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Editorial

The Sweet Dream of a Simple VAT Rate Structure

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In spite of the growing complexity of the VAT legislation, the huge cross-border trade of goods and services, the fast growing e-commerce and the distortive effects of VAT fraud, the VAT as general consumption tax has proven to be a robust revenue raiser. As shown in Figure 1 in this editorial, VAT (by far the greatest revenue source within the category 'taxes on production and import taxes' as defined by Eurostat) has shown its merits after the great crisis in 2008.[1] Since 2012 it is the top tax revenue raiser, now contributing some 20% of total tax and social premium revenues. In 2014 almost EUR 1 trillion VAT was collected in EU-28, which is equivalent to some 7% of Gross Domestic Product.

One of the complexities of this robust consumption tax is its rate structure. According to the VAT Directive 2006/112/EC, the Member States shall apply a standard rate of at least 15% and next to the standard rate they may apply either one or two reduced rates to goods or services listed in Annex III of the Directive, which shall not be less than 5%.[2]

The main rule looks simple, but the real picture of reduced VAT rates is quite complex because of many temporary derogations allowed by the Directive. For instance, Member States which, at 1 January 1991, applied a zero rate (i.e. an exemption with deducibility of the VAT paid at the preceding stage) or a reduced rate lower than 5% (super reduced rate), may continue to do so until the adoption of definitive arrangements replacing the transitional system for the taxation of trade between the Member States that is still in force since 1993.[3] Fourteen of the twenty-eight Member States may apply temporary derogations: three Member States (France, Luxembourg and Spain) are allowed to apply a super reduced rate for specific goods or services, nine Member States (Belgium, Cyprus, Denmark, Estonia, Finland, Malta, Poland, Sweden and the UK) are allowed to apply a zero rate for specific goods and services (which means that such goods or services are supplied tax-free), whereas Ireland and Italy are allowed to apply both a zero rate and a super reduced rate for specific goods and services.[4]

In the course of time the European Commission (EC) has reported regularly on the development of reduced VAT rates and the impact on the working of the single market.[5] Next to this, various study groups have suggested that mitigating or abolishing the application of reduced rates could make VAT simpler, reduce the administrative burden on VAT-liable persons and contribute to the EU-wide accepted policy objective of shifting the tax burden from taxes on (labour) income to taxes on consumption. Yet these advantages seem not to weigh-up against the disadvantages feared by retailers and service providers (in particular those who provide labour-intensive services) benefitting from reduced or super reduced VAT rates, as higher consumption prices may have a negative impact on their margins.

In her Action Plan of 7 April 2016 'Towards a single EU VAT area' the EC suggests two options for revising the VAT-rate structure.[6]

Option 1: regularly review the list of goods and services eligible for reduced rates, Member States could suggest potential adjustments, all currently existing reduced rates and derogations in the sphere of zero rates and super reduced rates will be maintained and made available to all Member States to ensure equal treatment.

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1 http://ec.europa.eu/eurostat/statistics-explained/index.php/Tax_revenue_statistics.

2 At this moment the standard rate in EU-28 varies from 17% (Luxembourg) to 27% (Hungary). Reduced rates may not be applied to electronically supplied services, such as referred to in Annex II of the Directive.

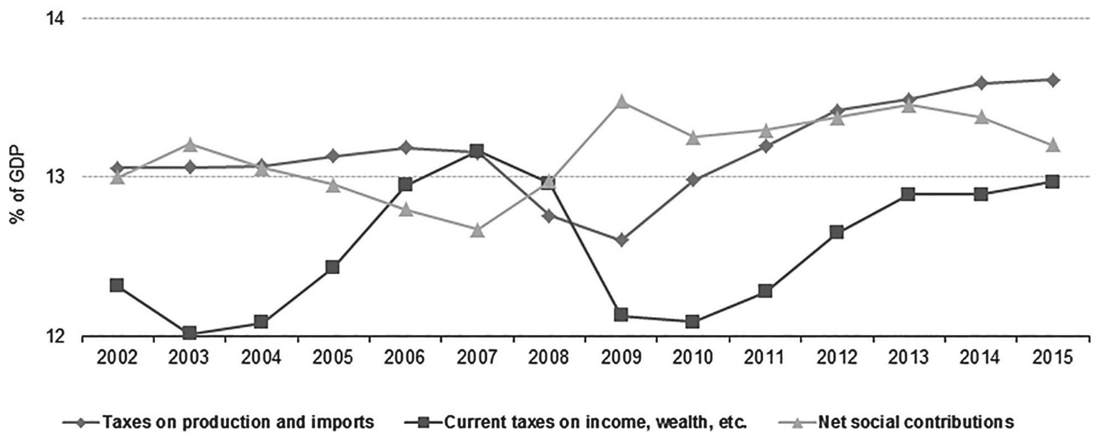
3 The VAT Action Plan (COM(2016) 148) includes a new cross-border VAT system in which sales of goods to VAT-liable persons in an other Member State are no longer zero-rated; a system that looks like the clearing system that was proposed (without success) before the introduction of the current transitional system in 1993. The main difference is that the tax rate applied on the intra-EU transaction would be the rate applicable in the Member State of the buyer instead of the rate applicable in the Member State of the seller. In this editorial I will not go further into this new proposal.

