

# Blueprint for reform of VAT rates in Europe

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# BLUEPRINT FOR REFORM OF VAT RATES IN EUROPE

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*Within Europe differentiated rates structures date back to the introduction of VAT itself. Evidence as regards the negative consequences of applying multiple rates has been apparent for some decades. In this context, since the late 1980s, there have been several attempts to amend European rates structures under the political guidance of the European Commission. However, the most recent agreed upon amendments to the rates structure have increased the level of differentiation, rather than decreased it, with more goods and services being subject to reduced rates in Europe today than even as recently as ten years ago. This reality seems to be changing in the last few years. Since 2008 a staggering twenty-two of the twenty-eight EU Member State countries have increased their VAT rates, resulting in a broad convergence of VAT standard rates across the EU around the 21% mark. Furthermore, there has also been a decrease in levels of differentiation with a reduction in number of VAT rates applicable in many Member States, as well as various base broadening measures. The latest developments seem to indicate that conditions may be present which allow the reversal of the status quo bias, creating the opportunity for base broadening tax reform. This raises the possibility that European countries might engage in an involuntary process of convergence of VAT bases, fuelled by domestic necessities. A politically achievable blueprint for reform of VAT rate structures in European is presented, which would result in a broader-based, and thus more efficient and neutral, VAT. Moreover, application of this blueprint across EU Member States would have the additional advantage of resulting in further convergence of VAT rate structures in Europe, to replace the long-sought, but so far unattainable, EU harmonisation.*

## 1. VAT Rates in Europe: 1967 to 2008<sup>1</sup>

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<sup>1</sup> A longer version of this section has been published in R. de la FERIA, “EU VAT Rate Structure: Towards Unilateral Convergence?” in F. Querol (ed.), *La réorientation européenne de la TVA* (LGDJ, Presses de l'Université de Toulouse 1 Capitole, 2014).

The introduction of the European VAT system dates back to 1967, with the approval of the First and Second VAT Directives.<sup>2</sup> The system put in place under those Directives, however, established only a basic framework, leaving a full autonomy to Member States insofar as rates were concerned: national legislators were free to establish their own rates structure, including number and level of rates.<sup>3</sup> Primarily for political and practical reasons, Member States used that freedom therefore to largely mimic the rates structures applied under their previous turnover taxes.<sup>4</sup> With the approval of the Sixth VAT Directive in 1977 there was a significant increase on the level of detail contained as regards the tax base, and a decrease in the level of freedom granted to Member States.<sup>5</sup> Yet, despite the progress achieved in some areas of the system, as regards other areas such as the rates structure, the EC Council of Ministers reportedly found it impossible to reach agreement and consequently further harmonisation was postponed to a later date. The rules applicable to rates under the original version of the Sixth VAT Directive were therefore similar to those previously applicable under the Second VAT Directive, i.e. there was total lack of specific rules as regards rates structures. For that outcome certainly contributed the opposition adopted by Member States at negotiations - such as France, Germany, and the United Kingdom - keen to maintain the domestic application of reduced VAT rates to specific products.

### **1.1. Towards an harmonised EU rates structure**

In June 1985, the European Commission presented the so-called White Paper for the completion of the Internal Market, which laid down a series of measures with a view to establishing an internal market by 1992. Under the heading removal of fiscal barriers, the paper contained several measures in the field of VAT.<sup>6</sup> According to the White Paper a close level of “approximation” within VAT was required in order to establish a true internal market, and in particular progress had to be achieved as regards tax rates. In this context, the European Commission was to present a proposal, which would deal both with the number of rates and level of these rates, in particular that of the standard rate. In the meantime, according to the White Paper “provisions should be adopted which will exclude the

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<sup>2</sup> First Council Directive 67/227/EEC of 11 April 1967, OJ 71, 14/04/1967, 1301 (hereafter “First VAT Directive”); and Second Council Directive 67/228/EEC of 11 April 1967, OJ P 71, 14/04/1967, 1303 (hereafter “Second VAT Directive”).

<sup>3</sup> Article 9 of the Second VAT Directive.

<sup>4</sup> See R. de la Feria and R. Krever, “Ending VAT Exemptions: Towards A *Post-Modern* VAT” in R. de la Feria (ed.), *VAT Exemptions: Consequences and Design Alternatives* (The Hague: Kluwer Law International, 2013), 3-36. See also S. Cnossen, “What Rate Structure for a Value-Added Tax?” (1982) *National Tax Journal* 35(2), 205-214, at 209; V. Lenoir, “April 1954–April 2004 – VAT Exemptions: The Original Misunderstanding” (2004) *European Taxation* 10, 456–459, at 456–457.

<sup>5</sup> Sixth Council Directive 77/388/EEC of 12 May 1977, OJ L 145, 13/06/1977, 1 (hereafter “Sixth VAT Directive”).

<sup>6</sup> *Completing the Internal Market – White Paper from the Commission to the European Council*, COM(85) 310, 14 June 1985. For a detailed analysis of the VAT measures in the White Paper see R. de la Feria, *The EU VAT System and the Internal Market* (Amsterdam: IBFD, 2009), at 57 et seq.

proliferation of VAT rates in Member States, or the widening of the gap between VAT rates, since this would make subsequent adjustment more difficult”.<sup>7</sup>

In 1987 the Commission put forward a proposal for a new VAT rates structure, which would be compatible with these objectives.<sup>8</sup> This new structure was based on three basic principles, as follows: dual-rate system; goods and services compulsorily allocated to each rate; and repeal of temporary derogations, allowing Member States to apply reduced rates and zero rates.<sup>9</sup> The 1987 proposals were widely regarded as very ambitious in both their aims and their prospected methods for achieving these aims.<sup>10</sup> Progress in Council discussions proved slow, and by June 1989 the Commission recognised that certain aspects of the 1987 VAT rates proposal were curtailing the possibility of reaching agreement.<sup>11</sup> It recognised then, that a more pragmatic approach would be required. The idea of a transitional phase, which would last beyond 1 January 1993, started to take shape in late 1989. During the period until 1991 a series of key meetings of the ECOFIN Council of Ministers took place, from which emerged the basic shape of what was to become known as the “transitional VAT system”.

The decision to introduce a VAT transitional system had serious implications for the discussions on the harmonisation of VAT rates. Rates approximation was still seen as an absolute necessity if abolition of border controls was to take place, however, a close approximation such as the one put forward by the Commission in its 1987 proposal was no longer required. In this context, and with a view to facilitate agreement within the Council, the Commission suggested in its Communication the following alternative rates structure: minimum standard rate; one reduced rate set between 4% and 9%; and maintenance of zero-rating for a limited number of products. This alternative rate structure was significantly more moderate and less ambitious than the structure originally proposed by the Commission. However, it was still over-ambitious for Member States, particularly as regards the reduced rates regime. In March and June 1991 the Council finally reached agreement on the essential characteristics of the VAT rate structure, which was to apply within the context of the new

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<sup>7</sup> White Paper, n. 6 above, at 52.

<sup>8</sup> *Proposal for a Council Directive completing the common system of value added tax and amending Directive 77/388/EEC – Approximation of VAT rates*, COM(87) 321 final/2, 21 August 1987.

<sup>9</sup> See *Completion of the Internal Market: approximation of indirect tax structures and harmonisation of indirect tax structure*, Global Communication from the Commission, COM(87) 320 final, 5 August 1987.

<sup>10</sup> A.J. Easson expressed a widely felt scepticism when he commented: “to expect to achieve an alignment of tax rates by 1992, by the end of the century or even by the middle of the next one, is to be completely unrealistic. The approach which has been exposed by the Commission for the past twenty-five years or so is doomed to fail”, in “The Elimination of Fiscal Frontiers”, in R. Bieber *et al* (eds.), *1992: One European Market? A Critical Analysis of the Commission’s Internal Market Strategy* (Baden-Baden: Nomos Verlagsgesellschaft, 1988), 241-260, at 260.

<sup>11</sup> *Completion of the Internal Market and Approximation of Indirect Taxes*, Communication from the Commission to the Council and to the European Parliament, COM(89) 260 final, 14 June 1989, at 1.

transitional system. The agreement, which eventually led to the approval of the Council Directive 92/77/EEC of 19 October 1992, known as the Approximation of VAT Rates Directive,<sup>12</sup> not only differed significantly from the Commission’s original 1987 proposal, but also differed from the alternative rates structure proposed by the Commission in its 1989 Communication.

The new VAT rate structure, which would apply from 31 December 1992 onwards, was largely a product of political compromises and a good example of the victory of politics over economic efficiency. The price for reaching agreement was an extremely complex system (mostly if compared with the simplicity of the structure initially proposed by the Commission), filled with exceptions and derogations. Overall, the new rate structure comprised two types of rules: general rules; and temporary measures, which in theory would apply only during the transitional system.

Under the general rules, Member States must apply a standard rate, which should not be lower than 15%, but no maximum limit was established. Member States could also apply either one or two reduced rates, which could not be lower than 5%. These rates could be applied to a range of seventeen goods and services listed in what is now Annex III and additionally, under certain conditions, to the supplies of natural gas and electricity. During the transitional period, and until the introduction of a definitive VAT system, Member States were allowed to maintain and/or introduce measures which derogated from the general rates’ rules. Under these measures, Member States were allowed, subject to certain conditions, to: continue to apply reduced rates lower than the 5% minimum; continue to apply zero-rates; continue to apply both reduced rates lower than the 5% minimum and zero-rates to items not listed in Annex III; continue to apply a reduced rate to restaurant services, children's clothing, children's footwear and housing; and introduce, dependent on certain requirements, an extra reduced rate, not lower than 12%.

Table 1 provides a comparative overview of the three VAT rate structures discussed above.

**TABLE 1**

<b>VAT RATE STRUCTURES: COMPARATIVE OVERVIEW</b>		
<b>COMMISSION’S 1987 PROPOSAL</b>	<b>COMMISSION’S 1989 ALTERNATIVE PROPOSAL</b>	<b>APPROXIMATION OF VAT RATES DIRECTIVE</b>
<b>Two rates system (standard rate and reduced rate)</b>	Two rates system (standard rate and reduced rate)	<b>Five rates system (standard rate, three reduced rates and zero-rate)</b>

<sup>12</sup> Council Directive 92/77/EEC of 19 October 1992, OJ L 316, 31/10/1992, 1 (hereafter the “Approximation of VAT Rates Directive”).

