European Commission

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Brussels,

Dear Minister,

The attack on Ukraine is causing incalculable suffering of the Ukrainian people and a deep wound to European values. Putin's senseless war has also an inevitable impact on the European economy and aggravates the challenges we were already facing, notably rising energy prices but also wheat prices, among others.

The European Commission is well aware of the need to cushion the impact of high energy prices on households and businesses, in particular the most vulnerable ones, while also avoiding supply disruptions. In its Communication of October 2021 on energy prices, the Commission presented a toolbox to guide Member States' action in this area. More recently, EU leaders discussed a number of options to curb prices, on the basis of the Commission Communication of 23 March.

As we discussed many times in the ECOFIN, a coordinated EU response is of the essence to safeguard the Single Market and avoid further divergences across Member States. In the last months, a majority of Member States have lowered taxation on energy, introducing reduced VAT rates or reduced excise duties on energy products and electricity, making use of the flexibility provided by the current EU legal framework. The purpose of this letter is to provide further guidance to Member States in the area of energy taxation by clarifying the applicable rules under EU law while recalling a number of key principles that should guide our action in this field.

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ECOFIN Ministers

First, as you know, the Commission does not envisage for the moment further revisions of the EU taxation framework to respond to the current crisis. The new VAT directive has just been adopted and the new provisions are in force since 6 April 2022[1]. The new Energy Taxation Directive (ETD) is currently under discussion in the Council, where the objective is to align the taxation of energy products with EU energy and climate policies by favouring clean technologies over fossil fuels.

Let me recall the main applicable rules:

- ***As regards VAT**,* the new regime allows the application of reduced VAT rates (respecting a minimum of 5%) to natural gas, electricity and district heating. Reduced rates are now also available on solar panels and certain energy efficient heating systems (including a zero rate on solar panels). Member States cannot have more than two different reduced rates. Motor fuels cannot benefit from reduced rates.
  The consultation of the VAT Committee is no longer needed, which allows for a swifter implementation. In compliance with the objectives of the EU Green Deal, a sunset clause stipulates that Member States have to phase out reduced rates on fossil fuels by 2030.
- ***As regards ETD***, the current framework allows for a number of differentiations, reductions and exemptions that are available to all Member States, including reduced rates or exemptions for households and reductions for fuels. Exceptionally, the Council may also authorise a Member State to go even below the minimum taxation rates, for specific policy considerations and on a temporary basis. Derogation requests are assessed by the Commission, including their compliance with State aid rules, where needed.

While my services remain at the disposal of Member States for further clarification of the legal framework, there are also relevant political considerations that should guide our action. I would like to recall three principles: ***effectiveness***, ***consistency*** and ***equity***.

Effectiveness: our policy response should be implemented swiftly to respond to the emergency and effectively support households and businesses in these challenging times. Lowering taxation on energy is easy to implement, and this is probably the reason why taxation measures have been used extensively in the first weeks and months of the crisis. However in case of persistent high prices, the benefit for businesses and consumers is more uncertain. Reductions in VAT rates, in particular, have a bad track record in translating into lower prices for consumers as tax cuts may be compensated by increased tariffs from energy suppliers. In such cases, non-energy businesses could even be worse off: they do not benefit from lower rates (since they deduct VAT anyway) and suffer from the price increase.

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[1] EUR-Lex - 32022L0542 - EN - EUR-Lex (europa.eu).

Consistency: our policy response should be consistent with our overarching goals of energy autonomy and our 2030 and 2050 climate targets. Achieving any of these objectives require tax relief measures on fossil fuels to be temporary and targeted at improving affordability of energy products for businesses and households while prices are high. This is important also to protect the capacity of Member States and of the EU to generate adequate tax revenues to finance the recovery and the twin transitions in a fair manner.

Equity: our policy response should promote equity within and among Member States. To ensure transparency within the Single Market, Member States should inform the Commission of the measures they intend to take, which should also be fully consistent with the EU State Aid framework. Regarding social fairness, let me also stress that lowering indirect taxation is not necessarily the most effective solution to tackle energy affordability, especially if high prices persist. Recycling higher revenues from energy taxes or from abnormal profits of energy companies can help financing targeted support to vulnerable households and businesses or to specific categories of transport users in a fairer and more sustainable way. Depending on national preferences, this can be implemented in the form of checks or refunds, bearing in mind the regressive impact of energy prices hikes.

Yours sincerely,

Paolo GENTILONI