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Proposal for a

COUNCIL DIRECTIVE

amending Directive 77/388/EEC as regards reduced rates of value added tax

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. INTRODUCTION

1. In its 2000 Communication, the Commission defined a strategy to improve the operation of the VAT system in the internal market.¹ The viable strategy it proposed is based on four main objectives: **simplification** and **modernisation** of current rules, **more uniform application** of current legislation and **a new approach** to **administrative cooperation**.
2. The Commission proposed a phased action programme to make concrete and essential improvements to the current system in the short term. It noted that a review and rationalisation of the rules and derogations applying to VAT rules would have to be considered in the medium term (point 2.10 of the Annex setting out possible measures).
3. In its 2001 report on reduced VAT rates,² the Commission made it clear that the time had come to look at the current **structure** of reduced rates as their complexity was the reason for most of the requests received by the Commission.
4. However, **there are no plans to change the level of rates** during the period in which the new strategy is to be implemented. The minimum standard rate was set at 15% until 31 December 2005³ and there would not appear to be any reason to reopen the debate on this under this review of the scope of reduced rates.
5. This explanatory memorandum assesses the impact of the current structure of VAT rates on the functioning of the internal market and the proposed directive which it accompanies contains the changes and rationalisation of current rules and derogations which the Commission considers necessary. Taking Article 93 of the Treaty as its basis it must comply with the objectives set out there, viz. **"harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market"**.

This also takes account of the report which the Commission is required to make every two years to the Council so it can review the scope of reduced rates (second subparagraph of Article 12(4) of the Sixth VAT Directive).

2. BACKGROUND

6. The current rules, which were introduced by Directive 92/77/EEC,⁴ are based on a definition of minimum rates: 15% for the standard rate and 5% for reduced rates. Member States may apply one or two reduced rates to the goods and services contained in a restrictive list (Annex H). A large number of specific derogations

¹ COM(2000) 348 of 7 June 2000.

² COM(2001) 599 of 22 October 2001.

³ Council Directive 2001/4/EC of 19 January 2001 (OJ L 22, 24.1.2001, p. 40; amending OJ L 26, 27.1.2001).

⁴ Council Directive of 19 October 1992 (OJ L 316, 31.10.1992).

allowing Member States or certain of them to apply different rules have been grafted on to these basis rules. This has created an extremely complex situation which needs to be reviewed.

7. The second subparagraph of Article 12(4) of the Sixth VAT Directive states that “on the basis of the report from the Commission, the Council shall, starting in 1994, review the scope of the reduced rates every two years. The Council, acting unanimously on a proposal from the Commission, may decide to alter the list of goods and services in Annex H”.
8. However, in its communication in 2000 on the VAT strategy, the Commission broadened the discussion beyond a simple amendment of Annex H indicating that the time had come to review and rationalise the rules and derogations applying to reduced VAT rates.

2.1. First Commission reports on reduced rates

9. The Commission presented the first report on 13 December 1994⁵ and the second on 13 November 1997.⁶ However these reports did not cause the Commission to propose a general review of the scope of reduced rates⁷ as it considered that there was no real need to do so and that the matter should be addressed in its entirety in the proposals on the adoption of the definitive VAT system.⁸

2.2. The last report of 22 October 2001

10. The report states from the outset that under the new VAT strategy greater harmonisation of rates could only be considered in the long term. However, a thorough review of the rules applying to reduced rates could already be undertaken after examining and drawing conclusions from the experimental application of reduced rates to labour-intensive services.⁹ The report states that in order to prepare for such a review the current structure of reduced rates should be re-examined, no new derogations be introduced and abolition of all or some of the derogations currently applying should be considered. This is fully consistent with the objectives of the new VAT strategy.
11. The failings of the internal market perceived by traders, particularly in the tax field, as a result of differences between VAT rates, are a reality that must be taken into account.
12. The report was intended (point 64) to stimulate consideration by business circles and Member States of the role of reduced rates, their effectiveness as tools of various Community or national policies and possible improvements or rationalisations. In the interim, the Commission has received numerous submissions from different branches of the economy setting out their analysis and requests.

⁵ COM(94) 584 final.

⁶ COM(97) 559 final.

⁷ The only change made concerned the reduced rate for live plants and flowers (Council Directive 96/42/EC of 25 June 1996 amending Directive 77/388/EEC on a common system of value added tax (OJ L 170, 9.7.1996, p. 34).

⁸ Article 281 and COM 328(96) final of 10 July 1996.

⁹ Directive 1999/85/EC of 22 October 1999 (OJ 277, 28.1.2002).

13. In the report (point 65) the Commission discusses one option which was designed to launch a debate on the role of reduced rates, their effectiveness as an instrument in Community or national policy and any improvements and rationalisation needed. This would be to establish a structure based on two reduced rates (possibly with a specific band for each category) applicable to individual lists of goods and services:¹⁰
- a reduced rate near the current minimum of 5% for a shortlist of goods and services which are either basic necessities or fulfil a social objective (possibly mandatory since the great majority of Member States already apply a reduced rate to such goods and services);
 - a higher reduced rate applicable to a list of goods and services which, for historical or for reasons of economic expediency, should be the subject of differentiated treatment in relation to the goods and services subject to the standard rate or which fulfil other objectives.
14. The report concludes by pointing out the following factors:
- (a) the properties of VAT, and in particular the obligation to guarantee its neutrality;
 - (b) the need to define clear criteria for applying reduced rates;
 - (c) the long-term objective of further harmonisation of rates and rationalisation of derogations.
15. The report is generally considered to faithfully reflect the situation concerning rates in the European Union and there were no new developments in 2002.

2.3. Conclusions of the experimental application of VAT rates to labour-intensive services

16. This experiment was introduced by Directive 99/85/EC for a period of three years. On 3 December 2002,¹¹ the Council adopted a Directive extending by one year (up to 31 December 2003) the reduced rates applying to labour-intensive services in order to guarantee continuity and legal certainty for the sectors currently eligible for the reduced rate until the Commission and the Council had completed a thorough evaluation of the results of this experiment.
17. In its report of 2 June 2003,¹² the Commission evaluated the effectiveness of the experiment in terms of job creation and efficiency. On the basis of assessment reports from the Member States which took part in this experiment it would seem that no country can robustly demonstrate that this has had a positive impact on all the sectors concerned in terms of job creation or efficiency. The reduction in VAT rates appears to have had very little, if any, impact on prices. Furthermore the reduction has been generally limited and its permanent nature is not demonstrated by the

¹⁰ N.B.: Member States currently have the option of applying one or two reduced rates to the whole of Annex H.

¹¹ Directive 2002/92/EC (OJ L 331, 7.12.2002).

¹² Report by the Commission to the Council and the European Parliament on the experimental application of reduced rates of VAT to certain labour-intensive services. COM(2003) 309 of 2 June 2003.

experiment. It is therefore concluded that a reduction in VAT rates cannot have a significant impact on demand.

18. Although there was an increase in demand in one sector, other significant measures (such as reduction in social security contributions, tax relief or possible deduction of indirect tax) were also introduced in the same period. Moreover the measure was introduced at a time when the economic situation was sound and unemployment was falling in all sectors of the economy.
19. These findings are in line with the conclusions of previous studies.¹³ Compared with measures which directly target labour costs, the impact of a reduction in VAT rates on employment always has a higher budgetary cost for each job created. According to the report's conclusions, for the EU as a whole, reducing labour costs creates 52% more jobs at the same cost to the budget. Thus cutting VAT rates is a waste of budget resources which could more usefully be deployed, e.g. by reducing labour costs or providing financial support for job creation, in a way that would be more effective and cost significantly less per job created. The results of the experiment therefore need to be taken into account in considering the use of reduced VAT rates.
20. In the light of the foregoing, it is evident that the VAT treatment of labour-intensive services should now be examined in the general debate on the scope of reduced VAT rates.
21. Quite separately from the outcome of the experimental application of the reduced VAT rate for labour-intensive services, the Commission would strongly encourage Member States to do all they can to reduce the burden on labour costs, in particular as concerns semi-skilled or manual work; specifically by a reduction in taxes and other levies on labour.

2.4. the recent accession negotiations

22. During the recent accession negotiations the Commission proposed to the Member States to grant derogations for certain reduced and zero rates for a limited period only. All 15 Member States agreed to this strategy. Moreover, it is worth noting that Member States were extremely reluctant to grant these transitional arrangements and did not respond favourably to every individual request put forward by the acceding countries, even when they were supported by the Commission. Against this background, the present proposal aims at ensuring a rationalisation of the transitional derogations in force in the current Member States in order to avoid unequal treatment between them and the acceding countries

3. RECENT CASE LAW OF THE COURT OF JUSTICE

23. The Commission has taken steps to ensure Community rules on reduced VAT rates are correctly applied by bringing four cases before the European Court of Justice. As a result the Court has clarified the scope of Article 12 of the Sixth VAT Directive.

¹³ See Communication SEC(97) 2089 final of 12 November 1997, which referred inter alia to a study entitled *Potential impact on employment creation of fiscal instruments (namely of a reduced VAT rate for selected sectors)*, by Cambridge Econometrics Ltd and the Institute of Employment Research, Warwick University, September 1996.

3.1 Judgment of 18 January 2001¹⁴

24. In this case the Court ruled that Spain had failed to fulfil its obligations under Article 12(3)(a) by applying a reduced rate to the supply of services consisting in making available road infrastructure to users in return for payment of a toll.

In paragraphs 18 and 19, the Court laid down the following principle:

"It follows from Article 12(3)(a) of the Sixth Directive that the application of one or two **reduced rates** is an option accorded to the Member States as an **exception to the principle that the standard rate applies**. Moreover, according to that provision the reduced rates of VAT may be applied only to the supplies of goods and services specified in Annex H.

