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## VAT-induced distortions in the passenger transport system in the European Union: assessment and options for reform

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### Abstract

This paper is based on a study by the same authors recently published by the European Commission. It provides an economic assessment of the impact of current VAT regimes on passenger transport in the EU, and the likely effects of alternative regimes. After a review of the features of the passenger transport industry as they relate to VAT, the paper identifies and assesses a number of distortions arising from unequal VAT treatment of operators or passengers. Using a series of transport-related econometric models it then evaluates a number of changes in the VAT regime that could address those distortions.

The main conclusion is that the distortions introduced by the rather byzantine current VAT system are small- or medium-sized. For the distortions on output (passenger demand), a large part of the explanation of their small impact is in the low 'pass through' of changes in costs to changes in fares, and the low system-wide elasticities of demand; for input distortions, the main explanation is in the ability of operators to reclaim VAT incurred on inputs, so the only cost distortion is that some operators incur additional financing costs between when VAT is paid and when it is rebated. These costs are small because of the short time between payment and reimbursement and the current low interest rates on that financing.

The paper identifies one set of measures that addresses output distortions deriving from different VAT rates and place of supply rules and another addresses input distortions.

The paper also provides valuable insights for tax administrations. It reveals an enormous potential of the application of VAT in the passenger transport sector with regard to generating revenue, and the small impact of applying simpler VAT rates.

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We can conclude that a simplified and harmonised application of VAT on all passenger modes, markets and all member states (aimed at elimination or reducing the distortions of the current VAT regime) would have only a small impact on both operators and passengers.

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## 1. Introduction

In December 2011 the European Commission set out the features of a future VAT system, one of the key priorities of which was that it should be more efficient than the current system. In respect of passenger transport services, the current system, with its many exemptions and special rates, has resulted in the application of a multiplicity of different rates by transport mode, transport market and Member State. The VAT regime for passenger transport has long been believed to result in many competitive distortions. This paper provides the results of an economic assessment of the impact of the current VAT regimes and the likely effects of alternative VAT regimes undertaken to help inform the policy makers dealing with VAT distortions.

## 2. Methods

This paper contributes to the debate by providing a summary of the current state of the passenger transport market, both its demand and supply, a review of the current VAT regime, an assessment of the impact of many of the perceived distortions and an evaluation of some of the alternative VAT structures on which a future VAT regime for the transport sector might be based.

### 2.1. *The current state of the EU market for passenger transport services*

The review of passenger demand and supply, so far as they relate to VAT was tackled in two parts. Transport demand was covered by a large scale review of passenger transport for the year 2010, based on the output of the FP7 project ETISplus and the European transport model TREMOVE. The output of this part was a detailed dataset of transport demand (expressed in passenger-kilometres (PKM) and number of passenger trips), split by transport mode, geographic location (using NUTS2<sup>1</sup> zone) and travel purpose (relevant because of VAT deductibility rules for business travel). Passenger demand was distinguished for four markets (urban, domestic non-urban, cross-border intra-EU and cross-border extra-EU transport) as many Member States have different VAT rates for each of them and they are regulated by different authorities. For the supply side, the assessment revolved around three key indicators: number of vehicles, number of seats and number of seat kilometres, for each of the transport modes and markets identified in the first phase. Data sources included Eurostat and national statistics, TREMOVE and dedicated publications from transport service operators or representative organizations (e.g. the UITP<sup>2</sup>). The competitiveness of each market was analysed for those countries with sufficient data availability using the Herfindahl-Hirschman Index (HHI).

### 2.2. *The current VAT regime for passenger transport services*

The second data set that needed to be collected was that relating to the current VAT regimes for passenger transport services at the national level and for each of the markets, taking account of any and all exceptions.

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<sup>1</sup> Nomenclature of Territorial Units for Statistics.

<sup>2</sup> International Association of Public Transport.

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