VALUE ADDED TAX (VAT), A TAX TO BE REFOCUSED ON ITS OBJECTIVE OF GENERATING REVENUE FOR PUBLIC FINANCES

Executive Summary

February 2023

Contents

Summary of the report

Value Added Tax (VAT) is a general consumption tax charged directly to customers on the goods they consume or the services they use in France. The substantial changes in its budgetary and legal framework, as well as recent developments in the economic situation, marked by the health crisis, the energy crisis and inflation and by growing concerns about long-term issues such as climate change, have led the Council of Mandatory Contributions (CPO) to take an interest in this tax, eight years after its previous report on VAT. The findings of this report can be summarised in two key ideas.

I - VAT must remain a tax that generates revenue of which the main objective is to finance public services

As the main tax of the French tax system, bringing in €186 billion and representing 17% of compulsory levies in 2021, VAT has many advantages for public finances and the economy. In this context, while it used to contribute mainly to central government's budget, central government now receives only half of the VAT revenue due to successive allocations of VAT portions to social welfare bodies and local authorities, in particular to compensate for the loss of pre-existing revenue. These allocations reflect structural choices in the organisation of financial relations between central government and these bodies. They can thus only be assessed in the light of the balance of social finances and local finances as a whole. However, they raise the question of the sustainability of public finances, as central government has, all other things being equal, fewer tax resources to finance an equivalent level of public spending. The allocation of VAT outside these two fields, as has been the case for public broadcasting since 2022, generates undesirable effects that have been highlighted on several occasions by the CPO and should be avoided. Moreover, they will be prohibited from 2025, pursuant to the amended Article 2 of the French Organic Law on Budget Acts.

Despite these allocations, VAT continues its purpose of financing public services. However, the revenue it generates is threatened by two phenomena of a distinct nature: the development of small and large-scale fraud, and the increase in the number of reduced rates which are rarely associated with impact studies beforehand or evaluations afterwards and which are very difficult to question, even when their effectiveness appears limited.

Firstly, recent estimates of VAT fraud are higher than previously suggested, with INSEE estimating irregularities, both intentional and unintentional, of between €20 billion and €26 billion based on 2012 data. While some VAT fraud schemes are now effectively identified by the public authorities, such as "carousel" fraud and the underground economy, new fraudulent schemes are emerging in connection with the digitalisation of the economy. In this respect, the e-commerce VAT package, which came into force in 2021, has profoundly revised the legal framework for imports into the European Union (EU) from third countries, notably by introducing an accountability mechanism for platforms selling goods online to individuals. Similarly, in order to prevent hidden economic activities and the economic and tax distortions that they generate, a reporting mechanism has been imposed on the digital matching platforms of the sharing economy and on payment service providers. Finally, electronic invoicing between companies and the transmission of electronic transaction data will be rolled out in France by 2024 to 2026.

In this context, the CPO suggests developing these mechanisms further in respect of closer monitoring of platforms selling goods from non-EU countries, the accountability of digital matching platforms, and the harmonisation of e-invoicing within the EU. This is the direction of the recent "VAT in the digital age" package, presented by the European Commission on 8 December 2022. These guidelines, together with the reorganisation of tax investigation services and judicial authorities, and the use of new legal instruments of plea bargaining in tax matters, should make it possible, in the short term, to reverse the downward trend in demands for arrears in VAT duties observed in recent years. They could help inform current thinking on the plan to prevent tax, social and customs fraud, announced by the Government for the end of the first half of 2023.

Secondly, reduced VAT rates represent a significant loss of revenue by international standards, currently amounting to €47 billion, or the equivalent of 24% of what it generates. In this context, the directive of 5 April 2022 opened up new possibilities for adopting reduced VAT rates, which have not yet been fully exploited in Europe and France. While reduced rates were previously strictly regulated, this relaxation, albeit limited, is explained by the adoption of a territory-level regime based on the country of destination. This limits risks of tax competition between Member States more than taxation in the country of origin.

However, the effectiveness of reduced VAT rates in achieving economic objectives appears to be limited, and they are a source of complexity for businesses, as illustrated by the issue of the diverse nature of offers. The assessment of existing rates should therefore prevent the adoption of new reduced VAT rates and lead to the use of other tools to pursue economic and public policy objectives. At the same time, this report suggests strengthening the monitoring and evaluation of existing reduced VAT rates by the CPO or an *ad hoc* body and, on the basis of these evaluations, abolishing ineffective reduced rates or, failing that, increasing them to a higher rate in the scale.

II - VAT is not the best instrument available to the public authorities for responding to the consequences of the current crises and to long-term economic challenges

Firstly, a reduction in VAT appears to have little relevance to the recovery of the French economy. In the context of the 2020 health crisis, several Member States, such as Germany, introduced sectoral or general VAT cuts as a counter-cyclical stimulus. In fact, empirical studies on these experiments show limited effects at a high cost. VAT therefore appears to be a less effective instrument of economic policy than other tools for influencing economic growth.

However, in the current post-Brexit context, VAT must consider the issues involved in terms of the competitiveness of the financial sector. While the exemption of financial activities is a significant feature of the European VAT system, the territory-based rules applicable do not exclude all tax competition between European countries or with third countries. This report therefore provides guidelines for modernising the VAT system for this sector.

Secondly, in the face of the energy shock and the resulting inflation, a VAT cut on energy appears less effective than other budgetary or fiscal instruments.