It is settled case-law that **provisions which are in the nature of exceptions to a principle must be interpreted strictly.**"

3.2. Judgment of 8 March 2001¹⁵

25. In this case the Court ruled that "by maintaining in force a reduced VAT rate of 5% applicable to transactions concerning the goods listed ... respectively covering wines, machines or equipment designed for research into alternative forms of energy, and agricultural foods and utensils, the Portuguese Republic has failed to fulfil its obligations under Articles 12 and 28(2) of the Sixth Directive."

3.3. Judgment of 3 May 2001¹⁶

26. The Court was asked for a ruling on the option for France to apply different rates to medicinal products according to whether they are reimbursable or not under the social security system.¹⁷
27. In paragraphs 21 and 22 of this judgment the Court notes that the introduction and maintenance of a rate of 2.1% for reimbursable medicinal products, whereas the supply of non-reimbursable medicinal products is subject to a rate of 5.5%, are permissible only insofar as they are consistent with the **principle of fiscal neutrality** inherent in the common system of VAT and in compliance with which the Member States are required to transpose the Sixth Directive (see the judgment of 7 September 1999 in Case C-216/97 Gregg (1999), ECR I-4947, paragraph 19).
28. That principle in particular precludes treating similar goods, which are therefore in direct competition with each other, differently for VAT purposes (see to this effect the eighth recital in the preamble to the First Directive and the judgment of 11 June 1998, in Case C-283/95 Fischer, ECR I-3369, paragraphs 21 and 27). It follows that the principle of fiscal neutrality **also includes the other two principles, namely the principles of VAT uniformity and of elimination of distortion in competition.**

¹⁴ Judgment of 18 January 2001, Commission v. Kingdom of Spain, C-83/99, ECR 2001, I-00445.

¹⁵ Judgment of 8 March 2001, Commission v. Portuguese Republic, C-276/98, ECR 2001, I-01699.

¹⁶ Judgment of the Court of 3 May 2001, Commission v. French Republic, C-481/98, ECR 2001, I-03369.

¹⁷ The 2.1% rate applies to medicinal products which are reimbursable under the social security system whereas other medicinal products are taxed at a reduced rate of 5.5%.

3.4. Judgment of 8 May 2003¹⁸

29. In this case the Court was asked to give a ruling on the option for France to apply a reduced rate solely to the fixed part of the prices for gas and electricity supplied by the public network whereas the variable part (actual amount consumed) remains subject to the standard rate. In its judgment the Court was asked to clarify the scope of Article 12(3)(b) in the light of the principle of fiscal neutrality inherent in the common VAT system.

In paragraphs 27 and 28 the Court states that "in any event, there is nothing in the text of Article 12(3)(b) of the Sixth Directive which requires that provision to be interpreted as requiring that the reduced rate can be charged only if it is applied to all supplies of natural gas and electricity. A comparison of the different language versions argues in favour of an interpretation that a selective application of the reduced rate can be excluded, provided that no risk of distortion of competition exists.

Moreover, since the reduced rate is the exception, the restriction of its application to concrete and specific aspects, such as the standing charge conferring entitlement to a minimum quantity of electricity on the account holders, is consistent with the principle that derogation of derogations must be interpreted restrictively."

All this case law is extremely useful for an analysis of measures taken by Member States to define the scope of the reduced rates and should guide the review and rationalisation of Annex H.

4. VAT RATES AND THE INTERNAL MARKET

30. An analysis of the current structure of VAT rates and, in particular the scope of the reduced rates, has revealed two factors which may hamper the proper functioning of the internal market and create distortion of competition: the optional nature of applying reduced rates for Member States and the lack of common definitions for the categories in Annex H. This is compounded by the huge number of specific derogations granted to certain Member States but refused to others.

4.1. The most frequent complaints

31. The conclusions of the 2001 report are still relevant. It should be noted that the main complaints from traders concern:
- a) the optional nature of applying reduced rates;
 - b) the huge variations between reduced rates;
 - c) the fact that the zero and super reduced rates continue to be applied by some Member States but are refused to others;
 - d) the lack of Community definitions for categories of goods and services in Annex H, and its restrictive nature;

¹⁸ Judgment of 8 May 2003, Commission v. French Republic, C-384/01. Not yet published.

- e) the uneven way in which the reduced rates are applied as the option exercised by one Member State does not oblige it to apply it to all goods and services of the category or categories chosen;
 - f) the conflict between the principle of uniformity of rates and the option of applying reduced rates to the whole or part of a category;
 - g) the complexity resulting from the permanent or transitional nature of the derogations.
32. Very often traders are at a loss to understand how particular goods or services which are not listed in Annex H can be eligible for a reduced, super reduced or zero rate in certain Member States. The reason must always be sought in the specific derogations negotiated at the time Directive 92/77/EEC on the harmonisation of VAT rates was adopted or under the Acts of Accession of the new Member States.
33. The time has now come to review all these situations to find a more consistent approach.
- 4.2. Contested differences in treatment**
34. The current system is based on the definition of a minimum standard rate of 15% and 5% for reduced rates. Member States may apply one or two reduced rates to goods and services included in a restrictive list (Annex H). This means that the same goods or services are treated differently from one Member State to another.
35. Generally speaking there is no evidence that this system has created serious distortion of competition calling for radical measures to achieve greater harmonisation of VAT rates.
36. However, there have been increasing questions and criticism from traders and some Member States about certain specific derogations which are granted to some Member States but not to others.
37. Restaurant services are one example. Under a transitional derogation they are subject to a reduced rate in eight Member States whereas current Community legislation prevents the other seven from introducing such rates. This situation has led this sector and certain governments to approach the Commission in order to secure this option for all Member States. The reduced rate for restaurants was also the subject of arduous negotiations under the enlargement process culminating in authorisation for Cyprus, Hungary, Poland and Slovenia to apply reduced rates for restaurants until 31 December 2007.
38. The situation is comparable in the housing sector where various specific derogations exempt many Member States from the obligation to restrict the reduced rate solely to housing under social policy.
39. The rationale for such situations is becoming increasingly tenuous as there is no real justification for perpetuating this state of affairs. There would seem to be two options open: either abolish such derogations and apply the standard rate in all Member States or extend the option to apply reduced rates to all Member States. In the sectors in question no complaint has provided any evidence of serious distortion of competition necessitating the abolition of the optional application of reduced rates in

these sectors. Consequently, there seems to be no reason not to extend this option to all Member States.

4.3. Contested practices in Member States

40. Traders regularly complain about certain practices in the application of the optional reduced rates authorised by Annex H which, although not prohibited, make it very difficult for companies to decide what rate applies to particular goods or services.
41. This will be illustrated by the following two examples:
- When the reduced rate for labour-intensive services was introduced the measures taken to distinguish between repair services (subject to a reduced rate) and the supply of equipment (subject to the standard rate) were sometimes so complex that some service providers have simply ceased applying the reduced rate.¹⁹
 - Reduced rates for food products are applied at different rates in certain Member States. These rules sometimes lead to incredible complexity.²⁰
42. In many cases only an experienced tax expert can determine with any certainty what rate is to be applied by comparing legislation and the exact characteristics of the products in question.
43. Such practices, although not illegal or jeopardising the principle of fiscal neutrality, make the application of VAT extremely complex for companies and unmonitable by the tax authorities.

4.4. The Commission's recommendations

44. It is not the Commission's intention to call into question the optional nature of reduced VAT rates. It notes that there is no obligation on a Member State to apply the same VAT rate to an entire category in Annex H provided this does not create distortion of competition. Consequently as the reduced rate is the exception, the limitation of its application to certain concrete and specific aspects is consistent with the principle under which derogations or derogations must be interpreted restrictively.²¹

Nevertheless, in a desire to help simplify the application of legislation, the Commission recommends that Member States avoid, in defining the scope of reduced rates, from making distinctions which are so complex as to introduce a risk of error where companies have to determine which rate applies to products they

¹⁹ In Belgium replacement of a front bicycle wheel is subject to the standard rate whereas replacement of the back wheel is subject to the reduced rate because the labour component is greater.

²⁰ In France, for example, the reduced rate applying to food products applies to chocolate only under certain very complex conditions. Products containing chocolate are subject to the standard or reduced rate according to their form, presentation or actual composition. Subtle distinctions have also been introduced in Portugal: whereas fresh fish is subject to the reduced rate of 5%, if it is cooked prior to being frozen it becomes subject to the standard rate of 19%; if it forms part of a ready made meal to be taken away or consumed on the spot, it is subject to a rate of 12%.

²¹ See judgment of 8 January 2001, *Commission v. Kingdom of Spain*, C-83/99, ECR 2001 I-00445 and judgment of 8 May 2003, *Commission v. France*, C-384/01, not yet published.

manufacture or sell. Such complexity is harmful to everyone and the principle of uniformity of rates must be respected, with exceptions only where a clear distinction can be made between the goods and/or services subject to a reduced rate (or two different reduced rates) and those subject to the standard rate. This must not of course lead to distortion of competition between the goods and/or services in question.

45. The Commission will of course continue to monitor the measures introduced by Member States in respect of rates as it did in the past (see the cases referred to above).

5. REVIEW AND RATIONALISATION OF RATES: THE PROPOSED STRATEGY

46. In formulating this proposal the Commission has continued along the lines mapped out in its Communication of 2000 defining a strategy to improve the functioning of the VAT system in the single market, an approach confirmed in *Tax policy in the European Union - Priorities for the years ahead*.²²

47. In so doing it is bound by the objective set for it in the Treaty, viz. the harmonisation of VAT to the extent necessary to ensure the establishment and functioning of the internal market.

A first step was taken in 1992 with Directive 92/77/EEC on the approximation of VAT rates. This new proposal is an extension of that approach, building on the degree of approximation achieved to date and improving the present VAT rate structure.

