

Passenger transport in the EU's VAT system

Time to abolish exemptions

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Summary

Environmental organisations have long been concerned about the current rules relating to passenger transport VAT. The transport sector now accounts for the largest share of the EU's greenhouse gas emissions, and the growth of aviation emissions now outstrips that of almost all other GHG sources. Yet member states oversee a VAT system which, through voluntary derogations, further inflates aviation's rapid growth while also distorting competition with less carbon intensive transport modes. T&E therefore welcomed the European Commission's review of the VAT system and the prospect that proposals to establish a definitive VAT regime could resolve the anomalies and deficiencies governing the VAT rules for passenger transport.

This position paper sets out T&E's views on the current situation together with ideas on how VAT rates can be best reformed to benefit EU competitiveness while also contributing in a positive way to the achievement of the EU's climate goals. It concludes with an analysis of the Commission's 18 January 2018 proposal on VAT rates. This document is also included in a [broader position paper](#) about how a green tax shift to transport can help fix the EU budget.

1. Background

VAT is currently applied to passenger transport on the basis of where the transport takes place. When selling a ticket for an intra-EU journey, the vendor must levy VAT proportionate to the distance travelled by the bus or train in each country and apply the VAT rates applicable in each country. However, there are exemptions for aviation and maritime passenger transport:

“All member states still make use of the derogations with regard to international passenger transport services and all of them de facto allow for a zero rate (exemption with a right to deduct) for all international air and maritime transport and a large majority apply such a zero rate as well to international road and rail transport.”¹

These derogations applying to passenger tickets grew out of the post-war practice of exempting international aviation and shipping from all taxes. Before the Union was established, travel between European countries was truly international and so no taxes were applied. Member states brought these practices into the VAT system at the time of the *acquis communautaire* as voluntary derogations subject to eventual harmonisation within the Union. However, they developed a life of their own over the years. The derogations are not obligatory on any member state and can be unilaterally abrogated at any time. As the Commission is now bringing forward a definitive regime for VAT, passenger transport VAT should be reformed. As the Commission itself points out, “in a definitive regime there is a need to abolish the existing derogations [for international passenger transport].”² The original exemptions were simply place holders to give member states time to converge rates. However, there has been little convergence on rates. In

¹ taxud.c.1(2015)3966929 – EN

² Ibid.

2011 the EC decided to abandon the objective of introducing an origin-based system for establishing a definitive VAT regime in favour of one based on the destination principle, according to which the VAT applicable is the one where the buyer is located (so that the same tax rate is paid by all sellers wherever located in the EU – which should reduce tax avoidance and fraud). For passenger transport this could be interpreted as meaning applying VAT on the basis of the point of departure of the journey.

The Commission has tried several times to change the existing provisions on the “place of supply” for passenger transport (i.e. the place defining where the VAT rate was set so that place of departure would be the basis for establishing the applicable rate of passenger transport VAT not the distance travelled, etc) but due to opposition from vested interests, most notably the airline industry, it has never succeeded. Now that the entire VAT regime is being reformed, the Commission must seize this opportunity to reform VAT for passenger transport.

2. Overarching considerations

VAT is one of the most important taxes for member state revenue across the EU. It is a general consumption tax and so VAT should apply to all goods and services across the EU unless there are very specific reasons for exemptions. There are no such reasons in the case of passenger transport. In fact there are a number of very strong reasons as to why the exemptions for passenger transport must end:

