

Proposed new EU rules on reduced VAT rates

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The harmonization of indirect tax rates in the EU is a sensitive issue. Although import duty rates are uniform in the EU, there is only modest harmonization of the VAT rates (and the excise rates). This is not surprising, as Member States consider the setting of rate levels as a prime element of their national tax sovereignty. In Articles 93 to 130 and Annex III and IV of the VAT Directive¹ a legal framework for the application of VAT rates in Member States has been provided. As a basic rule, the minimum standard rate is 15% and to a limited list of goods and services up to two optional reduced rates of minimum 5% can be applied. The minimum standard rate of 15% will expire at the end of 2010 (and it will probably be increased). At that time, the temporary derogations to the application of reduced VAT rates for Member States that joined after 2004, as well as the 'experimental' reduced VAT rates for certain labour-intensive services cease to apply.

On 7 July 2008, the Commission presented its proposal for a Council Directive amending the VAT Directive as regards reduced rates of value added tax.² The proposal focuses on allowing reduced rates for sectors that presently enjoy temporary provisions for labour-intensive services, and/or for which sufficient elements are already available, notably on the basis of the Copenhagen Economics study.³ As from 1 January 2011, Annex III to the VAT Directive, that contains the list of goods and services eligible for reduced rates, would also include the following issues:

- the whole housing sector as well as some services relating to places of worship, cultural heritage and historical monuments;⁴
- restaurant and catering services;
- locally supplied services including the labour-intensive services for which the reduced rates experiment expires by the end on 2010 and similar locally supplied services such as gardening, minor repair of movable tangible property, personal care, etc.;
- children's nappies;
- audio books, CD's, CD-ROMs or other physical support that predominantly reproduce the same information content as printed books;
- few other technical adaptations already proposed in 2003, which are still valid, as equipment, aids

and other appliances for disabled or services linked with waste treatment, etc.

Two years ago, in its Directive of 14 February 2006 including the third prolongation of the experiment on reduced rates for labour-intensive services until the end of 2010, the Council mandated the Commission to present, by the end of June 2007, an overall assessment report on the impact of reduced rates applied to locally supplied services, including restaurant services, in terms notably of job creation, economic growth and the internal market.⁵ Based upon the underlying study conducted by Copenhagen Economics, the Commission presented on 5 July 2007 a Communication to the Council and European Parliament on VAT rates other than standard VAT rates.⁶ As suggested by the Commission, other stakeholders were consulted before initiating a more far reaching proposal.

BusinessEurope, the Confederation of European Business representing forty national business federations in thirty-four countries, emphasizes the need to urgently agree on a new legal framework for reduced VAT rates that would lead to rationalization and simplification of the present system and to give

¹ Directive 2006/112/EC.

² COM(2008) 428 final.

³ Study on reduced VAT applied to goods and services in the Member States of the European Union, Final report by Copenhagen Economics, 21 Jun. 2007.

⁴ These changes will make it possible for Member States, for example, to apply reduced VAT rates to renovation and repair work aiming at increased energy-saving and efficiency.

⁵ Directive 2006/18/EC. These labour-intensive services cover minor repairing of bicycles, shoes and leather goods, clothing and household linen; renovation and repairing of private dwellings; window cleaning and cleaning in private households; domestic care services and hairdressing. Member States may only apply reduced rates to a maximum of three services of those categories.

⁶ Together with this Communication from the Commission to the Council and the European Parliament on VAT rates other than standard VAT rates (COM (2007)380 final), the Commission published a proposal for a Council Directive amending Directive 2006/112/EC with regard to certain temporary provisions concerning rates of value added tax (COM(2007) 381) and a 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 (SEC(2007) 910).

companies legal certainty over a sufficiently long time horizon. The list of areas of activity eligible for reduced VAT rates must be clearly identified and possibilities for derogation avoided. The merits of reduced VAT rates should always be evaluated against (i) other fiscal and non-fiscal measures that could be used to reach similar policy objectives in more cost effective ways; (ii) the potential impact on cross-border competition and compliance costs for business.