5.1. Objectives and constraints

48. As the Commission already indicated by way of introduction, it **does not intend to change the level of VAT rates** during the period in which the new VAT strategy is to be implemented.

49. Nevertheless, there must be a **review and rationalisation of the structure of VAT rates** in order to strike a difficult balance between - often contradictory - objectives and constraints.

50. The **objectives** are the following:

- Implement the new VAT strategy to **improve** the functioning of the **common VAT system in the internal market**: the objective here is to simplify and modernise current rules and to apply current legislation more uniformly;
- Preserve the **Community acquis** on rates and prevent current differences widening rather than narrowing;
- **Reduce inconsistencies** in the current system, i.e. in the many specific derogations granted to certain Member States.

²² COM(290) FINAL, 23.05.2001. Point 3.1.1. of the Communication deals with VAT.

51. Under the **principle of subsidiarity**, the Commission does not wish to **impinge upon Member States' tax competence beyond what is necessary** to ensure the proper functioning of the internal market, and in particular as regards the setting of the VAT rates that they wish to apply.
52. However, it is clearly part of its job to put proposals to the Council for rules needed to ensure the more efficient functioning of the internal market. The Commission has therefore decided, as a significant step in that direction to focus on the inconsistencies in VAT rates under the current system. The aim is to ensure a more level playing field for all the Member States, including the new ones, and to put an end to distortions arising from the fact that some Member States are allowed to charge reduced rates of VAT in certain sectors while others are not.
53. It is important to bear in mind in this connection that for some goods and services taxed at the place of consumption, differences in national rates are not necessarily incompatible with the internal market. Examples include work on housing or supplies of gas or electricity. Conversely, given the prevalence of distance selling for many types of goods, wide differences in the national rates can cause significant distortions of competition, particularly if the items concerned are easily transportable, like CDs, videos or other goods easy to trade across borders.
- The same is true where the standard rate applies across the board and there is no scope for applying a reduced rate, but where derogations enable just a few Member States to charge VAT at rates well below those in the rest of the Community. Some of the goods concerned are again easily transportable items like children's clothing.
54. It is also important to ensure that reduced rates of VAT are not interfering with other aspects of the internal market. Price comparisons across the Community have shown that consumer prices are not necessarily lower in Member States applying the reduced rates, since companies can tailor their profit strategy depending on the rate at which VAT is charged in each country. This suggests that reduced rates can be a factor in corporate profitability; companies trading in a Member State applying a reduced or zero rate of VAT may be able to take higher profit margins, giving them an advantage over competitors in other Member States.
55. The scope of reduced rates must therefore be carefully defined to ensure that such factors do not disrupt the operation of the internal market.
56. At the moment, however, VAT rates in the Community remain very disparate and highly complex. Annex 1 contains an illustrative list of the rates currently applying to certain categories of goods and services which it proposes should be rationalised.²³

This extreme complexity is largely due to the fact that Member States were concerned to avoid changing their own VAT structures as little as possible at the time Directive 92/77/EEC was adopted. This led to the adoption of Annex H which reflects these different national realities and contains a number of specific derogations which take into account the particular circumstances of certain Member States.

²³ For more details see Commission report of 22 October 2001 (COM(2001) 599 final) and the document on VAT rates in the Member States of the European Community
http://europa.eu.int/comm/taxation_customs/taxation/vatindex_en.htm

57. The basic rules are, however, simple: there is a minimum standard rate of 15% which applies in principle to supplies of goods and services subject to VAT and an option for Member States to apply one or two reduced rates which may not be lower than 5% but only to the goods and services listed in Annex H.
58. However, a large number of derogations which were accorded to some Member States - in some cases to most of them - in the negotiation of Directive 92/77/EEC or in the Acts of Accession, but refused to others have been grafted on to these simple rules. Most of these derogations are intended to ensure that pre-existing situations are maintained: they are confined to Member States which applied derogations, at a specific date, to Community rules on VAT rates and authorise them to maintain, on a transitional basis, these derogations. Their main objective is to ensure the gradual transition towards the application of these VAT rules. They allow either other rates lower than those normally applied (zero, super-reduced or parking rate) or derogations from the scope of Annex H (e.g. reduced rate for restaurants); in some cases these two types of derogations are combined (e.g., a super-reduced rate of 3% is applied to restaurants in Luxembourg).
59. Since maintenance of these derogations had been authorised solely for the transitional period leading up to the introduction of the definitive system of taxing trade between Member States (initially scheduled for 1 January 1996), they were intended to apply for a very short period of time.
60. In view of the lack of progress made in the Council on the proposals presented by the Commission to implement the 1996 programme, the Commission submitted, in 2000, its new VAT strategy to make concrete and essential improvements to the current system in the short term. Since it appears that the current system will continue to apply for some time, it is essential to consider whether these derogations should be maintained.
61. Finally, a thorough review of the current scope of reduced rates and derogations must not fail to take account of the **Lisbon Strategy** which was expanded at Göteborg. The European Councils on 23 and 24 March 2000 and 15 and 16 June 2001 defined a new strategic goal for the Union to promote sustainable development, increase employment, introduce economic reform and social cohesion in a knowledge-based society.
62. This strategy highlights the need to alleviate the tax pressure on labour, and especially on the relatively unskilled and low-paid. However more labour-friendly tax reforms must also ensure healthy public finances. This objective can be attained through strict control of or, where appropriate, reduction in public spending. It would, however, be extremely risky to reduce labour costs (by cutting direct taxation and social security contributions) and extend the scope of reduced VAT rates yet at the same time maintain a balanced budget.
63. It is essential to ensure Member States' budgetary equilibrium and to avoid creating structural budget deficits or drastic reductions in public spending owing to the lack of budget resources to finance it. When VAT rates are reduced, there is no guarantee that the final consumer will benefit from a corresponding reduction in prices. However, when a Member State decides to apply new reduced rates of VAT, it must offset the resulting loss of budget revenue by levying other taxes (e.g. income taxes) which will ultimately be borne by the taxpayer.

64. The greatest caution must therefore be exercised as the priority agreed under the Lisbon strategy was to reduce labour costs, not indirect taxation.

5.2. Broad outline of the proposal

65. In view of all these factors the Commission has decided to pursue a strategy based a balanced approach for the whole of the European Union for the following reasons:

- The Commission is convinced that the **reduction of VAT rates is not the best way of encouraging consumers to buy or use** certain goods or services. VAT, unlike excise duty for example, is not designed to change consumer behaviour. Although its main objective is to generate tax revenue, it is one of several instruments used by Member States in their policies. However, a reduction in VAT rates is never passed on in full in consumer prices. Very often it is negligible and temporary. An economic mechanism based on the premise that a reduction of VAT will lead to a reduction in prices and, consequently, an increase in demand does not function correctly in the vast majority of cases. A simple comparison of prices in the Community demonstrates that reduced VAT rates do not necessarily lead to lower prices. By way of example, Annex 2 contains a table comparing the level of prices of certain products in the Member States and the relevant VAT rates.
- VAT is a **consumption tax** and its main objective is to generate tax revenue: each Member State uses this revenue according to its own priorities. It **should not be used to subsidise** certain particular sectors. At the moment it is clear from many of the requests to apply reduced rates, that one of the main objectives is to help a particular sector because of its social, cultural or other features or the particular problems it is experiencing.
- If reduced rates were extended to new sectors, this would lead to a **lack of harmonisation** in VAT rates. As the reduced rate is optional, Member States are offered a wider range of rates. Yet it is vital to safeguard the degree of harmonisation already achieved through the application of the standard rate in all or most of the Member States.

66. The Commission considers it appropriate to propose the **simplification and rationalisation of rates** to implement the strategy to improve the operation of the VAT system in the internal market.

67. To achieve this objective the Commission has not taken up the approach it set out in its 2001 report, namely to introduce a structure of two reduced rates (possibly with a specific band for each category) applying to separate lists of goods and services.

It had considered this possibility in relation to the experimental application of reduced rates to labour-intensive services. If this experiment had showed that reduced VAT rates are a good way of promoting employment, the review of the scope of reduced rates would have taken this into account to examine whether rates could be used to achieve other objectives, such as those described above and, if necessary, be made mandatory.

However, the evaluation report on this experiment has not demonstrated a direct link between a reduction in VAT rates and an increase in employment or a reduction in

the black economy. A reduction in VAT rates is not therefore expected to have more tangible effects in other sectors.

Consequently, the optional nature of reduced rates must be maintained as this is closely linked to Member States' budget choices and the organisation of their public finances. Member States will therefore continue to be able to apply a reduced rate only to certain categories in Annex H or to certain of the transactions concerned within a category.

68. The Commission has adopted the following guidelines to simplify and rationalise rates.

5.2.1. Rationalisation of Annex H

69. Rationalisation will be undertaken by:

- **not extending the option** to apply **reduced rates to new categories** to which the standard rate already applies in all Member States and which already guarantees a certain degree of harmonisation (band of between 15% and 25%). The intention is not to take a backwards step by extending the scope of optional reduced rates as this would cancel out the harmonisation of rates already achieved through the application of the standard rate.
- **extending the option for Member States to apply reduced rates** only to the categories of goods and services for which **specific derogations** or other provisions already authorise a certain number of Member States to apply reduced rates or exemptions and where this has not been found to hinder the proper functioning of the internal market. This first measure concerns restaurant services, housing and supplies of gas, electricity, and domestic care services. This approach will enable a reduced rate to be applied in more Member States and should encourage more uniform application of reduced rates. However it is not proposed to extend this option to categories of goods or services for which only a minority of Member States have been granted a specific derogation.

