



European Economic and Social Committee

ECO/121
Reduced rates of VAT

Brussels, 30 October 2003

OPINION

of the European Economic and Social Committee

on the

Proposal for a Council Directive
amending Directive 77/388/EEC as regards reduced rates of value added tax

COM/2003/0397 final - CNS 2003/0169

On 1 August 2003 the Council of the European Union decided to consult the European Economic and Social Committee, under Article 262 of the Treaty establishing the European Community, on the

Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax

[COM(2003) 397 final – 2003/0169 (CNS)].

In view of the urgent nature of the work, the Committee decided at its 403rd plenary session of 29 and 30 October 2003 (meeting of 30 October) to appoint **Mr Bedossa** as rapporteur-general and adopted the following opinion by 66 votes to three with five abstentions:

1. **Introduction**

1.1 For tax consultants, VAT rates are more a question of political marketing and tax policy than of structural measures with an impact on company competitiveness and competition. However, in economic terms, any modification in the VAT rate has an immediate and long-term impact on consumption; cutting rates boosts consumption and thus has a direct impact on production and jobs, particularly when local activities are involved that do not distort competition. Creating jobs by cutting VAT in this way also has a major indirect impact on government income through the increased tax revenue from corporate earnings, earned income and social security charges and a cut in the cost of unemployment benefit.

1.2 Unlike other levies, VAT on final consumption is a visible tax and, because of that, is used as an excuse to cut other kinds of charges (specific indirect taxes, direct taxes, social security contributions and local taxes). As a matter of fact, VAT collection requires an exact registration of turnover, making other taxes and parafiscal charges much more difficult to evade.

1.3 Despite the fact that VAT rates are often the subject of intense lobbying and political activity, it is debatable whether they do in fact generate significant administrative difficulties for companies. Difficulties may perhaps be caused by having a plethora of rates, making it hard to determine which rate applies in a particular case. Problems do arise from time to time.

1.4 The Commission is right to say that companies are at a loss to understand how the system works, and that the rules do sometimes lead to incredible complexity, but this is not a matter specific to rates of VAT. Indeed, there have been considerably fewer problems since the number of rates was cut in 1993 and premium rates were curtailed. Very many companies operate using a single rate and the problems that do arise can be managed centrally and definitively for very long periods.

2. General comments

2.1 The European Economic and Social Committee welcomes the *Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax* adopted by the Commission on 16 July 2003.

2.2 In its opinion of 26 May 1999 and in accordance with the wishes of the European Council on employment, the Committee stated that, despite the manifold criticisms that can be levelled against this proposal, the VAT rate also had to be used in the fight against unemployment and as a weapon to combat the black economy.

2.3 The Committee recognises that, not least with enlargement imminent, this proposal seeks to give all Member States equal opportunities to apply reduced rates in very specific, defined and clearly itemised areas.

2.4 The Committee notes that the draft directive seeks to rationalise the numerous derogations that have grown up in some - but not all - Member States in respect of VAT rates.

2.5 The Committee notes that the recitals to Council Directive 1999/85/EC set out the aims of this experiment, namely to boost employment and curb the black economy. A global evaluation report was also to be drawn up on the experiment. Nine Member State elected to take part in the evaluation, which culminated in July 2002 in an exchange of views on the evaluation methods and the difficulties encountered in drawing up the report.

2.6 The underlying economic mechanism was based on boosting employment and curbing the black economy.

2.6.1 The purpose of lower VAT is to cut consumer prices for the services concerned and thus increase demand. Increased production is meant not to boost productivity but to encourage recruitment. Directive 1999/85/EC clearly stated that there had to be a close link between the lower prices resulting from the rate reduction and the foreseeable increase in demand.

2.6.2 Higher VAT can only influence those businesses which have legal status but which operate in part in the black economy. The problem with evaluation is that it is difficult to measure activity which is, in essence, "unobserved".

2.7 The Committee also notes the key importance of the observation period selected. Employment trends vary depending on whether the period selected is one of high growth or, as now, severe recession, as the economic environment has to be taken into account.

3. **Specific comments**

3.1 The Commission proposal has four facets.

3.1.1 The list of goods and services on which Member States have the option of applying reduced rates of VAT is to be rationalised in four main ways, namely by:

- not extending the option to apply reduced rates to new categories on which no Member State applies reduced rates at the moment;
- extending the option to apply reduced rates only to the categories of goods and services for which specific derogations already authorise a Member State to apply reduced rates, provided this does not hinder the proper functioning of the internal market: restaurant services, housing and gas and electricity supplies;
- introducing the option to apply reduced rates to plants and floricultural products;
- introducing special provisions, for instance for material used by disabled people, for sewage and street cleaning services and for waste recycling.

3.1.2 Rationalisation of other reduced rates:

- abolition of the derogations which, in the past, enabled some Member States to maintain reduced rates for goods and services not contained on the restrictive list;
- restriction of zero and super-reduced rates to the goods and services listed in Annex H.

