sector productivity growth over 50 years would equate to a reduction in public sector net debt equivalent to 64 per cent of GDP.
- 4.28 Following a review by Sir Michael Barber, the government has introduced a new Public Value Framework, a tool that will be used by government to measure how effectively public spending delivers results that improve people's lives. At Spring Statement 2019, the government published a revised version of the Public Value Framework with a renewed focus on the outcomes achieved for the money invested in public services, with maximising public value being a key element of that.

## Section 41 and Productivity

- 4.29 As set out above, Section 41 was introduced to address the barrier to getting the best value for money in policy delivery that results when government departments are unable to recover VAT on outsourced services.
- 4.30 Section 41 provides funding, in the form of VAT refunds, to ensure that the cost born by the department reflects the true cost to the Exchequer. It aims to ensure that VAT is no longer a burden on the department, and they are free to pursue the service which provides genuine value for money.

- 4.31 With the growing complexity of these rules and the way in which government departments deliver and procure services, Section 41 has become extremely burdensome. Simplification and reduced distortion should remove inefficiency from the system, boosting productivity and freeing tax professionals and businesses to add value elsewhere within their projects.
- 4.32 It is crucial that any reform does not reintroduce poor incentives for departments by artificially inflating the cost of certain delivery options. Given that seeking cost effective options has become an important element of public sector procurement and delivery, this is one reason why the Full Refund Model appears the most favourable option – it retains the current benefits of Section 41 whilst achieving administrative simplification, and allows bodies the most flexibility in delivering services.

## Organisational structures for policy delivery

- 4.33 Section 41 may also create an incentive to restructure organisations to make VAT savings similar to those outlined above. For example, captive subsidiaries of government departments or NHS organisations may have a simpler VAT treatment than the parent organisations themselves and this may result in a VAT saving through Section 41. Given that these funds ultimately return to the Exchequer when businesses remit the tax to HMRC, VAT should not be the driver in deciding the type of government organisation or legal structure that should deliver or procure services.
- 4.34 There are often other drivers for this behaviour by departments, such as spreading their portfolio of risk or to better manage the delivery of different services. However, as with other procurement decisions, these decisions are most efficient if driven by substantive policy rationale and not to achieve lower VAT costs which are ultimately cost neutral to the government as a whole.
- 4.35 Providing refunds on all goods and services will not remove any of these structuring options from a department's toolkit, rather it will give them the freedom to choose the best option to suit their objectives.
- 4.36 HM Treasury welcomes the views of government departments and other stakeholders in whether the proposed reform to VAT refund rules provides the benefits to productivity and organisational structuring that are set out above.

## Policy Delivery

- 4.37 Section 41 rules can be burdensome for government departments, the NHS and Highways England. Many options for policy delivery have finely balanced cost-benefit analyses which can be affected by the VAT treatment of certain costs. This may mean that Section 41 creates delays to the delivery of policies while time is taken to establish the VAT treatment and build a business case.
- 4.38 Equally, the differing VAT treatments of local and central public sector organisations can itself prove to be a barrier to certain procurement decisions. For example, the differing VAT recovery rules of local authorities

and other public sector bodies can give rise to difficulties in deciding which body should incur various costs and deliver services. The local authority may recover the VAT that they have incurred through Section 33, whereas if the government department were to take on the cost, this could generate an irrecoverable VAT liability.

- 4.39 A Full Refund Model should address these issues, reducing ambiguity in the financing of procurement options and removing barriers to implementing policy delivery options which may be more effective.

## **Flexible Working across Government.**

- 4.40 Section 41 rules may hinder government departments in adjusting their policies and practices to provide necessary service to the public. This was evident during the COVID-19 crisis and the response to that crisis, in which public bodies, including the NHS, could not effectively manage resource and service between themselves without risking irrecoverable VAT costs.
- 4.41 Although the government has provided the NHS enough funding to cover the irrecoverable VAT that might have arisen from providing support to the public during the outbreak, this has added complexity and administrative burden.
- 4.42 The Full Refund Model would allow departments to provide services and purchase goods flexibly to and from each other without the burden of considering the VAT implications. This would ensure there are fewer tax consequences of their activities within their budgets and provide greater flexibility in the resources used for essential public services.