5.2.2. Annex H will become the only reference for any derogation from the standard rate

70. The Commission proposes to make Annex H the only and single list of categories of goods and services to which rates other than the standard rate may be applied. These changes will put an end to the current confusion surrounding the scope of reduced VAT rates in the European Union. It proposes to make the following changes:
71. **The parking rate will be abolished.** The parking rate applies to goods and services not included in Annex H to which certain Member States applied reduced, super reduced or zero rates at 1 January 1991.²⁴ These Member States were authorised to apply reduced rates to them. These are therefore measures designed to ensure a gradual transition towards the standard rate and are of two types:
- Member States which, at 1 January 1991, applied a zero rate or super reduced rate in accordance with Community legislation may continue to do so.

²⁴ Derogation negotiated when Directive 92/77/EEC was adopted or under the Acts of Accession.

Nevertheless, if they decide to cease applying such rates to goods and services not listed in Annex H, they may apply a reduced rate of not less than 5% (Article 28(2)(b)).

- Member States which, at 1 January 1991, applied a reduced rate to goods and services not listed in Annex H and which must cease applying this rate, may continue to apply a reduced rate provided this is not less than 12% (Article 28(2)(e)).

It is proposed that these transitional measures be abolished having applied for over 10 years.

72. **Zero and super-reduced rates**²⁵ will be confined to the goods and services listed in Annex H.

Directive 92/77/EEC confirmed that zero and super-reduced rates could be maintained as the *status quo*. These measures had continued to apply since the adoption of the Sixth VAT Directive in 1977. They apply not only to goods and services listed in Annex H but also to products ranging from children's clothing and footwear, residential caravans and boats to motorcycle and bicycle boots and helmets which are subject to the standard rate in Member States other than those to whom a derogation applies.

Certain Member States (those which were required to raise their standard rate by 2% in 1993, i.e. Luxembourg and Spain) are also authorised to apply reduced rates of less than 5% to the products listed in Annex H and to restaurants, housing and children's clothing and footwear.

The Commission considers that it is not appropriate to propose the complete abolition of zero and super-reduced rates under this proposal because this goes beyond the objectives defined by the new VAT strategy adopted in 2000. It is, however, convinced that **the scope of the zero and super-reduced rates should be confined to goods and services listed in Annex H** in order to rationalise and simplify the current structure of rates in the Community.

Consequently, the **zero or super-reduced rates** currently applied by Member States may be **maintained for the goods and services** to which all Member States may apply **reduced rates**. This will mean that Member States will continue to be able to apply rates of less than 5% to food, medicinal products, housing, etc.

However, they will be required to cease applying zero and super-reduced rates to any other goods and services which are not listed in Annex H.

This approach is perfectly in keeping, and is indeed the only that is truly compatible with the policy pursued by the Commission and agreed by the Council during the negotiation of the Accession Treaties of the new member countries. Every derogation granted to them in respect of VAT rates is of strictly limited duration: the last expires on 1 January 2010. Moreover, they related almost exclusively to the goods and services listed in Annex H as amended by this proposal. In the interests of consistency, therefore, this first step towards the rationalisation of the transitional

²⁵ The super-reduced rate is any rate less than 5% but higher than 0%.

derogations already in force in the current Member States has to be taken now. The candidate countries cannot be expected to have made an effort in vain. Moreover, it is clear that, as the derogations granted to them relate to goods and services which will be included in the new Annex H, they may exercise their option, as the current Member States have done, to apply reduced rates in these sectors even after the derogation granted to them has expired.

5.2.3. *Rationalisation of derogations to enable certain Member States to apply lower rates in certain territories*

73. Some Member States have been authorised to apply in certain territories rates lower than those they normally apply in order to take account of their particular geographical situation (insular nature or remoteness). These provisions are only justified if they are strictly limited to the local market. The Commission proposes to rationalise them in order to define a clear legal basis for each of the derogations and to restrict their scope to goods and services consumed in these territories.

6. COMMENTS ON THE ARTICLES

6.1. Article 1(1)

74. Article 1(1) proposes four changes to Article 12:

- The deletion of paragraph 3(b): the reduced rate for natural gas and electricity is currently laid down in Article 12(3)(b), subject to prior authorisation from the Commission. This amendment involves no real substantial change from the current situation. It is merely proposed to incorporate it in a new heading in Annex H. This measure will put an end to the prior authorisation procedure in the interests of simplification and rationalisation as no complaint has been received and there is no evidence to the effect that the reduced rates applied in seven Member States have distorted competition. In addition, the proposed directive on the place of supply of electricity and gas²⁶ will ensure taxation at the place of actual consumption by the customer and thus avoid any distortion of competition between Member States depending on whether they apply a reduced rate or not. The proposed amendment to paragraph 4 also introduces the general provision that, when Member States apply a reduced rate only to certain supplies of goods or services, or certain specific aspects of them, they must comply with the condition that the distinction must not lead to distortion of competition. This general safeguard will accordingly ensure a similar level of security to the current situation. Lastly, this measure is part of a series of measures proposed with the aim of making Annex H the sole reference list for the application of rates other than the standard rate. See also the comments on the new Annex H.
- Two changes are proposed to paragraph 4:
 - firstly, it is proposed to replace the **period of two years** for the review of the scope of reduced rates by a period of **five years**. A review every two years on the basis of a report from the Commission has not in fact been

²⁶

COM(2002) 688 final of 5 December 2002.

necessary: experience has shown that a period of two years is too short for genuine new factors to emerge.

- Secondly, a new second subparagraph is proposed. In accordance with recent case law of the Court of Justice of the European Communities, it is essential to clarify the option for Member States to apply a reduced rate to the whole or part only of a category in Annex H. Implicit in that option, as stated by the Court in its above-mentioned judgment of 8 May 2003, is the option to restrict the application of a reduced rate to concrete and specific aspects of a supply of goods or services, since it is consistent with the principle that derogations or derogations must be interpreted restrictively. Accordingly, a Member State may limit the application of a reduced rate to concrete and specific aspects, such as the standing charge conferring entitlement to a minimum quantity of electricity on the account holders, or exclude the supply of alcoholic beverages from the reduced rate applying to restaurant services. Nevertheless, it is essential to ensure that the application of different rates does not lead to distortion of competition. It is therefore proposed that Member States be obliged to provide the Commission, at its request, with the necessary information to check whether that condition has indeed been met.
- The deletion of paragraph 6, introduced by the Act of Accession of Portugal,²⁷ and its incorporation in the new Article 2(2)(c): on this basis, "*the Portuguese Republic may apply to transactions carried out in the autonomous regions of the Azores and Madeira and to direct imports to those regions, reduced rates in comparison to those applying on the mainland*". It is proposed to rationalise all the specific exemptions granted to certain Member States on geographical grounds by laying down rules common to all of them. For further details, see the comments on the new Article 28(2)(c).

6.2. Article 1(2)

75. Article 1(2) makes two changes to Article 28: it replaces the current paragraph 2 and deletes paragraph 6.

6.2.1. Replacement of Article 28(2)

76. Article 28(2) is restructured so as to incorporate the following amendments.

77. Article 28(2)(a) (zero and super-reduced rates)

The rationalisation of the specific derogations will require the scope of zero and super-reduced rates to be strictly limited to the categories of goods and services listed in Annex H. A new subparagraph to this effect has therefore been added to the former text.

The specific derogation allowing Ireland to apply a lower rate of VAT to the supply of energy products for heating and lighting has also been abolished. This requires some very minor adjustments compared with the current situation. The supply of electricity, gas through the natural gas distribution network and district heating is

²⁷ Act of Accession: insertion of Article 12(6) allowing lower rates for the Azores and Madeira.

being included in the list in Annex H. The supply of any other energy product, however, must be subject to the standard rate of VAT. For further details on the addition of this new category, see the comments on Annex H.

78. **Article 28(2)(b)** (*provisional super-reduced rate*)

The new point (b) is a slightly amended version of the former Article 28(2)(c). This short-term measure, very like the standstill measure allowing zero and super-reduced rates to be maintained, can be also be maintained provided that its scope is limited to the categories listed in Annex H. However, the option to apply that rate to restaurant services, children's clothing, children's footwear and housing has been abolished. Note though that restaurant services and housing will now be included in Annex H. Following the new amendment, consequently, only children's clothing and footwear will no longer be eligible for the super-reduced rate.

79. **Article 28(2)(c) and (d)** (*derogations for certain remote territories*)

Some Member States are currently applying lower rates than normal in certain territories. This covers exemptions already granted to Austria,²⁸ Portugal²⁹ and Greece.³⁰ France, which is currently applying lower rates in Corsica than on the mainland, is added to the list. In the case of France, Greece and Portugal, the derogations were justified on the grounds of the geographical remoteness and insular nature of the regions concerned. In Austria's case, only two communes are concerned, Jungholz and Mittelberg, where the specific derogation is justified on account of their special geographical situation (in a remote mountain area, close to Germany).

It is proposed to group all the above derogations together in the new points (c) and (d) of Article 28(2), standardise them and limit them exclusively to goods and services giving rise to consumption in those territories. The current point (f) is accordingly deleted.

Two different measures are proposed:

Article 28(2)(c): In the case of island regions, it is proposed to authorise the Member States specified to apply (standard and/or reduced) rates up to 30% lower than the corresponding rates applied on the mainland. This 30% limit already exists in the text of the current Article 28(2)(f) in respect of Greece.

Article 28(2)(d): In the case of Jungholz and Mittelberg communes, it is proposed to maintain the authorisation to apply a second standard rate lower than the corresponding rate in other parts of Austria, provided it is no lower than 15%.

In both cases, the lower rates thus applied must be strictly limited to goods and services giving rise to consumption in those territories. Recent experience has shown that the current derogations can give rise to abuse: for example, there have been cases of businesses in the e-commerce and telecommunications sectors moving to the

²⁸ Act of Accession, Article 12(3)(a): for Jungholz and Mittelberg (Kleines Walsertal), possibility of applying a second standard rate.

²⁹ Act of Accession: insertion of Article 12(6) allowing lower rates for the Azores and Madeira.

