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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

on VAT rates other than standard VAT rates

{SEC(2007) 910}

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1. INTRODUCTION

The current VAT rate structure was adopted by the Council in 1992 as part of the package of measures considered necessary for the abolition of controls at frontiers and the creation of the Internal Market. Under this system, Member States are required to apply a single standard rate of at least 15% and may have a maximum of two reduced rates set no lower than 5%, which Member States may apply at their discretion, to the categories of goods and services listed in Annex III to Council Directive 2006/112/EC (the VAT Directive). In this respect, Member States remain free to apply a reduced rate to a whole category or to restrict its application to an (even very small) part of it. This basic structure, which applies to all Member States, is complicated by the plethora of different temporary derogations granted to individual Member States outside the general scheme.

In 2003, the Commission tabled a proposal concerning the review of reduced VAT rates[1], resulting in Council Directive 2006/18/EC of 14 February 2006. This Directive foresees the third prolongation of the experiment on reduced rates for labour-intensive services till the end of 2010, and a possibility to apply a reduced rate on district heating under the same procedure as for natural gas and electricity. No more far-reaching agreement on the scope and level of reduced rates could be reached. In particular, there was no agreement on the rationalisation of the structure of the reduced rates or on the application of a reduced rate for the whole sector of housing or for restaurant services, as proposed at that time by the Commission.

However, Council Directive 2006/18/EC included a request to the Commission to present to the European Parliament and to the Council, by the end of June 2007, an overall assessment report on the impact of reduced rates. This would cover locally-supplied services, including restaurant services, notably in terms of job creation, economic growth and the proper functioning of the internal market, and would be based on a study carried out by an independent economic think-tank.

The study contract was awarded to Copenhagen Economics[2]. The study mainly examined the impact of reduced VAT rates and of derogations, not only for locally supplied services, but also more globally. The effects on income distribution, the informal economy and on compliance costs for businesses were also taken into consideration.

This Communication presents the main conclusions of the above study, provides material for discussion and explores ways forward in the field of reduced VAT rates. The Commission considers that the study provides a sound basis for such work. Ideas on the possible ways forward presented hereafter take as a starting-point the results of the study but also take into account the current complex situation and political sensitivities. It is clear, however, that the need to simplify and rationalize the level and scope of reduced rates also forms a guiding principle of the reflections. The Commission's objective is to ensure equal opportunities for Member States as well as

[1] COM(2003) 397 final

[2] Copenhagen Economics ApS, Nyropsgade 13/1, DK-1602 Copenhague

more transparency, consistency and – above all - a smooth functioning of the internal market, e.g. via fewer obstacles to cross-border economic activity and lower VAT-induced compliance costs. Moreover, commonly agreed strategic Community policies and priorities, such as those relating to the Lisbon strategy, play an important role. Finally, it is clearly necessary to fully respect the subsidiarity principle for such a sensitive issue that touches on Member States' fiscal sovereignty.

2. MAIN CONCLUSIONS OF THE STUDY ON THE IMPACT OF REDUCED RATES

A summary of the study's results is further elaborated on in the Commission staff working document 'Main conclusions of the study on reduced VAT rates applied to goods and services in the Member States of the European Union'[3] . The Annex to that working document contains the full Copenhagen Economics' executive summary of their study. The following points highlight the **key results of the study**, in particular from the point of view of potential policy implications.

- The study stresses that **a single VAT rate** is by far the **best policy choice** *from a purely economic point of view*. A move towards more uniform rates has thus considerable advantages. First, a less complicated rate structure would generate substantial savings in compliance costs for business and tax administrations. Second, it could reduce distortions in the functioning of the internal market. Third, it is likely to slightly improve "consumer welfare" compared with the current situation.