<b>Standard rate band (14% to 20%)</b>	Standard rate minimum	<b>Standard rate minimum (15%)</b>
<b>Reduced rate band (4% to 9%)</b>	Reduced rate band (4% to 9%)	<b>Reduced rates minimum (5%) in theory; in practice no minimum applies</b>
<b>6 items which may be subject to reduced rate</b>	6 items which may be subject to reduced rate	<b>22 items which may be subject to reduced rates</b>
<b>Compulsory nature of list of goods / services subject to reduced rate</b>	Compulsory nature of list of goods / services subject to reduced rate	<b>Optional nature of list of goods / services subject to reduced rate</b>
<b>Abolition of zero-rating</b>	<b>Maintenance of zero-rating for a limited range of products</b>	<b>Maintenance of zero-rating</b>

## 1.2. Post-1992 failed initiatives

The VAT transitional system, including the temporary measures on VAT rates described above, was supposed to be in place for a period of four years after 1 January 1993. A time plan was therefore agreed upon according to which the European Commission would bring proposals forward by the end of 1994, with a view to implementing a definitive VAT system based on the origin principle by 1997. Unfortunately, the Commission was unable to fulfil this time plan and it was not until the summer of 1996 that a work programme was presented for the adoption of the definitive VAT system.<sup>13</sup> Although formal legislative proposals were never put forward, the programme contained an outline of the envisaged system, as well as a detailed work plan extending through to mid-1999.<sup>14</sup> Amongst the key features of the definitive VAT system, as foreseen under that programme, was the further harmonisation of the main aspects of the VAT system including rates.

This new attempt was too doomed to fail. The first setback came very soon after the presentation of the 1996 programme, as Member States failed to reach total agreement on the already tabled proposal regarding the establishment of a fixed band for standard rates of VAT. This included a minimum rate of 15% and a maximum rate of 25% and whilst Member States were able to agree on the minimum level, it was impossible to reach unanimity on a maximum level. Ultimately, the proposal was approved but the final text contained no reference to the maximum level of standard rate.<sup>15</sup> Thus, very little progress was made on the Commission's proposed 1996 programme and it

<sup>13</sup> See *A common system of VAT – A programme for the Single Market*, COM(96) 328 final, 22 July 1996.

<sup>14</sup> This means that in practice even if the proposals presented during this period would have been agreed upon by Member States, the definitive VAT system would not be in place until 2001 at the earliest, see *ibid*, at 34.

<sup>15</sup> Council Directive 96/95/EC of 20 December 1996, OJ L 338, 28/12/1996, 89.

soon became clear that the degree of harmonisation necessary for the introduction of a definitive VAT system (particularly in terms of VAT rates) would not be achieved.

### 1.3. Further differentiation of rates structures

Since the approval of the Approximation of VAT Rates Directive, VAT rates, far from converging as might have been expected,<sup>16</sup> can diverge much more than under the legal framework set up in 1992. As reported by the European Commission in 2001, despite its tentative efforts to increase convergence, “when current rates are compared with those applicable in 1997, it is apparent that rates continue to vary considerably”.<sup>17</sup>

The main reason for increased rate differentiation within Europe since 1992 has been the so-called labour-intensive services experiment. Implemented in 1999, the experiment allowed the application of reduced rates to certain labour-intensive services, such as hairdressing and window cleaning, with the aim of testing its impact on job creation and the combat against the “black market”.<sup>18</sup> Initially intended to last for three years, the experiment was consecutively extended despite disappointing results.<sup>19</sup> A report from the European Commission, published in 2003, confirmed that the impact of introducing reduced rates on prices of labour-intensive services was minimal. When conducting price surveys, Member States found that reduced rates were only partially reflected in consumer prices or not at all and that at least part of the VAT reduction was used to increase the margins of service providers. Moreover, even where the VAT reduction had been passed on to the consumers, Member States found that this was only a temporary measure and prices would subsequently increase.<sup>20</sup> Overall, the study concluded that, partially due to the lack of effect on prices, the aims of the experiment, namely to increase employment and to combat the black economy, had not been achieved.<sup>21</sup>

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<sup>16</sup> This was in fact the Parliament’s opinion, see *Options for a definitive VAT system*, Working Paper, Economic Affairs Series, E 5, October 1995, at 87. This was also the view expressed by several authors and Member States’ officials, as reported in P. Guieu and C. Bonnet, “Completion of the Internal Market and Indirect Taxation” (1987) *Journal of Common Market Studies* XXV(3), 209-222, at 215.

<sup>17</sup> See *Report from the Commission on reduced VAT rates drawn up in accordance with Article 12(4) of the Sixth Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment*, COM(2001) 599 final, 22 October 2001, at paragraph 19.

<sup>18</sup> Council Directive 1999/85/EC of 22 October 1999, OJ L277, 28/10/1999, 34.

<sup>19</sup> Council Directive 2002/92/EC of 2 December 2002, OJ L 331, 07/12/2002, p. 27; Council Directive 2006/18/EC of 14 February 2007, OJ L345, 28/12/2005, 19-20; Council Directive 2004/15/EC of 10 February 2004, OJ L52, 21/02/2004, 61.

<sup>20</sup> See *Experimental application of a reduced rate of VAT to certain labour-intensive services*, Report from the Commission to the Council and to the European Parliament, COM(2003) 309 final, 2 June 2003; and *Evaluation report on the experimental application of a reduced rate of VAT to certain labour-intensive services*, Commission Staff Working Paper, SEC(2003) 622, 2 June 2003.

<sup>21</sup> *Ibid*, at 28.

Yet, the above results did not prevent Member States from either further extending the experiment, but moreover, from transforming the temporary experiment into permanent measures. In 2008 the European Commission put forward a new legislative proposal, which it designated as “a first action concerning reduced VAT rates” and as a “limited legislative proposal [...] relating to urgent issues, which do not require any substantial additional study”.<sup>22</sup> The proposal had two objectives, both allowing for further differentiation of VAT rates: to make the possibility of applying reduced rates to certain labour-intensive services permanent, and to allow Member States the freedom to apply reduced rates to “locally supplies services”, such as restaurant services. The proposal was approved not long after its presentation, with the final legislative document essentially following its wording – both factors a clear indication that negotiations had been relatively straightforward, and that Member States were broadly in agreement with the new direction taken by the European Commission.<sup>23</sup>

In the meantime, Commission’s attempts at limiting overall differentiation failed miserably. In 2003 the Commission presented a proposal with a view to “review and rationalise the use of reduced rates”. The proposal left considerably more freedom to Member States to decide on their own VAT rates structure than under previous Commission’s proposals, namely the 1987 and 1989 proposals. Obviously, it considered that by allowing increased freedom, the likelihood of Member States reaching unanimous agreement at the Council would also increase. Although not exceedingly ambitious, however, the proposal did envisage the move to a compulsory natured list of products which may be subject to reduced rates, which seems to have been sufficient to cause concern amongst Member States.<sup>24</sup> After years of discussions at the Council,<sup>25</sup> the proposal was finally approved in 2006 but at significant costs: the emphasis was no longer on rationalisation of reduced rates, but rather on the extension of the temporary rates provisions within the VA Directive, as well as on the extension of the list of products to which reduced rates may apply.

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<sup>22</sup> *Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax*, COM(2008) 428 final, 7 July 2008, at 2. This is the sixth formal proposal by the Commission exclusively on VAT rates (excluding informal suggestions).

<sup>23</sup> Council Directive 2009/47/EC of 5 May 2009, OJ L116, 09/05/2009, 18-20.

<sup>24</sup> *Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax*, COM(2003) 397 final, 23 July 2003.

<sup>25</sup> See *Preparation of Eurogroup and Council of Economics and Finance Ministers, Luxembourg, 6-7 October 2003*, MEMO/03/191, 06/10/2003), and 2530<sup>th</sup> Council Meeting – Economic and Financial Affairs – Luxembourg, 7 October 2003, C/03/274, Pres/03/274, 07/10/2003 and *Results of the Council of Economics and Finance Ministers, 25<sup>th</sup> November 2003 – financial services and taxation*, MEMO/03/241, 26/11/2003). During 2005 a substantial push was given to this proposal by both Luxembourg and the United Kingdom – which held the Presidency of the Council during the first and second half of 2005, respectively, see *Results of Council of Economic and Finance Ministers, Brussels, 6-7 December 2004*, MEMO/04/289, 08/12/2004, and *Results of the 2688th ECOFIN Meeting*, Press Release 13678/05, Brussels, 8 November 2005, 21.

The 2006 legislation also included a mandate from the Council to the Commission to present to the European Parliament and to the Council, by the end of June 2007, an overall assessment report on the impact of reduced rates on job creation, economic growth and the internal market.<sup>26</sup> This mandate has produced quick results. In 2007 the Commission published a study undertaken by Copenhagen Economics on the economic impact of the application of reduced rates;<sup>27</sup> and in March 2008 it launched a public consultation as part of its aim of “launching a broad debate in the Council, the European Parliament and with other stakeholders to obtain all relevant views before initiating a more far reaching proposal on reduced rates is the most effective approach to develop a sustainable and well balanced proposal in the medium term”.<sup>28</sup> For those awaiting the presentation of this “far reaching proposal”, early signs were not encouraging. As discussed above the European Commission seemed to be moving in the wrong direction: not only had the most recent proposal on VAT rates been aimed at increasing differentiation of rates, rather than the opposite, but equally the consultation paper expressly stated that the Commission was considering introduction of further reduced rates to, amongst others, environmentally friendly products. As will be seen below, this approach changed radically in the wake of the economic and financial crisis.

#### **1.4. State-of-Play in 2008**

As discussed above, it is clear that although the provisions governing the rates structure have been subject to several amendments since the entering into force of the Approximation of VAT Rates Directive,<sup>29</sup> “the situation has changed little and the level of harmonisation of VAT rates has remained modest”.<sup>30</sup> At present the rates structure under the VAT Directive is a multiple-rate

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<sup>26</sup> Council Directive 2006/18/EC of 14 February 2006, OJ L51, 22/02/2006, 12.

<sup>27</sup> *Study on reduced VAT applied to goods and services in the Member States of the European Union*, Taxation Papers, Working Paper No. 13, 2008. A summary of the results of the study was then published in *Communication from the Commission to the Council and the European Parliament on VAT rates other than standard VAT rates*, COM(2007) 380 final, 5 July 2007.

<sup>28</sup> *Consultation Paper: Review of existing legislation on VAT reduced rates*, TAXUD/D1D/24232, 6 March 2008, at 2.

<sup>29</sup> In addition to the legislation already mentioned, the following has also included some amendments to VAT rates provisions: Council Directive 92/111/EEC of 14 December 1992, OJ L 384, 30/12/1992, 47; Council Directive 94/5/EC of 14 February 1994, OJ L 60, 03/03/1994, 16; Council Directive 95/7/EC of 10 April 1995, OJ L 102, 05/05/1995, 18; Council Directive 96/42/EC of 25 June 1996, OJ L170, 09/07/1996, 34; Council Directive 98/80/EC of 12 October 1998, OJ L 281, 17/01/1998, 31; Council Directive 1999/49/EC of 25 May 1999, OJ L 139, 02/06/1999, 27; Council Directive 2000/17/EC of 30 March 2000, OJ L84, 05/04/2000, 24; Council Directive 2001/4/EC of 19 January 2001, OJ L 22, 24/01/2001, 17; Council Directive 2002/38/EC of 7 May 2002, OJ L 128, 15/05/2002, 41; Council Directive 2005/92/EC of 12 December 2005, OJ L51, 22/02/2006, 12-13; Council Directive 2007/75/EC of 20 December 2007, OJ L346, 29/12/2007, 13-14; and finally, with effect from 1 January 2010, Council Directive 2008/8/EC of 12 February 2008, OJ L44, 20/02/2008, 11-22.

