Made on behalf of:	**Defendants**
Witness:	**MJ Cunningham**
Statement number:	**2**
Exhibits:	**MC19-MC30**
Dated:	**27 January 2021**

IN THE HIGH COURT OF JUSTICE **CLAIM NUMBER: CO/3995/2020**

QUEEN'S BENCH DIVISION

ADMINISTRATIVE COURT

BETWEEN

THE QUEEN

On the application of

(1) HEATHROW AIRPORT LIMITED

(2) GLOBAL BLUE (UK) LIMITED

(3) WDFG UK LIMITED

Claimants

-and-

(1) HM TREASURY

(2) THE COMMISSIONERS FOR

HER MAJESTY'S REVENUE AND CUSTOMS

Defendants

SECOND WITNESS STATEMENT OF MICHAEL JAMES CUNNINGHAM

I, Michael James Cunningham of Her Majesty's Treasury, WILL SAY as follows:-

1. I am employed as a Deputy Director at Her Majesty's Treasury (HMT), presently working at 1 Horse Guards Road, London, SW1A 2HQ.

2. I have been employed by HMT since September 2004 and have been working as a Deputy Director for the last 5 years. Before taking up my current role, I was a technical VAT policy lead, focussed on EU and international VAT issues. Prior to that, from March 1987, through to September 2004 I was employed by

Her Majesty's Customs and Excise (HMC&E), where I held posts mainly in the field of VAT.

3. This Witness Statement supplements the evidence already summitted relating to the Decision, including my previous Witness Statement (Cunningham 1). It is made in response to renewed grounds 3, 4, 6 and 7 which are due to be considered at a rolled-up hearing on 22-23 February 2021.

4. This Witness Statement also supplements the chronology given in Cunningham 1 and draws together strands from that and this Witness Statement relating to renewed grounds 3, 4, 6 and 7 and focuses on the evidence and analysis which were relevant to the Decision.

5. This Witness Statement has been prepared by e-mail and discussion. Except where I explain otherwise, the statements made in this Witness Statement are made from my own knowledge. Where that is not the case, I explain that they are made on information or belief and give the source of that information or belief.

6. I refer to the exhibits marked MC1 to MC18 which accompanied Cunningham 1 and to the exhibits marked MC19 to MC30 which accompany this Witness Statement.

The Government's approach to tax policy making and processes

7. For the benefit of the Court, it may be helpful if I explain that the evidence and analysis which were relevant to the Decision was brought together over a period of time, which includes evidence and analysis relevant to the 'no deal' policy announcement in September 2019 and that relevant to the 'post-transition period' policy announced in September 2020.

8. It might also be helpful if I distinguish between three different types of analysis of tax reliefs that I believe are in play in this case, to aid understanding of the various and iterative levels of analysis that was considered in reaching the Decision:
    a. The **Fiscal Cost** of each policy – which for this statement I use to mean the amount of VAT not charged as a result of providing a tax relief;

b. The **Exchequer Impact** – the impact of a change in policy on the public finances (i.e. the tax yield), with, for example, adjustments for possible behavioural response of consumers to the policy change;
c. The **Wider Economic Impact** – an assessment of how a policy change may affect the wider economy, for example indirect effects on other areas.

9. The key exhibits which cover the evidence and analysis which were used to support the Decision are:
    a. MC3 – evidence relevant to World Trade Organisation (WTO) compliance following the transition period;
    b. MC4 – Consultation Analysis Scoping Note;
    c. MC5 – Fiscal Cost of the VAT Retail Export Scheme (RES);
    d. MC7 – Fiscal Cost of the VAT RES and tax-free airside sales; and
    e. MC8 – MC12 – ministerial submissions with policy recommendations, alongside summaries of the costs and benefits of various options and Fiscal Costs, which went to the Chancellor.

10. The key analytical departments and organisations that fed into this analysis are:
    a. Her Majesty's Revenue and Customs (HMRC's) Knowledge, Analysis and Intelligence (KAI) team – KAI's primary purpose is to work with partners across HMRC, HMT and the Office for Budget Responsibility (OBR) to provide the relevant analysis to support tax policy.
    b. HMT and HMRC policy officials – the policy teams that conduct research, consultation exercises and synthesise evidence and analysis for ministerial advice.
    c. The OBR - the independent fiscal watchdog that reports to Parliament also produces analysis of particular policy options.

11. Tax policymaking is guided by "the new Budget timetable and the tax policy making process" 2017 policy paper, which builds on the 2010 paper, "Tax policy making: a new approach". These documents set out how the Government aims to make policy decisions in this area, which I exhibit as **MC19** and **MC20** respectively.

12. The Treasury Green Book and Better Regulation Framework do not apply to tax policy making. Tax policy is excluded from the definition of regulatory provisions which require, for example, an assessment of Wider Economic Impact to be conducted, as per this framework and as set out in sections 22 and 27 of the Small Business, Enterprise and Employment Act 2015. Instead, the Government publishes Tax Information and Impact Notes (TIINs). The TIIN provides an explanation of the policy objective and sets out in summary form the impacts relevant to each tax measure covered in a specific statutory instrument – including the Exchequer impact. The TIIN is normally published alongside the laying of the statutory instrument. There is also no statutory duty to publish a TIIN for each new tax measure. However, HMRC and HMT have made an undertaking to publish TIINs for all substantive tax policy changes. This process was followed in this case. The specific legislation (The Travellers' Allowances and Miscellaneous Provisions (EU Exit) Regulations 2020), and therefore the TIIN, included the withdrawal of the VAT RES and the extension of duty-free and personal allowances. Tax-free sales under the Extra Statutory Concession were withdrawn through a Revenue and Customs Briefing (21/2020: Withdrawal of the VAT Retail Export Scheme and the tax-free shopping concession) and thus were not accompanied by a TIIN.

13. The Government is committed to understanding the wide range of impacts and evidence bases associated with tax policy options to inform decision making, of which consultation exercises and TIINs are elements. The OBR is also a key part of that process as they independently review and publish information about tax policy decisions.

14. The OBR produce forecasts of the economy and public finances twice a year. The OBR scrutinise the Government's assessment of the Exchequer Impact of individual tax and welfare spending measures at each forecast (the costing being the term the OBR use to describe the exchequer, or public finance, impact). In the run up to each forecast, the Government provides the OBR with draft costings, accompanied by notes which explain the underpinning estimation method and the OBR subject these to detailed iterative scrutiny and challenge – for tax measures, the OBR commission KAI to produce these draft costings at an appropriate time before the forecast and then enter into the aforementioned iterative process of scrutiny. The OBR then state, alongside their Economic and Fiscal Outlook publication, whether they endorse the

costings as ‘reasonable and central’ estimates, and whether they have been incorporated into the OBR’s forecast, as explained in Cunningham 1 §84 [**B/669**]. Reasonable and central, although not strictly defined, is broadly taken to mean that the forecast is a reasonable estimate and no more likely to be wrong in either direction. The OBR also gives each costing an uncertainty rating, based on the data underpinning it, the complexity of the modelling involved and the possible behavioural impact of the policy. Usually, tax policy would be developed for announcement at a Budget and accompanied by an OBR forecast, referred to in Cunningham 1 §85 [**B/665**]. This would mean the Government would know what the OBR deem to be a ‘reasonable and central’ estimate of the exchequer impact *before* the tax policy is announced. The OBR also review how the forecast of the wider economy is likely to be affected by new policy measures in the round alongside all other policy measures, a process by which they capture the ‘indirect effects’ of policy (e.g. on inflation and Gross Domestic Product).

15. However, the process for the ‘Decision’ departed from this norm as the policy changes were not announced at a Budget or alongside an OBR forecast. Therefore, the Government was unable to know what OBR’s ‘reasonable and central’ view of the Exchequer Impact would have been before announcing the policy decision (stakeholders would also normally have been able to access this immediately after an announcement). Instead, the OBR-certified figures were necessarily published at a later date (25 November 2020) than would have ideally been the case. The OBR did not make any specific adjustments to their economy forecast as a result of the removal of the VAT RES and tax-free sales. This was against a wider backdrop of a substantial amount of policy support provided as a result of the effects of COVID-19.

16. The reason why the Decision was announced outside of the Budget process is as follows. Following the transition period, the UK’s VAT and excise rules would no longer be able to treat individuals carrying goods for personal use (passengers) to/from the EU, differently to those travelling to/from non-EU countries. This meant the Government had a deadline of 1 January 2021 to implement the policies contained within the Decision. The Government wanted to announce its decision as soon as was reasonably possible, to give businesses as much time as possible to prepare, as explained in Cunningham 1 §85 [**B/665**]. The Covid-19 pandemic also affected the usual fiscal event

cycle, with the Government focused on supporting individuals and businesses throughout this time.

17. Instead of being able to rely on the OBR's Exchequer Impact assessment, the Government conducted a range of analysis to a point where officials and ministers deemed this sufficiently robust and proportionate to finalise and announce the Decision on 11 September 2020.