With regard to the questions set out by the European Commission regarding the application of reduced rates on locally-supplied services, labour-intensive services, restaurants and housing, as well as their possible extension, BusinessEurope refers to the Copenhagen Economics Study. The targeted application of reduced VAT rates for such services, especially labour-intensive services, could have positive effects in the form of increased productivity and a shift from the shadow economy to legitimate business activity. That is: if the VAT rate reduction is passed through to the final consumer in lower prices, which will be very much depending on the economic situation. Anyhow, as stated by the Confederation of Netherlands Industry and Employers (VNO-NCW), a policy focused upon a reduced VAT rate for labour-intensive services is to be preferred above a general shift of the tax burden from direct to indirect taxation to create a more employment-friendly tax system (as suggested in the Commission's Consultation paper) because higher indirect taxes indirectly also increase employment cost. The diverging application of the reduced VAT to restaurant services (only eleven out of the twenty-seven Member States are currently allowed to apply a reduced rate on restaurant services) can be difficult and is an administrative burden, especially in restaurants that also offer 'take-away' services. Yet, for BusinessEurope to support the addition of restaurant services to Annex III of the VAT Directive, it should be demonstrated that a reduced rate on restaurant services is the best way to create jobs in this sector. I would say that this sounds as a fair *ex ante* condition for a go or no-go, but the proof of the pudding is in the eating and it would be politically very difficult to bring these services back to the standard VAT rate if substantially fewer jobs are created than expected. As regards the proposed extension of the current European rules for applying a reduced rate for the housing sector, European business shares the view of the Commission that this could avoid different fundamental approaches in the sector, if applicable services should be restricted to final consumers. There is also support for the Commission's suggestion for technical adjustments that grant eligibility for reduced VAT rates to equivalent digital products. I would even say that this is more than a technical adjustment, as it would create neutrality by eliminating distortion of competition between substitute products on the consumer market; think of the supplies of books, newspapers and periodicals in electronic form (now subject to the standard VAT rate) which should be brought under the reduced rate applied on their hard copy substitutes.

The Commission's idea to consider the reduced

VAT rate as incentive for the use of environmental friendly and energy efficient products would introduce a 'green' policy objective in the VAT. BusinessEurope, though welcoming the idea, would want to see the Commission's detailed proposals in this area before reaching a firm conclusion. This position is understandable as there is not even an assessment of the efficiency and effectiveness of using reduced VAT rates to achieve environmental policy objectives compared with other fiscal and non-fiscal mechanisms. One of the main difficulties is the development of a reliable list of green (energy/eco-labelled) products guaranteeing the environmental specification over their whole life cycle. Moreover, in order to avoid cross-border distortion of competition, the criteria for products to be put (and kept) on such a list should be identical throughout the EU.

So far the reactions of European business. In the explanatory memorandum to the proposed Directive of July 2008, the Commission sets short-term and longer term actions. In line with the priority action areas under the Lisbon strategy for growth and jobs, especially focused on small business, the proposal includes permanent, updated provisions on the now temporary experimental labour-intensive services which expire on 31 December 2010, and the addition of certain other locally supplied services, including restaurant services, to the current Annex III of the VAT Directive, as well as some technical adaptations taking account of technical progress or removal of current inconsistencies.

But the debate on an in-depth revision of the scope of reduced VAT rates at EU level has only started. In its explanatory memorandum the Commission has made clear that further time is still needed in order to gather all the elements to be taken into account as well as the input by the other EU institutions and stakeholders. The appropriateness of allowing the application of a reduced rate to energy saving materials and to other environmentally beneficial products or services is currently being examined by the Commission. The results, accompanied by relevant proposals and recommendations, are said to be presented in the autumn.

The proposal is a response to the urgent need for more clear and harmonized solutions to the EU-wide patchwork of applications of reduced VAT rates. Although one never can predict the willingness of Member States to agree on the proposal, the present economic situation of stagflation may be a good climate for achieving the required unanimity in the Council. Yet it is important to be aware that putting goods and services under the reduced VAT rate is a decision for the long term; once such goods and services are on the reduced rate list, it will be politically very difficult to take them off without creating problems for the sectors concerned. Therefore, I think it is also necessary to develop a well designed decision procedure for extending the scope of reduced VAT rates as a means to assess whether or not taxation should be used as an instrument for achieving non-fiscal policy objectives like environmental policy objectives. Such a decision framework has

been applied successfully by the Second Dutch Green Tax Commission in finding ways in which environmental impact could be lessened by fiscal means.⁷ The decision tree used by this commission includes a precise description of the environmental objective, a description of the proposed tax measure and three tests. In the first test the environmental effects, the revenues of the tax measure and the public support are estimated. The second test goes into the legislative aspects (including EU rules) and technical viability of the tax measure. The third test includes economic effects (e.g., cross-border competition and compliance

costs) and adjoining policy areas, if applicable. If the three tests are positive, the measure is recommended (on short term or long term). If at least one of the three tests fails, the proposed tax measure is rejected, unless another form of implementation of the tax measure (if available) can be tested, following the same procedure. After all, there should be an adequate procedure to assess and evaluate the real effects of the tax instrument.

⁷ Summary report “‘Greening’ the tax system”, 2001.