<sup>30</sup> See n. 13 above, at 5.

system, allowing for a standard rate and one or two reduced rates in theory (two more in practice), and subject to a few basic rules, as follows:<sup>31</sup>

- (1) The standard rate cannot be lower than 15% (Article 97 of the VAT Directive);<sup>32</sup>
- (2) Member States may apply one or two reduced rates to supplies of goods/services specified in Annex III, including labour-intensive services, but not where they are electronically supplied (Article 98 of the VAT Directive);
- (3) Subject to certain conditions, reduced rates may also be applied to supplies of natural gas and electricity (Article 102 of the Common VAT System Directive), imports of works of art, collectors' items and antiques and certain supplies of works of art (Article 103 of the VAT Directive);
- (4) During the transition period, i.e., until the entry into force of the definitive VAT system, Member States may maintain, under certain conditions, various special measures concerning the application of reduced rates, including: application of reduced rates lower than the authorised 5% minimum; maintenance of reduced rates for goods or services not covered by Annex III; or application of an additional reduced rate, known as the "parking rate", no lower than 12% (Articles 109 to 122 of the VAT Directive); and,
- (5) Finally, some Member States have been allowed to temporarily apply reduced rates to specific transactions (Articles 123 to 130 of the VAT Directive), and special rules also apply to specific EU regions (Articles 104 and 105 of the VAT Directive).

The described rules leave Member States significant freedom to establish their own rates structure. In practice Member States are free to decide on the following: whether to apply one or two reduced rates; whether to apply, subject to special conditions, an extra "parking rate"; the level of standard rate, as long as it is more than 15%; the level of the reduced rate(s), subject to certain conditions, which depend on each Member State's specific circumstances; and to which goods / services to apply reduced rates too, subject to the conditions set out in the VAT Directive.<sup>33</sup> Unsurprisingly, this freedom resulted until recently in VAT rates structures within the EU remaining highly discrepant, highly differentiated, and highly complex. The high level of differentiation is particularly worrying,

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<sup>31</sup> Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L347, 11/12/2006, 1–118 (hereafter "VAT Directive").

<sup>32</sup> The date until which this minimum standard rate level will apply has been consecutively postponed. This date currently stands at 31 December 2015, see Council Directive 2010/88/EU of 7 December 2010, OJ L326, 10/12/2010, p. 1-2.

<sup>33</sup> The Commission has been publishing on an annual basis, a document listing the VAT rates applied to a range of products across the EU, *VAT Rates Applied in the Member States of the European Community*. For an overview of the rates applicable before the economic and financial crisis see the document dated January 2008. See also A. Mathis, *VAT indicators*, Taxation Papers, Working Paper No. 2, April 2004.

since in itself will almost always result in high level of discrepancy across Member States, and unavoidably in high level of complexity.

Unfortunately, and until 2008, the rate differentiation in EU Member States was particularly extensive. As regards the “old” Member States, six (Greece, Spain, France, Ireland, Italy and Luxembourg) applied a reduced rate lower than the minimum laid down in Article 98 of the VAT Directive (a “super-reduced rate”); three (Belgium, Ireland and Luxembourg) applied a reduced rate not lower than 12% (the “parking rate”); five Member States (Belgium, Denmark, Finland, Italy and Sweden) applied a zero rate on a marginal and restricted basis; while Ireland and the United Kingdom continued to make extensive use of this derogation.<sup>34</sup> The situation was slightly different within the new Member States, but not radically so: six (Cyprus, Czech Republic, Estonia, Latvia, Malta and Slovakia) applied a zero rate of VAT, and almost all were granted authorisations to introduce / maintain the application of rates which derogated from Articles 98 and 99 of the VAT Directive.<sup>35</sup> Member States’ application of the labour-intensive services experiment was also a good example of the discrepancies that can emerge in the context of the application of reduced rates. In 2009 only eighteen, out of then twenty-seven Member States, submitted applications to avail of the option to apply reduced rates to labour-intensive services. Of those eighteen Member States, each of them had chosen different services from the ones listed in the old Annex IV (now part of Annex III): twelve had chosen renovation and repairing of private dwellings; eight, small services of repairing; six, domestic care services; seven, hairdressing; three window cleaning and household cleaning services; and one minor services of repairing clothing and household linen.<sup>36</sup> With the transformation of the labour-intensive services experiment into a permanent feature of the EU rates structure, as discussed above, this level of differentiation looked more likely to increase, rather than to decrease. Instead the financial and economic crisis hit, and Member States approach to rate differentiation changed radically.

## **2. EU VAT Rates: Post-2008**

According to the OECD, after a period of relative stability between 1996 and 2008, the average standard rate of VAT started to rise again after 2008,<sup>37</sup> and it now stands at around 21.5%.<sup>38</sup> Indeed

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<sup>34</sup> The data was reported on the Commission’s report on reduced VAT rates, COM(2001) 599 final, 22 October 2001, n. 17 above. An analysis of the rates in force on 1 January 2009 shows that the situation had not improved and, if anything, it had worsened by then.

<sup>35</sup> Articles 123 to 130 of the VAT Directive.

<sup>36</sup> See Council Decision 2006/774/EC of 7 November 2006, OJ L314, 15/11/2006, 28-32; and Council Decision 2007/50/EC of 30 January 2007, OJ L222, 31/1/2007, 14-15.

<sup>37</sup> See OECD, *Consumption Tax Trends 2012 – VAT/GST and Excise Rates, Trends and Administration Issues* (Paris: OECD Publishing, 2012), at 15.

between 1 January 2008 and 1 January 2014 many OECD countries increased their standard and / or their reduced VAT rate, including –albeit not exclusively – EU countries, as highlighted in Table 2 below. At the same time, as the table also demonstrates, several EU Member States have also made substantial amendments to their tax base, moving goods and services from reduced to intermediate rate, or from reduced and intermediate to standard rates. Overall a staggering twenty-three, out of the twenty-eight EU countries, changed their VAT rate structures during this period. Out of the few Member States not to change their rates, one, Germany, had also done so just one year beforehand, increasing their standard rate by 3%. This is, of course, not to say that there were no changes in the opposite direction, namely lowering of rate levels, or narrowing of the base, but as Table 3 demonstrates, these were comparatively rare and circumspect.

**Table 2**

<b>CHANGES IN VAT RATES IN THE PERIOD 2008-2014</b>			
<b>INCREASE OF RATE LEVELS / TAX BASE</b>			
	<b>Increase in Standard Rate</b>	<b>Increase in Reduced Rates</b>	<b>Base Broadening Measures</b>
<b>Bulgaria<sup>39</sup></b>	-	7% to 9%	
<b>Croatia<sup>40</sup></b>	23% to 25%	10% to 13%	Yes
<b>Cyprus<sup>41</sup></b>	15% to 19%	-	
<b>Czech Republic<sup>42</sup></b>	19% to 21%	9% to 15%	
<b>Estonia<sup>43</sup></b>	18% to 20%	5% to 9%	
<b>Finland<sup>44</sup></b>	22% to 24%	8% to 10%	

<sup>38</sup> In the end of 2012 it stood at 21.6%, but it is likely to have increased since then, see VATlive, *Global VAT rates on the increase – review the major changes*, November 23, 2012. See also R. Asquith, “On the rise” (2012) *Taxation* 169 (4341), 15.

<sup>39</sup> European Commission, *VAT Rates Applied in the Member States of the European Union – Situation at 1<sup>st</sup> July 2014*, taxud.c.1(2014)2276174 - EN, 25/06/2014.

<sup>40</sup> VATlive, *Croatia raises VAT rate on restaurants and other services*, September 27, 2013; and VATlive, *Further changes to Croatia VAT rules and rates*, December 4, 2013

<sup>41</sup> VATlive, *Cyprus raises VAT to 19% by 2014*, December 11, 2012.

<sup>42</sup> European Commission, n. 39 above. See also VATlive, *Czech VAT rate to increase 1% to 21% in 2013*, April 2, 2012; and VATlive, *Czech 1% VAT rise for 2013*, December 5, 2012.

<sup>43</sup> European Commission, n. 39 above.

<sup>44</sup> European Commission, n. 39 above. See also VATlive, *Finland raises VAT from 23% to 24% in 2013*, March 24, 2012.

<b>France</b> <sup>45</sup>	19.6% to 20%	7% to 10%	
<b>Greece</b> <sup>46</sup>	19% to 23%	4.5% to 6.5%	
		9% to 13%	
<b>Hungary</b> <sup>47</sup>	20% to 27%	15% to 18%	Yes
<b>Ireland</b> <sup>48</sup>	21% to 23%	-	Yes
<b>Italy</b> <sup>49</sup>	20% to 22%	-	Yes
<b>Latvia</b> <sup>50</sup>	18% to 21%	5% to 12%	
<b>Lithuania</b> <sup>51</sup>	18% to 21%	-	Yes
<b>Luxembourg</b> <sup>52</sup>	15% to 17%	-	Yes
<b>Malta</b> <sup>53</sup>	-	-	Yes
<b>Netherlands</b> <sup>54</sup>	19% to 21%		
<b>Poland</b> <sup>55</sup>	22% to 23%	3% to 7%	
		5% to 8%	
<b>Portugal</b> <sup>56</sup>	20% to 23%	5% to 6%	Yes
		12% to 13%	

<sup>45</sup> VATlive, *Implementation of French VAT Rise to 20% from 1 Jan 2014*, December 16, 2013; VATlive, *France confirms 2014 VAT rise to 20%*, November 22, 2013; VATlive, *French VAT rate rises from 19.6% to 20% in 2014*, November 8, 2012; and VATlive, *France to raise VAT rate on art from 7% to 10% Jan 2014*, August 29, 2013.

<sup>46</sup> European Commission, n. 39 above.

<sup>47</sup> European Commission, n. 39 above. See also VATlive, *Hungary raises VAT to 27% in 2012*, September 18, 2012; and VATlive, *Hungarian VAT goes ahead without foodstuffs VAT cut*, November 8, 2013.

<sup>48</sup> VATlive, *Irish Finance Bill 2013 includes VAT measures*, November 4, 2013; and VATlive, *Ireland raises VAT 2% to 23% from 1 January 2012*, December 7, 2011.

