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The reform of VAT rates

On 7th of April 2016 the European Commission (EC) adopted an Action Plan on VAT. One of the aims of the Action Plan on VAT is to modernize rates policy.

EU countries have been coordinating their VAT rates since 1992. Under current EU rules, countries must apply a minimum standard VAT rate of 15%. They have an option of applying one or two reduced rates, no lower than 5%, to certain specified goods on a pre-approved list. The current rules also allow for a series of reduced rates, even with rates under 5%. According to the derogations established in articles 109 – 122 of the Directive, Member States concerned were allowed to continue applying reduced or super-reduced rates after the Directive was adopted in their countries.

The Commission has put forward two options for giving Member States more freedom on setting the VAT rates:

- The first option would be to maintain the standard rate with a minimum of 15% and to extent the list of goods and services subject to reduced rate. The list of goods and services subject to reduced rate would be reviewed on a regular basis, taking political priorities into account.

- The second option would be to remove the standard rate with a minimum of 15% and to abolish the list of goods and services subject to the reduced rate, granting countries more freedom on the number of reduced rates and their level.

The Commission has launched a public consultation aiming at obtaining stakeholders views' on the proposed policy options. The Commission intends to present a reform proposal in autumn of 2017.

There are multiple reasons to suggest that the second option of removing the standard rate with a minimum of 15% and abolishing the list of goods and services subject to reduced rate would grant more flexibility and benefit the economy of Member States compared to the first option and the current system of VAT.

More freedom on the number of reduced rates and their level would contribute to the free movement of goods and services

A diversity of tax rates is not a roadblock for free trade. Quite the opposite, differences in tax systems might serve as a stimulus for the cross-border trade. Taxes constitute a significant share of costs and a large share of the price of factors of production, labour in particular. It is tax diversity (which is usually determined by the necessity to accommodate to local conditions and traditions) that frequently provides opportunities to produce cheaper goods and services and to offer them on the international market. Thus, absence of centralised tax harmonisation encourages beneficial trade rather than undermining it.

Countries have always competed using their exogenous factors (e.g. the amount of land, population, proximity to waterways, etc.) as well as endogenous one (e.g. the level of corruption, political stability, the level of bureaucracy and taxation). Competition by endogenous factors (e.g. taxation) should not be perceived as “unfair” or “unnatural.” Tax competition is no different than competing for investment by cutting red tape, lowering bureaucracy and other factors that depend on national governments.

The abolition of minimum VAT rate may open possibilities to reduce the overall tax burden

Under current rules Member States must set a minimum standard VAT rate of 15%. Those Member States that have fewer exemptions and/or reduced rates tend to keep a single tax rate for most of the categories of goods and services in order to avoid market distortions. Therefore, their VAT burden is comparatively high.

On average, approximately 65% of final consumption is subject to the standard rate in the entire European Union; in Portugal, Ireland and Greece, the share of the standard-rated goods and services is less than 50% of total consumption, whereas it is more than 90% in Bulgaria, the Slovak Republic and Romania. The share of reduced-rated goods and services is on average 26% and ranges from a few percentage points (in two Baltic Member States, Romania, Bulgaria and Denmark) to more than 40% of total consumption (in Portugal, Spain, Greece, and Poland). Finally, approximately 9% of final consumption is exempt or outside the scope of VAT.[1]

In Lithuania, where statutory VAT rate is 21% and effective VAT rate is 19.1%, the gap between the effective VAT rate and the statutory standard VAT rate is one of the smallest in the EU (less than 10%). Such rates are relatively high, compared to the EU, where average standard VAT rate is 20.7% and average effective VAT rate is 15.5%. Due to the inflation, VAT revenues are constantly growing. This is a strong basis to reduce the statutory VAT rates. For example, in Lithuania VAT revenues grew from 1.8 bln. Euros in 2006 to 3 bln. Euros in 2016.