3.1.3 The lower rates applicable in certain territories are to be rationalised in order to define a clear legal basis for each of the derogations and to restrict their scope to prevent abuse.

3.1.4 VAT on certain labour-intensive services: the Commission claims that the reduction in VAT rates has had very little, if any, impact on prices and job creation and thus feels that this may be a waste of budget resources which could be more usefully deployed – and thus have better results. The Commission does not, however, call into question the optional nature of applying reduced VAT rates.

3.2 **Objectives and constraints**

3.2.1 The Committee notes the directive's objectives, namely:

- to implement the new VAT strategy to improve the functioning of the common VAT system in the single market;

- to preserve the Community *acquis* on rates and prevent current differences widening;
- to reduce inconsistencies in the current system, i.e. in the many specific derogations currently granted to certain Member States.

3.2.2 The Committee welcomes the following points made in the draft directive:

- In line with the principle of subsidiarity, there is no impingement of Member States' tax competence beyond what is necessary to ensure the proper functioning of the single market.
- The scope of reduced VAT rates is to be carefully defined to ensure that such factors do not disrupt the operation of the internal market.
- The derogations should apply for a very short period of time.
- It is vital not to lose sight of the Lisbon Strategy, which was expanded at Gothenburg, to promote sustainable development, increase employment and introduce economic reform and social cohesion in a knowledge-based society.

3.2.3 The Committee took note of the conclusions of the informal Council meeting in Stresa on 13 September 2003 which confirmed the many discrepancies on the list of services that will be eligible for lower VAT.

3.2.3.1 With regard to these many discrepancies, the Committee agrees with the Commission, on the issue of passing on the VAT rate in consumer prices. Often, this is highly negligible and, if anything, temporary. It is undoubtedly a step backwards for the single market, given the high cost to the budget of measures of this kind.

3.2.3.2 If the aim is to simplify the VAT system and make it more coherent, maintaining these very many derogations may distort competition.

3.2.4 The Committee notes the growing importance of Court of Justice case law – including the judgements delivered on 18 January, 8 March, 3 May and 8 May 2001 – for assessing the various measures taken by the Member States to define the scope of the reduced rates. This case law will from now on serve as a guideline for revising and rationalising Annex H.

3.3 The economic activities eligible for reduced VAT rates set out in Annex K have their own hallmarks that differ from other industrial goods and services. They are mostly performed by small and micro enterprises at local level. These small and micro enterprises are vital, not least for the local economy, and the immediate impact of any expansion of their activities is to boost local jobs rather than relocate operations.

3.3.1 In its findings on the experiment with reduced VAT, the Commission underlines the fact that the participating Member States failed to furnish proof of the effectiveness of this measure on employment and curbing undeclared work. While it is true that the information provided by some of the Member States involved is inadequate, France reports a very large number of new jobs created in the construction industry, while Luxembourg and the Netherlands report a similar development in the hairdressing sector. Broadly speaking, reports from the organisations representing the eligible companies highlight the benefits of this measure. Moreover, the positive effects vary depending on the sector and Member State concerned. To give a fuller picture, the findings should also have analysed the impacts of new job creation on government (tax and social welfare) revenue.

3.3.1.1 The Commission feels that reduced VAT has not done enough to secure lower prices for consumers. The Commission's arguments are not convincing. According to the French government report, 75% of VAT cuts have been passed onto the final price in the construction business. This has enabled consumers to commission more work, generating added business for companies and creating jobs.

3.3.1.2 By its very nature, it is hard to show the impact of this measure on undeclared work - given the lack of information even about the scale of the problem. For the moment, we must make do with random, unquantifiable approaches. A number of reports note the views of grassroots entrepreneurs from the construction industry and elsewhere, who feel that undeclared work is on the wane both inside and outside companies.

3.3.2 The Committee feels therefore that, given the findings of some of the national reports, it is possible to objectively endorse the benefits of VAT reduction in certain sectors that have experience of this measure.

3.3.2.1 The Committee would also draw the attention of the Commission, the Parliament, the Council and the Member States to the serious economic consequences – in terms of jobs being destroyed - of discontinuing the experiment. The Committee feels therefore that this experiment now has to be turned into a definitive measure.

3.3.3 With regard to the activities mentioned in the new Annex H, the Committee is pleased with the Commission's proposal and the introduction of new sectors and new operations such as restaurant services. However, it is not clear why two sectors that used to be included in the former Annex K – hairdressing and small repair services – have been left out:

- It is unreasonable to definitively rule out any activities on the basis of inconclusive, disputed findings of short-term studies.
- It is vital to bear in mind the risk of losing the new jobs created in these two sectors.
- Restoring normal instead of reduced VAT rates in these sectors would have adverse economic effects.

3.3.4 Since Annex H is an option, not an obligation for Member States, the Committee calls for:

- confirmation of the twenty categories of activity in the new Annex H;
- the reintroduction of hairdressing and small repair services mentioned in the former Annex K;
- the addition, in category 10, of historic and religious buildings and buildings of private and professional/industrial cultural and architectural heritage.

