Blog: Low VAT rates for sustainable products are needed for a circular economy

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Ecopreneur.eu, the European Sustainable Business Federation, calls for further opening up the EU Value Added Tax (VAT) Directive to allow low VAT rates for sustainable products during the transition to a new economy.

Far too few people are aware that a sustainable economy could be created in a matter of days. And that introducing low VAT rates for sustainable goods and services is a key measure that could be solely responsible for a large part of the transition.

Now you might think, surely this is idealistic nonsense? How could governments decide this in a matter of days? How can they determine what is sustainable? And why does the EU have a say in taxes in the first place, taxes being a national matter?

A sustainable economy could be readily achieved given sufficient political will
Indeed, these are valid points, and each of them has delayed political decision making on modernising the EU tax system for many years. Fortunately, an important step forward was made in December 2021: the European Council finally updated and modernised the list of goods and services for which reduced VAT rates are allowed. Specifically, they added solar panels, waste treatment, bicycles, fruit and vegetables to this list. Repair services and the sales of second-hand goods were already on it. Low VAT rates for all goods and services not on this list remains forbidden in the EU. With good reason by the way: the harmonisation brought about by the EU VAT Directive has drastically simplified the tax regime on the EU market.

Other major steps recently taken by the EU include the Sustainable Products Initiative, the Corporate Sustainability Reporting Directive and the Corporate Sustainability Due Diligence Directive. These regulations will force all companies active in the EU to implement minimum sustainability requirements on all their products, such as repairability and recyclability, and all large companies to report on sustainability, and take responsibility for their entire value chain.

EU measures taken and proposed are still not enough
However, while the EU is internationally leading with new circular economy policy measures, this is still not enough by far. The main bottleneck for leading companies to introduce sustainable products is a lack of demand for them. The best way to overcome this hurdle is for the EU and member state governments to create framework conditions using economic incentives for companies to implement circular business models, as well as for users and consumers to purchase circular goods and services.

The current situation is schematically shown in Figure 1 (below).