'No deal' policy development

18. The consideration of a temporary continuation of the status quo for the VAT RES and tax-free sales under the Extra Statutory Concession in a 'no deal' scenario is referred to at Cunningham 1 §38 [**B/651**]. The related September 2019 announcement is described at Cunningham 1 §43 [**B/653**]. The continuation of the status quo in a 'no deal' scenario was considered a temporary measure. This was based on the very specific circumstances of a 'no deal' withdrawal from the EU, which would have resulted in a very limited amount of time to implement any of the 'passengers' policies. It would also have provided a short-term period for the determination of a longer-term policy, which the Government would consult on (referred to in Cunningham 1 §40 [**B/652**]). This was made clear in the announcement of the 'no deal' duty-free policy on 19 September 2019, which I exhibit as **MC21**. Although this announcement refers to 'duty-free' it was also in reference to tax-free policy as part of the 'passengers' policy package. Following that announcement, I attended some of the HMRC chaired meetings with industry stakeholders in which we clearly set out the temporary nature of the continuation of the status quo, pending a consultation on the longer-term policy.

19. A consultation on the long-term policy ran from 11 March to 20 May 2020 and is the subject of the claimants' complaint in this case. The situation at this time was different to the situation we faced in the 'no deal' scenario:
    a. The ratification of the Withdrawal Agreement and scope of ongoing negotiations with the EU had been set out by the Government in the Prime Minister's Written Ministerial Statement of 3 February 2020. That gave us certainty that the UK would be leaving the single market and customs union. Tax was also not to be included as an area for

consideration as part of the future Free Trade Agreement with the EU, except in the area of tax cooperation between the UK and EU tax authorities.

b. The clear lead in time and certain exit date of 1 January 2021 provided a timeframe to develop and implement policies in the transition period (which commenced on 1 February 2020 and ran through to 31 December 2020).

c. The consultation document, which set out the Government's proposed policy options, included the options to abolish the VAT RES and tax-free airside sales as WTO compliant alternatives to the 'status quo'.

20. Following the consultation, and based on the significant difference to the 'no deal' policy, as explained in §61 and §65c of Cunningham 1 [**B/659–60**], we reached the firm and final view in July 2020 that a temporary continuation of the status quo for the VAT RES and tax-free sales under the Extra Statutory Concession was not realistically possible following the end of the transition period.

Post-EU Withdrawal Agreement policy development

21. To assist with development of the long-term policy my team produced the December 2019 "scoping paper", referred to in Cunningham 1 §47 [**B/654**]. This was a summary of the key issues relevant to policy development, the policy questions we might want to research and a guide for the type of activities we might undertake, and is now exhibited as **MC22**. The key concerns following the close of the consultation were how to maintain compliance with WTO rules (the 'Most Favoured Nation' (MFN) principle) once the UK left the EU, and how to ensure revenue protection, compliance, passenger flow and operational viability, particularly of the VAT RES, at exit points. One issue was the extent to which KAI could assess the potential behavioural factors needed to build on the Fiscal Cost to produce wider analysis of the VAT RES as it currently operated and what it might be if it was extended to EU residents. Page 7 of the scoping paper posed a question about commissioning KAI to look at the trade-off between the loss of revenue from VAT RES claims and the potential gain in high street sales from the scheme.

22. KAI did not ultimately conduct the analysis as originally posed in the scoping paper. This was because, in my team's discussions with them, it became clear that the assumptions on which such an analysis would depend were too uncertain in this case to arrive at a 'precise' number for these impacts. I understand from my team's conversations with KAI that a significant difficulty was that any precise empirical estimates that are broader than the Fiscal Cost, including the effect on the high street, of the VAT RES or tax-free airside sales would be heavily dependent on key behavioural assumptions which were uncertain (e.g. on how it would affect purchasing decisions and someone's decision to visit the UK in the first place). Making these precise behavioural judgements, alongside the difficulty in obtaining, for example, granular sales data from retailers, was a key issue with conducting this kind of 'precise' estimate. However, my team had ongoing discussions with KAI from December 2019 onwards about potential ways to approach this issue and other analytical questions posed in the scoping paper.

23. In the event, KAI used a variety of data sources to initially assess the Fiscal Cost of the schemes, before the OBR forecast which would incorporate behavioural assumptions to assess the Exchequer Impact (which as explained at §14-15 was not until November 2020). KAI's analysis of the Fiscal Cost included analysis and discussion of the current cost and the impact of extending the schemes (MC5 [**B/1122**] and MC7 [**B/1143**]) – for example, KAI estimated the Fiscal Cost of the VAT RES using the total amount of VAT which refunded through the scheme, and the amount of VAT not charged to passengers travelling to non-EU countries for tax-free airside sales. This analysis also included analysis and discussion about the potential option of extending the schemes to EU residents, with uncertainties around passenger numbers and behaviours – as would be expected in any type of analysis such as this. MC5, which contained a section on the Fiscal Cost of extending the VAT RES to the EU, also included a discussion of the key behavioural factors that industry considered important (§44) and which would influence any estimate of the Exchequer Impact, subject to the limitations I have just explained. The Fiscal Cost of extending the schemes were presented to the Chancellor across the series of advices (MC8 – MC14).

Consultation development and policy development

24. Following my team's discussions with HMRC analysts in December 2019, and after considering our advice on a potential consultation (MC1 [**B/1084**] and MC2 [**B/1087**]), ministers gave a steer in January 2020 that they would like to explore the impacts of abolishing the VAT RES. Given the link between the two policies, officials produced a draft consultation document for ministerial approval to ask for evidence on, among other things, the benefits of the VAT RES and tax-free airside sales and the impacts of abolishing them, which would be useful in assessing the impacts of the options available to the Government.

25. Following the launch of the consultation and over the course of the consultation period, HMRC analysts and HMT research teams continued to gather valuable data to assist with this type of analysis. This included:
    a. KAI analysis and research in April 2020 on the total number and value of VAT RES refunds, which also demonstrated the total value of sales for which a VAT RES refund was received;
    b. ONS passenger numbers to the UK from both EU and non-EU countries;
    c. HMRC research and industry figures on regional use of the VAT RES;
    d. HMRC research in 2019 on the prevalence and type of fraud in the VAT RES;
    e. HMRC research conducted from September 2019 - July 2020 on administrative fees that were charged to VAT RES users;
    f. HMRC survey data from May 2020 of VAT RES user's perceptions, behaviours and decision making;
    g. analysis of the Fiscal Cost of the VAT RES and tax-free airside sales, using data on the level of VAT RES refunds and transactions which the Extra Statutory Concession applied to;
    h. analysis of the Fiscal Cost of extending both schemes to the EU; and
    i. analysis of consultation responses, which included industry views on the impacts of withdrawing the schemes.

26. This information was subsequently used to inform our underlying analysis of the various options following the close of the consultation, which is covered in further detail below. In short, while there was no formal statutory or policy requirement to conduct a Wider Economic Impact Assessment, or indeed an

Exchequer Impact assessment before a decision is made, we did seek to gather a substantial amount of analysis and amalgamate and summarise the analysis provided by industry, and those referred to in the responses. The costs and benefits which were derived from the analysis above were presented to the Chancellor (and other ministers) in summary form across the series of advice (MC8-MC14 [**B/1128–1202**]).

Consultation engagement and further policy development

27. To expand on Cunningham 1 §67 [**B/661**], which summarises the activities following the close of the consultation, HMT and HMRC officials worked collaboratively to summarise the consultation responses. Due to the number and the detail provided, the consultation responses were reviewed and summarised on an ongoing basis. This included the analysis and other data which respondents had submitted. This process took around 4 weeks to complete and I received updates on the progress of this work. The consultation responses were also used to inform the evidence of 19 June 2019 (see **MC3** [**B/1097**]) on retaining the VAT RES and airside tax-free sales 'as is' on 1 January 2021. Cunningham 1 §38 [**B/651**] summarises the main impacts of withdrawal that industry had provided, and detailed responses were replicated in §39 [**B/652**]. Following this collection of evidence, we came to the firm and final view in July 2020 that retaining the VAT RES and airside tax-free sales 'as is' on 1 January 2021 was not an option available to the Government (as it had been on a temporary basis if a 'no deal' scenario had materialised) because of WTO rules, as described in Cunningham 1.

28. It was clear from most of the responses from stakeholders with an interest in the VAT RES and tax-free airside sales that the overall industry views were very similar. These views were expressed as opinions but stakeholders did also relay analysis from third parties. This was also in line with the stakeholder engagement we held during the consultation period. For example:
    a. The VAT RES industry (retailers and refund providers) felt that the scheme incentivised tourism and contributed around £3.5 billion worth of sales to the economy. This was one of the most common figures cited and according to respondents was based on data obtained from Global Blue and other refund providers - KAI estimated in MC5 that the Fiscal Cost of the scheme (i.e. the amount of VAT refunded) was around £0.5

billion [**B/1125**], which would take sales made under the VAT RES to around £3 billion (including VAT later refunded), so there was some discrepancy here, which could be attributed to sales being made and registered with a refund provider/retailer but the refund never being made (for example as the customer did not present their goods at the border or they were not eligible etc). Stakeholders also felt that if the scheme were withdrawn visitors and sales would be displaced to EU countries – in effect predicting the £3.5 billion of sales, or a substantial proportion, would not occur without the VAT RES. There were also commonly cited concerns from most VAT RES stakeholders about the operation of the scheme, particularly that it was paper-based and so in need of reform.

b. For tax-free airside sales, airside retailers and airport operators viewed the concession as an incentive for airside purchases by passengers bound for non-EU destinations. Some stakeholders cited a March 2020 report (MC6 [**B/1133**]) which predicted that an extension to EU-bound passengers would bring £700m in 'net economic impacts' (referenced in §21 of MC4 [**B/1116**]). They felt that withdrawal would significantly reduce sales and have an adverse impact on the economy and retailers' ability to continue operating. Many responses reinforced the inconsistent application of the Extra Statutory Concession, with some retailers retaining the VAT relief, some offering 'dual pricing' dependent on customer destination and some using 'single pricing' for all customers (§§20-30 in MC4).