- However, there **may be specific benefits from operating a reduced VAT in carefully targeted sectors**. Lower VAT rates can increase overall productivity and thus GDP, as well as tax revenue, in a Member State if they can induce consumers to spend less time on do-it-yourself (DIY) activities and more time on their ordinary job. This behaviour would result in a shift of activities from DIY to the formal economy. *Locally supplied services (and restaurants)* are industries where households have considerable scope for carrying out DIY and therefore the area where such a shift could thus take place. The argument for a reduced rate on locally supplied services is significantly stronger in Member States with higher marginal income taxes and higher VAT-rates and for some sub-sectors within locally supplied services with limited need for formal training and specialised machinery. The same productivity argument holds, albeit to a lesser degree, if lower VAT rates can induce consumers to spend less money on the *"underground" economy*. Finally, it appears that different VAT rates applied to locally supplied services are of *no concern for the functioning of the internal market*. Services provided by *restaurants and hotels* are in-between, because they are mainly directed at domestic consumption, but may also affect distribution of tourism between Member States and may have a non-negligible impact in border regions.

- Lower VAT rates targeting sectors using many low skilled workers, such as locally supplied services, financed for example by higher VAT rates elsewhere can create *permanent* employment gains, but the overall gains are likely to be

[3] (SEC(2007)910)

minor. The net gains stem from the fact that demand for low skilled workers is likely to be boosted and that low skilled workers face more difficulties in obtaining a job than higher skilled workers, as a result of labour market rigidities. However, the gains are minor because the targeted sectors account only for a small proportion of the overall employment in low skilled sectors. So the increase in low skilled employment in these relatively small industries is nearly entirely offset by decreases in other industries hit by the higher VAT rate.

- Besides the above-mentioned efficiency arguments in favour of reduced rates, generally the argument of **improving equity** is advanced. In this respect, the study finds that for the improvement of income distribution in a Member State, reduced VAT rates are **effective only when** the share of **consumption expenditure of goods/services subject to a reduced rate** (out of the total consumption expenditure) **differs sufficiently between low and high-income groups and is stable over time**. These differences are the largest for *food.* However, in this respect there are relatively large differences between countries. Reduced rates are less potent in countries which already have high income equality. Moreover, in certain cases, policy goals may conflict internally (for example if the objective of a reduced rate is to promote the purchase of certain goods, it is possible that high-income groups benefit more from the reduced rate, which conflicts with the income equality goal).

- The study also makes a strong case that **reduced VAT rates create significant compliance costs for business and tax authorities**, partly at least because of the interpretations which have to be made in respect of borderline cases which are often costly and resource intensive.

- Other **alternative policy tools**, such as direct subsidies for particular activities, in the main **achieve the same goals as reduced VAT rates with fewer costs**. These subsidy schemes may be better targeted, better designed to avoid negative spill over effects at the EU level and, generally speaking, may be more transparent. They may also incur fewer compliance costs and budgetary losses. However, compared to reduced VAT rates, direct subsidies might appear less secure as a permanent solution for the businesses concerned.

- The study **recommends that Member States carefully examine all the options available** when they want to promote the consumption of specific goods or services: often other tools than reduced VAT rates are more efficient and less costly for the State budget, and this should be taken into account in the decision-making-process.

The Commission reads these results as confirming some usefulness in applying reduced rates to locally supplied services but only where such measures are very well targeted and specific market conditions are fulfilled. It has to be stressed, nevertheless, that effects on employment remain limited. Regarding restaurant services, the study calls, on the one side, for caution as to the cross border effects of a reduced rate, as such services in some case may form part of a more global tourism sector that is open to competition between Member States, but indicates, on the other side, a rather good potential for a reduced rate to be effective.

3. REFLECTION ON THE WAY FORWARD

The results of the economic study provide a very detailed and sound economic evaluation for assessing the usefulness of applying reduced VAT rates in specific cases. The Commission remains convinced that the application of a single VAT rate to all goods and services would be an ideal solution from an economic point of view but recognizes that policy considerations will not allow for such a simple approach. It observes, moreover, that even Denmark having opted for such a single rate approach does allow exceptions to the principle.

Therefore, the Commission sets out hereafter how to apply the results of the study more concretely and how to usefully translate them into operational policy conclusions in order to provide input to the political debate to come. On this basis it seeks the views of the Council, the European Parliament and other interested parties on a possible future legislative action in this field. The objective is to foster a fundamental debate among all stakeholders on the issue, in order to identify a sustainable way forward which could be acceptable to all Member States and provide a step forward for the single market.