<sup>49</sup> VATlive, *Italy to raise VAT 1% from 21% to 22% September 2011*, September 8, 2011; VATlive, *Italy VAT rise to 22% proceeds 1<sup>st</sup> Oct 2013 as government teeters*, September 29, 2013; VATlive, *Italy increases VAT from 21% to 22% 1 July 2013*, October 12, 2013; and VATlive, *Italian VAT rise has no effect on inflation figures*, December 5, 2013.

<sup>50</sup> European Commission, n. 39 above.

<sup>51</sup> VATlive, *Lithuania new VAT rates and compliance simplifications*, February 5, 2013.

<sup>52</sup> VATlive, *Luxembourg VAT increase confirmation*, May 8, 2013; and VATlive, *EU member states must broaden VAT base*, October 13, 2013; VATlive, *Luxembourg VAT rise to 17% in 2015*, February 3, 2014.

<sup>53</sup> European Commission, n. 39 above.

<sup>54</sup> European Commission, n. 39 above. See also VATlive, *Netherlands raises VAT from 19% to 21% October 2012*, May 1, 2012.

<sup>55</sup> European Commission, n. 39 above. See also VATlive, *Poland increases VAT 1% to 23% January 2013*, July 7, 2010; and VATlive, *Poland confirms 23% VAT rate till at least 2016*, September 4, 2013.

<sup>56</sup> European Commission, n. 39 above. See also VATlive, *Portugal raises VAT 1% to 21%*, May 15, 2010; and VATlive, *Portugal raises VAT 2% to 23% from January 2011*, October 1, 2010.

Romania <sup>57</sup>	19% to 24%	-	Yes
Slovakia <sup>58</sup>	19% to 20%	-	
Slovenia <sup>59</sup>	20% to 22%	8.5% to 9.5%	
Spain <sup>60</sup>	16% to 21%	7% to 10%	Yes
UK <sup>61</sup>	17,5% to 20%	-	

**Table 3**

CHANGES IN VAT RATES IN THE PERIOD 2009-2014				
(POTENTIAL) DECREASES IN RATE LEVELS / TAX BASE				
	Decrease in Standard Rate	Decrease in Reduced Rate	Increase in Levels of Differentiation	Base Narrowing Measures
Czech Republic <sup>62</sup>	-	-	Yes	-
Finland <sup>63</sup>	-	17% to 14%	-	-
Greece <sup>64</sup>	-	-	-	Yes
Hungary <sup>65</sup>	-	-	Yes	-
Ireland <sup>66</sup>	-	-	-	Yes
Romania <sup>67</sup>	-	-	Yes	-

These numbers demonstrate the extent to which Member States turned to VAT policy in the wake of the economic and financial crisis. The reason is clear: confronted with high budget deficits and limited (or negative) economic growth, whilst at the same time deprived of the possibility of

<sup>57</sup> European Commission, n. 39 above. See also VATlive, *Romania cuts VAT rate on bread*, August 10, 2013.

<sup>58</sup> VATlive, *Slovakia raises VAT 1% to 20% in January 2011*, October 8, 2010.

<sup>59</sup> VATlive, *Slovenia 2% VAT rate increase July 2013*, March 29, 2013

<sup>60</sup> European Commission, n. 39 above. See also VATlive, *Spain raises VAT from 18% to 21% 1 September 2012*, July 4, 2012; and VATlive, *EU member states must broaden VAT base*, October 13, 2013.

<sup>61</sup> VATlive, *UK raises VAT 2.5% to 20% in 2011*, June 22, 2010.

<sup>62</sup> VATlive, *Czech Republic considers new reduced VAT rate*, December 19, 2013.

<sup>63</sup> European Commission, n. 39 above.

<sup>64</sup> VATlive, *Greece wins reduction to restaurant VAT from 23% to 13%*, July 11, 2013.

<sup>65</sup> VATlive, *Hungary to debate 35% luxury rate this week*, October 17, 2013.

<sup>66</sup> VATlive, *Ireland reduces VAT on tourism until 2013*, June 2, 2012; and VATlive, *Ireland extends 9% VAT subsidy on tourism and newspapers*, October 16, 2013.

<sup>67</sup> European Commission, n. 39 above.

currency devaluation and bound to a common interest rate, Member States—specifically those which are part of the Eurozone—were confronted with serious limitations on their abilities to respond effectively; it was therefore unsurprising that most turned to tax policy as their preferred means of macro-economic intervention.<sup>68</sup> Within tax policy the weapon of choice seems to have been VAT.

This focus at national level on VAT policy in the current economic climate is hardly surprising. Certainly it comes within the context of the general trend for a long-term shift towards indirect taxation, rather than direct taxation. This trend is based largely on the traditional economic view that consumption taxes are relatively more efficient as a revenue source, are less distortive, and have favourable effects on growth and employment. Thus, in many Member States, VAT has become the main source of national revenue: in 2009 it accounted for 21% of the tax revenues of EU Member States, an increase of 12% since 1995. Against the background of the economic crisis, however, these comparative advantages of VAT have become particularly significant: on one hand, national governments need additional revenue, and VAT presents itself as a more reliable and stable source of revenue than profits and income, especially during an economic downturn; on the other hand, the emphasis is also on economic growth as the only medium to long-term solution, with less distortive taxes becoming particularly appealing.

Having opted for VAT policy as an instrument to deal with the effects of the economic and financial crisis, Member States had the further choice of whether to raise rates or broaden the tax base in order to raise further revenue. As Table 2 demonstrates almost all Member States opted for increase in rates, with some of these *also* adopting base broad measures; only one Member State adopted base broadening measures whilst *not* increasing rates.

Clearly keen to harness the political momentum, the European Commission presented in December 2010 the Green Paper on the Future of VAT.<sup>69</sup> The stated aim of the paper, which was said to be “one of the most important documents issued by the European Commission for some time”,<sup>70</sup> was to launch a broad based consultation process on the functioning of the current EU VAT system.

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<sup>68</sup> As A. J. Easson prophetically pointed out in 1993, “the fiscal implications of EMU are obvious and considerable. Of the three main instruments of economic policy, Member States will soon relinquish all control over exchange rate policy and will gradually, over the next five years or so, lose much of their control over monetary policy. They will thus be left with fiscal policy alone”, see *Taxation in the European Community*, European Community Law Series (London & Atlantic Highlands, NJ: The Athlone Press, 1993), at 18-19.

<sup>69</sup> European Commission, *Green Paper on the Future of VAT—Towards a simpler, more robust and efficient VAT system*, COM(2010) 695 final, December 1, 2010. See also, *Accompanying document to the Green Paper on the Future of VAT—Towards a simpler, more robust and efficient VAT system*, Commission Staff Working Document, SEC(2010) 1455 final, December 1, 2010.

<sup>70</sup> R. Maas et al., “VAT Focus—Roundtable discussion: The Green Paper & the Future of VAT” (2011) *Tax Journal* 1094, 12.

Indeed, whilst the paper itself was hardly as ambitious as that aim might suggest, it was nevertheless far-reaching, covering many—albeit not all—of the most problematic areas of the system, including harmonisation of rates. A year later, amidst favourable reactions from other European institutions and various stakeholders,<sup>71</sup> the Commission issued a follow-up Communication, which had two stated purposes: in the long term, to set out the fundamental features of a future EU VAT system—a system which continues to raise revenue but which also increases competitiveness; and in the short to medium term, to list the priority areas for further action in the coming years—with a view to moving towards those objectives.<sup>72</sup> Amongst these listed priority areas was the review of the rate structure.

In the Communication the Commission states that in order to increase the efficiency of the VAT system, it favours restricted use of reduced VAT rates. The use of reduced rates should then be based upon a few guiding principles:

- (1) Abolition of those reduced rates which constitute an obstacle to the proper functioning of the internal market;
- (2) Abolition of reduced rates on goods and services for which the consumption is discouraged by other EU policies;
- (3) Similar goods and services should be subject to the same VAT rate.

The Commission set out the aim of launching in 2012 an assessment of the current VAT rates structure in the light of these guiding principles, and subsequently make proposals along those lines after ample consultation with stakeholders and Member States by the end of 2013.<sup>73</sup> In this context it launched a public consultation in October 2012 on the review of the EU legislation on VAT reduced rates.<sup>74</sup> As opposed to previous initiatives which were broad in their scope, this was a very targeted public consultation: only nine questions, strictly framed by the guiding principles, eight of which concerned specific sectors of activity, namely the application of reduced rates of VAT to water,

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<sup>71</sup> See European Commission, *Summary Report of the Outcome of the Public Consultation on the Green Paper on the Future of VAT—Towards a simpler, more robust and efficient VAT system (December 1, 2010-May 31, 2011)*, taxud.c.1(2011)1417007, December 2, 2011; European Parliament, *Report on the Future of VAT (2011/2082(INI))*, Committee on Economic and Monetary Affairs, A7-0318/2011, September 30, 2011; European Economic and Social Committee, *Opinion on “Green Paper on the Future of VAT—Towards a simpler, more robust and efficient VAT system”*, July 14, 2011, [2011] OJ C318/87; and European Commission, *Future VAT System: pro-business, pro-growth*, Press Release IP/11/1508, December 6, 2011.

<sup>72</sup> *Future of VAT—Towards a simpler, more robust and efficient VAT system tailored to the single market*, Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, COM(2011) 851 final, December 6, 2011.

<sup>73</sup> *Ibid.*, at 11-12.

<sup>74</sup> European Commission, *Review of existing legislation on VAT reduced rates*, Consultation Paper, TAXUD/C1, October 2012.

energy, waste and e-books. Despite the limited scope of the questions asked, the Commission also asked more generally for any “concrete examples of distortions of competition within the internal market or of specific problems encountered due to the current VAT rules”. Despite this effective broadening of the scope of the consultation, the targeted nature of the questions resulted in a low number of submissions from academics, tax advisors and tax practitioners; and on the contrary, a very high number – more than half of all submissions – from national or European associations, the large majority of them representing sectors currently benefiting from a reduced VAT rate.<sup>75</sup> Unsurprisingly, the nature of the respondents reflected heavily on the contents of the responses: most were opposed to the abolition of the reduced rates and/or advocating for their extension; and many challenged the general trend of shifting taxation away from labour towards consumption. Some submissions also defended that no further harmonisation should take place, and that the decision on whether or not to apply reduced VAT rates should be left to the Member States.

In the context of the outcome of this public consultation, it is pertinent to question whether this latest initiative can be successful. Reviewing the rate structure has been part of every Commission’s attempt to reform the EU VAT system—and with good reason. A recent study commissioned by the EU Commission indicates that a 50% reduction in the dissimilarity in VAT rates structures between Member States could result in a rise of 9.8% in intra-EU trade and an increase in real GDP of 1.1%.<sup>76</sup> Moreover, this is merely the last of several studies indicating the negative consequences of rate differentiation and its unproven positive effects. Yet, these studies in themselves have traditionally been insufficient to convince Member States to act. On the contrary, what has now made many Member States act at a domestic level has been the pressing need for extra revenue. Whilst no reference is made to this reality in the Communication, it is clear that the Commission is relying on that need in order to push this measure forward—the fact that so many Member States have already taken this political choice at national level might just be enough to create the necessary momentum for agreement at EU level.