29. In terms of the analysis that stakeholders relayed from third parties – for example, the 2017 CEBR Report submitted by Global Blue and the March 2020 York Aviation Report submitted by UKTRF - officials read and noted the findings of the reports as part of the consultation analysis exercise. The headline findings were considered and formed part of the wider exercise of summarising the views and evidence that had been put forward in consultation responses. The 2017 CEBR and March 2020 York Aviation documents were not sent to the Chancellor. Generally speaking, these reports claimed to predict with some certainty the impacts of extending the VAT RES and tax-free airside sales. The reports presented the Wider Economic Impact of the schemes and relied on behavioural judgements and assumptions, which officials considered to be at the very upper end of the range for this type of analysis, and not what

the OBR would likely deem as ‘reasonable and central’. While stakeholders might refer to these reports as evidence of the benefits of extending the scheme, they are very clearly estimates and predictions and open to challenge. These reports also contained little discussion about the uncertainties in predicting behaviour or the impact of passenger/visitor numbers, as KAI’s initial analysis of the Fiscal Cost had done. My team also had conversations with KAI about the general findings in these reports, with the view taken that these types of analysis were significantly uncertain and the claimed outcomes very difficult to predict. As referenced in Cunningham 1 §68c [**B/662**], my team and KAI also held a meeting with the authors of the March 2020 York Aviation report to understand better the data used in their analysis of the Exchequer Impact of extending tax- and duty-free sales which formed part of their assessment of Wider Economic Impact. However, in short, we formed a different view to these reports on the behavioural assumptions and uncertainties that fed through into the claimed Wider Economic Impact of the schemes.

30. These views, and key parts of the analysis which were submitted by stakeholders, were subsequently used to formulate an ‘industry view’ of the costs and benefits of each scheme and the impacts of withdrawal. This was captured in the Analysis Scoping Note (MC4 [**B/1110**]), which subsequently informed advice to ministers (but was not itself sent to the Chancellor), as detailed in Cunningham 1 §68 - §70 [**B/662**]. Most responses were clearly in favour of extending the VAT RES and tax-free sales to EU visitors and those traveling to the EU respectively. These views and key parts of the evidence that was provided, were considered alongside other factors, which were also captured in a final draft of the Analysis Scoping Note on 13 July 2020.

31. Officials framed initial advice for the Chancellor (MC8 - an updated version of MC8 with some redactions removed is exhibited as **MC23**) around the main policy objectives for the ‘passengers’ policy package of:
    a. maintaining flow at the border;
    b. minimising the need for infrastructure changes;
    c. ensuring revenue protection and compliance; and
    d. ensuring compliance with WTO rules.

32. Officials also took account of the evolving pandemic and included the objective of potential support for retailers through the Covid-19 recovery (e.g. in MC8 §2

[**B/1149**]). We also factored in the 'internal assessment criteria' used in the Analysis Scoping Note (MC4), and the views submitted by stakeholders were also included in the ministerial advice.

33. Officials also took a view on the key pieces of analysis and information that were needed for the Chancellor to make a Decision on all of the policies contained within the 'passengers' package – including the VAT RES and tax-free airside sales. The Chancellor also engaged extensively with the series of advice (MC8 – MC14), challenging and testing the rationale and evidence we had provided (Cunningham 1 §71 [**B/664**]) judging for himself what information, analysis and evidence he needed to make the Decision.

The decision to withdraw tax-free 'airside' sales (Grounds 3 and 4)

34. The initial information to inform the decision on tax-free 'airside' sales was provided in the first submission to the Chancellor (MC8 [**B/1148**]), as summarised in Cunningham 1 §71 – 72 [**B/664**]. This initial high-level, concise advice conveyed what we as officials felt were the most important aspects of the analysis, evidence, consultation responses and policy issues. This included:
    a. Compliance with the WTO 'Most Favoured Nation' rules (one of the policy objectives), which would require the Government to treat all passengers equally following the end of the transition period. The options available were therefore to extend tax-free sales to all passengers and exit points or remove them completely (§1 of MC8 [**B/1149**]).
    b. The current operation of the policy under the Extra Statutory Concession and the sustained concerns about how it operated (§7 of MC8 [**B/1149**]). This was based on evidence HMRC had collected following the 2015/16 media coverage and reinforced by consultation responses summarised in the Analysis Scoping Note which detailed how the VAT relief was retained by retailers in some instances and that there was inconsistent application of the relief (e.g. dual pricing vs single pricing) (MC4 §§24 -25 [**B/116–17**]). This drew on the objective of ensuring revenue protection and compliance.

c. The ‘industry view’ which opposed abolition and the view that the Government should extend the relief to EU-bound passengers to support the recovery from Covid-19 (§8 of MC8 [**B/1149**]) – relevant to the additional objective that the Chancellor may wish to consider support for retailers through the Covid-19 recovery.

d. Analysis of the fiscal cost of extending the scheme to EU-bound passengers (§9 of MC 8 [**B/1149**]), again taking into account the objective of protecting revenue.

35. This was then expanded on in the subsequent pieces of advice (MC8 – MC14) in response to the Chancellor’s requests for additional information, follow up questions and steers (which are set out in Cunningham 1 §§73–78 [**B/665–66**]), to inform his decision making at the time. This therefore included additional information providing:

    a. Further detail on how the relief is operated, why there is inconsistency in the application of the rules and the types of goods and retailers covered by the scheme (MC10, §§2-3 [**B/1157**]).

    b. Further detail on the ‘industry view’ that abolition would result in retailers closing and that airfares would increase, which was based on the assumption that sales would drop significantly. This was considered alongside officials’ assessment that passengers were largely a captive audience in airports (due to the amount of time many passengers are required to spend in departure terminals before boarding a flight), so the issue of price sensitivity was less clear (MC10, §4 [**B/1158**]).

    c. International comparisons of similar reliefs, particularly in the EU (MC10, §5 [**B/1159**]).

    d. More information on the rationale for officials’ proposal for a temporary extension of the policy (through legislation), as set out in MC8 at §10 [**B/1150**], of the policy under the Extra Statutory Concession (MC10, §§6-7 [**B/1159**]).

    e. Outcomes from discussions with Special Advisers and junior ministers, in which we highlighted their view that tax-free sales may be considered a relatively uncontroversial relief. We also highlighted that retailers were limited in their use of the Extra Statutory Concession, due to the limited amount of flights to non-EU destinations, as opposed to EU destinations (MC11, §§7-8 [**B/1169**]).

36. Since the scheme was a retail tax relief, its Fiscal Cost was a key part of the analysis, including the cost of an extension to the EU (due to the objective of revenue protection). The current Fiscal Cost was understood as the maximum amount of revenue that would be recouped from withdrawing the scheme as the behavioural effects of removing the relief (such as lower purchasing levels) would reduce the revenue recouped. KAI provided my team with an analysis of the Fiscal Cost of extending tax-free sales, duty-free sales and personal allowances to the EU in MC7. [**B/1143**]. For the possible extension of tax-free and duty-free sales, KAI used publicly available data from WDFG and ONS passenger data to estimate the amount of VAT collected from sales of all items (non-excise and excise goods) to EU passengers in the secure zone of UK airports to be £110 million (i.e. those passengers purchasing goods that were not currently eligible for tax- and duty-free sales). They assumed that these goods would be cheaper if tax- and duty-free shopping was extended to the EU and that demand might increase – using a price elasticity of demand of -1.4 – to produce an initial estimate of the Exchequer Impact. This resulted in a post-behavioural Exchequer Impact estimate of a loss of around £150 million if tax- and duty-free sales were extended to the EU. As £40 million of that was attributed to excise goods to cost the extension of duty-free (alcohol and tobacco), the final Exchequer Impact of extending tax-free airside sales to the EU was estimated to be a £110 million loss of revenue (subject to the uncertainties around behaviours and passenger numbers that we would expect to see in this type of analysis), which was reflected to the Chancellor in MC8 §8 [**B/1149**].

37. The inconsistent operation of tax-free sales under the Extra Statutory Concession was also a key part of this evidence, which was reinforced by consultation responses (covered in MC4, §§20-30 [**B/1116–17**]) – for example, highlighting the nature of the relief as a concession, that there is no requirement for passengers to receive any of the VAT relief, that the VAT saving is not consistently passed on to consumers, and is applied to goods that are to be consumed in the airport and to goods being brought back into the country by UK residents with tax unaccounted for. The assumption from industry that the relief is integral to sales being made in airports and that withdrawal would significantly reduce sales and have an adverse impact on the economy and retailers' ability to continue operating was balanced with HMT's analysis (as detailed in §35.b. above). Retailers were limited in their use of the Extra

Statutory Concession for sales only to passengers departing for a non-EU destination, and a high proportion of flights from the UK were to the EU (MC8, §7 [**B/1149**]; MC10, §2 and §4 [**B/1157–58**]; MC11, §8 [**B/1169**]; MC14, page 8 [**B/1192**]). Stakeholders had also submitted evidence during the consultation which detailed what they considered the direct and indirect benefits of the scheme, which was summarised in the Analysis Scoping Note (MC4 [**B/1110**]), with stakeholder views on the withdrawal of the scheme summarised in MC10, §4 [**B/1158**].