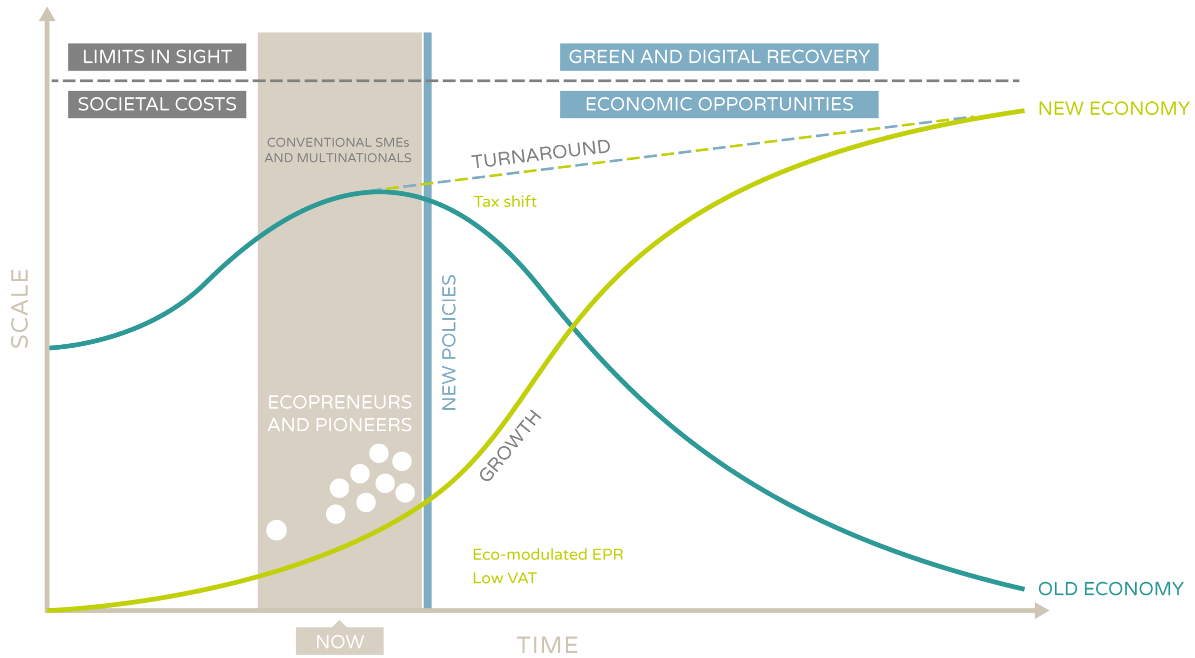

Figure 1. Schematic overview of the transition to a new economy which is low-carbon, circular and inclusive. The "free" market forces of the old economy have optimised all activity to grow beyond our planetary limits (horizontal dotted grey line). This has resulted in huge and increasing societal costs which include those of the COVID-19 and climate crisis. A new economy is emerging but faces multiple barriers. New policies (some of them indicated, in green) including eco-modulated Extended Producer Responsibility (EPR) and temporary low VAT regimes are needed to enable ecopreneurs and other pioneering companies to grow and mainstream. Similarly, a tax shift from labour to resources will have to be introduced to enable conventional SMEs and multinationals to turnaround (dotted grey line) into the new economy as well (rising blue line), with the use of old economy models decreasing to zero (decreasing blue line). Conventional SMEs include proactive and reactive SMEs. With the new policies, the societal costs make way for green and digital recovery and economic opportunities. Source: Why sustainable SMEs hold the key to the circular economy, Ecopreneur.eu, 2021

To boost the circular economy, Ecopreneur.eu calls for economy-wide tax measures including a tax shift from labour to resources and differentiated VAT rates to boost the circular economy. The VAT is a powerful economic instrument. We have been urging low VAT rates for sustainable products and services since our foundation in 2016. Sustainable businesses all over Europe ask for low VAT rates for circular goods and services on a temporary basis to overcome the current barrier of lacking demand. Given the choice between two otherwise equal goods or services, even a moderate VAT difference can effectively nudge consumers to purchase the circular option rather than the linear one. Existing evidence concerning limited impact of VAT differentiation of an entire product group (e.g. all hair dryers) are therefore not applicable to differentiation based on circularity.

Further open up the VAT directive

Ecopreneur.eu has therefore welcomed the European Council's decision on updated rules for VAT rates as a step in the right direction. We also urge governments to implement the permitted low VAT rates as soon as possible, although with two reservations: a low tax on solar panels seems likely to mostly stimulate Chinese industry, and the costs of waste incineration must be increased, not decreased. These examples show that further decisions on future VAT rates should address EU industry policy besides sustainability.

Moreover, the Council decision forms a welcome precedent that opens up the way to introduce further fiscal incentives. Ecopreneur.eu stresses the importance of extending this list to many more, including: renewable energy production, Cradle-to-Cradle products, goods with recycled content, and lease or rent with product-return and recycling provisions (e.g. "lease a jeans"). This can increase the demand. But mostly, we urge the EU to further open up the VAT directive with the end goal to cover *all* sustainable products and services – N.B. on a temporary basis. Enterprises in the membership of Ecopreneur.eu stress they want fair competition on the market at all times. So once a level playing field for sustainable goods and services has been established at the EU market by other measures, these low VAT rates would no longer be needed.

True Pricing across the board

Finally, next to VAT differentiation, Ecopreneur.eu also urges the EU and Member States to initiate a tax shift from labour to natural resource use, as advocated by Ex'tax and the European Commission. This tax shift implies increasing taxes on fossil fuels, the use of virgin materials and pollution, that are compensated by lowering taxes on labour. It will make unsustainable products more expensive than sustainable ones, with a similar impact on the market as low VAT rates: boosting demand for sustainable products. This would effectively create a new economy based on True Pricing on the EU market across the board. Consumers would have more money to spend due to the lower labour taxes, and be nudged to sustainable choices because they would become cheaper – not more expensive, but less.

Finally, could this be decided in a matter of days? No of course not. On the other hand, the Covid-19 pandemic has shown that Member States *do* have the power to implement drastic matters in a matter of days, with immediate impact. Ecopreneur.eu and our enterprises are convinced that once governments create a level playing field for sustainable products, companies will rally to put sustainable solutions on the market in no time. And *that* would be a sustainable economy. The 3000 companies in the membership of Ecopreneur.eu – mostly SMEs - are committed to already deliver sustainable products in the current linear economy. Our goal is a sustainable economy where all 19 million EU companies are doing that.