³⁰ Article 28(2)(f) relating to certain Greek islands, negotiated in Directive 92/77/EEC.

Azores and Madeira in order to apply the lower rates applicable there to services they supply to final consumers throughout the Community. Steps must be taken to put a swift end to such practices as they are a misuse of the derogations which were granted solely to allow the Member States concerned to take account of the remoteness and special geographical situation of those regions.

80. New Article 28(2)(e)

This point, which concerns the rate applicable to contract work, reproduces the former Article 28(2)(h) unchanged.

81. Deletion of the following provisions:

- Former *points* (b) and (e) of Article 28(2). These two measures allowed Member States to continue applying reduced rates to goods and services not covered by Annex H. Their deletion makes Annex H the sole reference list defining the scope of reduced rates and other derogations from the standard rate.
- Point (g), requiring a review of the derogations provided for in Article 28(2)(a) to (f) by 31 December 1994, on the basis of a report by the Commission, is now obsolete.
- Former points (i), (j) and (k) of Article 28(2): these specific derogations relate to the categories of goods and services which have been added to Annex H and are therefore obsolete.

6.2.2. Deletion of Article 28(6)

82. This was considered a temporary measure from the outset: the experimental nature of the introduction of reduced rates for labour-intensive services required a definitive decision to be taken following the evaluation of the results of the experiment: they would either be added to Annex H or deleted. The Commission's evaluation report of 2 June 2003 (COM(2003) 309), based partly on reports produced by the Member States who took part in the experiment, concludes that in the context of the experiment concerning labour-intensive services, and taking account of the limitation in the analytical methodology used, it is not possible to find clear evidence of any favourable impact on employment or reduction of the black economy following the reduction in the rate of VAT. The Commission accordingly proposes not to adopt this criterion for the revision of Annex H and to concentrate instead on improving the functioning of the internal market.

The Commission has in the past expressed misgivings about the use of reduced VAT rates as an instrument of job creation. In its communication to the Council entitled *Job creation: Possibility of a reduced VAT rate on labour-intensive services for an experimental period and on an optional basis*³¹ it pointed out that an initiative of this kind could jeopardise both tax neutrality and the proper functioning of the Single Market, while it was far from certain that any job-creating effects, e.g. the cut in rates being passed on in lower prices to the consumer, would actually materialise. It repeated this view in the proposal to authorise the experimental reduction in VAT

³¹ Communication SEC(97) 2089 final of 12 November 1997.

rates on labour-intensive services, and a number of Member States shared its misgivings. In the face of the unemployment situation, however, it agreed with the Council that those Member States who so desired should be allowed to try out the effect of a targeted VAT reduction for labour-intensive services.

Unfortunately, no clear benefit has emerged from the reduction in the rate of VAT. This is closely linked to the difficulty in finding reliable data in this regard. Nevertheless, macro-economic simulations have shown that a reduction in labour costs would create 52% more jobs at the same cost to the budget. The Commission therefore prefers not to continue with this approach.

This does not, however, mean that the standard rate of VAT need necessarily be reintroduced for all the services involved in the experiment; some of them - the renovation and repair of private dwellings, and window cleaning and cleaning in private housing - will be permanently incorporated into Annex H, as the new Category 10. This is part of the process of rationalising the specific derogations currently available to some Member States.

The Commission is conscious of the need to permit Member States to take whatever measures are possible to support families and elderly, sick and mentally handicapped persons and therefore proposes to integrate the domestic care services currently in Annex K into Annex H.

6.3. Article 1(3) and (4)

83. Article 1(3) and (4) replace the current Annex H and delete Annex K. The changes to Annex H are explained in detail below.

84. Annex K has to be deleted as a result of the deletion of Article 28(6).

6.4. New Annex H

85. Annex H has been rewritten in the interests of rationalisation and simplification. It now becomes the sole point of reference for defining the scope of reduced, super-reduced and zero rates. The amendments made are as follows:

- rationalisation of its structure;
- rationalisation of certain categories through the necessary corrections and clarifications;
- addition of three new categories.

86. The introductory sentence has also been reorganised so as to deliberately draw the attention of Member States to the possibility of using the COICOP codes, a classification system for goods and services developed for statistical purposes at international level. The use of these codes to precisely define the categories in Annex H is highly recommended in order to improve the functioning of the internal market. The current reference to the Combined Nomenclature only actually relates to goods.

6.4.1. *Rationalisation of the structure of Annex H*

87. **The current structure has been slightly modified** in order to group together categories of goods and services of a similar nature. Former categories 12 and 13 (admission to sporting events and use of sporting facilities) have been merged and put with similar categories (culture, leisure activities and sport). Following the same line of thinking, the new headings have been put inside the current list and not just tagged on the end.

6.4.2. *Changes to existing categories*

88. Category 4: **equipment for the disabled** The 2001 report noted that many requests related to category 4 of Annex H, which covers only medical equipment, aids and other appliances normally intended to alleviate or treat disability. In particular, there were queries about whether the category could also apply to chronic illness. There seems to be no need for any change in the definition; the concept of disability is broad enough to encompass serious or chronic illness as well. On the other hand, equipment or apparatus specially designed or adapted for the disabled (e.g., Braille keyboards, specially adapted cars, etc.) were clearly not eligible for the reduced rate even though they logically belonged to the existing category. The Commission therefore proposes including them in category 4.

89. Category 10: **housing**

This **amendment** is **essential** and consists of a major extension of Member States' option to apply reduced rates in the housing sector. It simplifies and rationalises the current, extremely complex situation.

In the 2001 report, the Commission stated (point 48) that the VAT treatment of building services is a textbook example of the complexity of the rules on reduced rates. In principle, under the first subparagraph of Article 12(3)(a) of the Sixth Directive, the standard rate applies to supplies of goods and services connected with buildings. However, the legal basis for applying reduced rates provides for three types of arrangement:

- The third subparagraph allows Member States wishing to do so to apply a reduced rate to transactions covered by category 9 of Annex H, namely the *supply, construction, renovation and alteration of housing provided as part of a social policy*. This limitation has proved particularly difficult to put into effect and has given rise to wide divergences in practice between Member States, given that the concept itself of a social policy on housing is not defined at Community level and is therefore Member State responsibility. Moreover, the distinction between renovation and alteration, on the one hand, and repair (not currently specified) is far from clear.

- Article 28(2) allows, for the duration of a transitional period and subject to certain conditions, certain Member States to apply to housing - not otherwise defined - either a reduced rate lower than the minimum fixed by the third subparagraph of Article 12(3)(a), one of the two reduced rates laid down in that Article or a reduced rate not lower than 12%.

- Article 28(6) (introduced by the Directive on labour-intensive services) provides for the application of a reduced rate for a period of three years. That rate is not, however,

confined to social housing, applying instead to the "renovation and repair of private dwellings, excluding materials which form a significant part of the value of the supply".

Housing is currently subject to the reduced rate in ten Member States, while the restriction to social housing is applied in a variety of ways or not at all, by virtue of any specific derogation. The problem with these specific derogations is that they are reserved for the Member States which negotiated them, and prohibited to others. Moreover, without a Community definition of social policy on housing, the restriction makes no sense and is totally ineffective.

In order to rationalise this complex and chaotic situation and improve the functioning of the internal market, it is proposed to:

- delete the words "provided as part of a social policy";
- add repair, maintenance and cleaning of housing;
- add rental of housing insofar as that service is not exempt under Article 13. Member States may allow taxable persons a right to opt for taxation in cases of letting and leasing of immovable property: insofar as the taxation concerns housing, it seems appropriate to give the Member State concerned the right to apply the reduced rate. In this connection, Austria has negotiated and obtained the option to apply a reduced rate to the leasing and letting of residential property: with a view to rationalising the transitional derogations, that option should be extended to all Member States.

The above amendments ensure that the scope of reduced rates is substantially rationalised and that it embraces categories 2 and 3 of Annex K (renovation and repair of private dwellings, and window cleaning and cleaning in private households). In accordance with the principle of subsidiarity, it will always be the Member States' responsibility to define the scope of reduced rates: they will always be able therefore to apply the reduced rate only to some of the transactions referred to in Annex H.

These changes are unlikely to create distortion of competition to the detriment of the smooth functioning of the internal market: the place of taxation of services relating to immovable property is, in fact, always at the place where the property is located. All providers of property-related services are therefore subject to the same conditions as regards rates regardless of the Member State in which they are established.

90. Category 19: **street cleaning, waste treatment, etc.**

The scope of this category is too narrowly defined with the result that services of a very similar nature are treated very differently as regards rates. For instance, whereas street cleaning and household refuse collection are eligible for the reduced rate, there is no reference to sewer services. Likewise, the reduced rate may apply to waste treatment, but not to recycling. It is proposed to remove these inconsistencies.

6.4.3. Addition of new categories

91. **The option to apply reduced rates is extended** to categories of goods and services to which some Member States are already authorised to apply reduced rates under

specific derogations and there has been no detriment to the smooth functioning of the internal market.

The following categories are added accordingly.

92. Category 12: live plants, including bulbs, roots and the like, cut flowers and ornamental foliage, and wood for use as firewood

The addition of this category introduces no substantive change to the current structure of the reduced rates. Article 28(2)(i) already allows all Member States to apply a reduced rate to the above products. This provision was added in 1996 by Directive 96/42/EC as a transitional measure, on the grounds that the best solution was to extend the option to all Member States, provisionally, to apply a reduced rate to supplies of such products. The reduced rate concerned is currently applied by eleven Member States (in various measures). This provision should therefore cease to be transitional and the category permanently incorporated into Annex H. This measure rationalises and simplifies the current structure of the rates.

93. Category 14: **restaurant services**

Eight Member States (Spain, Greece, Ireland, Italy, Luxembourg, Netherlands, Austria and Portugal) are already authorised to apply a reduced rate. The other seven Member States, however, are not authorised to introduce this reduced rate.

