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Greening the EU VAT Rate System: The Case for a Differentiated Assessment

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The EU VAT Rate Reform 2022, Including a Two-Pronged Approach to Align the EU VAT Rate System with the Green New Deal

In April 2022, the Council of the European Union adopted a Directive (2022/542) which brings about significant changes to the rate system of the EU VAT Directive (Council Directive 2006/112/EC). Most notably, it will do away with most of the existing country-specific derogations.[i] Instead, all Member States will be allowed to introduce, in addition to the current standard rate and two reduced rates, a super reduced rate (ranging between 0% and 5%) as well as a zero tax rate (so that supplies are not subject to VAT while retaining the right to deduct input VAT). Their use is however limited to 7 categories of goods and services, as is the application of the existing two reduced rates (maximum 24 categories of goods and services).[ii]

Apart from establishing a harmonized legal framework for VAT rates within the EU territory, the EU lawmakers sought to bring the EU VAT rate system in line with other EU policies, such as the Green New Deal (see the EU Commission's Communication). The actions taken to achieve this objective are characterized by a two-pronged approach:

- On the one hand, the Member States have been enabled to apply zero, super reduced or reduced VAT rates to the supply of certain environmentally friendly goods and services. This concerns the supply and installation of solar panels, the supply of renewable energy sources, and the supply and installation of highly efficient low emissions heating systems.[iii]
- On the other hand, they have been obliged to phase out preferential VAT treatment of certain environmentally harmful supplies, where applicable, by 2030 or 2032 respectively at the latest. This includes fossil fuels and other goods with a similar impact on greenhouse gas emissions, such as peat and wood used as firewood, chemical pesticides and chemical fertilizers.[iv]

These combined measures are aimed to accelerate decarbonization of energy production, promote and support the transition towards the use of environmentally friendly heating systems and renewable energy sources, and improve final consumers' access to green energy sources.[v]

The Assessment of the Green Measures of the EU VAT Rate Reform 2022 from an Environmental Tax Policy Perspective Calls for a Differentiated Approach

The good intentions of the EU lawmakers regarding the environment-related measures of the EU VAT rate reform 2022 are undisputed. However, a prudent and sustainable tax policy requires more. Above all, tax-induced measures should only be used to reach environmental goals when they can be assumed to accomplish the intended objectives effectively, and should be preferred to other means only when it can be reasonably expected that this is the best way to attain these aims.

In the context of the EU VAT rate reform 2022, the EU lawmakers have identified increases and decreases in VAT rates as their preferred policy tool to advance their green agenda in the area of EU VAT. In order for these measures to have an impact on consumer behavior (so that environmentally friendly supplies are favored over environmentally harmful supplies), it is therefore critical that these increases and decreases are passed on to the consumer, as to send a positive or negative price signal respectively.[vi]

For obvious reasons, the actual effects of legal amendments based on Directive (EU) 2022/542 cannot yet be measured. However, the extensive knowledge developed in the context of previous VAT rate reforms allows predictions to be made about the adequacy of the measures taken.

Therefore, attention should be directed to the fact that the overwhelming majority of related studies found that VAT rate reductions were not or not fully passed on to consumers.[vii] This phenomenon was detected particularly in the context of reclassifications, hence when the standard VAT rate was changed to a reduced VAT rate.[viii] Conversely, VAT increases were typically reflected in prices, and to a greater extent than VAT decreases. At least, that has been the finding of virtually all studies devoted to identifying potentially different outcomes of increases and decreases in VAT rates.[ix]

The existing body of research thus indicates the need for a differentiated assessment of the environmental measures of the EU VAT rate reform 2022. Accordingly, it seems likely that the phasing-out of preferential VAT treatment of environmentally harmful supplies will be reflected in correspondingly higher prices. The intended price signal should hence be sent, and the objective pursued with this measure achieved.[x] In contrast, it seems highly questionable whether decreases in VAT rates for environmentally friendly supplies would be passed on to the consumers in full (if at all), which alone would render them – at least to a certain extent – an unfavorable means to reach environmental goals. Even in the case of a (partial) pass-through, there are other factors which deserve consideration by national lawmakers:[xi]

- VAT rate reductions are rather blunt policy instruments which do not allow any distinction between wealthier and less-affluent households. Hence, they lead to subsidies for those who would be able to pay the price including the standard VAT rate (and who might have acquired these products also without this financial incentive). This particularly contradicts the fundamental idea of VAT to tax consumption expenditure in accordance with the individual consumption-specific ability to pay (*Konsumleistungsfähigkeit*).[xii]
- Conversely, it is unclear whether a mere reduction of VAT rates would make comparably larger investments, such as solar panels and heating systems, more affordable for lower income and less-affluent households If these households were still dependent on additional financial aid, it would make a parallel reduction in VAT appear obsolete.