3.1. General

Although reduced rates, as they diverge from the standard rate, appear to create distortions from an economic perspective and may affect fiscal neutrality, they are nonetheless applied in all but one Member State. Moreover, there appears to be a wide range of reasons to explain why Member States have chosen the policy route of rate differentiation. It has to be acknowledged that Community legislation as it stands today is not based on a well structured or logical approach; but rather simply reflects the situation existing in Member States at the beginning of the 90s. It is logical that each Member State should be able to re-assess the value of its own reasoning against the findings of the study and taking into account its own and Community policy objectives, such as those of the Lisbon strategy before engaging into a debate on the review of reduced rates. From a Community point of view the main parameters for further political reflection and debate are:

- the support of the Lisbon strategy for growth, jobs and competitiveness.
- the Internal Market imperatives;
- the degree of flexibility that can be offered to Member States under subsidiarity considerations to set reduced rates;

3.2. Subsidiarity

VAT is a harmonised tax that applies to supplies of goods and services the free movement of which is one of the characteristics of a true Single Market. Nevertheless, VAT has never been a fully harmonised tax but leaves options and derogations possible for Member States in a number of areas. This includes the area of VAT rates. The agreement on the current level of harmonisation in 1992 was based on two major considerations: (1) what was considered necessary to avoid distortions of competition once the Internal Market came into being (see the next section) and (2) the higher degree of harmonisation needed for the so called "definitive" VAT system based on taxation at origin. This objective would have called for a far greater harmonisation of VAT rates than was possible to achieve either at the time or subsequently. Consequently, little if any progress has been made towards a "definitive" system, despite the relevant Commission proposals having been made, and there is little expectation of achieving this objective in the short or even the mid term. The Commission has therefore in the meantime adopted a VAT strategy that has set other priorities. One of them is to offset the potential economic effects of VAT rate differentials between Member States by changing, where necessary, the place of supply rule for services to the Member State of consumption thus ensuring taxation where consumption takes place. Against this background, it appears to be no longer essential to maintain exactly the same level of harmonisation that was needed in 1992. There are, however, limits to the flexibility that can be offered under subsidiarity considerations given that there are still risks of distortions or disproportionate compliance costs for internationally traded goods and services.

The study confirms the view defended by the Commission in previous Council debates on the issue[4], in particular that there is room for manoeuvre to grant more autonomy to the Member States in setting reduced rates for local services which cannot be delivered from a remote location. On the other hand, there is little margin for manoeuvre for more autonomy for goods or services which can be supplied from a remote location since the risk of introducing differences in the conditions of competition through differences in VAT rates is not negligible.

In conclusion, there is room for more flexibility to be given to Member States but this flexibility needs to be balanced against the need to ensure the continued proper functioning of the Internal Market and to avoid disproportionate costs for business involved in intra-Community trade.

3.3. Internal Market imperatives

The Internal Market requires that goods and services can be traded within the EU without giving rise to distortions of competition or to costs that can translate into market access problems (see next section). Distortion can result at the level of companies and at the level of states. Companies are affected by distortions where the applicable rate impacts on their capacity to sell their product in, or to citizens of, another Member State. Such distortions are likely to arise as a result of consumers having the right within the internal market to buy in other Member States at the prevailing tax conditions or to buy goods or services via distance selling arrangements. Only the so-called local services have little or no cross border impact. According to the study, restaurant and hotel services are on the borderline in respect of their cross-border effects. In addition, VAT rates on inputs can influence costs at which business can offer their products where they are not able to fully deduct input VAT or where they are acting outside the scope of VAT. In a similar way Member States themselves might suffer from rate differentials that undermine their revenue raising capacity where citizens decide to buy cross-border to benefit from lower tax levels. Nevertheless, it appears that a certain degree of rate differential can be

[4] In particular in the Non-Paper prepared in February 2004 on the possibilities of granting more autonomy to the Member States in deciding the VAT rates applicable on their respective territories, where this does not interfere with the proper functioning of the internal market.

tolerated and the Council of Ministers has so far accepted rate differentials both for the standard VAT rate and for the reduced rate subject to the observation of certain minimum levels and a number of special tax schemes such as the current distance selling arrangements.

