

The EU Council's New Agreement On VAT Rates Is a Poisonous Gift To Member States, Citizens, And Businesses

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The European Academic Network of VAT (EANO VAT) issued the following statement on December 13. It was written by Rita de la Feria (Leeds University), Tina Ehrke-Rabel (University of Graz), Joachim Englisch (Muenster University), Marie Lamensch (UCLouvain), Madeleine Merckx (Erasmus University Rotterdam), Edoardo Traversa (UCLouvain), and Ad van Doesum (Maastricht University).

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On December 7, 2021, the EU Council reached a political agreement on a revised 2018 European Commission proposal that broadens the list of goods and services that can be subjected to reduced VAT rates. After decades of advocating the benefits of rationalization of VAT rates across the EU member states, the European Commission has asked the Council to partially undo what it had achieved, at great effort, in 1992. At a time when public resources are needed to help the EU recover from the negative effects of the pandemic, this step back in the harmonization process is likely not only to hinder member states' ability to collect tax revenues, but also to create discriminations between EU businesses and consumers — critically, without achieving any significant social or environmental gains. This is a grave policy mistake that the EU and its member states may come to regret for many years to come.

At present, EU law allows member states to apply up to two reduced rates to a positive (short) list of goods and services provided therein — although in practice many member states have been granted derogations to these rules, with some applying as many as five reduced rates. The approved proposal significantly broadens this list. At first sight, it is likely that this reform will be welcomed by the general public in most of the EU

member states, who often see reduced rates or exemptions as a way to either protect the poorest or to pursue social goals, such as gender equality or environmental sustainability.

These are certainly meritorious aims. Yet the key issue is not whether the aims are meritorious, but whether applying reduced rates of VAT to them is the most appropriate instrument to attain them. And the problem is that, over the last 40 years, an overwhelming body of legal and economic evidence has shown that they are not.

There are various reasons as to why this is the case. First, contrary to the common assumption that reductions in VAT rates are fully passed through in consumer prices, prices often do not fully reflect changes in rates, but often just result in higher margins for businesses offering those goods and services. Moreover, even assuming that the decrease in VAT will indeed affect prices, that does not mean that goods and services will become affordable. In the U.K., the Treasury estimated the abolition of the “tampon tax” (application of the standard VAT rate on feminine hygiene products) would save the average woman only £40 over her lifetime, a very small, if not negligible, fraction of the total amount spent on that product.

Second, consumption, even of essential items, is overwhelmingly done by the richest. Assuming reductions are reflected in lower prices, it is those consumers, therefore, that benefit the most from VAT decreases. This is especially the case if they apply to cultural or environmentally-friendly products (such as books or cultural events, electric bikes or solar panels), which are to a great extent consumed by the richest.

Third, there are very significant costs attached to the application of reduced VAT rates. From a tax revenue perspective, the costs for State budgets tend to be extremely significant: The foregone revenue will impact the provision of higher standard public services, to the detriment

of lower-income households. From a legal perspective, more reduced rates within the EU will also mean more distortions to competition between similar products, more opportunities for tax planning and avoidance, and more compliance and administrative costs for businesses.

Finally, from a treaties perspective, the EU should exercise its powers to enact law that is (a) harmonizing in nature, and (b) necessary to ensure the establishment and the functioning of the internal market and avoid distortions to competition. The approval of the proposal arguably has the opposite effect, creating higher levels of divergence, making intra-EU business more difficult, and disproportionately impacting small and medium sized enterprises.

Despite the strong evidence against the effectiveness of using reduced rates of VAT to

achieve social and distributional aims, the pressure for their increased use remains a constant. Similarly, to other areas of the tax system, these pressures for VAT base-narrowing, arise not from efficiency or equity considerations, but from politically-oriented ones, often inspired by influential lobbies. The approval of this proposal will significantly increase the scope for such pressures and make them harder to resist at the domestic level. The hard truth is that at present EU VAT law restrains and protects national governments; but now, the EU will no longer be able to play the role of the external culprit. The risk of entering a vicious circle is evident: Tax concessions create moral hazards, and one concession is likely to give rise to more, progressively eroding the tax base, with all the efficiency – and critically, equity – costs that this entails. ■