- **Fairness:** it does not make sense that probably the only luxury products not subject to VAT are air and cruise/ferry tickets. These exemptions sit alongside basic foods, children’s clothing and other essentials. There is no justifiable reason to keep this situation as it is, even more so because cruise and air tickets are largely consumed by people with above-average incomes, thus having negative social consequences.
- **Tax strategy and economic efficiency:** The Commission has long pointed out that indirect taxes are more growth-friendly than direct taxes and broadening tax bases is preferable to increasing tax rates. The Commission must assist member states and come forward with a strong proposal that will broaden the tax base by placing or facilitating the placing of VAT on all passenger transport tickets. The case for aviation is particularly strong since a web of international bilateral agreements effectively precludes taxing international aviation fuel whereas road transport pays on average a 48 cents/litre fuel tax in Europe.
- **Hostile regulatory environment:** The exemption creates a hostile regulatory environment for investment in lower-carbon transport alternatives such as rail and, increasingly, bus. Investment in these sectors will be discouraged by the fact that it will face an uneven playing field with aviation. This goes against the better regulation agenda adopted by the current Commission.
- **Environment:** aviation is by far the most climate-intensive mode of transport. In the context of reducing greenhouse gas emissions from transport by 70% in 2050 and 30-40% in 2030, compared with 2008 levels, ending this implicit subsidy that leads to artificial demand for air tickets in particular is of utmost importance.

These concerns have been set out several times in detail by the environmental sector and detail on each of them can be found, for example, in T&E’s response to the 2011 and 2017 VAT consultations.³

3. Examination of distortions

The Commission has carried out a number of studies on passenger transport VAT which unfortunately underplayed a number of very large distortions across the single market:

- The Commission concluded in 2015 that there were no large distortions of competition in the passenger transport sector partly because in many countries the VAT rate was low or zero.

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<https://www.transportenvironment.org/sites/te/files/media/2011%2005%20T%20E%20Response%20to%20VAT%20Consultation%20Final.pdf>

<https://www.transportenvironment.org/publications/te-response-european-commission-consultation-passenger-vat-rules>

Environmental NGOs disagree and consider that this can only be an appropriate conclusion if the Commission believes that low or zero rates for passenger VAT are fair and appropriate.

- The current place of supply rules for passenger transport place an inordinate administrative burden on rail and coach operators for cross-border travel as VAT for each ticket must account in advance for the varying VAT rates and distances traversed in each country – complications which do not arise with intra-EU aviation and ferry/cruise ships because they are VAT exempt.
- The analysis of the direct distortion between air and rail transport is based on the current state of Europe's transport network. However, it is stated European policy to expand its network of High Speed Rail Lines⁴. This will further increase the distortion created by this unequal treatment. This future increased distortion should be taken into account.

The distortions are much greater than that studied – the lack of VAT on aviation distorts the internal market more generally than just within the passenger transport market. EU citizens are incentivised to spend their money on climate-intensive aviation tickets rather than purchasing other goods or services. Taking a flight is by far the quickest, nearly always the cheapest and certainly the most damaging way any individual can heat the planet, giving rise to almost as much CO₂ as billions of the world's less well off might themselves each generate in an entire year.

Today's complicated place-of-supply rules also represent a considerable deterrent to member states from unilaterally abrogating their intra EU derogations as regards aviation as there is currently no readily acceptable way for an individual member state to calculate the applicable VAT of such a flight. Flights change routings all the time due to weather or air traffic restrictions and keeping track of routings, while technically possible, would probably need to involve Eurocontrol. Agreement on an appropriate methodology for both aviation and cruise/passenger ships would then need to be harmonised. It would also potentially require averaging or default values of VAT payable as EU passenger rights legislation requires the VAT to be shown at the time of online ticket purchase ie before the actual routing of the flight would be known.

4. Particular considerations in the case of the VAT exemption for intra-EU aviation

Aviation benefits from additional subsidies compared to other transport modes. Busses pay on average 48cents/litre fuel tax and rail pays similar diesel fuel taxes. In the case of electrified rail, electricity is subject to the ETS and full auctioning of allowances. The intra-EU fuel tax exemption for aviation is estimated to amount to some €8 billion per annum and the VAT exemption for intra and extra EU flights around €24 billion across the EU in 2016 (before deducting ticket taxes).⁵

These exemptions constitute a subsidy to fly. They swamp current external costs levied on airlines under the intra-EU ETS – approximately €150m per annum. In the case of shipping, the polluter pay principle does not yet apply. So that seven-day Mediterranean cruise is entirely VAT exempt while the air is polluted by ships burning heavy fuel oil.

