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Editorial

A Lot Ado About Reduced VAT Rates

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Although prima facie the EU harmonization rules for VAT rates look quite simple, the EU-rules on the use of reduced VAT rates are contaminated with numerous derogations and special regimes for individual Member States. Several attempts by the European Commission to get a more transparent harmonization in this field have not yet led to success. Will Member States be prepared to find a solution?

According to Title VIII of the Council Directive 2006/112/EC (hereinafter: VAT Directive), the EU Member States shall apply a standard VAT rate that shall not be less than 15%. Until the beginning of the big crisis (2008), the highest standard rate was levied in Denmark and Sweden (25%).[1] Since 2008, the vast majority of Member States (nineteen) increased their standard VAT rate. VAT appears to be a pretty robust revenue raiser for governments with serious budget problems. At present, the highest standard rate is levied in Hungary (27%), whereas the lowest standard rate (15%) is still levied in Luxembourg. In spite of complaints about a VAT gap, Next to the standard VAT rate, Member States may apply either one or two reduced rates, but the application is restricted to supplies of goods and services mentioned in Annex III of the VAT Directive. Moreover, the reduced rates shall not be less than 5%. This reads as a strict rule, but the reality shows a great number of derogations, e.g., the possibility of 'super reduced rates' below the minimum level (even including 'zero rate') or 'parking rates' (if a Member State requires some transitory time to adapt).[2] Sometimes Member States even ignore the rule and apply reduced rates to goods or services that are not mentioned in the list of Annex III, and it may take several years to repair this through legal procedures.

VAT rates are an important policy issue for the EU Member States. As shown in the table under this editorial, within EU-28 as a whole an average of 40.6% of GDP is levied through all taxes and social contributions together, whereas VAT alone takes 7.2% of GDP.[3] In eighteen Member States VAT revenues are more than 7.2% of GDP. If we look at the part that VAT takes in the total of taxes and social contributions, the EU-28 average is 17.7%, but in twenty-three Member States this figure is higher.

The reactions of consumers on a change in VAT rates depend on the price elasticity (price sensitivity) of goods and services. The lower the price sensitivity, the easier it is charging a higher VAT amount to the final consumer (or to a VAT-exempt business who cannot deduct input VAT) and the higher the extra revenue for government. However, the higher the price sensitivity, the more difficult it is charging a higher VAT amount to the final consumer and the lower the extra revenue for government. A rise of VAT rates in relatively small Member States with neighbour countries in which lower VAT rates are levied, may even lead to more cross-border shopping. Retailers in the frontier area, who suffer from this effect, perceive it as a distortion of competition within an internal market without fiscal frontiers.

The effects of 'moving' specific goods or services from the standard VAT rate to a reduced VAT rate, or the other way around, depend on price sensitivity as well. In 2000, the Dutch government moved hairdressers' services from the standard VAT rate (at that time 17.5%) to the reduced VAT rate of 6%. However, the prices went down with around 3%, instead of the expected price fall of around 9%, indicating a rather low price elasticity for such services. Mid 2011 the Dutch government increased the rates of tickets for theatres, shows and music festivals from the reduced VAT rate to the standard rate. Although in most cases the rate increase was inserted in the ticket prices, the sales of the tickets hardly decreased. The long-term effects are unknown, because within one year and under a new government coalition, these services were moved back to the reduced VAT rate.

Once subject to a reduced VAT rate, it appears to be politically almost undoable to move goods or services back to the standard rate. One of the most stunning examples is the zero (!) VAT rate the UK applies for

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[1] In Ireland a standard rate of 35% was levied between 1982 and 1984. The rate decreased to 21% between 1984 and 2005.

[2] See for more detailed information on VAT rates: *A comprehensive overview of the VAT rates applied in the Member States of the European Union*, status January 2014, taxud.c.1(2014)48867.