38. The overall costs and benefits (that is, including but not restricted to economic aspects) of tax-free sales under the Extra Statutory Concession were therefore considered within the framework of the available options. These were extending the scheme to EU-bound passengers or withdrawing tax-free sales to remain compliant with WTO rules. Officials had reached the view that withdrawing the scheme in the long term should be the primary aim and recommendation, so modifications to the rules in the short term were not considered (see §41 below). As explained above, there is no formal statutory or policy requirement to conduct a Wider Economic or Exchequer Impact assessment before a decision is made in tax policy making (see §§11 - 13). We considered, therefore, that presenting these costs and benefits, as outlined in the Analysis Scoping Note, in the series of advice to ministers (as detailed above) was a sufficiently robust and proportionate approach in the circumstances. That was based on the wide range and forms of analysis that we had conducted over a period of time to feed into policy advice to Ministers on specific options, proposals and decisions (as set out in §25 above)

39. We had also made clear in the original consultation document (paragraph 4.25 [**B/210**]) that there were concerns with how tax-free airside sales operated under the Extra Statutory Concession. If the decision was to legislate for tax-free sales for non-EU and EU passengers, then the concern was that the extension would essentially reinforce these issues as they would continue to occur and at a larger scale than previously (with sales to EU-bound passengers included). The concerns with how the relief would apply would have existed and been the same had we been able to amend the Extra Statutory Concession to extend the scheme to the EU, the possibility of which was restricted by the *Wilkinson* ruling. In other words, the concerns didn't arise from the type of legal or extra-statutory framework but with how the rules would apply.

40. Officials had also explored what options were available to mitigate these concerns with a future tax-free sales regime. As the Extra Statutory Concession could not be amended post-*Wilkinson*, we explored how the requirements of tax-free sales might be 'tightened up' if a decision was made to extend the scheme in legislation. For example, officials had explored at a high-level that there could be options to improve compliance, refine eligibility criteria, and the type of goods that may be in scope of a new legislative regime for tax-free sales (§ 28 of MC4 [**B/1117**]). The costs and benefits of this had also been explored at a high-level in the Analysis Scoping Note (MC4, page 6 [**B/1115**]) under the following headings:
    a. Revenue Implications – "improved compliance by business if tightened up requirements";
    b. HMRC and BF delivery – "policy objectives and operational requirements will need to be developed for SOLS instructions – work ongoing on this".
    c. Business / consumer impacts – "Retailers may be…unhappy with stricter requirements (if we decide on this)".
    d. Policy implications/Qs – "Flexibility to design processes".

41. While we had explored what a legislative tax-free sales regime might look like in that paper, ultimately the final recommendation that officials made to the Chancellor was to extend the current rules for the policy to the EU through legislation, which would <u>not</u> have tightened up requirements (clarified in MC12, paragraph 11 [**B/1177**]). This was on the basis that this would be a <u>temporary</u> extension to support retailers through Covid-19 disruption, but that the relief should be withdrawn in the long term. Had the Chancellor been minded to pursue that option, the Government would have accepted the inconsistent application of the relief on a temporary basis (as we had done since the 2015/16 review) due to the extraordinary circumstances of the pandemic. However, in response to our initial advice (MC8 [**B/1148**]) which proposed a temporary extension of the scheme to the EU, the Chancellor's steer was to withdraw the scheme completely. We went back in subsequent advice (MC10 - MC12 [**B/1156–83**]) to that proposal having explored further issues and evidence, as requested by the Chancellor, and as documented above in §§34 - 35.

42. To address the ‘level playing field’ issues that some stakeholders raised, we provided the Chancellor with international comparisons of similar reliefs in the EU and elsewhere in MC10 (§5) [**B/1159**]. We highlighted the industry view of a potential disparity between tax-free sales in EU and UK airports, but also pointed out that the precise application of the scheme across the EU was unclear as the relief is not a requirement of EU law (MC10, §7 [**B/1159**]). To illustrate this, we provided examples of how different jurisdictions operated similar schemes in §5 of MC10. As the relief is not a requirement of EU law it was optional for jurisdictions to apply tax-free airside sales. However, if Member States chose to do so, in principle, EU law would require tax-free airside sales across the EU to be similar to the VAT RES, in that it would allow a zero-rate based on residency, rather than destination. This was at the heart of the sensitives around reforming tax-free sales in the UK following the 2015/16 media coverage, in which there was a risk that the EU would infract the UK for the tax-free sales being based on a passenger’s destination, rather than residency.

43. The consultation response was explicit on the key rationale behind the decisions, based on officials’ analysis of the issues and the advice we had provided to ministers. We agreed this rationale with the Chancellor and Exchequer Secretary. For tax-free airside sales, the consultation response set out at §3.26 [**B/239**] that:
    a. There were concerns that the tax-free concession isn’t consistent with international tax norms – for example, where snacks and drinks are consumed in the airport.
    b. There is inconsistency of how the relief under the airside tax-free concession is passed on to consumers.
    c. UK residents could use the relief to bring goods back with them with tax unaccounted for.
    d. Extending the relief to EU-bound passengers would reinforce these issues.

44. The consultation response also stated factually that the mechanism which had previously allowed tax-free sales - the Extra Statutory Concession - would be withdrawn (§3.25 [**B/239**]). The language used here reflected the advice we had submitted to the Chancellor on 18 August (MC12, §10 [**B/1177**]) in which we then went on to explain that legislation would be needed for any extension

of the tax-free policy. This statement was important in the consultation response as it was clear during the consultation period that stakeholders wanted us to ‘extend’ the Extra Statutory Concession, which we knew was not possible post-*Wilkinson*. That legislation would be required for any changes to the tax-free policy was also set out in the e-mail of 13 May 2020 to stakeholders that attended a roundtable the previous day (Cunningham 1 §59 [**B/658**]).

45. As to the Fiscal Cost of extending airside tax-free sales to the EU, we had highlighted to the Chancellor that the savings from tax-free sales (expressed as the current Fiscal Cost of the scheme which would be the maximum amount of revenue recouped) could be used to partially finance the extension of duty-free (MC8, §8 [**B/1149**] and MC10, §6 [**B/1159**]). The Fiscal Cost was not referenced in the consultation response because we had not received clearance to release Fiscal Costings for any policy contained in the ‘passengers’ package (and as noted above, this type of analysis would normally form part of the OBR process at a fiscal event). However, our ministerial advice made clear that an extension would increase the cost of the scheme and withdrawing it would result in a saving to the Exchequer. This information was therefore before the Chancellor when the decision was made.

46. The OBR subsequently published the figure that they believed was reasonable and central for the direct Exchequer Impact from removing tax-free airside sales in their November 2020 Economic and Fiscal Outlook. The OBR estimated the removal of tax-free airside sales against the counterfactual of it continuing for non-EU bound passengers only (as that is the policy assumption they were removing from their forecast). I understand that the iterative process of the analysis of the Exchequer Impact (as described at §14 above) started on 16 September 2020 when KAI were first commissioned by the OBR to produce the analysis of the withdrawal for the forecast, which included key behavioural judgements.

47. In the final analysis of the Exchequer Impact, the OBR accounted for the effects of COVID-19 on passenger numbers and for a behavioural response to account for a reduction in spending from non-EU bound passengers and the impact on retail pricing. As described above §14 above although not a requirement, usually, this type of a change to tax measures would be announced at a Budget and this OBR analysis would have been provided to HMT before the decision

and published alongside the consultation response on Budget day. However, due to the exceptional circumstances of EU Exit, combined with the pandemic (which resulted in no Autumn Budget in 2020), the OBR's analysis was published after the announcement of 11 September (which, as stated in Cunningham 1, § 85 [**B/669**], reflected the Government's need to announce these changes as soon as we could to give individuals and businesses as much time as possible to prepare ahead of these changes coming into effect from 1 January 2021). In any case, the OBR's analysis reaffirmed the view presented to the Chancellor, that the removal of tax-free airside sales would result in a direct Exchequer Impact saving of £170 million per year, after behavioural responses are taken into account and passenger numbers recover from the impacts of COVID-19 .

The decision to withdraw the VAT RES (Grounds 6 and 7)

48. As with the tax-free 'airside' sales, the costs and benefits of the VAT RES were presented to the Chancellor within the framework of the available options. These were extending the scheme to EU residents (with some uncertainty around the operational modifications required for this) or withdrawing it, in order to remain compliant with WTO rules. These were then presented alongside the policy objectives and 'internal assessment criteria' that officials had developed in the Analysis Scoping Note (MC4 [**B/1110**]). By July 2020 it was clear that maintaining the status quo was not an option (Cunningham 1 §61 and 65c [**B/659–60**]) and we had made clear to ministers in both our initial advice in January 2020 (MC 1 and MC2 [**B/1084–96**]) and the series of advice to the Chancellor from July 2020 (MC8 – MC14 [**B/1148–202**]) that there were significant operational and fiscal concerns about extending the scheme in its current form. The decision facing the Chancellor therefore was whether and how the scheme might be made available to EU residents by taking account of these considerable challenges; or whether to withdraw the scheme entirely, while noting the costs of doing so.