This signals a significant shift in approach to VAT harmonisation by the European Commission. For the last four decades the Commission’s approach has been primarily to convince Member States that harmonisation is an essential step for the establishment and the functioning of the European Internal Market. Although one can certainly agree with that statement,<sup>77</sup> the reality is that this approach has failed consistently to create the necessary political enthusiasm for reform. In essence,

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<sup>75</sup> European Commission, *Review of Existing Legislation on VAT Reduced Rates*, Summary Report of the Outcome of the Public Consultation (8 October 2012–4 January 2013), taxud.c.1. (2013) 708070, 12/04/2013.

<sup>76</sup> See *A Retrospective Evaluation of Elements of the EU VAT System — Final Report*, TAXUD/2010/DE/328, FWC No. TAXUD/2010/CC/104, December 1, 2011.

<sup>77</sup> See R. de la Feria, n. 6 above.

it has failed to rally the troops. The approach now adopted by the European Commission is very different: there are comparatively few references to the EU perspective, and indeed there is only one reference in the entire Green Paper on the Future of VAT to the “Internal Market”; instead the focus is clearly on “consolidation of public finances” and “sustainable economic growth”. In the midst of the economic and financial crisis, the Commission has clearly re-packaged long-sought reform by offering Member States EU answers to national needs—and that is why this time, it might just succeed.<sup>78</sup> Furthermore it must also be acknowledged that the limited, or specific, nature of the review now being considered may make it politically easier to attain Member States’ agreement on. This limited nature of the review, however, also raises concerns namely on whether, even if successful, is this proposed review worthwhile? Certainly it would result in an improvement to the current EU VAT rate structure, but not a massive one. Essentially there is a trade of: lower risks, lower returns; such are the costs of political realism.

### **3. Blueprint for Reform of VAT Rates in Europe**

Whether the latest European Commission’s initiative on the review of the EU VAT rate structure gathers the necessary support or not, it is clear that only limited improvements to the structure can be achieved. Therefore, if significant gains are to be attained, they must come through a different route. In this context, would it be possible to have significantly improved, even converging, VAT rate structures in Europe, through national, uncoordinated, action? How would such a VAT rate structure look like, and how would it be achieved?

#### **3.1 Ideal VAT rate structure**

The case for differential tax rates under optimum commodity taxation has been consistently made since the elaboration in the 1920s of the inverse elasticity rule, which suggests that economic efficiency is maximised by taxing consumption goods at rates that are inversely proportional to their price elasticity.<sup>79</sup> In practice, however, this rule raises various difficulties. Firstly, the information required about consumers’ behaviour needed to operate a differential tax system that improved economic welfare would be so extensive as to make such regimes impracticable: it would not only require estimates of price-elasticities of every product on the market, but also regular updates of

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<sup>78</sup> This point is developed further in R. de la Feria, “The 2011 Communication on the Future of VAT: Harnessing the economic crisis for EU VAT reform” (2012) *British Tax Review* 2, 119-133.

<sup>79</sup> F. Ramsey, “A Contribution to the Theory of Taxation” (1927) *Economic Journal* 37, 47-61. See also A.B. Atkinson and J.E. Stiglitz, “The Structure of Indirect Taxation and Economic Efficiency” (1972) *Journal of Public Economics* 1, 97-119. For a comprehensive review of the literature on optimal commodity taxation theory see I. Crawford, M. Keen and S. Smith, “Value-Added Tax and Excises” in S. Adam et al (eds.), *Dimensions of Tax Design – the Mirrlees Review* (Oxford: Oxford University Press, 2010), 275-422.

those elasticities to take into account changes in preferences and / or technology.<sup>80</sup> The rule also raises vertical equity concerns, since it suggests higher tax rates on price-inelastic products, which are typically basic goods that make up larger proportion of the expenditures of low-income households.<sup>81</sup> Finally, application of this rule to take into account cross-price elasticities, would suggest higher rates on products for which high-income individuals tend to have a relatively strong taste. However, cross-price elasticities are particularly difficult to estimate, deeming implementation of this rule even more complex.<sup>82</sup>

In any event, the VAT rates structures currently applied in Europe do not reflect the inverse elasticity rule, but quite the opposite with reduced rates applying primarily to low elasticity products, such as food. As discussed above, the original introduction of reduced VAT rates was based not so much on clearly articulated policy objectives but rather on pragmatic political goals, as designers of the VAT sought to replicate the impact of the predecessor turnover taxes and deflect concerns about the tax on beneficiaries of previous concessions. Over time, however, it was argued that the use of reduced rates achieves social and distributional aims. This rationale for applying reduced rates of VAT supports the characterisation of the use of these rates as tax expenditure. Indeed, whilst the exact concept is controversial, tax expenditures are generally defined as deviations from a tax norm or a benchmark that result in a reduced tax liability for the beneficiaries, who are generally a particular group of taxpayers or an economic activity.<sup>83</sup> What constitutes the benchmark, insofar as VAT is concerned, involves an element of judgment on what constitutes the normal VAT tax base and rate, and consequently it may vary across countries and over time.<sup>84</sup> However, the use of reduced rates for distributional and social reasons does fit the general definition of tax expenditure, and therefore is usually characterised as such – as opposed to tax exemptions which are characterised by some EU countries as part of their benchmark system.<sup>85</sup>

Once it is accepted that the application of reduced rates amounts to tax expenditures, these should be subject to a cost-benefit analysis similarly to direct expenditure programs: what are the benefits, and what are the costs of applying reduced VAT rates? Moreover, is increasing VAT rates more effective in terms of both revenue and economic growth, and to decrease / eliminate tax expenditures?

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<sup>80</sup> OECD, *Choosing a Broad Base – Low Rate Approach to Taxation*, OECD Tax Policy Studies, No. 19 (OECD Publishing, 2010), at 16.

<sup>81</sup> Ibid.

<sup>82</sup> P.B. Sorensen, "The Theory of Optimal Taxation: What is the Policy Relevance?" (2007) *International Tax and Public Finance* 14, 383-406.

<sup>83</sup> OECD, n.80, at 39.

<sup>84</sup> Ibid, at 39-40.

<sup>85</sup> Ibid, at 50.

### 3.1.1 What are the benefits of applying reduced VAT rates?

As discussed above, it has been argued that the use of reduced rates achieves social and distributional aims, and namely three rationales have been offered, as follows:

- (1) Vertical equity: idea that these concessions limit the natural regressivity of VAT, i.e. that the tax weights more heavily on poorer households; so applying reduced rates to key products such as food, energy, healthcare, education, etc, would limit the impact of this tax on those households.
- (2) Positive externalities: idea that these concessions increased consumption of so-called merit goods, such as cultural events, books, sport activities, etc.
- (3) Increase employment: idea that application of reduced rates will ultimately lead to increase employment in labour-intensive industries (e.g. hairdressing), or areas where price is particularly elastic (e.g. electronics), or both (e.g. restaurants).

The equity argument derives from the fact that the proportion of income that is saved reduces as income reduces, with the lowest income earners using all their income for consumption and diverting none to savings. As VAT falls only on income used for consumption and exempts income that is applied to savings, the tax is said to fall more heavily on lower income persons than on higher income persons in terms of the proportion of income derived by those persons.<sup>86</sup> Reduced rates for commodities that form a higher percentage of the spending budget of lower income persons are seen as a way of reducing the tax burden on these persons, and thus increasing their consumption capability. This argument is the rationale invoked for the application of reduced rates to food, medication, utilities, etc.

The positive externalities rationale for reduced rates derives from a belief that the market price for some types of supplies does not fully reflect the overall benefits from consumption of those supplies for society as a whole, and thus government intervention to subsidise consumption of those goods is deemed desirable. This argument is the rationale invoked for the application of reduced rates to books, cultural events, sports activities, etc.

The job creation argument has been developed relatively recently, when compared with the other two rationales for the use of reduced VAT rates. It derives from the belief that price decreases resulting from the introduction of reduced rates will lead to increase in demand, which in turn will result in increased supply. In labour-intensive services that increased supply will necessarily lead to

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<sup>86</sup> It has been argued that VAT is regressive with respect to income but not necessarily with respect to consumption, see S. Cnossen, "The Value-added Tax: Key to a Better Tax Mix" (1989) *Australian Tax Forum* 6(3), 265-281. For a general discussion on the regressive nature of VAT, or otherwise, see also G.N. Carlson and M.K. Patrick, "Addressing the Regressivity of a Value-Added Tax" (1989) *National Tax Journal* 42(3), 339-351; and N. Warren, "A Review of Studies on the Distributional Impact of Consumption Taxes in OECD Countries" (2008) *OECD Social, Employment, and Migration Working Paper* 64, June 2008, at 24.

new job creation. This argument attained political endorsement within the EU in the late nineties, leading to the approval of the so-called labour-intensive services experiment in 1999.

Crucially, these arguments – i.e. that application of reduced rates contributes to vertical equity, increases the consumption of merit products, and leads to job creation – presuppose that the decrease in the VAT rate is reflected in consumer prices. Theoretically, this should indeed be the case: generally, in a competitive market if costs go down (including taxes), so should prices. However, recent empirical experiments with VAT rates seem to indicate the opposite. The first and most significant has been the labour-intensive services experiment discussed above. The second experiment to assess the impact of reduced rates on prices took place in Ireland. Struggling with high levels of inflation, as a collateral effect of their outstanding economic growth, Ireland decided to reduce the standard VAT rate from 21% to 20% from January 2001. In a speech in December 2000, the Irish Finance Minister stated that: “The government expects to see the VAT reduction passed on to the consumer and not absorbed in higher retail margins. If this does not occur, the wisdom of further VAT cuts will be placed in doubt. We will be monitoring the situation and I hope consumers will be vigilant in seeing that the VAT reduction is passed on to them”. In 2002, Ireland decided to raise back the rate of VAT from 20% to 21%. In a speech in December 2001, the Finance Minister stated that the lower rate of VAT had not been passed on to consumers: “I had reservations about cutting that rate last year. I said that I would be looking to see if it was fully passed on. I am not convinced that this was the case.”<sup>87</sup>

How to explain this discrepancy between theoretical and empirical results? A convincing explanation has yet to be given. A study published in 2008 has suggested that the empirical results of the labour-intensive services experiment might be due to its temporary nature, i.e. if firms know that a lower VAT rate is temporary, why would they use time and money to expand production capacity and incur costs if they have to revert to their previous production level within a few years.<sup>88</sup> It is also possible that, labour-intensive services do not operate in fully competitive markets,<sup>89</sup> and that a decrease of 1% in the rate of VAT is too minimal to be passed on. Finally, it is also worth noting that both experiments took place in a boom economy, where it is possible that demand outweighed supply. Yet, these are merely tentative explanations: in practice, until definite arguments are presented all that can be said with certainty is that evidence so far does not support the argument that reduced VAT rates reduce prices.