As a first step, the matter of VAT differentiation to boost a sustainable economy should be urgently discussed further by stakeholders and substantiated in impact assessments by the European Commission. Insofar this debate has taken place at all, it is stuck in differences of opinion, even between proponents of the transition. As input for these discussions and assessments, Table 1 (see below) lists various arguments for and against low VAT rates exchanged about the issue, alongside with counter-arguments against raised objections.

The EU has been *talking* long enough about "the circular economy" while only referring to regulations, new technologies and circular start-ups putting new products on the market. It is high time that the focus shifts to implementing impactful economic incentives: green public procurement, a high price on carbon, a Carbon Border Adjustment Mechanism

(CBAM) for *all* goods facing unfair international competition, a tax shift from labour to resources - and a low VAT rate for sustainable goods and services.

For the For our full positions on VAT differentiation see here and here.

Table 1: Arguments for and against low VAT rates for sustainable goods and services, together with counter arguments against raised objections, as a basis for further discussion and impact assessments

Arguments for low VAT	**Objections raised against low VAT**	**Counter arguments against raised objections**
Given the choice between two otherwise equal goods or services, even a moderate VAT difference can effectively nudge consumers to purchase the circular option rather than the linear one. This can alleviate the biggest hurdle for sustainable products, which is lack of demand.	Research has shown that low VAT rates often lead to profit increases, by not transferring the rate difference to the consumer, and thereby fails to induce behavioural change or innovation	The research quoted concerns low rates for an entire product group instead of VAT differentiation within a product group. They should have investigated the effects of a low and high VAT rate for sustainable and unsustainable versions of otherwise identical products – such as energy, cars or matrasses
Temporary low VAT rates for sustainable products are urgently needed to accelerate the transition to a low-carbon circular economy	The tax shift from labour to resources provides sufficient acceleration. In addition, Extended Producer Responsibility (EPR) measures are effectively increasing the cost of waste-intensive products	The tax shift is not being implemented because the political will is lacking. EPR schemes are still largely ineffective since they lack eco-modulation of the fee. Low VAT rates are therefore needed a level playing field has been established by these and/or other measures.
It is politically much easier to lower the tax on sustainable products than to increase the tax on unsustainable ones.	There is growing support for the tax shift from labour to resources	Individual member states hesitate to implement the tax shift on their own, the EU has no mandate on taxes, and consensus in the Council is lacking, with veto right is blocking decision making at EU level. The 2019 Council decision opening up the EU VAT directive for low rates for a few sustainable, circular and healthy products was the only positive one and has created a precedent
	Opening up the EU VAT directive further will further complicate the tax regime on the EU market, which is already too complicated and requires simplification	The urgency of the transition justifies new exceptions. Moreover, additional low VAT regimes can and should be agreed on in a harmonised way at the EU level as much as possible as to avoid fragmentation of the EU market
	To remain tax neutral, other taxes will have to increase if VAT rates are implemented at large scale. In 2020 in the EU, revenue from VAT accounted for around 51.7 % of	Indeed, but that holds for *any* tax reform favouring sustainability, including the tax shift. Taxes on resource use, waste and pollution can be increased. If needed, other

	the total taxes on production and imports.	sources of compensating tax revenues can be readily found
	Governments cannot determine if a product or service is sustainable	Life cycle sustainability assessments can and should form the basis for low VAT rates, the tax shift and any other economic incentive
	Low VAT rates undermine their own success: if they are impactful, eventually all products fall under the low regime	Low VAT rates can be ended once a level playing field for sustainable products has been established by other measures
	VAT differentiation based on sustainability will lead to “leakage” of industrial activities from the EU to other continents	Similar to the CBAM, VAT differentiation can be devised to avoid “leakage” of industrial activities by covering all imports from outside the EU as well as exports from the EU
	Split incentives between chain partners limit the impact of VAT measures on the sustainability of products	Split incentives between chain partners are avoided by covering business activities along the full cycle
	By acting on end products, VAT differentiation is an expensive and inefficient measure for those cases where negative impacts are caused early in the value chain, e.g. by the choice of materials	Materials-specific fiscal tariffs may be used where needed
	The “chicken and the egg” problem blocking decision making on the VAT has not been solved: member states are in charge but concerted EU action is needed	The EU should decide to switch from unanimous to majority decision making on tax matters as soon as possible. Meanwhile, it can continue further opening up the EU VAT directive