INCEPTION IMPACT ASSESSMENT

TITLE OF THE INITIATIVE	Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax (VAT) as regards the rules governing the application of VAT rates (Short name: Reform of VAT rates)
LEAD DG – RESPONSIBLE UNIT	TAXUD C.1 — **DATE OF ROADMAP**: 22/12/2016
LIKELY TYPE OF INITIATIVE	Amendment to VAT Directive (2006/112/EC)
INDICATIVE PLANNING	Q3 2017
ADDITIONAL INFORMATION	-

This Inception Impact Assessment aims to inform stakeholders about the Commission's work in order to allow them to provide feedback on the intended initiative and to participate effectively in future consultation activities. Stakeholders are in particular invited to provide views on the Commission's understanding of the problem and possible solutions and to make available any relevant information that they may have, including on possible impacts of the different options. The Inception Impact Assessment is provided for information purposes only and its content may change. This Inception Impact Assessment does not prejudge the final decision of the Commission on whether this initiative will be pursued or on its final content.

A. Context, Problem definition and Subsidiarity Check

Context

In the 2016 VAT Action Plan[1], and the 2017 Work Programme[2] the Commission outlined its plans towards a single EU VAT area. Following this, four VAT-related proposals will be adopted in 2017: definitive VAT system, the reform of VAT rate-setting, a simplification package for small and medium sized companies (SME package) and an initiative on improved administrative cooperation.

The reform of VAT rates is particularly linked with the initiative on the definitive VAT regime because the existing extensive system of derogations to the VAT rates is largely set to expire when the definitive regime is adopted. Thus, this proposal will also have to determine the regime that will apply following the expiration of the derogations to the VAT rates.

The VAT Action Plan highlighted that the rules on VAT rates should be updated to give more flexibility to Member States in setting VAT rates, also taking into account the subsidiarity principle set out in Article 113 TFEU.

The existing regime for VAT rates was devised with the objective to put in place a VAT system based on the origin principle, under which the VAT rate applicable to a transaction is determined by the Member State where the seller is located. To avoid competitive distortions by different VAT rates for the same product pending the origin of the seller, this system would require a very high degree of rate alignment among Member States. Given that, already upon the entry into force of the VAT Directive, there were stark differences in the level of VAT rates, the legislator, encouraging rate convergence amongst Member States, set floors on the level of VAT rates, or limited the application of reduced rates.

In 2011, however, given the lack of progress on rate convergence, the Commission with agreement of the Council and the European Parliament decided to abandon the objective of a VAT system based on the origin principle in favour of one based on the destination system, according to which the VAT rate applicable is the one where the consumption normally takes place. In this system,goods sold in a Member State are subject to the VAT rate set by that Member State. Suppliers derive no significant benefit from being established in a lower-rate Member State, so VAT rate differences have less potential to disrupt the functioning of the single market. This opened up the possibility to reform rules on rates to make them less constraining for Member States.

Finally, it should be noted that a specific proposal on rates for e-publications was adopted by the Commission on 30 November 2016 - following a particularly urgent need to adapt VAT to digital technologies. Under the general

1 See Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on an action plan on VAT – Towards a single EU VAT area – Time to decide, COM(2016) 148 final.

2 See Commission Work programme 2017: Delivering a Europe that protects, empowers and defends, COM(2016) 710 final.

proposal on VAT rates, such targeted proposals would not be necessary anymore..

Problem the initiative aims to tackle

The current rules

The VAT Directive sets out general rules limiting Member States' freedom to set VAT rates. A standard VAT rate (minimum 15 %) is applied to all taxable supplies of goods and services and a maximum of two reduced rates (minimum 5 %), may be applied to certain goods and services listed in Annex III of the VAT Directive. In addition, Member States were granted a wide range of derogations, allowing them to apply, in specific cases, reduced rates lower than 5 %, including exemptions with a right to deduct VAT occurred at the preceding stage (often called 'zero rates').