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<sup>87</sup> See n. 20 above, at 26.

<sup>88</sup> See Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, Taxation Papers, Working Paper No. 13, 2008, at 13.

<sup>89</sup> For example, there might be geographical restraints, with only one hairdresser, or repair shop in a specific area.

The recent changes to VAT rate structures, which took place in various Member States since 2009, will offer new opportunities for assessing the incidence of VAT, and the impact of reduced rates on prices, in particular in the context of a downturn economy.<sup>90</sup> In fact some initial examples, which took place in the beginning of the economic crisis, are already available, appearing to add support to the results of previous experiments.<sup>91</sup> In 2009, France dropped the VAT rate from 19.6% to 5.5% for supplies of restaurant and catering services on the assumption that restaurants would reduce prices substantially, raise wages, or create new jobs, and improve compliance. However, according to the French National Institute for Statistics and Economic Studies, the decrease in prices for restaurant services was not minimal – around 1% - but also temporary. According to the French authorities, if only 30% of the VAT cut had been passed on to customer, this would create 6,000 jobs in the long run, but the government stood to lose up to €3 billion in revenue in a full fiscal year from the cut; this would equate to each new job in the sector costing French taxpayers €500,000. In 2010 Germany reduced the VAT rate applicable to the hotel industry as part of a more general tax cut. A recent survey indicated that the cut had not been passed on to consumers, and instead prices had remained the same.

If reduced VAT rates cannot reduce prices, then the logical conclusion is that they cannot attain the distributional and social aims that they are set up to achieve. However, even if one assumes that the above empirical results are flawed, and that indeed reduced rates of VAT do affect prices, there are still no certainties that distributional and social aims are, or can be, reached. A recent empirical study seems to indicate that the effectiveness of applying such rates depends on the elasticity of specific products: in the case of basic goods, such as food, consumers react only weakly to lower prices (where consumption is price in-elastic), so production and employment will not increase significantly; in contrast, if consumers react strongly to new prices, as in the case for high value goods, such as package holidays, books, and electronic equipment (where consumption is price elastic), production and employment may increase significantly.<sup>92</sup> Moreover, other economic studies have consistently shown that since VAT is not an effective method of pursuing distributional goals, and it is far better to tax as broadly as possible,<sup>93</sup> using the yield to compensate low-income

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<sup>90</sup> For early studies on the effects of the VAT temporary standard rate reduction in the UK in 2009 see T. Crossley et al., “The Economics of a Temporary VAT Cut” (2009) *Fiscal Studies* 30(1), 3-16; R. Barrell and M. Weale, “The Economics of a Reduction in VAT” (2009) *Fiscal Studies* 30(1), 17-30; and R. Blundell, “Assessing the Temporary VAT Cut Policy in the UK” (2009) *Fiscal Studies* 30(1), 31-38.

<sup>91</sup> See A. Charlet and J. Owens, “An International Perspective on VAT” (2010) *Tax Notes International* 59(12), 943, at 950.

<sup>92</sup> See Copenhagen Economics, n. 88 above, at 12.

<sup>93</sup> C.L. Ballard and J.B. Shoven conclude that differentiation of rates used to partially replace the income tax would do little to mitigate the adverse distributional impact of the change, see “The Value-Added-Tax: The efficiency cost of achieving progressivity by using exemptions” in M.J. Boskin (ed.), *Modern Development in Public Finance: Essays in Honor of Arnold Harberger* (Oxford, B. Backwell, 1987), 109-129.

households.<sup>94</sup> High-income households typically consume more of basic necessities than low-income households. In this context, if items currently subject to reduced rates were fully taxed – personal income tax relief or means-tested social security benefits – the government could more effectively achieve social and distributional aims, and have additional revenue left over to apply to other redistributive programs.<sup>95</sup> In this sense, lower income persons may be much worse off with a tax system that contains reduced VAT rates designed to assist them, than they would be in a tax system with one single rate and redistribution of the excess revenue raised under a more neutral tax base. In addition, job creation or protection of key sectors of the economy, would also be better achieved through direct subsidies.

### 3.1.2 *What are the costs of applying reduced VAT rates?*

The benefits of applying reduced VAT rates are therefore questionable. Moreover, the costs of subsidising consumption of target goods and services in this manner are on the contrary likely to be significant.

The most obvious cost is revenue loss, which is estimated to be substantial. The VAT tax expenditures, as calculated by the OECD for 2007 on the basis of countries' tax expenditures reports and responses to a questionnaire targeted at OECD delegates, was very significant. In at least three EU Member States – namely Italy, Spain and the UK – the revenue forgone from those expenditures amounted to more than 1/3 of total VAT revenues.<sup>96</sup> It is of course true that not all those expenditures are connected with the application of reduced rates, many will be related to the application of exemptions. It is also true that the amount of revenue forgone may not be exactly equal to the revenue that would be actually obtained if the tax expenditures were eliminated and the standard rate of VAT was to be applied; it is likely that consumption will somewhat contract, depending on the price elasticities of the products in question. However, the estimates on the level of VAT tax expenditures present in EU Member States does provide a rough indication of the revenue costs of applying reduced rates in those countries. Another method of estimating the revenue cost of applying reduced rates (and exemptions) is the so-called VAT Revenue Ratio (VRR), which expresses the revenue that would be raised if the standard VAT rate was applied to all consumption. Using this method, the OECD estimates that, between half and 1/3 of potential revenues of its member countries are not subject to VAT or, if they are, are not collected.<sup>97</sup>

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<sup>94</sup> See OECD, n. 80, at 73.

<sup>95</sup> Godbout and St. Gerny show that with tax credits targeted at lowest income individuals in place, the effective tax rate of consumption taxes increases with income, see "Are Consumption Taxes Regressive in Quebec?" (2011) *Canadian Tax Journal* 59(3), 463-493.

<sup>96</sup> OECD, n. 80, at 50.

<sup>97</sup> *Ibid*, at 61.

Beyond the estimated revenue losses, however, applying reduced rates of VAT raises significant other costs. From a legal perspective application of reduced rates gives rise to definitional and interpretative problems, and constitute an incentive to engage in aggressive tax planning. For these reasons reduced rates tend to result in substantial – and increasing – litigation, which in turn results in substantial compliance and administrative costs.<sup>98</sup>

Symptomatic of this increase in litigation is the number of cases brought before the Court of Justice of the European Union (CJEU) in relation to the application of reduced rates by Member States to various goods and services.<sup>99</sup> At stake in many of these cases was the application of reduced rates to specific products, whilst other similar products were subject to standard rates. The Court has consistently emphasised the importance of respecting the principle of fiscal neutrality: the application of reduced rates to certain products must be consistent with this principle that precludes treating similar goods, which are therefore in direct competition with each other, differently for VAT purposes. In a recent case concerning exemptions the Court has gone further in application of the principle of fiscal neutrality by stating that Member States cannot apply different VAT treatments to services that are comparable to each other from the point of view of the customer or meet the same needs of the customer.<sup>100</sup> Following this decision the debate has been on whether the new criteria will have implications for the Court approach to VAT rates structures. Some have already been defending that it will, stating that it is “highly likely” that the criteria laid down in *Rank Group* will affect the application of VAT rates, particularly to food.<sup>101</sup> The big test should come soon with the

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<sup>98</sup> E.H. Davis and J.A. Kay provide amusing examples to illustrate the shortcomings of using the VAT structure as a mean to diminish its regressivity, see “Extending the VAT base: problems and possibilities” (1985) *Fiscal Studies*, 6(1), 1-16, at 11-12.

<sup>99</sup> See cases 415/85, *Commission v Ireland*, [1988] ECR 3097; 416/85, *Commission v United Kingdom*, [1988] ECR 3127; C-276/98, *Commission v Portugal*, [2001] ECR I-1699; C-481/98, *Commission v France*, [2001] ECR I-3369; C-83/99, *Commission v Spain*, [2001] ECR I-445; C-384/01, *Commission v France*, [2003] ECR I-4395; C-109/02, *Commission v Germany*, [2004] ECR I-12691; C-309/06, *Marks & Spencer*, [2008] ECR I-2283; C-462/05, *Commission v Portugal*, [2008]; C-492/08, *Commission v France*, [2010] ECR I-5471; C-3/09, *Erotic Center*, [2010] ECR I-2361; C-41/09, *Commission v Netherlands*, [2011] ECR I-831; C-49/09, *Commission v Poland*, [2010] ECR I-10619; C-94/09, *Commission v France* [2010] ECR I-4261; C-441/09, *Commission v Austria*, [2011] ECR I-72; C-453/09, *Commission v Germany*, [2011] ECR I-74; and C-108/11, *Commission v Ireland*, [2013] ECR I-000.

<sup>100</sup> Case C-259/10, *Rank Group*, [2011] ECR I-000. For an analysis of this case see R. de la Feria “Rank Group. VAT exemption on gambling. Principle of fiscal neutrality. Court of Justice” (2012) *Highlights & Insights on European Taxation* 1; and R. de la Feria, “Novo rumo para a aplicação do princípio da neutralidade fiscal às isenções em IVA?” (2011) *Revista de Finanças Públicas e Direito Fiscal* 4(4), 295-309.

<sup>101</sup> See V. Sloane, “VAT Focus – Rank and Fiscal Neutrality” (2011) *Tax Journal* 1101, 20, 18 November 2011. See also G. Morse, “Sub One Ltd v HMRC: applying EU law principles to the zero-rating provisions of UK VAT law; the limits of discretion” (2013) *British Tax Review* 1, 28-34.

eagerly expected decisions in the e-books cases, where the Court has been called to decide on whether e-books can be subject to reduced rates of VAT similarly to hardcopy books.<sup>102</sup>

In the meantime, national courts too have been struggling with similar difficulties, and in this regard, United Kingdom court cases concerning food products are particularly telling.<sup>103</sup> In addition to highlighting definitional and interpretative difficulties, these rulings also demonstrate the pitfalls of attempting to attain distributional and social aims through reduced rates: certain food products were excluded from the scope of application of the reduced rates because the UK legislator deemed these products as not fulfilling those distributional and social aims; yet, similar products are benefiting from reduced rates; the result being that the tax system is *de facto* subsidising those products, in detriment of competing products. The consequences for fiscal neutrality are obvious: treating competing products differently for VAT purposes is bound to create distortions to competition. In addition there might be unexpected detrimental effects: some decisions, for example, would have been likely to create an incentive to alter the manufacturing of their products in order to benefit from a reduced rate.