Possibility to set statutory VAT rate below 15% for a wider set of different goods and services may lead to lower effective VAT rates in various Member States. Therefore, countries, which have fewer exemptions and/or reduced rates, may maintain the same principles of taxation but lower their standard VAT rate.

Of course, there is a possibility that countries may differentiate VAT rates for different groups of products and services extensively and in order to raise the same budgetary revenues or reduce the consumption of some goods or services for those they may set a disproportionately high VAT rates.

[1] Borselli, Fabrizio, Salvatore Chiri, Ettore Romagnano, *Patterns of Reduced VAT Rates in the European Union*, http://empcom.gov.in/WriteReadData/UserFiles/file/No_1%20A-5%20Patterns%20of%20Reduced%20VAT%20Rates%20in%20the%20European%20Union%20Jan%20Feb%20page%2013-21.pdf

However, there is a little possibility, that the VAT may be used as a tool to reduce the consumption of some products, e.g. alcohol or tobacco, as other taxes aimed at the same purpose already exist. As EU will continue to set the minimum excise rates, Member States will continue to use them as a regulatory tool.

Similarly, due to free movement, citizens of the EU could buy goods in other Member States, thus discouraging governments, that decide to abuse the possibility to set the VAT for different goods at their discretion, from such practice.

Greater autonomy on setting VAT rates would contribute to the greater subsidiarity in the EU

Abolishing the list of goods and services subject to reduced rate and granting countries more freedom on the number of reduced rates and their level would increase the subsidiarity of Member States' tax systems, as decisions would be taken closer to the citizen. It would allow Member States to control the level of revenue at the margin more consistently, *i.e.* they will be able to set the level of taxes to correspond to the desires of voters.[2] It would be a very important change for those countries, which gain a large share of their budget revenues from the VAT, as they are at current disadvantage looking from the perspective, that they have less freedom of manoeuvre. *I.e.*, countries relying on other forms of taxation revenues have more discretion in setting the tax rates.

In addition, choosing the second option would allow Member States to set their tax rates in accordance to the existing purchasing power. For example, countries with low purchasing power may set lower VAT rates for a wider set of goods and services. As due to the single market the prices of consumer goods tend to converge in the entire EU, it is an important issue, especially for the new Member States, where consumers pay a larger share of their income as consumption taxes, than the citizens of the old EU Member States.

In the light of recent tax harmonization activities regarding the corporate income tax, greater autonomy on setting the VAT rates may be welcomed by the public and appease the Eurosceptic sentiments. The claims that Member States now cannot impose a lower VAT level were extensively used during the vote on the Brexit campaign.[3] As the VAT is paid by personal end-consumers, therefore more people confront the obligation to pay this tax during their daily activities, compared to CIT and other forms of taxes. For this reason, more flexibility on the VAT regime may be widely welcomed by the general audience.

[2] Cnossen, Sijbren, *Tax Policy in the European Union: A Review of Issues and Options,* https://www.econstor.eu/bitstream/10419/76060/1/cesifo_wp758.pdf

[3] *Reality Check: Does the EU control UK VAT rates?* http://www.bbc.com/news/uk-politics-eu-referendum-36430504

Conclusions

- The abolition of the standard rate with a minimum of 15% together with more freedom on the number of reduced rates and their level would contribute to the free movement of goods and services in the EU.
- Possibility to set statutory VAT rate below 15% for different goods and services may lead to lower effective VAT rates in various Member States.
- Greater autonomy on setting VAT rates would contribute to the greater subsidiarity in the EU and may be welcomed by the public, which, in the current light of the growing Euroscepticism views tax harmonization as a breach of EU subsidiarity principle.

Recommendations

- The European Commission should work to preserve the highest degree of tax competition between Member States.
- High-tax EU Member States advocating tax harmonisation should take practical steps towards harmonisation by aligning their tax systems with those tax regimes that are the most conducive to economic growth.
- The European Commission should further develop the proposal to remove the standard rate with a minimum of 15% and to abolish the list of goods and services subject to reduced rate, granting countries more freedom on the number of reduced rates and their level.