49. Like tax-free sales, the VAT RES was a retail tax relief, so the Fiscal Cost of the scheme was a key part of the analysis, both the current cost and an extension to the EU. Again, the current Fiscal Cost was understood as the maximum amount of revenue that would be recouped from withdrawing the

scheme as the behavioural effects of removing the relief (such as lower purchasing levels) would reduce the revenue recouped. The operational challenges were also a key part of the evidence, alongside the industry view that the relief is integral to attracting visitors to the UK. Stakeholders had also submitted evidence during the consultation which set out what they considered the direct and indirect benefits of the scheme, as summarised in MC4, §31-40 [**B/1119–21**] and above at §28.

50. We subsequently presented the key costs and benefits (again, using this phrase more broadly than in the purely economic sense), which were derived from the consultation responses and MC4 [**B/1110**], in summary form across advice to the Chancellor. This included the potential for job losses for refund providers and potentially retailers if the scheme were to be withdrawn, although the scale of the impacts for the latter were far more uncertain due to the range of factors that influence individual decisions to come to the UK and shop. The relevant information on this aspect of the cost of withdrawing the schemes was mistakenly redacted in MC9 and the relevant information now has been unredacted in **MC24**. These potential impacts were not quantified at this stage, again due to the issues with making 'precise' predictions about the effects of this relief on the retail industry, and absent behavioural assumptions certified by the OBR as reasonable and central for analysis of the Exchequer Impact. As with tax-free airside sales, officials' view, supported by the evidence we had collected on the use of the scheme, was the VAT RES had a marginal impact on decisions to visit the UK and, in part due to this, was a significant negative Exchequer Impact (see §52 below). What was clear, however, was that removing a tax relief which refund providers relied on would likely result in those UK operations of refund providers ceasing to trade. In summary:
    a. "abolishing the scheme would be challenging to announce now (see Annex D [*i.e.* MC9]) as the majority of industry stakeholders want to see the VAT RES extended to the EU in digital form, not least to support the recovery from COVID-19." (MC8, §21 [**B/1152**]).
    b. "The retail industry and refund operators have pushed hard for VAT RES to be extended to the EU in digital form, not least to support the recovery from COVID-19 which has severely disrupted their businesses." (MC9, §2 [**B/1154**]).
    c. "If you wish to permanently abolish the VAT RES you will need to consider that job losses are likely for refund operators, and potentially

retailers. The VAT RES industry is relatively small, so this may be an outcome you are prepared to accept. Retailers would also still be able to zero rate purchases they export direct to overseas addresses." (MC9, §6.i.).

d. "If you wish to temporarily suspend the scheme, while we develop a digital system, a HMRC-delivered system may be deliverable, but not for at least 18 months following ministerial sign off. Market based solutions may also be available to similar timescales. The industry would oppose any suspension, with a similar risk of job losses above." (MC9, §7.i.).
e. "If you are minded to permanently abolish the VAT RES you will need to consider that GB will be one of the only advanced economies in the world that does not operate a tax-free shopping scheme. (MC10, §11 [**B/1160**]).

51. We also presented the impacts of withdrawing the scheme on what the industry considered the benefits of the scheme in the advices:
    a. "The retail industry and refund operators have pushed hard for VAT RES to be extended to the EU in digital form, not least to support the recovery from COVID-19 which has severely disrupted their businesses. West End retailers, where use of the scheme is highly concentrated – the [REDACTED] accounts for 65% of all tax-free sales in the UK - argue that RoW visitor numbers will remain low due to COVID-19, so we should extend VAT RES to the EU in current form to support the economic recovery." (MC 9, paragraph 2 [**B/1154**])
    b. Absent the OBR's analysis of the Exchequer Impact, which would include behavioural assumptions, my team highlighted that "Industry stakeholders claim that VAT RES promotes tourism and creates direct and indirect benefits for the exchequer. For example, responses highlight that VAT RES accounts for approximately £3.5bn of sales to RoW visitors and is a major attraction for tourists. While much of the data provided is hard to verify, internal research from HMRC's digitisation team reinforces some assertions, not least illustrating that VAT RES is a key factor in decisions to visit the UK, and in the amount spent during a visit." (MC 9, paragraph 4 [**B/1154**]).
    c. "Stakeholders will argue that high-spending tourists visiting several countries in Europe may therefore choose to buy luxury goods tax-free

in nearby Paris or Milan. However, some tourists may still want to buy certain British brands in London, for example, a Mulberry bag or Burberry scarf" (MC10, paragraph 11 [**B/1160**]).

52. We had also concluded that the benefits of the scheme remained uncertain and any precise assessment of the benefits would be dependent on a number of behaviours, which are not necessarily observable, and data which is hard to verify. For example, identifying how many sales and how much tourist spending were as a direct consequence of the VAT RES would require making an assumption about how many of those consumers would have bought those products if the VAT RES did not exist. The HMRC survey referred to in MC9 (with further detail below) did indicate that some visitors were incentivised by the VAT RES to visit the UK and purchase various items. There was, however, also contradictory evidence that some visitors would have bought goods and visited the UK anyway (the results of this HMRC research, which was conducted in May 2020, were later presented more fully in **MC26**, see §78 below). With the data being hard to verify and surveys indicating different behaviours, the precise impact of the scheme remained uncertain.

53. We stated as much to the Chancellor in MC9 (§4) [**B/1154**] – "Industry stakeholders claim that VAT RES promotes tourism and creates direct and indirect benefits for the exchequer. For example, responses highlight that VAT RES accounts for approximately £3.5bn of sales to RoW visitors and is a major attraction for tourists. *While much of the data provided is hard to verify*, internal research from HMRC's digitisation team reinforces some assertions, not least illustrating that VAT RES is a key factor in decisions to visit the UK, and in the amount spent during a visit." (emphasis added). At this stage we did not seek to nuance that analysis any further (for example, highlighting contradictory behaviours) as this was a key cost that we thought the Chancellor should consider.

54. A key piece of evidence to inform our behavioural judgements was HMRC's research that fewer than 1 in 10 non-EU visitors (8%) received a refund in 2019, as detailed in KAI's analysis of the Fiscal Cost (MC5 §14 [**B/1124**]). In effect up to 90% of non-EU visitors came to the UK and might spend their money in the high street, hotels and restaurants without using the VAT RES. This was supported by HMRC's research that the fees charged to consumers before

receiving refunds were high (MC8 §20(i) [**B/1152**]) and would affect the scale of the financial motive of the VAT RES for consumers and visitors to the UK. Consultation respondents had provided high level data on the fees they charged in response to a request for this information in the consultation (largely as there was no publicly available information about the average level of fees charges on, for example, refund providers websites). Global Blue reported that they had the lowest fees in Europe with an average free of around 20% of the VAT refund. However, HMRC had conducted consumer research over the course of September 2019 – July 2020 which found that fees ranged from 70% - 10% of the VAT refund (as this research occurred in parallel with policy development, we used an early figure from this research in MC8 §20(i) [**B/1152**] to say 70–30%). Limited use of the scheme, combined with the high level of fees, indicated that overall the VAT RES had a more limited impact on consumer behaviour than the 'industry view' suggested, and that removing the scheme would have a positive Exchequer Impact. This is the view officials formed and presented to ministers. It was also stated in advice (MC8 and MC9 [**B/1148–55**]) that extending the scheme to EU residents would significantly increase the net cost of the scheme.

55. In the analysis conducted internally (MC5 [**B/1122**]), HMRC acknowledged that the exact Exchequer Impact of removing the VAT RES would be uncertain and that this uncertainty was driven, in large part, by the behavioural effects – for example, exactly how it would affect purchasing decisions and visitor numbers. At this stage, before the OBR forecast, this analysis therefore did not attempt to 'pinpoint' an exact number. Instead (as described above) we used the analysis of the Fiscal Cost and wider evidence to inform our judgement that removing the scheme would have a positive Exchequer Impact. In particular, whilst we were aware that some claims had been made that the VAT RES raises more tax than it costs, this is a common claim made about tax reliefs and we did not consider that the behavioural effects would be so significant – our conclusion was that the withdrawal would have a limited effect on passenger numbers and that a large number of purchases would still occur without the VAT RES in place. We therefore presented the current Fiscal Cost of the scheme, based on 2019 figures, as the maximum potential saving from the VAT RES removal.

56. Likewise, for the extension of the scheme to the EU HMRC did not estimate a precise figure for this and instead used an estimate of the Fiscal Cost by taking account of passengers numbers and the potential behavioural factors that retailers had stated (paragraph 44 of MC5) to describe that an extension to the EU could cost ‘up to £0.9 billion per year’, as an extreme upper bound (referenced in MC9 §1.iii [**B/1154**]).

57. As with tax-free airside sales (§46) the OBR subsequently published the figure that they believed was reasonable and central for the direct net Exchequer Impact from removing the VAT RES in their November 2020 Economic and Fiscal Outlook. The key difference between this analysis and the Fiscal Cost produced by KAI was that the OBR estimated a ‘central’ figure and thus had to certify the judgements that KAI had made about what they thought the behavioural effects would be of removing the VAT RES, including a reduction in the number of tourists lost to other destinations (as they will be less incentivised to come to the UK) and a reduction in spending from tourists that still come (as the goods will be comparatively more expensive without the refund opportunity). It is also worth noting that the OBR estimated the removal of the VAT RES against the counterfactual of it continuing for non-EU visitors only (as that is the policy assumption they were removing from their forecast). Similarly to tax-free airside sales, I understand that the iterative process of the OBR’s analysis of the Exchequer Impact started on 16 September 2020, when KAI were first commissioned by the OBR to produce the analysis of the withdrawal for the forecast, which included key behavioural judgements.