Whilst difficult to quantify, the costs of these distortions of consumption and investment decisions may be extremely significant. Reduced rates of VAT erode the tax base, and importantly may subsidise inefficient production – since the suppliers of products subject to reduced rates do not have to compete on a level playing field with suppliers of products subject to standard. The results of the cost-benefit analysis as applied to reduced VAT rates is therefore particularly negative: not only it is unclear whether they accomplish any of the social and distributional objectives that they set out to achieve, but they also carry significant costs beyond the mere loss of potential revenue.<sup>104</sup> The result is a significant decrease in efficiency of the tax, as measured by the IMF and the OECD,

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<sup>102</sup> See European Commission, *Taxation: Commission refers France and Luxembourg to the Court of Justice over reduced VAT rates on ebooks*, Press Release IP/13/137, 21/02/2013; and VATLive, *Europe details case against Luxembourg ebooks VAT rates*, December 9, 2013.

<sup>103</sup> See *United Biscuits (UK) Ltd (No 2)* (LON/91/160) VAT Decision 6344, known as the Jaffa Cakes decision; Marks & Spencer, [1997] VAT & Duties Report 85; and *Pringles*, [1999] Simon Tax Cases 205, and [2000] Simon Tax Cases 16. See also M. Schofield, “Snowballs and windfalls: VAT reduced rates lead to unpredictable and unreasoned jurisprudence”, *DELI Blog*, 24 July 2014; M. Devereux and R. de la Feria, “VAT – Unjust Enrichment” (2008) *Tax Journal*, 12 May, 13-15; G. Morse, “Proctor & Gamble UK v HMRC (Pringles Two) – a very peculiar UK practice – the characterisation of food products for zero-rating” (2009) *British Tax Review* 1, 59-67; G. Morse, “HMRC v Proctor & Gamble UK (Pringles Two) in the Court of Appeal: determining classification cases for VAT – a short practical answer and an end to ‘almost mind-numbing legal analysis’?” (2009) *British Tax Review* 4, 401-405; and I. Roxan “Interpreting exceptional VAT legislation: or, are there principles in Pringles?” (2010) *British Tax Review* 6, 699-716

<sup>104</sup> See also S. Cnossen, “Value-Added Tax and Excises: Commentary” in S. Adam et al (eds.), n. 74 above.

which shows that European countries' VAT systems tend to rank below the OECD C-efficiency ratio, average, which stands at 55 points out of 100 possible.<sup>105</sup>

The ideal VAT – at least insofar as higher income countries are concerned – is therefore thought to be a broad-based, single rate tax.<sup>106</sup> This much has been consistently defended by the OECD since the 1980s,<sup>107</sup> and was recently supported by the European Commission in the 2010 Green Paper on the Future of VAT. This has also been the position of the IMF, which has recommended the introduction of a single-rate VAT system to many countries around the world.<sup>108</sup>

### 3.1.3 What is the ideal VAT (standard) rate?

The idea that tax revenue increases as tax rate increases only up to a certain level – the maximum tax rate – and that from that point onwards increases in the tax rate actually lead to a decrease in tax revenue, was first suggested in 1970s.<sup>109</sup> Whether this u-shape effect, known as the Laffer Curve, applies to VAT is not an uncontested matter. Empirical evidence suggests that rate increases does result in, both a decrease in average propensity for consumption – or at least a decrease in the formal economy –, and an increase in non-compliance / fraud, i.e. an increase in activities in the informal economy.<sup>110</sup> Whether those effects do result in the existence of maximum rate in terms of revenue maximisation, however, is less clear.

Prior to 2008 it was suggested that indeed there was a revenue maximising rate for VAT, which stood at a range between 18% and 19.3% in EU countries;<sup>111</sup> more recently, it has been estimated the VAT maximising revenue rate in those countries to be 22.5%.<sup>112</sup> It is also suggested that the maximum rate is different according to business cycle, i.e. that it is slightly higher in low growth years – this would be explained with changes in the structure of consumption, as well as with VAT

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<sup>105</sup> See OECD, n. 80 above, at 113. The significance, in terms of welfare, of this low C-efficiency in EU Member States is somewhat unclear, but it has proved very useful for policy analysis, see M. Keen, "The Anatomy of the VAT" (2013) *IMF Working Papers* WP/13/111, May 2013, at 10. For a useful explanation of the methodologies used for establishing the efficiency of VAT systems see F. Borselli, S. Chiri and E. Romagnano, "Patterns of Reduced VAT Rates in the European Union" (2012) *International VAT Monitor* 1, 13-21.

<sup>106</sup> Whether this is still the case for developing countries, or whether the case for multiple rates in those countries is stronger, is less widely agreed, see M. Keen, n. 105, at 11.

<sup>107</sup> See A. Charlet and J. Owens, n. 91 above, at 949.

<sup>108</sup> See L. Ebrill et al, *The Modern VAT* (Washington DC: IMF, 2001). See also J. Norregaard and T.S. Kahn, "Tax Policy: Recent Trends and Coming Challenges" (2007) *IMF Working Papers* WP/07/274, at 38.

<sup>109</sup> J. Wanniski, "Taxes, Revenues and the 'Laffer Curve'" (1978) *Public Interest* 50.

<sup>110</sup> See J. Alm and A. El-Ganeiry, "Value Added Taxation and Consumption" (2013) *International Tax and Public Finance* 20, 105-128; and W.J.M. Heijmen and J.A.C. Van Ophen, "The Willingness to Pay Tax: Laffer Curve Revisited for 12 OECD Countries" (2005) *Journal of Socio-Economics* 34(5), 714-723.

<sup>111</sup> K. Matthews, "VAT Evasion and VAT Avoidance: is there a European Laffer Curve for VAT?" (2003) *International Review of Applied Economics* 17(1).

<sup>112</sup> F. Guedes de Oliveira and L. Costa, "The VAT Laffer Curve and the Business Cycle" (2013) *Economics Working Paper* WP 02/2013.

collection effectiveness.<sup>113</sup> However, both studies have shortcomings.<sup>114</sup> Moreover, latest evidence indicates that, if there is a VAT Laffer Curve, the maximising revenue rate has not yet been achieved in EU countries, with Member States still reporting increases in VAT revenue intakes, despite the increase in rates to unprecedented levels.

Whether increasing rates is the most effective way to increase VAT revenues, nevertheless, is an entirely different question. As discussed above, whilst most EU Member States increased their standard rates in the last 5 years, only a relatively small number extended their VAT base. Yet, empirical evidences demonstrates the most effective and immediate driver of changes in VAT revenues is base-broadening; changes in the standard rate, in contrast, directly account for a relatively small part of the development in VAT revenues.<sup>115</sup> Moreover, increases in standard VAT rates may potentially amplify the difficulties and distortions caused by reduced rates, if it widens the gap between the two.

The ideal VAT is thought therefore, not only to be broad-based, with a single rate tax, but equally that rate should also be low. Unfortunately, such a VAT rate structure would be extremely difficult – if not impossible – to implement in European countries. So the question is, what would constitute an improved, achievable, VAT rate structure in Europe.

### **3.2. Achievable VAT rate structure**

In light of the above, any reform of national VAT rate structures with a view to having a significantly improved structure, must take in consideration various factors. First, it must be acknowledged that, in the immediate term, moving products from reduced to standard rate is likely to have a significant economic impact, namely in the context of the high standard rates applied in almost all Member States, which mean that this move could represent as much as a 20% or 15% tax hike. This economic impact could be reflected in higher prices, which would hit the poorest households the hardest, or in increased unemployment / low salaries: one can imagine that in price inelastic sectors, such as food or utilities, prices will most likely increase;<sup>116</sup> in other price elastic sectors, where an increase in price might lead to a considerable contraction in consumption, suppliers may opt to maintain prices, but will need instead to decrease costs, which in a labour-intensive sector, such as restaurant services or tourism, would lead to job loses.

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<sup>113</sup> Ibid.

<sup>114</sup> K Matthews uses standard rates as a proxy for VAT rates, without consideration of application of reduced rates, see *ibid.*

<sup>115</sup> See M. Keen, n. 105 above, at 8.

<sup>116</sup> As acknowledged by the OECD, see n. 80 above, at 73.

Secondly, it must be accepted that in the current financial environment that most European countries find themselves in – and not just the ones which benefited from a bail-out agreement – in the context of problematic budget deficits, and significant financial restraints, the likelihood of introduction of measures at personal income tax or social security level, to compensate the VAT hike, is small at best. This concern was indeed expressed by several respondents to the European Commission’s latest public consultation on review of reduced rates: in the current economic climate respondents expressed fear that there might be no national compensating measures, or that they would be insufficient.<sup>117</sup>

Third, any reform of national VAT rate structures must take into consideration EU law limitations. As opposed to exemptions, application of reduced rates under the VAT Directive is non-compulsory, i.e. the Directive establishes maximum standards of differentiation – number of rates, number of products to which reduced rates can be applied – but does not establish a minimum level of differentiation; Member States are free to apply reduced rates to as limited number of products as they wish, and *ad extremis* are even free to apply only one rate. Therefore extension of the VAT base through elimination of reduced rates is not subject to any EU law limitations. However, the implementation of compensatory measures may be; in particular, the freedom to introduce measures to compensate labour-intensive or key economic sectors for the increase in VAT rates in might be severely reduced. Within the EU, national subsidies to specific industries, either in the form of tax relief / incentives or direct subsidies, are limited by state aid law.<sup>118</sup>

Finally, the long-running history of European failed attempts to harmonise VAT rate structures, is indicative of the political difficulties in reforming this area of the tax system. Aside from the well-known specific European dynamics at force, such as unanimity voting – which can be bypassed by national, unilateral action – it must also be acknowledged that opposition to reform in this area may be partially explained by the theory of *status quo* bias, which lies behind the opposition to abolition of preferential tax regimes more generally.<sup>119</sup>

In light of the above limitations, what would be suitable criteria for better, more efficient, more neutral, yet achievable, European VAT rate structures?

### 3.2.1 Criteria for Reform of European VAT Rate Structures

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<sup>117</sup> See European Commission, n. 75 above.

<sup>118</sup> There is an extensive, and ever growing, literature on the intersection between tax and state aid law, in particular following the CJEU decision in *Gibraltar*, case C-106/09, [2011] ECR I-11113. See amongst many others, T. Lyons, “Commission and Spain v Gibraltar and the United Kingdom: a landmark case on engineering tax regimes” (2012) *British Tax Review* 1, 55-63; and A. Rust and C. Micheau, *State Aid and Tax Law* (The Hague: Kluwer Law International, 2012).

<sup>119</sup> R. Fernandez and D. Rodrik, “Resistance to Reform: Status Quo Bias in the Presence of Individual Specific Uncertainty” (1991) *American Economic Review* 81, 1146-1155.

In terms of the VAT base, four criteria are proposed, as follows.