Problem 1: The current rules are too limiting for Member States

The described alignment of VAT rates was needed when the objective was still to achieve a VAT system based on the origin principle, which is no longer the case. The design of the rates regime should take this into account, particularly as it is difficult for Member States to extend reduced VAT rates to new areas. This is the main problem that the initiative aims to tackle.

Extending reduced VAT rates to new areas requires unanimity in the Council. As a result, the rules for VAT rates are in some cases becoming obsolete, for example as regards products subject to technological progress. As a consequence, Member States are tempted to act themselves, sometimes in breach of the rules. To date, the Commission has had to open more than 40 infringement proceedings regarding rates against over two thirds of Member States. A reform giving more freedom to Member States would enable them to take policy decisions on VAT rates more rapidly, while providing legal certainty and relieving the EU of unnecessary litigation.

Problem 2: Expiry of derogations to rates in the VAT Directive

A number of derogations are set to expire when the definitive regime is adopted. The lack of a clear and agreed solution on the derogations may in itself prevent agreement on the definitive regime. And if no decision is taken on the derogations despite the adoption of the definitive regime, this would cause legal and economic uncertainty for the affected sectors.

Subsidiarity check (and legal basis)

As set out above, this initiative aims at granting Member States more freedom to set VAT rates while maintaining certain safeguards for the Internal Market and national budgets, providing EU added value compared to the current regime. The current limitaions for Member States in setting VAT rates are set out in the VAT Directive. An initiative to modernise the VAT rules for rates therefore requires a proposal by the Commission to amend that Directive.

The legal basis is Article 113 of the TFEU that states: "The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.".

B. Objectives and Policy options

General objectives:

1. To better take into account the subsidiarity principle following the switch to the destination system while minimising administrative burden, protecting the Internal Market, and avoiding an erosion of VAT revenues.

2. To achieve a more neutral rates regime for the Member States (as compared to the current one where certain derogations to VAT rates apply only to certain Member States).

3. To prepare the ground for the parallel introduction of the definitive VAT regime.

Specific objective:

1. To provide Member States with more leeway in determining the level of VAT rates without creating risks for the single market.

2. To provide a technical solution to the fact that derogations will expire when the definitive regime is adopted.

The main options to be explored are those presented in the Action Plan for VAT:

Option 1: Maintaining the minimum rate combined with extension and regular review of the list of goods and services eligible for reduced rates.

The minimum standard VAT rate of 15 % would be maintained. The list of goods and services that can benefit from the application of a reduced rate would be reviewed in the context of the transition to the definitive system and then at regular intervals, in particular taking account of political priorities. Member States would be able to submit to the Commission their views on the needs for adjustment. The Commission, with the support of the Member States, would analyse whether such changes would pose any risk to the functioning of the single market or distort competition, and would report its findings before any change. Under this option all currently existing reduced rates, including derogations, legally applied in Member States would be maintained and could be included in the list of optional reduced rates available to all Member States, ensuring equal treatment.

Option 2: Greater freedom for member states in setting rates and abolition of the list of goods and services eligible for reduced rates.

The most ambitious approach in terms of granting Member States greater rate-setting power would be to abolish the Annex III list and allow them greater freedom on the number of reduced rates and their level. While Member States would remain constrained by EU legislation, such as single market or competition rules, and the EU's economic governance framework, this option would require safeguards to be put in place to avoid unfair tax competition within the single market, while also guaranteeing legal certainty and reducing compliance costs. The freedom to set VAT rates should be thus accompanied by a number of basic rules framing the cases in which reduced rates may be applied. In particular, Member States could be asked to inform the Commission and other Member States about any new measure and to assess any impact it might have on the single market. To prevent unfair tax competition in cross-border shopping, one possible solution could be to prevent application of reduced rates to high-value goods and services, in particular easily transportable items. To ensure the overall consistency and simplicity of the rates system, the total number of reduced rates allowed by Member States could be limited. These elements would limit the possibility of narrowly targeting sectors for unfair tax relief. Also under this option all currently existing reduced rates, including derogations, legally applied in Member States would be maintained and the possibility to apply them could be made available to all Member States. The minimum standard VAT rate would be removed.