58. In the final analysis of the Exchequer Impact, the OBR accounted for the effects of COVID-19 on travel numbers and they judged that the removal of the VAT RES would result in roughly 20,000 – 30,000 fewer visitors to the UK per year, once passengers numbers recover. Using this, and analytical information provided by HMRC, they estimated the removal of the VAT RES would result in a direct net Exchequer Impact of approximately £400 million in revenue per year, once passengers numbers recovered from the effects of Covid-19. These impacts were subsequently used in the TIIN (see §90 below) As described above (§14) although not a requirement, usually, this type of change to tax measures would be announced at a Budget and this OBR analysis would have been provided to HMT before the decision and published alongside the consultation response on Budget day. However, due to the exceptional

circumstances of EU Exit, combined with the pandemic (which resulted in no Autumn Budget in 2020), the OBR's analysis was published after the announcement of 11 September (which, as stated in Cunningham 1, § 85 [**B/669**], reflected the Government's need to announce these changes as soon as we could to give individuals and businesses as much time as possible to prepare ahead of these changes coming into effect from 1 January 2021). In any case, the OBR's analysis reaffirmed the view presented to the Chancellor and in the consultation response, that the VAT RES was a costly scheme and its removal would result in a direct Exchequer saving.

59. Officials also considered the 'destination principle' in the information that was presented. The effect of this principle is not that tax 'will' be paid in the destination but that it 'ought' to be. In consideration of the principle, jurisdictions should also take account of factors, such as administrative cost, tax avoidance and the risk of non-taxation. These were all issues in play in this case. For example, in June 2020 HMT and HMRC officials held a meeting with a VAT RES operator, who was lobbying the Government to include online purchases in the scheme. HMRC explained that visitors can already benefit from a zero rate if they order items direct to their overseas address on the internet. In response, the operator told us that these visitors would not want to use this 'shop and ship' arrangement over the internet to send UK purchases home as this would mean they will have to pay tax in their destination – goods sent directly to a customer's overseas address by a retailer would enable them to zero rate the sale and parcels are far more likely to be checked by the relevant customs staff in that destination, with the relevant import taxes and duties charged. Overall, the VAT RES was an imperfect mechanism to achieve taxation in the place of consumption. We used this understanding to state in MC10:

> "In principle these passengers should be declaring the goods and paying tax in their destination. In reality, passengers are unlikely to do this, with the VAT RES largely used as a significant tax-break for high-spending Middle Eastern, Chinese and South East Asian tourists, who are the majority of users of the scheme." (paragraph 12 [**B/1160**])

60. Officials were also very aware of the operational issues with the VAT RES from work on the 'no deal' policy and the sustained lobbying from stakeholders to

introduce a digital system. Heathrow's consultation response reinforced our understanding of the operational difficulties (page 6 [**B/943**]), as did many others as summarised in the Analysis Scoping Note (MC4 [**B/1110**]). Global Blue also raised concerns (on page 8 and 10 of their consultation response [**B/850, 852**]) about the paper-based nature of the scheme and the operational difficulties that stem from this. We evidenced the operational issues in the Annex of the first submission to the Chancellor (MC9 [**B/1154**]):

a. "the scheme is paper-based and an extension is likely to exacerbate the existing queues and disruption at exit points, with an estimated increase in forms from 5.6 million to 15 million. There are already reports of up to 2-hour queues at Heathrow." (§1.i)
b. "Heathrow and [REDACTED] – the main exit points that process claims – do not want to see the scheme extended in current form as they expect this will cause further disruption at the border. Ports and regional airports do not currently have the infrastructure to process claims 'landside', with [REDACTED] concerned about the potential impact on outbound flow (as they are with inbound allowances)." (§3).

61. A further concern was that many EU-facing exit points did not have the infrastructure, or Border Force presence, to process claims for passengers destined for the EU. And, as highlighted above, exit points that currently processed claims (e.g. Heathrow) were concerned about the effect on flow at the border from any extension of the paper-based scheme.

62. However, officials continued to explore options to mitigate this, including the potential for digitisation and introducing a minimum claim level. The Annex of the first ministerial submission (MC9) points out: "a digital solution would ease the issues at the border and better enable an extension to the EU. HMRC are continuing work on this but early estimates are this will not be deliverable for at least 18 months following ministerial sign off of a digital system." (MC9, §1.ii [**B/1152**]).

63. We also stated in the first submission that, was the Chancellor minded to retain the scheme in the long term, "we should take time to consider alternative ways of operating VATRES in the short term, such as:

a. temporarily suspending the scheme, while we develop a digital system;

b. extending the scheme in current form to the EU, with restrictions in place to reduce volumes.” (MC8, §22 [**B/1152**]).

64. The steer we sought from the Chancellor in this first piece of advice was whether he wished to permanently abolish the VAT RES or retain the scheme in the long term while we developed a digital solution or other alternatives (MC8, §18 [**B/1151**]). We required an initial steer so that we could prioritise further work to support retaining and extending the scheme if needed. We subsequently presented various options and evidence to inform this choice.

65. The consultation had also asked for evidence of the regional use of the VAT RES. Global Blue and other refund providers had included a regional breakdown of VAT RES use in their consultation response (§ix of Global Blue’s response) which was used to inform ministerial advice. The evidence showed that use of the scheme was highly concentrated in London and Oxford. Advice to the Chancellor picked that up: “With the VAT RES largely centred in London, UK residents and the regions do not benefit from the scheme – only 3% of transactions from the largest refund provider occur in Manchester or Edinburgh, with 10% in Bicester Village and 80% in London” (MC10, paragraph 12 [**B/1160**]). These figures were taken directly from Global Blue’s response.

66. In drafting the consultation response, we also highlighted that VAT RES was an imperfect mechanism to ensure taxation in the place of consumption due to:
    a. Administration fees being charged to customers to obtain a VAT refund;
    b. The need to present goods at the border to obtain a refund and the effects this has on the flow of passengers;
    c. The expectation that tax is then paid in the customer’s destination but our belief that this often does not happen;
    d. The prevalence of fraud, non-exportation, and non-compliance in the scheme;
    e. And other policy mechanisms being available – i.e. ‘shop and ship’ - which ensures that the goods are exported and that tax is paid on receipt in the destination country.

67. Fraud and non-compliance were also a concern, particularly with any extension to the EU. The evidence of 19 June 2020 (**MC3**) on retaining the VAT RES and airside tax-free sales ‘as is’ on 1 January 2021 detailed the risks of this in §§17

– 20 [**B/1099**]. This highlighted an HMRC report on the prevalence of fraud in the scheme, which was estimated to cost between £22 - £50 million per year. We had also come to the view that extending the scheme to the EU would likely increase this to an estimated £59 - £135 million per year. We referenced these risks at a high-level in the factsheet provided to the Chancellor before the decision document was published (MC14 [**B/1198**]) and these risks were highlighted in the consultation response (§3.18 [**B/237**]).

Technical note

68. To expand briefly on Cunningham 1 §89-92 [**B/670**] regarding the Technical Note, the evidence and analysis which were included in this note came from the information that was presented to the Chancellor as part of the decision-making process and the underlying documents that informed this advice. We were not cleared to release certain information, such as our initial fiscal costings of policies, at the time the consultation response was published (as explained at §14 - 15 above, these costings would usually be certified and released by the OBR at the Budget but we had to announce the policies outside of this process due to the upcoming end of the transition period.) This also included the fiscal cost of other policies in the package, such as extending duty-free to the EU and introducing personal allowances. We provided the reason for the Technical Note in the note itself:

> "The consultation response, published on 11 September, sets out in detail the rationale for the decision to withdraw the VAT Retail Export Scheme (VAT RES) and tax-free airside sales. *As we have received a large amount of correspondence following the announcement, we have formulated this technical note to expand on this document and to respond to issues raised by stakeholders*." (emphasis added).

69. The Fiscal Cost of the VAT RES was presented in the sixth paragraph of the first page of the Technical Note [**B/1255**], as originally estimated by KAI in MC5 and presented to the Chancellor in MC8, §§19 and 20.iii. [**B/1151–52**]. It was made clear in the Technical Note that this was the value of refunds provided in 2019 (i.e. not a precise prediction of the revenue which would be generated by the removal of the VAT RES). The Fiscal Cost of tax-free airside sales was detailed in the second paragraph of the third page of the technical note [**B/1257**], with the cost of an extension estimated by KAI in MC7 presented to

the Chancellor in MC8, §8 [**B/1149**]. Following the announcement, and as detailed above (§§46 and 57) KAI had also been commissioned by the OBR to refine their costings and produce a costing explanatory note for an analysis of the Exchequer Impact in preparation for the OBR forecast on 25 November 2020 – my team received an updated costing explanatory note from KAI, in preparation for the OBR process, on 7 October 2020, which estimated the current Fiscal Cost to be £150 million per year . We used the up-to-date costing in the explanatory note from 7 October 2020 in the Technical Note, which was cleared by the Exchequer Secretary to the Treasury on 9 October 2020, and which was sent to the Chancellor for information on the same day. The final draft of the costing explanatory note in this iterative process on 18 November 2020 estimated the Fiscal Cost to be higher at £183 million, which I exhibit as **MC25**.