During the accession negotiations, four of the candidate countries were also given permission to maintain a reduced rate for restaurant services until 31 December 2007: Cyprus, Hungary, Poland and Slovenia.

The Commission is aware of the restaurant sector problem. There have been several calls to apply the reduced rate for labour-intensive services to this sector. However, it was not selected by the Council for this experiment. Nevertheless, the current situation must be rationalised as the grounds for it no longer pertain.

It is therefore proposed to include restaurant services in Annex H. Restaurant services cover not only traditional restaurants, but also catering services or related services, to provide prepared meals or the services for their distribution, under a fixed-term contract between a catering firm and a principal (companies, public authorities, hospitals, etc.).

The nature of the services concerned and the rules applicable to the place of taxation mean that the risk of relocation is minimal. Moreover, accommodation in hotels and similar establishments is already included in Annex H. The addition of restaurant services can therefore be considered to be genuine rationalisation. Its inclusion should allow the reduced rate to be applied to restaurant services in more Member States and may be a step in the direction of more uniform application of reduced rates.

94. Category 18: domestic care services

It is proposed that domestic care services which currently feature in paragraph 4 of Annex K be included in Annex H. This means that a reduced rate could be applied to, for example, home help and the care of the young, the elderly, the sick and the disabled. In this way, the application of a reduced rate of VAT could be an essential

supplement to other actions already taken at national level to support families, and to tackle, for example, the problems related to an ageing population. Taking into account the very local nature of these services, the extension of the application of the reduced rate will not create difficulties for the proper functioning of the internal market. In addition, some of these services, where they are provided by charitable organisations can benefit either from an exemption in accordance with Article 13(A)(1)(g) or a reduced rate in accordance with the current category 14. At the moment, most Member States exempt or apply the reduced rate to some of these services.

95. Category 20: the supply of electricity, gas and heating supplies

Article 12(3)(b) of the Sixth VAT Directive already provides for the application of a reduced rate to supplies of natural gas and electricity. However, this is currently subject to prior authorisation by the Commission to ensure that there is no likelihood of distortion of competition.

Ireland is also authorised, pursuant to the third subparagraph of Article 28(2)(a), to apply a reduced rate to certain energy products used for heating and lighting.

Seven Member States are currently applying a reduced rate to supplies of natural gas and/or electricity and there have been no reports of distortion of competition in relation to the other Member States applying the standard rate. Moreover, the taxation rules included in the proposed directive on the rules governing the place of supply of gas and electricity will avoid any risk in future.

Inclusion in Annex H will therefore simplify the procedure and rationalise the current rules.

District heating is added because it shares the same features and meets the same requirements as the supply of electricity and of gas through the natural gas network. The ban on applying a reduced rate to district heating appears to have led to unequal tax treatment by comparison with gas and electricity. Yet all three forms of energy supply operate via a network in a very similar manner. As such networks are essentially local by nature, the risk of distortion of competition between Member States can be considered minimal, if not non-existent.

6.4.4. Reception of radio and television broadcasting services and the cultural sector

96. Article 13(A)(1)(q) currently exempts activities of public radio and television bodies other than those of a commercial nature. That exemption is not changed by this proposed Directive.

97. On the basis of the current category 7 of Annex H, the reduced rate is currently applied (under various measures) by six Member States: Belgium, Greece, France, Italy, Austria and Finland (on licence fees only).

Maintaining the reduced rate for radio and television broadcasting services while it is not authorised for services supplied by electronic means has been very carefully examined by the Commission as it is likely to result in a problem of distortion of competition, in view of the prospect of increasing distribution of TV/radio programmes via the Internet and, vice versa, of Internet services via television. If the option to apply a reduced rate is maintained, this may lead to different rates of

taxation within the same country of the same service according to its mode of transmission and cause substantial differences in taxation between Member States. Distortion might occur in particular in rapid growth sectors with fierce price competition. In the case of high-speed Internet access, for example, there is strong competition between ADSL via the telephone or cable television networks. These services are, by their very nature, very liable to create cross-border distortion of competition because they can be provided from anywhere in the world or in the EU.

The standard rate is already widely applied to the reception of radio and television broadcasting services (ten Member States) and is mandatory for telecommunication services and services provided by electronic means. When adopting the e-Commerce Directive, the Council was already quite clear in its message: there can be no reduced rate for services provided by electronic means. The Commission has accordingly examined whether it would be preferable to adopt the same approach on the reception of radio and television broadcasting services, thus ensuring equality of treatment between the audiovisual, information technology and telecommunications sectors.

However, since the markets in question are emerging markets and it has not yet been possible to identify actual problems of distortion of competition, the Commission is not at this stage proposing to abolish the reduced rate for the reception of radio and television broadcasting services. It will nevertheless monitor this sector very closely and, if necessary, put forward appropriate proposals.

In addition, the question of possible distortions of competition within the overall cultural sector, in particular between the different cultural media, will be examined in detail, since complaints have been voiced concerning apparent unequal treatment within the sector.

In any case, these sectors will be re-examined in depth when the next report is presented in 2008 reviewing the scope of reduced rates.

6.4.5 Other ongoing changes: reduced rate for certain postal services

98. In its proposal for a Directive amending Directive 77/388/EEC as regards value added tax on services provided in the postal sector,³² the Commission proposed to insert in Annex H “*Standard postal services relating to any addressed envelopes or packages, of ordinary correspondence, direct mail, books, catalogues and newspapers, where that item individually weighs no more than 2 Kg, that being a fixed ceiling for the purposes of exercising this option*”.

The Commission considered that, even if at a purely technical level, the best and simplest solution would be to tax all postal services at a uniform rate, it was important to allow the Member States to apply a reduced rate in order to minimise the effect of an increase in prices for the final consumer as a result of the abolition of the current exemption.

It should be underlined here that the main aim of the proposal in question is, first of all, to abolish the exemption currently enjoyed by public postal services. The future application of a reduced rate is only a consequence of abolishing the exemption.

³² COM(2003) 234 final of 5 May 2003.

The above proposal is currently before the Council and the reduced rate in question will be incorporated in Annex H as soon as the other proposal is adopted. There is no need, however, to propose any amendment in the context of the present proposal. It would indeed be legally incorrect to include a reduced rate of VAT for these services in this proposal before the decision to abolish the current exemption for postal services has been adopted by the Council.

7. CONCLUSION

99. The proposed revision represents an important step in the improvement of the common VAT system with a view to improving the functioning of the internal market. It will greatly simplify VAT rates for the whole of the Union, yet safeguard the competence of Member States to decide the VAT rates applicable to their territories. The Commission is proposing neither to change the level of VAT rates nor to abolish the optional nature of reduced rates.
100. This step is a long way from fully achieving the harmonisation of rates started in 1992 with a view to the completion of the internal market: other steps must follow in due course.
101. An initial review will at any rate take place as part of the revision of the VAT arrangements applicable to public authority activities, associated with the revision of the system of derogations for certain activities in the public interest provided for in Article 13 of the Sixth Directive.
102. A number of the existing categories in Annex H already concern goods and services provided by public bodies or for which an derogation is allowed: VAT applies only where such bodies are privatised or such services are provided by undertakings which do not meet the conditions for exclusion from the scope of VAT or derogation. Provision is made for some reduced rates in this context.
103. This review is planned for 2004 to allow an impact assessment, designed to analyse the economic, environmental and social impacts of a proposal, to be carried out. The issue of the applicable rates of VAT must of necessity be taken into account in this context.

ANNEX 1

List of rates currently applied to certain categories of goods and services which should be rationalised

GOODS AND SERVICES	B	DK	D	EL	E	F	IRL	I	L	NL	A	PT	FIN	S	UK
Medical equipment for the disabled	6 21	25	7	8	7	5.5	0	4 20	3	19	20	5	22 [ex]	25 [ex]	0 5
Real estate sector:															
Social housing (category 9 /Annex H)	12	25	7 16	8	4 7	5.5 19.6	13.5	4 10	3 15	19	20	[ex] 5	22	25 [ex]	17.5 5 0
Renovation and repair (category 2 /Annex K)	6 ³³ 21	25	16	18	7 ³⁴	5.5 ³⁵ 19.6	13.5 ³⁶	10 20	3 15	6 ³⁷ 19	20	5 19	22	25	17.5 5 ³⁸

³³ Renovation and repair of private dwellings over five years old.

³⁴ Building work to repair private dwellings.

³⁵ Renovation and repair of private dwellings completed over two years ago.

³⁶ Parking rate.

³⁷ Painting and plastering to renovate or repair private dwellings over 15 years old.

³⁸ Solely for the Isle of Man.

GOODS AND SERVICES	B	DK	D	EL	E	F	IRL	I	L	NL	A	PT	FIN	S	UK
Building land	[ex]	[ex]	[ex]	[ex]	16	19.6	[ex]	20	[ex]	19	[ex]	[ex]	[ex]	[ex]	[ex]
Supply of new buildings	21	[ex]	[ex]	18	7	19.6	13.5 ³⁹	10	15	19	[ex]	[ex]	[ex]	[ex]	17.5
					16			20							17.5
Construction of new buildings	21	25	16	18	4	19.6	13.5 ⁴⁰	10	3	19	20	5	22	25	17.5
					7				15			19			0
Treatment of waste and effluent	21	25	[-]	8	7	5.5	[-]	10	3	19	10	19	22	25	17.5
			16			19.6	13.5	20				5			0
Cut flowers and plants:															
Ornamental	6	25	7	8	7	5.5	13.5	10	6	6	10	12	22	25	17.5
										19					

³⁹ Parking rate.

⁴⁰ Parking rate.