It follows that Community legislation cannot expose Member States and/or business to distortions by not providing a framework for reduced rates. Indeed, although the application of reduced rates is optional for Member States (which could therefore lead to very high rate differentials and thus significant distortions), in reality it is notable that for the main categories of goods for which a reduced rate is possible (food, medicines, books and newspapers) a large majority of Member States apply a low rate. Member States and the Commission will therefore have to analyse the different candidates for further reduced rates to determine the level of distortions that can arise from their – optional – eligibility and to decide if such level of distortion is acceptable especially to the business being active in the relevant sectors. Such discussion must base itself both on economic evaluation and political appreciation as potential distortions need also to be assessed as to their political acceptance.

On the other hand it should not be overlooked that distortions can also be created between different similar products; therefore it appears to be important to define categories for the application of a reduced rate in a coherent way reflecting clearly defined (sub-) sectors of activities (e.g. the food sector: the categories should be designed in a way avoiding subtle distinction between different kinds of food). Such categories need to be well defined to avoid distortions between the various products and differences in application, even at national level.

In conclusion, any rate differential may lead to economic distortions but not all distortions are necessarily incompatible with the Internal Market. The consequences need to be assessed on a case by case basis whereas it is obvious that products that are locally traded do raise less concern.

3.4. Compliance cost for business

Compliance costs due to rate differentiation are a significant issue. A Swedish survey carried out by the Swedish Tax Board on compliance costs of VAT in Sweden[5] shows that there is a clear correlation between the costs of handling VAT in businesses and the number of rates of VAT to be handled. The cost per business increases both between one and two and between two and three or more rates of VAT[6].

Compliance costs are the mirror of non harmonised rules: the more that different rules are applied within the EU the more business has to spend to comply with the regulations in the various Member States. The Lisbon strategy aiming at growth, more jobs and increased competitiveness of European business therefore stresses the need for a true internal market and simplifications. Being subject to different VAT rates in different Member States clearly creates a cost; which becomes particularly

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5 Compliance costs of value-added tax in Sweden, report 2006:3B, Skatteverket, http://skatteverket.se/omskatteverket/rapporter.4.584dfe11039cdb626980000.html

6 The study indicates that a uniform rate of VAT in Sweden would entail a reduction of compliance costs by approximately SEK 500 million (or approximately EUR 54 million)

burdensome where variations of applicable rates concern not just a few goods or services but hundreds or thousands of them with different definitions for the scope of each reduced rate. More transparency would reduce compliance costs for business in line with the Lisbon strategy and with the Communication on Action Programme for Reducing Administrative Burdens in the European Union[7], which was given full support by Member States.

Effectively, businesses need to know whether a reduced rate is applied in a particular case and if so at which level. This can be very cumbersome, especially when VAT is due in a Member State where the business is not established and can also cause a barrier to starting activities in other Member States. The Commission has received representations to this effect, clearly showing that companies give up doing business in other Member States for this reason or simply because of fearing the expensive consequences of an erroneous application of rates, even in good faith. Ultimately, this might also increase the positive effects on consumer welfare.

A company selling the same goods in the 27 Member States will have to invest in a close examination of the level of rates, on top of the administrative costs of VAT obligations in the different Member States, such as VAT registration and filing of returns. The One-Stop-Shop scheme has been proposed by the Commission to remedy this latter problem and has been welcomed within the context of the Lisbon agenda but has not yet been adopted by the Council. Moreover, even at domestic level, a lot of interpretation problems about which rate to apply to which product result from borderline cases. This generates compliance costs and liability risks for business and costs for tax administrations in managing and controlling the application of reduced rates. The Commission considers that these aspects should be carefully taken into account when reduced rates are discussed.

In conclusion, flexibility that might be possible in allowing a wider range for reduced rates needs to be balanced by measures ensuring transparency and simplification to reduce compliance costs.