Intermediate or technical sub-options may be added during the course of the analysis.

C. Preliminary Assessment of Expected Impacts

Likely economic impacts

The reform is not expected to have major economic impacts on the EU as a whole, as there is no reason to expect that there will be major shifts in Member States' rates policies even when limitations in the VAT Directive are lifted. This is because Member States are constrained by the need to raise tax revenue if they were to use all possibilities of applying reduced rates which are accorded to them under the current rules.

It is nevertheless likely that rates on certain goods or services deemed to be worthy of special treatment, on the basis of social or political considerations, will be cut. While it seems likely that the revenue consequences will be limited, there is a possibility that the scope of application for reduced rates would increase over time. This in turn might lead to increases in rate differentiation (if e.g. the standard rate goes up to compensate for revenue shortfalls) or to an erosion of revenues if policymakers would want to hold the other VAT rates constant. To put this in perspective, it should however be recalled that already now there is a wide differentiation in rates.

Likely social impacts

The reform will give Member States additional room for manoeuvre regarding the use of VAT to achieve certain policy objectives. Thus, depending on the choices made at national level, particular population groups may benefit, provided that VAT reductions will be passed on and lead to lower prices, which in the end will depend on competition and substitutability of products .

Likely environmental impacts

The reform will give Member States additional room for manoeuvre. If choices made at national level go in the direction of using VAT to achieve environmental policy aims, there may be some beneficial environmental impacts, provided that VAT reductions will be passed on and lead to lower prices, which in the end will depend on competition and substitutability of products

Likely impacts on fundamental rights

No impact expected.

Likely impacts on simplification and/or administrative burden

A reform would have the advantage of decreasing litigation regarding VAT rates at EU level. It will also become easier and quicker for Member States to take policy decisions on VAT rates.

On the downside, there is a risk that the VAT rates regime in the EU becomes more complex depending on how Member States act when they are less constrained in setting rates. An increase in the number of rates across the EU is likely to increase the administrative burden and compliance costs on both authorities and operators.

D. Data Collection and Better Regulation Instruments

Impact assessment

An impact assessment is being prepared to support the preparation of this initiative and to inform the Commission's decision.

The current rates regime was examined at length in "A retrospective evaluation of elements of the EU VAT system" by the Institute for Fiscal Studies in 2011 . The study specifically included three extensive chapters on rates; a quantitative analysis of VAT rate structures, an assessment of the existing rate structure and a final chapter on the macroeconomic effects of VAT rates and structure. Given that there have not been any reforms to the rates structure since the study was conducted, it will serve well as an evaluation to the impact assessment.

Data collection

The effects of increased rate differentiation is currently being analysed by PwC in a study commissioned by TAXUD Unit C1. The results will be delivered in mid-2017. Case studies analysing specific goods and country pairs will be included, targeting goods with the highest risks of distortion due to cross-border consumption.

Consultation strategy

- A public consultation on the Reform of VAT rates was launched in December 2016[3]. In addition, public consultations on the related VAT initiatives (the definitive VAT regime, the SME package and the initiative on improved administrative cooperation) will also be conducted.
- Furthermore, Member States will be consulted in the Group on the Future of VAT (GFV) and the community of VAT experts will be consulted in the VAT expert group.

Will an Implementation plan be established?

This initiative is directed at Member States' administrations. In the course of the impact assessment it will be analysed whether and what kind of implementation plan is needed.

[3] https://ec.europa.eu/taxation_customs/consultations-get-involved/tax-consultations/public-consultation-reform-rates-vat-towards-modernised-vat-rates-policy_en