GOODS AND SERVICES	B	DK	D	EL	E	F	IRL	I	L	NL	A	PT	FIN	S	UK
Food production	6	25	7	4 8	7	5.5	0	10	3	6	10	5	17	25	0
Hotels	6/[ex]	25	16	8	7	5.5	13.5	10	3	6	10	5	8	12	17.5
Restaurants	21	25	16	8 18	7	19.6	13.5	10	3	6	10 20	12	22	25	17.5
Water	6	25	7	8	7	5.5	[ex]	10	3	6	10	5	22	25	0 17.5
Gas	21	25	16	8	16	19.6/ 5.5	13.5 ⁴¹	10	6	19	20	5	22	25	5
Electricity	21	25	16	8	16	19.6/ 5.5	13.5 ⁴²	10	6	19	20	5	22	25	5
Wood for use as firewood	6	25	7	8	16	5.5	13.5 ⁴³	10	12	19	10	19	22	25	17.5
Wood for industrial use	21	25	7	18	16	19.6	21	20	15	19	10 20	19	22	25	17.5

⁴¹ Parking rate.

⁴² Parking rate.

⁴³ Parking rate.

GOODS AND SERVICES	B	DK	D	EL	E	F	IRL	I	L	NL	A	PT	FIN	S	UK
Telecommunication services:															
-Telephone/fax/telex/etc.	21	25	[ex]	18	16	19.6	21	20	15	19	20	19	22	25	17.5
Pay TV/	12	25	16	8	16	5.5	21	10	15	19	10	19	22	25	17.5
Cable TV networks	21														
Licence fees	[-]	25	[ex]	[ex]		2.1	[ex]	4	[ex]	[ex]	10		8	[ex]	[ex]
Clothing: Adults'	21	25	16	18	16	19.6	21	20	12	19	20	19	22	25	17.5
									15						
Children's	21	25	16	18	16	19.6	0	20	3	19	20	19	22	25	0
Footwear: Adults'	21	25	16	18	16	19.6	21	20	15	19	20	19	22	25	17.5
Children's	21	25	16	18	16	19.6	0	20	3	19	20	19	22	25	0

ANNEX 2
Comparison of prices and VAT rates for certain sectors – 1999

The following table shows the European Union average (100) in the Member States corrected for purchasing power parities

	B	DK	D	EL	E	F	IRL	I	L	NL	A	PT	FIN	S	UK
CATEGORY															
Clothing															
prices	147	102	92	101	87	103	72	120	120	76	133	71	97	125	89
rates	21%	25%	16%	18%	16%	20.6%	21%	20%	15%	17.5%	20%	17%	22%	25%	17.5%
Children's clothing															
prices	117	92	118	125	103	104	61	92	119	98	103	88	95	103	99
rates	21%	25%	16%	18%	16%	19.6%	0%	20%	3%	19%	20%	17%	22%	25%	0%
Children's footwear															
Prices	128	119	111	85	77	101	92	81	126	105	109	67	110	98	116
rates	21%	25%	16%	18%	16%	19.6%	0%	20%	3%	19%	20%	17%	22%	25%	0%
Pre-recorded media (disks, CDs, audio cassettes, video cassettes, etc.)															

Prices	87	121	82	87	95	110	100	106	85	111	89	88	130	107	116
rates	21%	25%	16%	18%	16%	20.6%	21%	20%	15%	17.5%	20%	17%	22%	25%	17.5%
Hairdressing															
Prices	90	127	101	84	103	95	81	91	124	96	124	62	119	108	120
rates	21%	25%	16%	18%	7%	19.6%	12.5%	20%	6%	6%	20%	17%	22%	25%	17.5%

Source: Eurostat - EU level=100, 1999 data

Prices include VAT

Proposal for a

COUNCIL DIRECTIVE

amending Directive 77/388/EEC as regards reduced rates of value added tax

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 93 thereof,

Having regard to the proposal from the Commission,⁴⁴

Having regard to the opinion of the European Parliament,⁴⁵

Having regard to the opinion of the Economic and Social Committee,⁴⁶

Whereas:

- (1) Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of valued added tax: uniform basis of assessment⁴⁷ authorises Member States to apply one or two reduced rates which may not be lower than 5% and are applicable only to a restrictive list of supplies of goods and services.
- (2) It also stipulates that the Council should review the scope of reduced rates, on the basis of a report from the Commission, every two years with effect from 1994.
- (3) In a communication in 2000,⁴⁸ the Commission set out a strategy designed to improve the way the VAT system works under the internal market. It proposed a viable strategy geared to four main objectives: the simplification and modernisation of existing rules, more uniform application of current rules and a new system of administrative cooperation.
- (4) The Commission has accordingly proposed a phased action plan designed to bring about, in the short term, the required practical improvements in the current system. This will involve a review and a rationalisation of the rules and derogations applicable to the reduced rates of VAT.

⁴⁴ OJ C [...], [...], p. [...].

⁴⁵ OJ C [...], [...], p. [...].

⁴⁶ OJ C [...], [...], p. [...].

⁴⁷ OJ L 145, 13.6.1977, p. 1. Directive last amended by Directive 2002/93/EC (OJ L 331, 7.12.2002, p. 27).

⁴⁸ COM(2000) 348 final of 7 June 2000.

- (5) In any case, all modifications should be consistent with the Community's long term objective of moving to a definitive VAT system, based on the principle of taxation in the country of origin; this implies that there should be a continuation of the approach towards approximation of VAT rates.
- (6) The latest Commission report of 22 October 2001⁴⁹ concluded that the scope of reduced rates needed to be reviewed following the evaluation of the experiment involving the application of reduced rates of VAT to labour-intensive services.
- (7) The Commission's evaluation report of 2 June 2003,⁵⁰ which is based on the reports produced by the Member States which took part in the experiment on reduced rates for labour-intensive services, concludes that, as a result of the experiment, it is not possible to clearly identify any favourable impact on employment or a reduction in the black economy.
- (8) In view of the inconclusive results of the experiment to apply reduced rates in labour-intensive services and the need to improve the functioning of the internal market, the current structure of the reduced rates of VAT needs to be reviewed.
- (9) The review must go beyond a revision of the scope of the rates, the inclusion of new categories or the clarification of existing categories, and be extended to the various specific derogations applicable to them, with a view to their simplification and rationalisation. It must also include appropriate measures to enable a definitive decision to be taken on the VAT rate for labour-intensive services.
- (10) In the interests of legal certainty, it must first be specified that Member States have the option to apply a reduced rate to only a part of a category of supplies of goods or services listed in Annex H, provided that the application of that reduced rate does not give rise to distortion of competition and that the Commission has the necessary information at its disposal to check that no such distortion exists.
- (11) The period of two years for the review of the scope of reduced rates should also be replaced by a period of five years. Experience has shown that a period of two years is too short for genuine new factors to emerge.
- (12) Member States should be afforded equal opportunity to apply reduced rates in certain areas and to rationalise the numerous derogations currently applying to rates so as to avoid potential distortion of competition.
- (13) The list of supplies of goods and services qualifying for reduced rates of VAT must therefore be revised so as to incorporate categories of goods and services to which some Member States apply a reduced rate under specific derogations without any discernible detriment to the smooth functioning of the internal market.
- (14) The derogations applying to rates must also be revised to maintain only those relating to goods and services eligible for reduced rates so as to produce a single reference list for the application of rates other than the standard rate. This represents a substantial simplification and rationalisation of the structure of VAT rates designed to improve the functioning of the internal market.

⁴⁹ COM(2001) 599 final of 22 October 2001.

⁵⁰ COM(2003) 309 final of 2 June 2003.

- (15) The derogations granted to take account of the geographical situation of certain regions must be standardised and strictly limited to the goods and services giving rise to consumption in those territories.
- (16) Directive 77/388/EEC should be amended accordingly,

HAS ADOPTED THIS DIRECTIVE:

Article 1

Directive 77/388/EEC is hereby amended as follows:

- (1) Article 12 is amended as follows:

- (a) Paragraph 3(b) is deleted.
- (b) Paragraph 4 is replaced by the following:

"Each reduced rate shall be so fixed that the amount of value added tax resulting from the application thereof shall be such as in the normal way to permit the deduction therefrom of the whole of the value added tax deductible under the provisions of Article 17.

Member States may apply a reduced rate within a given category of Annex H only to certain supplies of goods or services or only to certain specific aspects of a single supply of goods or services provided that the application of different rates does not cause distortion of competition.

The Member States must send the necessary information to the Commission, on its request, to check that this condition has been met.

On the basis of a report from the Commission, the Council shall, with effect from 2004, review the scope of the reduced rates every five years. The Council, acting unanimously on a proposal from the Commission, may amend the list in Annex H."

- (c) Paragraph 6 is deleted.
- (2) Article 28 is amended as follows:
- (a) Paragraph 2 is replaced by the following:

"2. Notwithstanding Article 12(3), points (a) to (e) shall apply during the transitional period referred to in Article 28I.

(a) Derogations with refund of the tax paid at the preceding stage and reduced rates lower than the minimum rate laid down in Article 12(3) in respect of the reduced rates, which were in force on 1 January 2003 and which are in accordance with Community law, and satisfy the conditions stated in the last indent of Article 17 of the second Council Directive of 11 April 1967, may be maintained.

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.

Member States shall adopt the measures necessary to ensure the determination of own resources relating to these transactions.

(b) Member States which, under the terms of Article 12(3), were obliged to increase their standard rate as applied at 1 January 1991 by more than 2%, may apply a reduced rate lower than the minimum laid down in Article 12(3) in respect of the reduced rate for supplies of categories of goods and services specified in Annex H.

Member States may not introduce derogations with refund of the tax at the preceding stage on the basis of the first subparagraph.