Criterion 1: Elimination of application of reduced rates of VAT, where the rationale for its application is the creation of positive externalities and/or correction of externalities. There are various arguments to support this criterion. First, it is notoriously difficult (and subjective) to attach positive externalities to specific products; for example, few may argue against the positive externalities of reading, yet do all books or magazines hold positive externalities? Do celebrities' biographies, or astrology books? And even if so, are these potential positive externalities sufficient to justify a government subsidy? Different people will hold different views. Second, goods or services which are usually perceived as holding positive externalities, such as books or cultural events, are statistically much more likely to be consumed by high-income households. So that applying reduced rates to these products constitutes a *de facto* subsidy from poor-income to high-income households, thus holding negative distributional effects. It has been argued that the maintenance of reduce rates for these products has an aspirational value. Even if that is the case, is it legitimate to ask low-income households to subsidise attendance to theatre plays, or the opera, by high-income households? Third, these products are by nature price elastic, so it is unclear to what extent prices will be affected by a VAT rate increase. It is possible that they will be an effect on employment, in the context of a possible need to decrease costs, but it is worth keeping in mind that these are not usually labour-intensive industries for unqualified workers, but quite the opposite: they tend to employ small number of qualified workers. Finally, in the context of the current financial and economic crisis, encouraging the consumption of products which hold positive externalities is hardly a priority.

Criterion 2: Maintaining the application of reduced rates of VAT where the rationale for is application is vertical equity. The basis for this criterion is the low price elasticity of these products; prices will most likely increase, hitting low-income households hardest. However, given that high-income households consume considerably more of these products, it makes sense to limit the application of reduce rates to those categories of goods and services which are truly essential, such as food.

Criterion 3: Maintaining the application of reduced rates of VAT where its elimination would have a serious impact on industries which are either labour-intensive or key for economic recovery. The arguments in favour of maintaining reduced rates for these sectors are based on keeping competitiveness of national products in the international market, and employment concerns. In principle the tax hike could be absorbed by suppliers by decrease in their margins, but considering the size of the hike it is likely that at least part of the increase will have to be passed on to consumers in higher prices, or to employees in lower salaries / job losses. Both options carry economic risks for key sectors of the economy and those which are labour-intensive: if passed on in

higher prices there is a risk of decrease competitiveness for exporting sectors of the economy, which in labour-intensive sectors can have the added effect of raising unemployment; even for non-exporting sectors, if price elastic, it is more likely that the VAT hike would be passed on employees, as increase in prices would lead to contraction in consumption, and then again there would be a significant risk of job losses.

Criterion 4: Rationalisation of categories of goods and services to which reduced rates of VAT apply, by eliminating distinctions within categories, and limiting the use of different rates to different products within the same category. Distinctions within categories are the main sources of interpretative and definitional difficulties; elimination of these distinctions would therefore lead to higher legal certainty, be a disincentive to planning, abuse and fraud, and decrease significantly the potential for litigation – all of which would in turn result in lower compliance and administrative costs. Elimination of distinctions would also avoid other economic distortions, such as product manipulation so as to avail of the reduce VAT rate.

### 3.2.2 How to Reform European VAT Rate Structures

Whilst the economic case for VAT base-broadening has been often done by the European Commission –and many academics – the persuasiveness of the economic case has clearly been insufficient to secure political support. As discussed above, this is undoubtedly partially due to the difficulties in approving EU legislation; however, EU legislative procedure dynamics alone do not explain the fact that, until recently, VAT base broadening measures have also been relatively rare at national European level. A better explanation for it may be the existence of *status quo* bias.

Broadening the VAT base means essentially moving from an existing tax regime, towards a new one; adoption of such measures requires, therefore, overcoming the *status quo* bias. This bias means that voters will impose more conditions to move from *status quo* A to a new tax system B, than to remain in A.<sup>120</sup> The bias can be explained by creation of losers and winners, uncertainty, and imperfect information. Any tax reform process necessarily results in losers and winners, and broadening of VAT is no exception. Those that had been so far benefiting from the existence of reduced rates will naturally loose with the reform; they are easily identifiable, compared to the second group of most taxpayers that stand to gain (perhaps only marginally), and they have a strong incentive to lobby hard against the reform, in contrast with the winners, who are often silent.<sup>121</sup> Additionally, the reform process itself may create uncertainty, which will be aggravated by voters' lack of understanding of the tax system (imperfect information). On VAT specifically, it has been

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<sup>120</sup> Ribid.

<sup>121</sup> OECD, n. 80 above, at 100 and 107.

suggested that the main cause of the unpopularity of broadening-base measures is the imperfect information on the potential revenue and redistributive impact of these base-broadening measures.<sup>122</sup>

The *status quo* bias means in practice that a pure economic argument, focussing on efficiency gains, may not be sufficient to obtain the political agreement necessary for the adoption of VAT base-broadening measures, according to the above proposed criteria. Overcoming this bias may require EU Member States to consider other factors regarding the form and timing of the reform.

In terms of form, it has been suggested as a solution to circumventing the *status quo* bias, to pursue gradual reforms, by splitting the reform into different components, and to explicitly link the abolition of preferential tax treatments that only benefit some taxpayers – such as application of reduced rates to specific products – with the introduction of tax measures from which most taxpayers will gain.<sup>123</sup> As discussed above,<sup>124</sup> both these approaches have been tried within the EU for the reform of VAT rates, with no success. More promising is the suggestion that base broadening measures may be more acceptable if bundled; when elements are viewed in isolation, and the debate focuses on particular goods, the status quo may be seen as genuinely redistributive, which may prevent voters from supporting the reform.<sup>125</sup> The EU experience seems to confirm this view. Moreover, international constraints, such as those emerging from the IMF or the European Commission, may also assist in the introduction of unpopular reforms,<sup>126</sup> as the experience post-2008 in countries subject to bail-out demonstrates.

Insofar as timing for the introduction of base broadening measures, whilst it is difficult to define the right moment, quick reforms appear to be the most effective.<sup>127</sup> Not only there is a possibility that the announcement might change the behaviour of economic operators,<sup>128</sup> but equally it may encourage the mobilisation of those that will lose out with the reform to lobby (harder) for the maintenance of the *status quo*.

### 3.2.3 Portuguese 2012 VAT Reform

The above proposed base-broadening criteria were used as a basis for the Portuguese VAT rate structure reform in 2012, which through strategic designed form and timing was able to overcome

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<sup>122</sup> J. Alt et al, “The Political Economy of Tax Policy” in S. Adam et al (eds.), n. (...) above.

<sup>123</sup> Ibid, at 100.

<sup>124</sup> See Sections 1 and 2.

<sup>125</sup> OECD, n. 80 above, at 107-108.

<sup>126</sup> A, Alesina and A. Drazen, “Why Are Stabilizations Delayed?” (1991) *American Economic Review* 81(5), 1170-1188.

<sup>127</sup> OECD, n. 80 above, at 109.

<sup>128</sup> As *BUPA* demonstrates, see case C-419/02, [2006] ECR I-1685.

the *status quo* bias. Under the bail-out agreement signed with the EU and the IMF in 2011, Portugal was required to reform its VAT, which was deemed to be highly inefficient and if reformed offered potential to help the Portuguese Government reduce its budget deficit. The required reform, based on the above criteria, was implemented in the 2012 State Budget, and it resulted in the following key changes to the existing rate structure:

- (1) Cultural events, sports activities and environmentally friendly products were moved from the reduced and intermediate rates to the standard rate (on the basis of criterion 1).
- (2) Non-essential food and beverages, take-away and restaurant services were moved from the reduced and intermediate rates to the standard rate (on the basis of criterion 2).
- (3) Hotel accommodation and tourism-related services, as well as agricultural inputs have been kept at reduced and intermediate rates (on the basis of criterion 3).
- (4) Distinctions within categories of foodstuff have been eliminated, so that specific categories are either subject to reduced or to standard rates (on the basis of criterion 4).

The reform resulted in a 30 points reduction in tax expenditure, as well as a significant increase in the C-efficiency level, which before the reform stood at 44 points.<sup>129</sup> Consumption contracted significantly; however, until reliable price data is available, it is difficult to dissociate the extent to which the contraction resulted from the VAT base broadening, from the contraction that it would have happen as a result of the economic and financial crisis regardless of any tax hikes. Consequently VAT revenue has increased, but at lower levels than expected.

Despite the somewhat disappointing short-term results in terms of revenue collected, the Portuguese reform of the VAT rate structure was broadly complimented by the EU and the IMF. The IMF Country Report on Portugal at the time of the reforms stated that as a result of these the VAT tax base levied at the standard rates was enlarged from 60 to 80% of the total base, which would generate savings of about 1.2% of GDP.<sup>130</sup> The report from the European Commission referred to additional revenues of 1.4% of GDP, stating:

“Following past increases in the VAT rates, the 2012 budget focused mostly on broadening the tax base [...] In order to protect vulnerable groups, many essential goods remain subject to the 6% reduced rate and this rate also continues to be applied to goods considered crucial for

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<sup>129</sup> Although it has been recently suggested that an imperfect extension of the VAT base to cover more but not all services, might be welfare inferior to the baseline, see B. Bye et al, “Welfare effects of VAT reforms: a general equilibrium analysis” (2012) *International Tax and Public Finance* 19, 368-392.

<sup>130</sup> See “Taxing Matters”, *Society Now*, Spring 2013, 25.

domestic production, such as wine. Overall, the measures will help to significantly increase VAT efficiency.”<sup>131</sup>

The success of these measures – even if more limited than expected – allowed the Portuguese Government to focus on introducing amendments to the VAT legislation to promote growth, in particular by helping small and medium-sized businesses, in the 2013 State Budget. Measures introduced included the simplification of the bad debts regime, and a cash-flow tax accounting scheme for companies with turnover below €500,000.

#### **4. Achieving Broad-Based VAT(s) in Europe**

EU agreement on reduced VAT rates is difficult to achieve; and even if achievable, it will result in only minor improvements to the current EU VAT rate structure. In this context it is necessary to consider whether it would be possible to have significantly improved VAT rate structures in Europe, through national, uncoordinated, action. Implementation of an ideal VAT by Member States – i.e. a single-rate system with compensatory measures low-income households, and key sectors of the economy – is conditioned by political constraints present in most European countries, as well as significant budgetary limitations. Moreover, the form and timing of the reform is not indifferent, the presence of *status quo* bias means that EU Member States must consider the best strategy to overcome that bias.

The criteria proposed here for reform of national VAT rate structures will not result in the best VAT possible, but rather in the best VAT Member States can possible have given the circumstances. A broader-based VAT, which will result in increased revenue, decreased administrative and compliance costs, and less susceptibility to fraud, avoidance and planning; overall a more efficient, more neutral VAT. In the process the holy grail of EU VAT might be finally attained: decreased divergence and even approximation of VAT rates structures across the EU. Not through a process of EU harmonisation, but instead through a process of natural convergence of national VAT policies – a rare case of significant gain, with limited pain.

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<sup>131</sup> See European Commission, *The Economic Adjustment Programme for Portugal – Third review-Winter 2011/2012*, April 2012.

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