Given the political difficulties inherent in adopting climate regulations at the international level, there can be no justification for continuing the VAT exemption in Europe which depresses ticket prices and thus serves to boost demand and CO₂ artificially. As observed by the World Bank and the International Monetary Fund, international aviation is generally undertaxed.⁶ Given the targets member states have set to meet the goals of the Paris Agreement, continuation of the exemption has no climate rationale. Perpetuation of the distortion for aviation undermines the integrity of the VAT regime, runs directly

⁴ http://ec.europa.eu/transport/sites/transport/files/themes/infrastructure/studies/doc/2010_high_speed_rail_en.pdf

⁵ T&E in-house analysis

⁶ IMF WP/06/124S

counter to Europe's commitment and efforts to implement the Paris Agreement, fuels the unbridled growth of a sector that has few ready means to reduce its emissions, and bleeds traffic away from rail, a transport mode that is universally judged to be preferred over both air and road.

5. Extra-EU VAT

A worldwide web of mutual fuel tax exemptions under international air service agreements between the EU and third countries means aviation kerosene is, outside of a few domestic cases, nowhere taxed in the EU. Globally the fuel tax exemption exceeds some \$60 billion per annum while the ICAO CORSIA is expected over the entire 15 years of the scheme, to levy average annual costs of \$1.5 billion per annum across international aviation worldwide⁷. When considering a future VAT regime and reviewing VAT rates, the Commission and member states should therefore also apply VAT to extra-EU flights. VAT already applies in many cases to extra-EU coach traffic. 80% of passengers flying extra-EU do so for leisure purposes and generally come from an even more well off segment of the population who might even fly intercontinentally several times a year. The VAT exemption for these flights can in many cases amount to hundreds of euros per ticket. There can be no economic, legal or equity justification for such an exemption. We estimate total EU-28 2016 potential revenues for extra-EU VAT at around €9 billion (depending on the VAT rate used).

6. Passenger transport under a definitive VAT regime

The Commission noted in its 2016 Working Paper on the Definitive VAT Regime, "A robust single European VAT area would treat cross-border transactions in the same way as domestic transactions, putting an end to the endemic weakness of the system".⁸ It is clear therefore that different rules for domestic versus international transport VAT cannot continue. Further, the current situation of applying the VAT based on where the journey takes place, with rail and bus companies needing to break down the journey and pay separate member states different VAT rates for different portions of the journey, makes intra-EU travel unnecessarily more complex than domestic travel in what should be a single market. A single rule on VAT needs to be agreed.

7. Point of departure

NGOs have long argued for reforming the application of passenger transport VAT to be at the point of departure. The Commission similarly has attempted in the past to find sufficient support to change to the point of departure rule for passenger transport but has yet to come forward with proposals, essentially because of intense lobbying by the aviation industry, who are well aware that changing the place of supply makes applying passenger transport VAT administratively easy. Given this decades long standoff, and in the face of unworkable administrative difficulties in applying the current rules, some coach and rail companies have given up trying to challenge the aviation lobby and are, instead, now calling for zero rating of their modes as well. There can be no excuse not to reform the rules applying to passenger transport now that a definitive regime is being designed. Just as there are no logical grounds for exempting aviation, there are no grounds for zero rating coach and rail.

T&E considers that the place of departure would seem to be a good approximation of where the customer resides since the customer will have to be there in person to board the plane. We agree with the Commission's statement in the 2015 Paper for the Group on the Future of VAT that, "the place of departure is an adequate proxy to tax at the place of actual consumption and it practically implements the destination principle".⁹ The Commission should proceed on this basis.