## **Financial Certainty**

- 4.43 The complexity of the current rules for VAT refunds can lead to errors being made or differences in interpretation between HMRC and departments. Not only does this manifestly increase the burden on both taxpayers and HMRC, but this can also create financial uncertainty for departments.
- 4.44 Government departments may spend years operating under the assumption that certain VAT liabilities will be refunded through Section 41 and then be assessed by HMRC and discover that this may not be the case. These occurrences can lead to substantial unforeseen costs for the department and can require additional funding from the Exchequer.
- 4.45 These circumstances can lead to disputes between HMRC appropriately fulfilling its role as the tax authority and a department aiming to deliver value for money on its objectives. This could be avoided by minimising ambiguity in the VAT refund system.
- 4.46 This financial uncertainty is also challenging for government departments and HMT when setting departmental budgets at Spending Reviews/Rounds. Given that there is a mixture of irrecoverable and refundable VAT costs borne



by a department, it can be difficult to predict in advance how much of this should be budgeted for through DEL.

- 4.47 Under the current rules, the DEL requirements of a government department to cover irrecoverable VAT costs are fluid and subject to change, dependent on procurement needs and wider policy decisions. The full refund model will minimise instances where departments find that they have unexpected costs from VAT and remove ambiguity for both departments and HM Treasury when setting DEL budgets at spending review.

## Legal Disputes

### Legal Disputes

- 4.48 Complexity in the tax system can create legal risks for taxpayers and HMRC and this is no different for public bodies. These organisations may be required to enter into contracts or arrangements where the VAT treatment is unclear or still to be bottomed out with HMRC and this can lead to future disputes. These disputes can be between two organisations within the government – HMRC and the relevant department.
- 4.49 With a system as complex as Section 41, the government is at risk of incurring legal and tax professional resource to work out disputes within the government. These disputes may well be resolved but more simple tax rules could negate the need for resolution in the first place.
- 4.50 The Full Refund Model should neutralise VAT in procurement and structuring decisions for government departments, allowing them to better assess legal risk reflecting true value for money for both the department and the Exchequer. The government welcome views as to whether this is an issue in the current system and whether the Full Refund Model will address this.

## Competition and Subsidy Control

- 4.51 A key aspect of ensuring that extension of VAT refunds to cover both goods and services is that it is limited to non-business activity. Where the public sector is engaging in business activity, allowing refunds on VAT incurred during the course of VAT exempt supplies would be economically distortive of competition. This is because businesses are also unable to recover input tax if it is incurred during the course of making supplies that are exempt from VAT or outside of the scope of VAT.
- 4.52 However, the government is keen to ensure that the UK remains an attractive place for business and enterprise and welcomes views on the implications of this reform for fair competition. As these reforms progress the government will ensure they are compliant with relevant rules on competition and subsidy controls.

# Chapter 5

## Delivering Change

- 5.1 There are several benefits to reforming Section 41 and expanding to scope of the goods and services on which central government can claim VAT refunds. HMT's early interactions with other government departments has been positive on this change but many organisations have cited that implementation of a new refund system could create administrative challenges. These are explored further below.

### Fiscal considerations

- 5.2 Any reform to Section 41 that results in increases in VAT refunds to government departments will lead to an increase in AME spending across government. For the Full Refund Model reform to be fiscally neutral, DEL will need to be reduced in order to account for the reduced VAT costs for government departments. The government is committed to ensuring that a reform will not negatively impact the delivery of public services across the UK and a robust approach will be taken to quantitatively and qualitatively ensuring that any reform reflects existing budgets as accurately as possible. It is very important that the budget adjustments required for Section 41 reform are accurate and the review of Section 41 should focus on this.
- 5.3 Analysis suggests that departmental irrecoverable VAT costs total £10-15 billion, however these estimates are highly uncertain as data is not currently readily available.
- 5.4 HMT has begun the process of internally gathering the data necessary to establish the impact of a reform and the scale of any budget adjustment required. HM Treasury will provide further information on this process in due course.