70. We also made clear in the Technical Note that the wider 'passengers' policy package of changes also included the extension of duty-sales to EU-bound passengers as the decision was taken in the round with the VAT RES, tax-free airside sales, personal allowances and duty-free. The decision on duty-free was relevant as it formed part of the wider impact of the package, which was presented in the round to the Chancellor in the series of advices (MC8 – MC14) and informed ministerial thinking. The benefits of the extension of duty-free would accrue to airport operators in addition to those making duty free sales. We had received responses to the consultation from airport operators which were supportive of the extension of duty-free, not least due to the financing arrangements in airports (summarised in MC4, §21 [**B/1116**]).

71. In terms of balancing this against the withdrawal of tax-free airside sales, my team highlighted in the third piece of advice to the Chancellor (MC11, §8b [**B/1169**]) that "EU-facing regional airports and international rail terminals have never been able to use the relief, which may make it easier to remove, not least as they will now benefit from the extension of duty-free sales.". We did not claim that the duty-free extension would exactly offset the removal of the tax-free sales, not least because different airports and retailers would see different levels of costs and benefits depending on the type of goods sold and level of EU and non-EU bound passengers.

72. We subsequently set out in the ministerial factsheet (MC14, page 8 [**B/1192**]) the limited availability of tax-free sales for different airports (and by extension duty-free) by the number of flights to non-EU countries. This illustrated the high volume of passenger travel to the EU, and we were aware from consultation responses that these passengers do purchase goods in airports without the direct benefit of the Extra Statutory Concession (e.g. retailers cannot zero rate those sales to passengers bound for EU destinations).

73. We also highlighted in the Technical Note the Government's unprecedented support to businesses, including the aviation industry, in the light of Covid-19, although the decision was not directly connected to this.

74. As detailed in §§91 – 92 of Cunningham 1 [**B/670–1**], we also included key parts of our analysis of the VAT RES in the Technical Note. As part of this, we also expanded on the Government's view of the behavioural impact and assumptions, which we had made as part of the policy development and advice process, stating in the first paragraph of the second page:

> "At the margin, this [the withdrawal of the VAT RES] may of course affect demand for these goods and could impact incentives for a small proportion of non-EU residents to visit the UK. However, based on ONS passenger estimates and the 1.2m visitors who used the VAT RES in 2019, HMRC estimate that fewer than one in ten non-EU visitors use the VAT RES. VAT refunds are also less likely to be a significant pull factor for lower value purchases, and for higher value purchases passengers will be much more likely to be liable to pay the relevant import taxes in their destination country if the goods breach personal allowance limits."

75. This reflected our view that withdrawal of the scheme would result in a positive Exchequer Impact but acknowledged that the withdrawal would of course result in a small behavioural change for a minority of visitors (i.e. that the negative aspect of the Exchequer Impact of the removal of the schemes would be lower than the amount refunded under the VAT RES). It also incorporated our view that the VAT RES was an imperfect mechanism to achieve taxation in the place of consumption due to the belief that passengers were very unlikely to declare goods and pay the relevant taxes in their destination.

Mythbuster and events Subsequent to the Decision

76. As highlighted in §82 of Cunningham 1 [**B/668**], the Technical Note formed the basis of the Mythbuster for Conservative MPs. The Chancellor also wanted my team to provide more information for these MPs, which further drew on his rationale for the decision and his view of the behavioural assumptions and analysis that had been put forward by industry following the announcement (in particular the CEBR 2020 report which had generated a significant amount of media interest).

77. As a result of the lobbying and media coverage to reverse the decision (Cunningham 1, § § 89 – 90 [**B/670**]), on 7 October 2020 the Chancellor asked my team for an update on the reaction to the policy, covering:
    a. A reminder of the legislation required for tax-free airside sales and VAT RES;
    b. If we wanted to do some sort of 1 year concessions on the VAT RES and tax-free airside sales, how would we do it, and would we recommend that course of action;
    c. A price comparison for a set of goods (e.g. Rolex watches, Chanel handbag) – excluding sales tax and taking out the Foreign Exchange impacts – between Paris Milan and London,– asking the question whether it was still cheaper or not to buy those products in the UK vs Paris/Milan.
    d. If we could show that Chinese tourists already travel to multiple places in Europe, so don't just have the opportunity to shop in London

78. On 9 October 2020 my team replied with a piece of advice and annexes, which I exhibit as **MC26** covering, among other things:
    a. the reaction to the announcement on the VAT RES and tax-free airside sales, and stakeholder engagement so far (§§ 2 – 6)
    b. analysis of the 2020 CEBR 'economic impact' report (referenced in paragraph 89 – 90 of Cunningham 1 [**B/670**]) (§§ 6 – 9)
    c. possible concession options, which we recommended against largely due to the operational issues and timing (§§ 12 – 14)
    d. an update on digitisation work following the announcement (Annex E)
    e. a draft of the technical note and mythbuster

f. a summary of, and in some cases additional information, regarding the analysis that was presented during the course of advice (MC8 – MC14), including further detail of our analysis of the 2020 CEBR report (Annex B)

79. A key part of this advice was highlighting that industry analysis and media coverage on the impacts of the decision, including the purported wider economic impact, were derived from the 2020 CEBR paper (referenced in § 89 – 90 of Cunningham 1 [**B/670**]). My team were also aware of a September 2020 report from York Aviation on the impacts of withdrawing tax-free airside sales. As discussed in §29 regarding the 2017 CEBR report, this paper had used similar modelling to predict the potential effects of the decision using behavioural assumptions, and presented an Exchequer and Wider Economic Impact analysis of the withdrawal. Due to the references to this report in the media my team conducted an analysis of the report and disagreed with a number of the behavioural assumptions used to arrive at their Exchequer and Wider Economic Impact analysis, which we considered were unrealistic – especially on the extent to which VAT RES acted as a 'pull factor' for visitors and on the impact of purchasing decisions (where the report uses a very high 'price elasticity' to estimate the additional purchases generated). My team highlighted in the advice to the Chancellor that officials had held a meeting with the report's author (earlier that day) to understand the analysis but that officials fundamentally disagreed with the behavioural assumptions which underpinned the findings – officials set out what the disagreements were in the advice and that the author also stated in their meeting with him that his analysis was done quickly and was not definitive. My team also provided the Chancellor with a copy of the 2020 CEBR report so he could consider the analysis which was presented within it.

80. On 12 October 2020 my team reported back from discussions they had with the Chancellor's office and advised me that he had noted the whole suite of documents, including the analysis of the 2020 CEBR report. I also understand from a meeting my team attended with the Chancellor, that he did not consider the report a convincing prediction on the Exchequer and Wider Economic Impacts. The Chancellor also asked further questions that he would like more clarity on:

a. The final percentage saving to a customer after VAT RES fees. For example, if someone spent £100 on VAT full price goods, how much might they actually save. He wanted us to find out all the fees and processing costs as the net saving was clearly less than 20% after fees were accounted for. The Chancellor noted that there was some data in **MC26** about average refund per person of £400/500 but wanted clarity on whether this was gross or net of fees.
b. The average cost of a trip to the UK from China and a multi country trip to reflect an average trip taken. This was to calculate the percentage of the overall trip costs that the saving above generates for various levels of spend as the 8% in **MC26** seems high to the Chancellor if gross refund pre fees is £400/500.
c. Further price comparison data across Italy, France and UK for various luxury goods.
d. What options there were to potentially delay the withdrawal of the VAT RES by one year, accepting that we would have to extend it to EU in any such period. The Chancellor was uncertain why that might cause any issues for the Government, such as with systems; and, if fraud was the answer, whether we could introduce stricter legislation.

81. On 14 October 2020 my team provided a further advice in response to the requests, exhibited as **MC27**, which covered:
    a. HMRC's previous research on the level and type of VAT RES fees (§§ 1 – 4);
    b. The cost of a trip to the UK from China (§§ 5 – 8);
    c. A cross-country price comparison of luxury goods (§9)
    d. Advice on potential options for delaying the withdrawal of the VAT RES (and tax-free airside sales) (§§10 – 13)

82. On d), my team counselled against delaying the withdrawal decision by a year predominantly due to the well-known operational issues, particularly the concerns with EU-facing exit points not having the relevant infrastructure, and the Fiscal Cost. However, the advice also asked for a steer on whether the Chancellor wanted my team to develop a delay option.

83. On 19 October 2020, in response to that advice, the Chancellor asked my team to clarify whether the issue with extending the scheme to the EU was that

people would need to declare their goods at the port of exit; whether it was necessary to police this at the actual port; whether we had that capability in our EU facing airports and at the Eurostar terminal; and what the EU were planning to do at Gare du Nord?