⁷ http://www.theicct.org/sites/default/files/publications/ICAO%20MBM_Policy-Update_13022017_vF.pdf

⁸ http://ec.europa.eu/taxation_customs/sites/taxation/files/com_2016_148_en.pdf

⁹ taxud.c.1(2015)3966929 – EN

8. Establishing a definitive VAT regime. Proposal of January 18, 2018

The passenger VAT exemption for intra-EU aviation and shipping was supposed to be phased out after the Union was formed and members joined. However this never occurred due to industry opposition and possible indifference. In the meantime climate change has risen to the top of the political agenda and indeed transport is now the biggest CO2 emitter in Europe. So the VAT reform offers an opportunity to simplify the way VAT is applied to passenger transport and do away with the aviation and shipping VAT exemptions which are helping drive the growth in CO2 emissions.

Such hopes have not been realised. On 18 January 2018 the Commission introduced a proposal to reform the VAT rate structure. Responding to a long series of discussions and consultations with Member States and experts, the proposal, rather than restricting the ability of member states to apply reduced rates or derogations, gives them increased flexibility. From 2022 all member states will be able to apply existing, reduced or zero rates which currently apply in at least one member state. This, the Commission argues, because there is no appetite in member states to forego existing reduced rates or abolish derogations and to ensure equal treatment across the Union. In order to avoid erosion of VAT revenues through excessive application of such reduced rates by member states, the existing Annex III list of eligible goods and services for reduced/zero rates would be replaced by a negative list of goods and services to which the standard VAT rate of 15% would have to apply in all member states.

So how does this affect VAT on passenger transport?

Once the definitive VAT regime comes into effect in 2022, the place of supply for passenger transport will change to the destination ie where the customer (passenger) resides – or commences the journey. So VAT will apply to the cost of the entire ticket and be charged at the rate of the member state where the journey begins. This will simplify charging and collection by transport operators and should resolve problems of under-collection. Better if the change could come as soon as possible.

As for VAT rates for passenger transport, existing reduced rates and derogations will continue and be enshrined permanently in the Directive rather than living on as temporary derogations. Any member state can apply the reduced rates or indeed a zero rate if at least one member state currently applies it. Since all passenger transport modes are zero-rated in at least one member state, the proposal effectively gives a green light for member states to exempt passenger transport entirely from VAT if they chose to. The Commission has turned its back on the long-standing provisions that historical exemptions for intra EU aviation and shipping would be abolished. And citing more general requirements to make the VAT regime more flexible and responsive to member state wishes, it has ignored the issue of climate change – indeed neither DG Clima nor DG Move were even consulted on the proposal.

The Commission justifies this move by the statement that no member states are prepared to give up their reduced rates, derogations or exemptions. And further points out that almost all of the EUR8.8billion VAT revenue from passenger transport in 2010 came from domestic VAT with intra EU bus and rail VAT generating only some €0.5billion. So, the Commission argues, even if all member states zero rate domestic passenger transport in the future, the revenue loss would only amount to 1% (€8.8 billion) of total VAT revenues which in 2010 were €861billion; “zero rating all *domestic* passenger transport is only a potential risk, because Member States currently taxing it at the standard rate are well aware of what the passenger transport study emphasises, namely the enormous potential that the application of VAT in this sector would have in terms of generating revenue and the limited impact of applying reduced or zero rates on the demand for such services (due to low elasticities of demand and pass-through rates that are very low, varying between 7% and 50%). Conversely, zero rating all *international* passenger transport is a much more likely risk, as already now only few Member States tax international road and rail transport.

So the Commission acknowledges that taxing passenger transport at the 15% standard rate would have little impact on demand and could constitute an important source of incremental revenues – and so one might think passenger transport should be included in the negative list. But the Commission has proposed to relax existing provisions even further raising the prospect that domestic and intra-EU bus and rail VAT rates could reduce to zero as well. As acknowledged elsewhere in the Impact Assessment; “the environmental impacts would be even more specific and would depend strictly on Member States’ choices. Whereas option 2 (the Commission’s proposal) would allow for the possibility to use VAT subsidies, instead of direct subsidies, to promote e.g. energy efficient products, at the same time – depending on the decisions made by Member States – environmentally harmful products could also end up benefiting from reduced VAT rates. And so it seems it may well be as regards passenger transport.

Further information

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