[3] Figures for 2012 as published in Eurostat *Main national accounts tax aggregates* (update 7 Mar. 2014).

children footwear. When the UK became Member of the EEC in 1973, it succeeded in getting a derogation for a zero VAT rate in order to continue its policy (under the former purchase tax) of exempting children footwear. Although the derogation was said to be temporary, it survived the important changes in the VAT directives in 1977 and 1992 and is even still covered by Article 110 of the present VAT Directive.[4] This does not mean, however, that the European Commission is silently accepting the proliferation of reduced and super-reduced VAT rates.

Together with a Communication in 2007 the Commission successfully tabled a legislative proposal in which the temporary application of a reduced rate for a number of labour-intensive services was made permanent. At the same time the Commission announced a broad political debate on the VAT rate structure with all stakeholders concerned. Also in 2007, the Copenhagen Economics Think Tank concluded in its final report (rather vaguely) that there seems to be a strong argument for making the current VAT structure more simple and uniform, but also an argument for selective cuts in VAT rates, primarily in locally supplied services and parts of the hospitality sector.[5]

However, since the crisis the prime focus of the Commission is on achieving a more modern, more robust, simpler and safer VAT system, and therefore the development of a comprehensive EU policy on the use of reduced VAT rates is not to be expected in the near future – the more so as Member States seem not to be in favour of further shifting their already reduced fiscal autonomy to 'Europe'. So probably there will remain a lot ado about reduced VAT rates.

	Taxes as % of GDP		*VAT as %*	
Ranking	*VAT*	*Total **	*Ranking*	*of Total **
Croatia	12.4%	35.9%	Croatia	34.5%
Denmark	10.0%	49.1%	Bulgaria	33.7%
Bulgaria	9.4%	27.9%	Romania	29.8%
Hungary	9.4%	39.3%	Lithuania	28.0%
Sweden	9.3%	44.8%	Estonia	26.6%
Finland	9.2%	44.3%	Latvia	25.3%
Cyprus	8.9%	35.3%	Cyprus	25.2%
Estonia	8.7%	32.7%	Portugal	24.4%
Portugal	8.5%	34.9%	Hungary	23.9%
Romania	8.5%	28.5%	Iceland	22.8%
Iceland	8.4%	36.8%	Poland	22.5%
Slovenia	8.2%	37.9%	Malta	22.3%
Austria	8.0%	44.8%	Slovenia	21.6%
Malta	7.8%	34.9%	Slovakia	21.4%
Lithuania	7.7%	27.5%	Finland	20.8%
Germany	7.3%	40.4%	Sweden	20.8%
Poland	7.3%	32.5%	Czech Republic	20.6%
United Kingdom	7.3%	37.1%	Ireland	20.5%
EU-28 average	7.2%	40.6%	Denmark	20.4%
Belgium	7.2%	48.0%	United Kingdom	19.7%
Czech Republic	7.2%	35.0%	Greece	19.4%
Greece	7.1%	36.6%	Germany	18.1%

4 See: Han Kogels, *The Application of the Zero Vat Rate on Children's Footwear*, in British Tax review, Number 6, Essays in Honour of John F. Avery Jones, 688–698(Sweet & Maxwell 2010).

5 Study on reduced VAT applied to goods and services in the Member States of the European Union, Final report, on http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/study_reduced_VAT.pdf.

	Taxes as % of GDP			VAT as %
Ranking	*VAT*	*Total **	*Ranking*	*of Total **
Latvia	7.1%	28.1%	Austria	17.9%
Luxembourg	7.1%	40.3%	EU-28 average	**17.7%**
France	7.0%	47.0%	Netherlands	17.7%
Netherlands	7.0%	39.6%	Luxembourg	17.6%
Ireland	6.2%	30.2%	Spain	16.4%
Italy	6.1%	44.3%	Belgium	15.0%
Slovakia	6.1%	28.5%	France	14.9%
Spain	5.5%	33.6%	Italy	13.8%

* *Total Taxes and Social Contributions*