All of this suggests that exercising the option to apply reduced VAT rates to environmentally friendly supplies according to Directive (EU) 2022/542 would come at high costs for the Member States at a time of severe economic hardship due to a global pandemic, soaring energy and food prices as well as a war right next to the EU border, without making a meaningful contribution to achieving the climate goals.

Concluding Remarks

In view of the observations made above, national lawmakers should carefully weigh their options due to the EU VAT rate reform 2022. Most importantly, they should avoid giving in to pressure from lobby groups or the temptation of making quick political gains by introducing fast and high-profile (albeit rather ineffective) action against climate change.[xiii] Instead, before implementing any environment-related VAT reductions, they should carry out a cost-benefit analysis and thereby carefully assess fiscal and welfare trade-offs.

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[i] Some special provisions for certain regions will remain; see therefore Article 104 EU VAT Directive, as amended by Directive (EU) 2022/542.

[ii] Article 98(1) and (2) EU VAT Directive, as amended by Directive (EU) 2022/542.

[iii] Article 98(2)(2)(a) and (b) in conjunction with Annex III (10c) and (22) EU VAT Directive, as amended by Directive (EU) 2022/542).

[iv] (Article 105a(4) and Annex III (11) and (22) EU VAT Directive, as amended by Directive (EU) 2022/542.

[v] Recitals 7 and 15 Directive (EU) 2022/542.

[vi] Rita de la Feria, ‘Blueprint for Reform of VAT Rates in Europe’, Intertax, Vol. 43, Issue 2 (February 2015), p. 155, p. 166; Eduardo Traversa and Benoît Timmermans, ‘Value-Added Tax (VAT) and Sustainability in the European Union: A Radical Proposal: Design Issues, Legal Aspects, and Policy Alternatives’, Intertax, Vol. 49, Issue 11 (November 2021), p. 871, p. 872.

[vii] See for a recent comprehensive presentation and discussion of the empirical evidence Eckhard Binder, ‘VAT gap, reduced VAT rates and their impact on compliance costs for businesses and on consumers: European Implementation Assessment’, Study by the Ex-Post Evaluation Unit within the European Parliamentary Research Service (EPRS) (September 2021), pp. 53–56.

[viii] Dora Benedek, Ruud A. De Mooij, Michael Keen and Philippe Wingeder, ‘Varieties of VAT pass through’, International Tax and Public Finance, Vol. 27, Issue 4 (August 2020), pp. 890–930 (who observed the effect of absent pass-throughs in the context of reclassifications for both VAT decreases and increases).

[ix] Clément Carbonnier, ‘Is Tax Shifting Asymmetric? Evidence from French VAT reforms, 1995-2000’, Working Paper N° 2005 – 34, https://halshs.archives-ouvertes.fr/halshs-00590719 (last assessed 8 July 2022) (in relation to labor-intensive services); Ricardo Batista Politi and

Enlinson Mattos, ‘Ad-valorem tax incidence and after-tax price adjustments: evidence from Brazilian basic basket food’, 44(4) Canadian Journal of Economics/Revue canadienne d’économique, Vol. 44, Issue 4 (November 2011), pp. 1438–1470; Youssef Benzarti, Dorian Carloni, Jarkko Harju and Tuomas Kosonen, ‘What Goes Up May Not Come Down: Asymmetric Incidence of Value-Added Taxes’, Journal of Political Economy, Vol. 128, Issue 12 (December 2020), pp. 4438–4474.

[x] Notwithstanding the fact that switching to eco-friendlier products presupposes that such alternatives are available, accessible, and affordable (and ideally also cheaper than the corresponding environmental harmful substitutes).

[xi] Beyond the national level, making use of the options provided by Directive (EU) 2022/542 could further prove unfavorable from the EU perspective against the background that different VAT rates for environmentally friendly supplies in the Member States might create additional potential for VAT fraud and evasion.

[xii] Joachim Englisch, ‘VAT/GST and Direct Taxes: Different Purposes’, p. 22, in ‘Value Added Tax and Direct Taxation: Similarities and Differences‘, edited by Michael Lang, Peter Melz and Eleonor Kristoffersson (IBFD, 2009) (with further references).

[xiii] The political dynamics affecting consumption rate policy are discussed in detail in Rita de la Feria and Michael Walpole, ‘The Impact of Public Perceptions on General Consumption Taxes’, British Tax Review, Vol. 67, Issue 5 (2020), p. 637, pp. 657–664.

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