84. On 20 October 2020 my team provided a final draft of the Mythbuster and an email advice which answered the Chancellor's queries. I quote in full that short advice:

"Is the issue in bringing in the EU for Jan 1st that people will need to declare their goods at the port of exit? Is it necessary to police this at the actual port? Do we have that capability in our EU facing airports/Eurostar?

a. Yes, the key issue is that declarations will be required, that we do not have infrastructure at EU facing exit points to process these and that an extension would increase claim volumes across all exit points.
b. VAT RES claims need to be endorsed (stamped) by a Border Force official on exiting the UK. 95% of current users exit the UK through Heathrow and Gatwick, where the checks on forms and goods take place. The remaining 5% use drop boxes to submit their claims and minimal, if any, checks on goods are performed. The scope for fraud significantly increases with such arrangements.
c. The majority of EU facing airports/ports do not currently have <u>any</u> infrastructure or Border Force presence to process claims or undertake checks on goods purchased under the scheme – including drop boxes.
d. Dover and Eurotunnel have specific infrastructure difficulties which are likely to make the processing of claims and compliance challenging (e.g. due to vehicles being in free-flowing traffic). We would need to discuss any impacts of increasing demand and use of exit points, including those who currently process claims, with BF.

What are the Europeans planning on doing at Gare du Nord?

e. France has a digitised VAT RES claims process and have installed claims kiosks at Gare du Nord. This does not remove the need to undertake physical compliance checks on the goods but the digital process identifies and refers high-risk claims to border officials."

85. The Chancellor accepted these answers with no follow up questions on 21 October 2020. The Mythbuster was subsequently issued to MPs on 26 October 2020.

The OBR Analysis, TIIN and SI

86. In preparation for the OBR forecast on 25 November 2020 which, as explained at §14 - 15 above sat outside of the normal fiscal events process, HMRC provided costing explanatory notes to the OBR (as part of the iterative process) of the Exchequer Impact of the withdrawal of the VAT RES and tax-free airside sales. These costings factored in the analysis provided in MC5 and MC7 and included behavioural predictions.

87. For the VAT RES, HMRC estimated the Exchequer Impact of removing the scheme in a costing explanatory note for the OBR as discussed at §57 above. I exhibit the final draft of this note as **MC28**. This note was similar in form to the one for tax-free airside sales in described in §69 above, and assessed the change against the counterfactual of the VAT RES continuing for non-EU visitors only, and included information such as:
    a. VAT RES user numbers (1.2 million out of 16 million non-EU visitors to the UK);
    b. Their estimate of the VAT RES refund amount (c. £0.5 billion);
    c. Regional use of the scheme;
    d. The average level of fees; and
    e. The behavioural responses HMRC believed to be reasonable and central.

88. For the ESC, HMRC similarly provided an estimate of the Exchequer Impact (i.e. the revenue generated from removing the scheme) in an explanatory costing note against the counterfactual of it continuing for non-EU bound passengers only, and provided any purchasing data they had, alongside initial assumptions on the effect of this on purchasing decisions in airports (exhibited at §69). HMRC provided assumptions about the effects of COVID-19 on passenger numbers and on an expected behavioural response to account for a reduction in spending from non-EU bound passengers.

89. The OBR refined this analysis before reaching a final number the OBR believed to be reasonable and central which they ‘certified’ and included in the fiscal forecast of Government tax revenues. These numbers are explained in Cunningham 1 §93 [**B/673**]. In both cases, the costings of the policy decisions represented the Exchequer Impact of the policy changes. The OBR also reviewed how the forecast of the wider economy is likely to be affected in the round with all policy measures which had been announced before their November 2020 publication, a process by which they captured the ‘indirect effects’ of policy (e.g. on inflation and Gross Domestic Product) as part the overall economic forecast. The OBR deemed the withdrawal of the VAT RES and tax-free airside sales to not have any significant economic effects which would be incorporated into the overall forecast – I understand this assessment was subsequently used to inform the Economic Impact section of the TIIN, as discussed below.

90. As highlighted in Cunningham 1 §§94 – 96 [**B/672**], on 27 November 2020 the Exchequer Secretary cleared the statutory instrument which would withdraw the VAT RES (and extend duty-free sales and personal allowances to the EU) on 1 January 2021 to be laid on 3 December 2020 (The Travellers’ Allowances and Miscellaneous Provisions (EU Exit) Regulations 2020). This advice also clarified that the Extra Statutory Concession which allowed tax-free sales would be withdrawn by HMRC from 1 January 2021 via removal of the concession from guidance – and that no legislation was required. HMRC advised that they were planning to issue a Revenue and Customs Brief shortly after the laying of the statutory instrument on the rest of the package to confirm this. The advice also included approval to publish the TIIN[1] which set out in summary form the impacts relevant to the withdrawal of the VAT RES as certified by the OBR, which I exhibit as **MC29**. As the OBR deemed the withdrawal of the VAT RES to not have any significant economic effects which would be incorporated into the overall forecast, the TIIN stated that the measures contained within the statutory instrument (which included the withdrawal of the VAT RES) were not expected to have any significant Economic Impacts. The TIIN also included further analysis on the Business Impacts. The following detail of the Exchequer Impact which was based on the OBR’s certified costings and analysis:

[1] https://www.gov.uk/government/publications/the-travellers-allowances-and-miscellaneous-provisions-eu-exit-regulations-2020

a. **Exchequer impact of the withdrawal of the VAT RES:**

2020 to 2021	2021 to 2022	2022 to 2023	2023 to 2024	2024 to 2025	2025 to 2026
+35	+195	+310	+400	+440	+460

91. Tax-free sales under the Extra Statutory Concession were withdrawn through Revenue and Customs Briefing 21/2020: Withdrawal of the VAT Retail Export Scheme and the tax-free shopping concession[2], which I exhibit as **MC30**. The OBR's certified costing for the withdrawal of tax-free airside sales illustrated the following Exchequer Impact:

a. **Exchequer impact of the withdrawal of tax-free airside sales:**

2020 to 2021	2021 to 2022	2022 to 2023	2023 to 2024	2024 to 2025	2025 to 2026
+15	+85	+130	+170	+185	+195

Summary of the evidence and analysis used in the Decision

92. In summary, the Government consulted widely on this change and specifically asked for evidence on the impacts of withdrawing the schemes. This evidence, which included industry predictions of the Wider Economic Impacts was assessed alongside the Fiscal Costs and Exchequer Impacts and balanced against the policy objectives in this area.

93. Fiscal Costs, Exchequer Impacts, and Wider Economic Impacts, while very important, were also not the only issue informing the Decision. The Government had to balance the Decision against a range of other factors such as WTO compliance, maintaining flow at the border, minimising the need for infrastructure changes, and combatting fraud and non-compliance in the schemes.

[2] https://www.gov.uk/government/publications/revenue-and-customs-brief-21-2020-withdrawal-of-the-vat-retail-export-scheme-and-the-tax-free-shopping-concession

94. As has been noted above, this Decision fell outside the usual fiscal event cycle and OBR process, out of the necessity of announcing and implementing policies for the end of the transition period. Had the final OBR analysis of the Exchequer Impact been available at the time the advices were put to the Chancellor, the Decision would have been highly likely not to have been different. This is due to the fact that the OBR's independent assessment of the Exchequer Impacts reaffirmed the view that the withdrawal of the VAT RES and tax-free sales will raise a significant amount of revenue for the Exchequer, with a limited behavioural response and impact on retailers and visitor numbers.

95. Likewise, had the 2020 CEBR report on the extension and withdrawal of the VAT RES and the September 2020 York Aviation report on tax-free sales been available at the time the advices were put to the Chancellor, the advice that we would have put to him and the outcome of the Decision would have been highly likely not to have been different. As set out in §§79 - 80 above, officials had formed a view that the behavioural effects of the removal of the schemes would be less extreme than those predicted in these reports. In the case of the 2020 CEBR report officials presented the Chancellor with a copy. I was updated by my team that he subsequently agreed with officials' assessment that it was not a convincing prediction of the Wider Economic Impacts. In my view, the wider considerations, including the operational issues, would also not have changed as a result of these reports.

The UK's Free Trade Agreement with the EU

96. As highlighted in Cunningham 1, §§ 45 and 46 [**B/653–54**], the ratification of the EU Withdrawal Agreement meant that the UK had left the EU on 31 January 2020 on the basis of a deal, agreed by both sides at the end of 2019. From 1 February 2020, we entered the transition period, in which all existing VAT and excise rules and regulations would continue to apply, as well as the customs union and single market. The PM's vision for the UK's future relationship was set out in a Written Ministerial Statement on 3 February 2020. That included the fact that the Government was clear that Great Britain was leaving the single market and customs union after the end of the transition period. That then had clear implications for VAT and excise, as it effectively meant we would be completely independent from EU VAT and excise rules from 1 January

2021.The original consultation document had also set this out at para 1.1 [**B/200**].

97. On 26 December 2020 the UK reached a deal on the type of trading relationship that would occur after the transition period under the EU-UK Trade and Cooperation Agreement. Whilst the Agreement was a very important agreement for trade, it had no bearing on the 'passengers' policy package, which included the abolition of the VAT RES and airside tax-free sales. The Agreement was clear that in 2021 Great Britain would no longer be part of the single market and customs union, and independent from EU VAT and excise rules. It did not deal with any material VAT issues relevant to the passengers policy.

Statement of Truth

I believe the facts stated in this witness statement are true. I understand that proceedings for contempt of court may be brought against anyone who makes, or causes to be made, a false statement in a document verified by a statement of truth without an honest belief in its truth.

Signed ……………………………………
Michael James Cunningham

Dated 27 January 2021