Unlike most of its European neighbours, France has prioritised instruments other than a cut in VAT in response to rising energy prices. Simulations carried out for the CPO confirm that the 'tariff shield' appears to be more effective than a 10% cut in VAT on gas and electricity in order to limit price increases, while being three times more expensive. Similarly, the energy voucher provides more protection for vulnerable households than a non-targeted VAT reduction measure, while costing less for public finances.

However, non-targeted support measures for energy expenditure must not jeopardise the achievement of national environmental targets and can therefore only be temporary. In the long term, the priority must be to change behaviour through structural incentives for decarbonisation. In this context, some general thinking on energy taxation seems necessary. It should aim to bring excise duties and VAT in line with national targets for reducing greenhouse gas emissions. At the same time, these changes in the fiscal framework may be accompanied by temporary support for businesses and the purchasing power of low-income households.

Finally, other instruments appear to be more effective than VAT in reducing inequalities and addressing environmental and public health challenges. Firstly, VAT is a regressive tax in the sense that in low-income households, which use a larger portion of their income, a larger share of household income goes towards VAT. However, this observation must be qualified in two respects. First of all, a life-cycle analysis, which takes into account the subsequent use of a part of the saving, confirms the regressive nature of VAT, but this is reduced by almost half. Secondly, this observation can be put into perspective by considering the socio-fiscal system as a whole, i.e. by considering the fact that VAT finances expenditure which, in some cases, benefits low-income households more, as the CPO demonstrated in its report of February 2022[1]. In this context, a VAT cut, especially on food products, is a less effective measure for supporting the purchasing power of low-income households than monetary transfers, due to the uncertainty about the rate of pass-through to prices and the impossibility of targeting certain categories of households through a VAT cut.

Similarly, VAT is not an effective instrument for addressing environmental and public health challenges. In particular, the proposal of an "environmental VAT", or VAT adjusted to food labelling such as the Nutri-score, faces significant legal, economic and financial obstacles that limit targeting possibilities and its impact on the various stages of the value chain. This suggests that other instruments, such as targeted transfers, excise duties, the EU Emissions Trading System, investments or regulation, should be prioritised on the one hand, and existing nutritional taxation on the other hand, in order to pursue these long-term economic objectives. This report comes to a similar conclusion for the support of the 'energy efficient' economic sectors of rail transport and the circular economy.

[1] CPO, February 2022, "Redistribution, innovation, lutte contre le changement climatique : trois enjeux fiscaux majeurs en sortie de crise sanitaire" (Redistribution, innovation, climate change: three major fiscal challenges in the wake of the health crisis).

Summary of findings and recommendations

I - Summary of findings

Finding 1: VAT is the largest tax in France and accounted for 17% of mandatory levies in 2021. However, this share is relatively low compared to other European countries, due to it being one of the lowest standard rates and to the importance of reduced rates in France.

Finding 2: In France and at European level, the organisation of the judicial authority and of the investigation services has undergone profound changes since 2015, which aim to strengthen the fight against tax fraud, including VAT fraud.

Finding 3: Reduced VAT rates, more widely used in France than in the rest of Europe, reduce VAT revenue. Although their economic effects on prices, employment or activity are not proven, they are very rarely abolished.

Finding 4: In the short term, the energy voucher is more effective and efficient than a VAT cut to temporarily protect low-income households from rising energy prices.

Finding 5: VAT is a regressive tax in the sense that in low-income households, which use a larger portion of their income, a larger share of household income goes towards VAT. However, this observation can be qualified if we take into account the deferred use of a part of savings and the fact that VAT finances expenditure which, in some cases, benefits more to low-income households.

Finding 6: Targeted support measures, both for supply and demand, seem preferable to a VAT cut on train tickets in order to encourage the use of rail transport.

Finding 7: Supporting repair and reuse services, as well as the eco-design of products, must consider the specific characteristics of each sector, which does not allow for a cut in VAT.

II - Summary of recommendations

Recommendation 1: Avoid the allocation of VAT outside the scope of social welfare bodies and local authorities.

Recommendation 2: Define a methodology to assess the amount of VAT fraud and report the results each year to Parliament.

Recommendation 3: Strengthen the fight against VAT fraud in the context of the platform economy through:

- assessing the effectiveness of the reporting obligations of digital matching platforms;
- adapting the scheduling of tax audits to take account of the reporting obligations of payment service providers;
- supporting, subject to trade-offs on various difficult issues, a reform at European level of the accountability system for transport and accommodation service platforms.

Recommendation 4: In order to limit the extent of reduced rates, which diminish VAT revenue, entrust the CPO or an *ad hoc* body with a multi-year review of reduced rates by identifying their objectives, assessing their performance and proposing more effective and efficient measures where necessary.

Recommendation 5: Abolish the reduced VAT rates, where evaluations confirm they are ineffective; if they are not abolished, raise them to a higher tax rate.

Recommendation 6: Modernise the VAT system for the financial sector by updating the scope and concepts of the option scheme and by reflecting on the use of the exemption rules with a right of deduction for competitive purposes.

Recommendation 7: Conduct a general review of energy taxation to ensure that VAT and excise duties are consistent with national environmental targets.

Recommendation 8: Favour the use of social benefits and targeted monetary transfers over a VAT cut in order to support the purchasing power of low-income households.

Recommendation 9: Make the integration of the environmental dimension in the evaluation of fiscal measures systematic, including in the field of VAT.

Recommendation 10: Favour excise duties over VAT as the main instrument for environmental tax incentives.

Recommendation 11: Discard VAT rate adjustments as a nutrition-based public health instrument.