4. Conclusion

4.1 VAT rates are undoubtedly a tax policy concern, as rates on final consumption impact public revenue.

4.1.1 The rates issue played a potentially key role in the European Commission draft papers discussed in the late 1980s and early 1990s where the aim was to abolish VAT exemptions in intra-Community relations and to introduce a system of VAT levied in the country of origin. Against that background, it was important to harmonise the rates.

4.1.2 Thankfully, however, the plan to levy VAT in the country of origin was deferred. At that time, there was much questioning of Member States' egotism, what was seen as their refusal to give up their tax prerogatives, the fear of an all-powerful European Commission, etc.

4.1.3 Under the Commission's plans it was not possible to allocate precisely each rate of VAT on consumption in the territory concerned. That does not mean that the aim of introducing VAT levied in the country of origin as propounded by the Commission was a mistake. It simply means that the ways of achieving that aim were not consistent the objective in mind.

4.1.4 Quite the reverse in fact: the abolition of exemptions in intra-Community relations would be likely to significantly cut "carousel" fraud perpetrated by criminal organisations at the expense of the public purse and, above all, the companies concerned. This is a serious problem to which many companies fall victim.

4.2 The Committee welcomes the moves to draft the new Annex H, with a view to rationalising and simplifying it so that it becomes *ipso facto* the sole reference for defining the scope of reduced, super-reduced and zero rates.

4.2.1 The addition of new categories comes in response to pressing demands from the Member States who had not secured the requisite authorisation. This applies particularly to category 14 (restaurant services). This addition is designed to allow the reduced rate to be applied to restaurant services in more Member States and is thus a decisive step towards the more uniform application of reduced rates.

4.3 The Committee does not wholly share the Commission's view on the outcome of the evaluation of the experiment's effectiveness, not least in terms of job creation and efficiency.

4.3.1 Although the studies that have been carried out do point in the same direction, in one category at least (category 10: housing), convincing results have been achieved for small and medium-sized enterprises (SMEs) in one of the Member States applying the scheme. The rate rise has stimulated demand and boosted employment for craft workers in the sector concerned.

4.4 Nonetheless, the Committee welcomes the proposed revision, which is an important step towards improving the common VAT system with a view to improving the functioning of the single market.

4.4.1 This major simplification of the VAT rate for the European Union as a whole also maintains Member States' tax competence in setting the VAT rates applicable on their territory.

4.5 The Committee endorses the plan for a revision to be carried out in 2004 to allow an assessment of the economic, environmental and social impacts of the proposal.

4.6 The Commission proposal is useful in that it reintroduces a more rational approach and removes some of the inequalities in the application of the common VAT system. However, this situation is not specific to VAT rates and the adoption of the directive would not warrant the abandonment of other priorities such as, for example, eradicating discrimination and the serious inconsistencies in the economic sectors to which VAT exemptions apply. With this in mind, it would be advisable to allow Member States to extend the zero rate to all operations falling under Article 13 of the sixth directive.

4.6.1 In view of the above, we would propose that the Committee ask the Commission to amend the second subparagraph of Article 1(2)(a) of the proposal as follows:

"The derogation laid down in the first subparagraph may relate only to supplies of goods or services of one of the categories listed in Annex H *or Article 13*".

4.6.2 In Article 1(2)(c), the proposal is to delete the words "**which give rise to consumption in those territories**".

4.7 The Committee challenges the Commission's finding that lower VAT rates are never the most effective tool, that the cost of such a measure to the budget is high when set against its economic impact, and that a preferable option is to reduce labour costs. Cutting costs and lowering VAT are interactive measures and, under the subsidiarity principle, the Commission must leave it up to the Member States to select the measures they feel best fit in with their own policies.

4.7.1 The Committee would again draw attention to the indicative, non-mandatory nature of the Commission's proposed directive. As the Annex H categories deal with local activities unlikely

to distort cross-border competition, it is vital that Member States do not oppose the idea simply because they do not want to apply a particular measure contained in the directive in their particular country. In order to boost the ongoing development of dynamic policies to assist the sectors concerned and to avert the risk of a sharp economic and social slump that would result if VAT were to return to its normal rate, the Committee urges the Member States to adopt the proposed directive, bearing in mind the proposals set out above.

4.7.1.1 The Committee notes that this measure – which reflects the priorities of the European Charter for Small Enterprises – is of major benefit to local small and micro enterprises and must be stepped up accordingly. Like the Parliament, the Committee would like to see VAT reduction extended to all highly labour-intensive activities.

4.7.1.2 The Committee has been informed of the difficulties experienced by the companies concerned, not least in the construction business, in planning their operations for 2004 in the absence of any clear decision. The Committee asks the governments to adopt the proposal for a directive so as not to put a brake on company activities over the coming months.

Brussels, 30 October 2003.

The President
of the
European Economic and Social Committee

The Secretary-General
of the
European Economic and Social Committee

Roger Briesch

Patrick Venturini