(c) The following Member States may apply VAT rates up to 30% lower than the corresponding rates applied on the mainland to supplies of goods and services in certain remote island regions which give rise to consumption in those territories and to goods directly imported into those regions:

(i) France: Corsica;

(ii) Greece: the departments of Lesbos, Chios, Samos, the Dodecanese and the Cyclades, and on the following islands in the Aegean: Thasos, Northern Sporades, Samothrace and Skiros;

(iii) Portugal: the autonomous regions of the Azores and Madeira.

(d) Austria may apply to supplies of goods and services in the communes of Jungholz and Mittelberg which give rise to consumption in those territories a second standard rate which is lower than the corresponding rate applied in the rest of Austria but is not less than 15%.

(e) Member States which, on 1 January 1993, were availing themselves of the option provided for in Article 5(5)(a) as in force on that date, may apply to supplies under a contract to make up work the rate applicable to the goods after making up.

For the purposes of applying the first subparagraph, supplies under a contract to make up work shall be deemed to be delivery by a contractor to his customer of movable property made or assembled by the contractor from materials or objects entrusted to him by the customer for this purpose, whether or not the contractor has provided any part of the materials used."

(b) Paragraph 6 is deleted.

3) Annex H is replaced by the text in the Annex to this Directive.

4) Annex K is deleted.

Article 2

Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive not later than 31 December 2003. They shall forthwith communicate to the Commission the text of those provisions and a correlation table between those provisions and this Directive.

When Member States adopt these measures, they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods of making such reference shall be laid down by the Member States.

Article 3

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 4

This Directive is addressed to the Member States.

Done at Brussels, [...]

For the Council
The President

ANNEX H

LIST OF SUPPLIES OF GOODS AND SERVICES TO WHICH REDUCED VAT RATES MAY BE APPLIED

When they transpose the following categories into their national legislation Member States may use the COICOP classification codes or, in the case of goods, the Combined Nomenclature in order to accurately define the category in question.

Category	Description
1	The supply of foodstuffs (including beverages, but excluding alcoholic beverages) for human and animal consumption; live animals, seeds, plants and ingredients normally intended for use in the preparation of foodstuffs; products normally intended to be used to supplement or replace foodstuffs
2	The supply of water
3	The supply of pharmaceutical products of a kind normally used for health care, prevention of diseases and treatment for medical and veterinary purposes, including products used for contraception and sanitary protection
4	The supply of medical equipment, aids and other appliances normally intended to alleviate or treat disability, for the exclusive personal use of the disabled, and apparatus and electrical, electronic or other equipment and means of transport, designed or specially adapted for the disabled Repair of such goods. Child car seats
5	Transport of passengers and their accompanying luggage
6	The supply, including on loan by libraries, books (including brochures, leaflets and similar printed matter, children's picture, drawing or colouring books, music printed or in manuscript form, maps and hydrographic or similar charts), newspapers and periodicals, other than material wholly or substantially devoted to advertising matter
7	Admission to shows, theatres, circuses, fairs, amusement parks, concerts, museums, zoos, cinemas, exhibitions and similar cultural events and facilities Reception of radio and television broadcasting services
8	The supply of services by or royalties due to writers, composers and performing artists
9	Admission to sporting events and use of sporting facilities
10	The supply, construction, renovation, alteration, repair, maintenance and cleaning of housing. The rental of housing insofar as this service is not exempted under Article 13

11	The supply of goods and services of a kind normally intended for use in agricultural production but excluding capital goods such as machinery or buildings
12	The supply of plants' bulbs, roots and the like, cut flowers and ornamental foliage and the supply of wood for use as firewood
13	Accommodation provided by hotels and similar establishments including the provision of holiday accommodation, letting of caravan sites and caravan parks
14	Restaurant services
15	The supply of goods and services by organisations recognised as charities by Member States and engaged in welfare or social security work, insofar as these supplies are not exempt under Article 13
16	The supply of services by undertakers and cremation services, together with the supply of goods related thereto
17	The provision of medical and dental care and thermal treatment insofar as these services are not exempt under Article 13
18	Domestic care services (e.g. home help and care of the young, elderly, sick or disabled).
19	The supply of services in connection with sewage, street cleaning, refuse collection and waste treatment or waste recycling other than the supply of such services by bodies referred to in Article 4(5).
20	The supply of electricity, gas through the natural gas distribution network and district heating

IMPACT ASSESSMENT FORM

IMPACT OF THE PROPOSAL ON BUSINESS WITH SPECIAL REFERENCE TO SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs)

TITLE OF PROPOSAL

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

DOCUMENT REFERENCE NUMBER

THE PROPOSAL

1. Taking account of the principle of subsidiarity, why is Community legislation necessary in this area and what are its main aims?

The VAT rules governing reduced rates need to be amended to improve the functioning of the internal market. In its 2000 communication (COM (2000) 348 final), the Commission set out a strategy to improve the operation of the VAT system in the internal market. It proposed a phased action programme to achieve concrete and essential improvements to the current system in the short term. It indicated that the rules and derogations applying to reduced VAT rates would have to be reviewed and rationalised. VAT rates in the Community are extremely disparate. However, the basic rules are simple: a mandatory minimum standard rate of 15% and the option for Member States to apply one or two reduced rates of not less than 5% but solely to the goods and services listed in Annex H. A number of derogations granted to some Member States - in some cases to most of them - in the negotiation of previous Directives or the Acts of Accession but refused to others have been grafted on to these simple rules.

The Commission's proposal is to simplify and rationalise the rates. It proposes that Annex H be rationalised to include all the categories of goods and services that qualify for reduced rates and that the specific derogations allowing a rate other than the standard rate for other categories of goods and services be abolished. This will improve the functioning of the internal market and preserve the Community acquis already achieved.

THE IMPACT ON BUSINESS

2. Who will be affected by the proposal?
 - Which sectors of business? All sectors which may be concerned: i.e. those where the reduced rates can be applied and those where they cannot because they are excluded.
 - Which size of business (what is the concentration of small and medium-sized firms? All.

- Are there particular geographical areas of the Community where these businesses are found? NO
3. What will business have to do to comply with the proposal? Nothing in particular. Businesses must comply with national legislation introduced by their Member State to amend, where appropriate, the applicable VAT rates in order to transpose the Directive.
 4. What economic effects is the proposal likely to have:
 - on employment?

The evaluation report on the experimental application of reduced rates for labour-intensive services concluded that it was impossible to identify with any certainty any beneficial impact on employment or a reduction in the black economy as a result of reducing VAT rates under this experiment. This proposal is therefore unlikely to have an economic effect on employment.

- on investment and the creation of new businesses?

VAT can be deducted by business and any change in rates is unlikely to have an impact on the creation of new businesses.

- on the competitiveness of businesses?

The proposed review of the scope of reduced rates is unlikely to have a direct impact on the competitiveness of businesses. VAT is a tax on final consumption. Nevertheless, it may reduce the costs in correctly applying different rates of VAT through the simplification of rates it proposes.

- On consumers?

Annex H has been amended to include some new categories on a permanent basis; the impact on consumers will depend on whether individual Member States decide to exercise their freedom to apply a reduced rate, and ultimately on how firms pass on that reduction to their customers. The results of the experiment involving labour-intensive services suggest that in most cases the cuts were neither wholly - nor, in particular , permanently - passed on to consumers.

The **proposal to abolish zero, super-reduced and parking rates** for goods not listed in Annex H affects only a small number of sectors and Member States. We can assume that the effect on prices as a whole will be slight and often negligible, and in any case only temporary. A comparison of current prices suggests that there should be enough margin for manoeuvre to absorb the increase in VAT without a concomitant increase in prices. The removal of the exemption for tax-free shops is instructive: on 1 July 1999 tax relief on intra-Community sales was replaced by taxation at the standard rate, but consumer prices remained the same. The industry was able to absorb the introduction of the tax, in other words, without loss of viability.

5. Does the proposal contain measures to take account of the specific situation of small and medium-sized firms (reduced for different requirements, etc.)?

NO

CONSULTATION

6. Many economic sectors have notified the Commission that they would like to be added to the list of supplies of goods and services which qualify for reduced VAT rates. The report of 22 October 2001 on reduced VAT rates (COM (2001) 599 final) contains a list of the sectors in question. All these applications argue that a reduced rate is justified in a particular sector in view of its culture, social or environmental importance or the particular problems it faces.

IMPACT ON MEMBER STATES

The proposed amendments will not have any impact on own resources.

7. Impact of amending Annex H on the Member States

The proposal does not call into question the optional nature of reduced VAT rates. No Member State will suffer any budgetary loss as a result of the proposal: any reduction in the rates applying following the addition of new categories will continue to be their sole responsibility. If the rate of VAT applying to a service or goods is reduced, the economic impact will be a loss of revenue for a Member State. There will be no inflationary impact.

If a reduction in VAT rates is reflected in prices, they may fall. In practice the experiment involving labour-intensive services has shown that a reduction in VAT rates is never reflected fully or permanently in prices. Demand is therefore unlikely to change significantly.

8. Economic effects of abolishing the zero, super-reduced and parking rates for goods not listed in Annex H of the Sixth VAT Directive

This measure concerns only a small number of Member States.

An increase in VAT rates will put direct upward pressure on prices. VAT is paid by the consumer and any increase in VAT is likely to be passed on, at least in part, in prices. The impact on demand will depend on the magnitude of price elasticity and degree to which this increase in VAT is passed on to prices. The impact on demand will be neutral (not passed on to prices and/or very low price elasticity) or negative and demand will fall (increase in prices with high price elasticity).

Generally speaking, the proposal to abolish the zero, super reduced and parking rates for goods not listed in Annex H of the Sixth VAT Directive will have a fairly low (overall) and, often negligible, impact on the general level of prices. This effect will only be temporary. In the case of certain Member States the level of current prices for the goods concerned compared to those in other Member States shows that there is some capacity for absorbing for this increase in VAT without causing prices to rise. Consequently, the proposal is unlikely to have an inflationary impact and, if it did, it would be low and be only of a temporary nature.