4. INVITATION FOR A POLITICAL DEBATE

4.1. Balance between flexibility, internal market imperatives and simplification

There is a strong economic rationale for a uniform rates structure (one single rate per Member State). However, the study also argues that there are real and valid economic arguments for lower VAT rates in some very specific sectors. In view of the present situation in Member States and the political reality it appears to be impossible to abolish reduced rates even if the study tells us that reduced rates is not the best way to deal with the possible regressivity of VAT. **Finding the right balance between political and economic imperatives is the main issue.**

[7] Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of Regions on Action Programme for Reducing Administrative Burdens in the European Union - COM(2007) 23 final.

4.2. Rates structure

The current VAT rate structure that does not follow any clear logic is clearly not effective from an internal market and a global EU business competitiveness perspective. It is simply a result of past political negotiations.

Taking into account the study results, the Commission could see some merit in a new architecture for reduced VAT rates in the Community. Such approach would need to take account of the following objectives:

– the need to ensure **equal treatment** of all Member States, which means the ending of country specific derogations;

– recognition that in most Member States there is a strong political will to apply **very low reduced rates including zero rates** particularly for social purposes[8];

– recognition of the increased (economic and budgetary) **difficulties** for Member States **to move products from one rate category to another** because of the often very huge difference between the standard rate and a reduced rate (in most cases more than 10 sometimes more than 15 points);

– the need to **establishing a clear logic** of the purposes for which a reduced rate should be used;

– the need to **balance increased flexibility with a reduction of compliance costs**.

In a first step, the Commission would like to obtain the views from the European Parliament and the Council as to what extent they share these objectives.

One of the ways – but certainly not the only one – to translate these objectives into more practical arrangements could be:

∉ to allow for **a very low rate for goods and services of first necessity** such as food. Obviously, the discussion on the scope for such a rate will be difficult (should medical treatment, social housing etc be included?) but it would offer the opportunity to limit the application of such a low rate (and its cost) to the real basic needs of citizens and thereby to exclusively social considerations;

∉ in addition, **a second rate could be used for other purposes** that are not basic needs but that are felt deserving of preferential treatment for other reasons (e.g. cultural and educational reasons, public transport, employment, energy and environment, etc). Obviously, such a scheme needs to remain optional to preserve Member States political choices and to preserve the possibility to apply simpler

8 It is however to be taken into consideration that pursuant to Article 99 (2) of the VAT Directive, each reduced rate shall be so fixed that the amount of VAT resulting from its application is such that the VAT deductible can normally be deducted in full.

and more effective rate structures. However, as already explained, most member States do already apply two reduced rates in addition to the standard rate;

∉ to limit the cost of a three rate structure both for tax administrations and for businesses, the **categories of goods and services eligible** for different reduced rates should be **clearly defined** in order to limit difficult border-line cases; also Member States should only be able to chose a whole category for the application of a reduced rate and not only parts of it; to allow, nevertheless, a high degree of flexibility there should be a greater number of categories than today but each of them harmonised as to its content.

Further reflection on the scope and underpinning policy goals of the categories to be included within such a structure would be necessary: should the application of the second rate be strictly limited or not; and should it also be applied to the complete housing sector (e.g. as a fraud combating strategy), restaurant services, children's clothes or baby nappies, for example? The level of the first rate would have to be quite low, e.g. in the range of 0 to 5%. The level of the 'intermediate' reduced rate could be higher and set, for example, between 10 and 12%. The setting of the level of the rates could take the form of two rate bands or of two minimum rates.

It is to be added that rate differentiation in certain categories of goods/services, such as books, appear to have a very direct Internal Market implication. Restaurants and hotels are in-between as such implications occur in the context of tourism or in border regions. The question arises whether an optional system of reduced rates is acceptable in such cases or whether it should be made compulsory to avoid competition distortions.

Another issue relates to the effectiveness of **using VAT reduced rates for the promotion of certain goods/services**. Typical examples of currently discussed ideas to use VAT as an incentive for a particular behaviour are: energy saving materials, energy efficient products, environmentally beneficial products, biomass, healthy food etc. In addition, in some Member States, baby diapers are considered to serve social goals. The Commission considers that there is a need to discuss the usefulness or not of the VAT instrument for such purposes and it strongly encourages the Council to organise this debate taking the findings of the study into account.