4 Sources: *VAT Rates Applied in the Member States of the European Union*, Taxud.c.1(2017)-EN and *Practical Information on European VAT*, Annex to International VAT Monitor Jan./Feb. 2017, IBFD.

5 COM(1994) 584, COM(1997) 559, COM(2000) 348, COM(2001) 599, COM(2003) 397 and COM(2007) 380.

6 COM(2016) 148.

Figure 1



Option 2: abolishing the list and giving the Member States control of the number of goods and services taxed at reduced rates and the rate-levels they could put in place. This would require safeguards to avoid unfair tax competition within the single market and to prevent fraud. The Member States would have to continue abiding by EU legislation, such as the Single Market rules and the EU's economic governance framework.

Although both options are still vague and not yet elaborated in concrete proposals, they seem not no lead to simplification and lower compliance costs. Option 1 would make the current temporary derogations permanent and applicable to all Member States. So entrepreneurs in Member States that decide to introduce these derogations, will face increasing compliance costs. Option 2 would put an end to the harmonization of the scope and level of reduced VAT rates. This might look attractive to Member States eager to regain fiscal autonomy. However, giving Member States the autonomy to choose the goods and services they want to be taxed at a reduced rate and to set the levels of these rates, may lead to an arbitrary and extremely complex and VAT-rate structure within the Single Market and to increasing compliance costs. Moreover, it is not yet clear how unfair tax competition could be avoided and fraud could be prevented, especially in intra-EU border areas where retailers and service providers will face substantial differences in VAT rates for the same product or service.

In December 2016 the EC launched an open public consultation on the reform of VAT rates. The summary of the responses to that consultation contains some interesting findings.[7]

As regards the list of goods and services eligible for reduced VAT rates: 49% of all respondents are in favour of extending the list, while 30% find the current list adequate (20% no opinion). There are no respondents suggesting the list should be reduced.

As regards the priority of reform: 52% prefer simplicity of the VAT system and 29% prefer flexibility for Member States (19% no opinion).

As regards the number of reduced VAT rates: 52% prefer the status quo (one or two), whereas 26% find that Member States should have no limits in the number of reduced VAT rates (22% no opinion).

As regards the current minimum standard rate of 15%: 52% want to keep it and 16% are against keeping it (32% no opinion).

As regards the current minimum reduced rate of 5%: 50% want to keep it, while 20% want to abolish it (30% no opinion).

With regard to the two suggested scenarios in the Commission's Action Plan: 46% prefer Option 1 and 22% prefer Option 2, whereas 14% want to keep the current system (17% no opinion).

The outcome of the consultation indicates no sufficient support for Option 2 (less harmonization and more flexibility for the Member States as regards reduced rates) and I tend to assume that the EC is secretly happy with this outcome.

At the time of completing this editorial we are still awaiting the concrete proposals the EC has said to publish by the end of 2017. Looking at the responses to the consultation, we may expect that the EC will put emphasis on Option 1.

If that would be the result of the Action Plan, sectors currently enjoying a zero rate or a (super) reduced VAT rate would feel safe and similar sectors in all other Member States may welcome these benefits as well. However, those who dream the sweet dream of a simple VAT rate structure would better keep dreaming.

7 *Summary Report of Responses to European Commission's Open Public Consultation on the Reform of VAT Rates* (June 2017), https://circabc.europa.eu/sd/a/61ba74bc-a346-41ee-88e5-c0e2dbfc8f86/Summary%20Report.pdf. The number of responses to the questionnaire amounted to 327 and 60 position papers were submitted. In terms of Member States, twelve of the twenty-eight Member States did not respond to the consultation.