### Devolution

- 5.5 If the Full Refund Model is implemented, an adjustment to the Scottish and Welsh Government's DEL block grants would take place. There will also be a corresponding increase in their VAT refunds. [HM Treasury therefore welcomes views from the Scottish Government and Welsh Government on how best to ensure this is fiscally neutral.](#)
- 5.6 The Northern Ireland Executive accounts for VAT under different rules to central government bodies in the rest of the UK<sup>1</sup> but HMT welcomes feedback from the Northern Ireland Executive on how to ensure that the VAT

---

<sup>1</sup> Section 99 UK VAT Act, 1994 - <https://www.legislation.gov.uk/ukpga/1994/23/section/99>

abatement within the Barnett formula is updated to ensure these reforms are fiscally neutral in Northern Ireland.

- 5.7 HMT will continue to engage with the devolved administrations to ensure that any reform is fiscally neutral and benefits the delivery of public services across the UK.

## Timeline for implementation

- 5.8 HMT is aware that accounting systems vary between organisations currently within the scope of Section 41 and recognises that the challenges of adapting to a reform in this area will also vary. Furthermore, government departments, like many private sector organisations, are already in the process of making changes to their systems in line with the government's making tax digital framework.
- 5.9 Early engagement has suggested that some favour a reform to take place quickly, i.e. within one fiscal event cycle, whereas some stakeholders favour reform over a longer timeframe. There are clear benefits to enacting a reform in a timely fashion, to minimise further complexity and address outstanding issues with the system, however care must be taken not create new burdens on departments. This may suggest that any reform should be implemented over two to three years with time built into the schedule to evaluate implementation.
- 5.10 For the same reasons there are advantages to implementing a reform for all bodies within Section 41 in one go rather than on an organisation by organisation basis. Indeed, if the Full Refund Model delivers simplicity and benefits to productivity then this may justify such a significant shift in VAT refund rules across government to avoid any unfairness between organisations within Section 41.
- 5.11 There are clear potential benefits to the Full Refund Model, however the government recognises that the initial adjustments to budgets and accounting systems will be the most challenging aspect of any reform.
- Moreover, we do not underestimate the significance of such fundamental changes for these bodies, and that this should not be undertaken at a time of great stress. Given the ongoing COVID-19 crisis and responses to the crisis, we would not look to implement any changes to the NHS, or related bodies, until the crisis eases. After that we would work with affected bodies on the timescale to minimise burdens on them.
- 5.12 The government welcomes views from all interested parties on appropriate timing and methodology for implementation. In particular, the government welcomes views on the impact a reform would have on existing accounting systems and contracts with external service providers, and any associated potential costs.

# Chapter 6

## Conclusion

- 6.1 The government is committed to improving the UK economy's performance on productivity and to ensuring a robust and reliable tax system, capable of generating the revenue required to support our public services, but also ensuring that it is a system which encourages and supports economic activity. To achieve this the tax system should be as simple and efficient as possible, creating the right incentives to deliver value for money and world class public services to the taxpayer
- 6.2 The current system for the administration of VAT for government departments, the NHS and Highways England may benefit in a reform to minimise issues with the current system.
- 6.3 Analysis suggests that reforming Section 41 to the Full Refund Model will improve tax neutrality in government procurement, encouraging productive delivery which represents the genuine best value to the Exchequer.
- 6.4 The Full Refund Model is HM Treasury's preferred option for reform to Section 41 at this stage, following initial positive feedback from across government, however the government is mindful of the complexity of implementing the reform and welcomes views from any interested stakeholders.
- 6.5 The government would welcome views on the issues discussed in this Policy Paper. This is a long-term project and views are welcome at any time. For issues discussed in this Paper we would appreciate views before 19 November 2020 to [HMTVATandExcisePolicy@hmtreasury.gov.uk](mailto:HMTVATandExcisePolicy@hmtreasury.gov.uk)