From a purely *technical* point of view, it should be borne in mind that the level of a VAT rate – by its very mechanism – can only have an impact on purchases by final consumers. It will only indirectly affect the behaviour of business – via changes in consumer behaviour -, and other actors that dispose of the right to deduct VAT. Moreover, VAT does not allow to single out the tax treatment of a specific good that is used for the supply of a service: for example an energy saving material that is used in the course of the renovation of a building (which constitutes a service) will not any more be subject to a specific rate. In addition, it appears that problems arise from the need to exactly define the category of product to be promoted; again, compliance costs need to be factored in and may influence the choice of the most efficient policy tool. The Commission recalls, however, that the study finds that, generally speaking, reduced VAT rates are not the most effective policy tool in this context.

From a political point of view, the question arises that if such incentives are considered to be efficient should they – be made compulsory? It is recalled that the study confirms the increased risk of distortion stemming from optional reduced rates on goods.

Moreover, there is a question of **fiscal coherence** to be discussed: does it make sense to allow for a reduced rate for electricity and natural gas if we assume that this rate will have the incentive of generating more consumption while we want to reduce such consumption at the same time by promoting energy saving materials and energy efficient products, which are currently taxed at the standard rate? This question of coherence needs to be answered also as regards taxes additional to VAT: is it meaningful to apply a reduced VAT rate to products that are at the same time subject to specific excise duties?

4.3. Maintenance of the status quo pending the outcome of the political debate

As has been explained above the Commission wishes to launch the debate on the future of reduced rates. This Communication as well as the results of the study are intended to form the basis for such a discussion. The Commission would expect indications from the European institutions as to the way forward and the key elements to be respected, by the end of this year (2007). On that basis it will work towards the presentation of legislative proposals at the end of 2008/beginning 2009 to allow an adoption of the relevant legislative act by the Council in time before authorisation for Member States to apply specific arrangements for labour-intensive services will expire end of 2010.

In that context, the Commission would like to recall that the basic rates structure, which applies to all Member States, is complicated by different temporary derogations granted to particular Member States. These exceptions derogate either from the level of the rate fixed by the rules (zero rates, super reduced rates of less than 5%), or they concern supplies which should be taxed at the standard rate (such as the intermediary rates, the so-called parking rates set at a minimum of 12 %). Whereas the derogations granted during the last enlargement have a precise deadline, those agreed earlier[9] are allowed until the entry into force of the "definitive system" for intra-Community transactions. As the definitive system is unlikely to be adopted for the foreseeable future, these transitional arrangements are still in force, until a new unanimous decision of the Council. In the case of the Member States which joined the EU after the 1st January 1995 the temporary derogations resulting from the accession negotiations apply for a more limited period of time, i.e. in many cases only till the end of 2007.

The Commission takes the view that **derogations coming to an end soon should, with one or two exceptions, be temporarily prolonged until the end of 2010**, i.e. the date of expiry of the experiment on the application of reduced VAT rates to certain labour-intensive services and the most likely date of entry into force of new arrangements for reduced rates. Derogations cannot, however, be prolonged where they conflict with the proper functioning of the internal market and/or with other Community policies (e.g. derogations regarding agricultural input, or, coal, coke, fuel, oil that are contrary to energy and environmental objectives) or where they are already covered by general provisions on rates (e.g. district heating). On the other

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9 See articles 93 to 130 of VAT directive (Council Directive 2006/112/EC of 28.11.2006).

hand, for the restaurant, food, pharmaceuticals', books and housing sectors, derogations could be prolonged as a difference in treatment would provide unequal opportunities to Member States without any substantial justification and would create unacceptable tensions.

The Commission, therefore, proposes to extend most of the derogations for Member States which joined the EU after 1 January 1995.

5. CONCLUSION

The Commission considers that a new framework for reduced VAT rates should rationalise the use of reduced rates, create more transparency, and allow for flexibility for the Member States whilst at the same time respecting the principle set out in Article 93 of the Treaty. It has presented some thought on how this can be achieved but is aware of the need for a political debate to define the orientation before a more detailed proposal can be elaborated.

In this political debate, the Commission insists on the need to keep in mind that any change of a VAT rate applicable to particular goods or services, either an increase or a decrease, will impact not only on the sector concerned but also on other parts of the economy as well as on government budgets.