



COMMISSION OF THE EUROPEAN COMMUNITIES

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**REPORT FROM THE COMMISSION
TO THE COUNCIL AND TO THE EUROPEAN
PARLIAMENT**

**in accordance with Article 12(4) of
the Sixth Council Directive of 17 May 1977
on the harmonisation of the laws of the Member States
relating to turn-over taxes - Common system of
value added tax: uniform basis of assessment**

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1 INTRODUCTION

This document constitutes the report the Commission is required to submit to the Council according to Article 12 (4) of the sixth VAT Directive in order to review the scope of the reduced VAT rates. This review, as in all matters of VAT rate harmonisation, is based on the criterion set out in Article 99 of the EC-Treaty which specifies that harmonisation is necessary to ensure the establishment and the functioning of the Single Market. Thus, the report has as its objectives the following:

- To review the state of play in the area of VAT rate harmonisation and to report major actions and events since the last report COM(94) 584 [chapter 2].
- To assess the influence of the VAT rate structure on the functioning of the Single Market. The report seeks, therefore, to establish whether VAT-induced distortions of competition or deflections of trade between Member States have arisen. In particular to examine whether or not VAT rate differentials hamper cross-frontier purchases or influence retailer's supply patterns [chapter 3].
- To examine the scope of the reduced rate and the coverage of supplies of goods and services laid down in Annex H to the sixth VAT directive. According to Article 12 (4) of the Directive the Council is to review Annex H every two years to see whether changes to its scope are desirable. Hence, all complaints and representations made to the Commission relating to the scope of the reduced VAT rate are considered in this context. Particular attention is also given to Article 12 (3) (b) on the taxation of certain energy supplies [chapter 4].
- To reflect on the way forward in harmonising the scope of the reduced VAT rates. Future harmonisation cannot be based only on the discussions and requests of the day. It is therefore necessary to undertake a broader analysis of the current situation in Member States. Such analysis allows for an assessment of the state of play in the light of the proposed new common system of VAT [chapter 5].
- To summarise the main findings of the report and to draw conclusions with a view to possible legislative action by the Commission regarding Article 12 (4) [chapter 6].

It is important to note that this report does not cover the harmonisation of excise duties. Moreover, the report does not deal in detail with all rate-related issues that are intrinsically linked to the realisation of the programme for a common system of VAT for the Single Market [COM(96) 328 final] which explicitly calls for a higher degree of convergence of VAT rates. It does not, in particular, anticipate the Commission's legislative proposals to this end.

Finally it should be noted that this report does not review the transitional VAT rate provisions. According to Article 28 (2) (g) of the Directive the Commission was required to re-examine the provisions of Article 28 (2) (a) to 28 (2) (f) before 31 December 1994. In this context reference is made to the report COM(94) 584. It is self-evident, however, that by limiting this report to the requirements of the 6th Directive the Commission does not automatically approve continuation of these arrangements; the Commission will address these provisions in its proposals on the programme for a common system of VAT for the Single Market.

2 HARMONISATION OF VAT RATES: THE STATE OF PLAY 1996

Under the current Community VAT legislation Member States may apply either one or two reduced VAT rates which may not be less than 5% and that they shall only apply to supplies of the categories of goods and services specified in Annex H (Article 12 (3) (a))¹. Moreover Member States may apply a reduced rate to supplies of natural gas and electricity provided that no risk of distortion of competition exists (Article 12 (3) (b)). These provisions are subject to a detailed examination in chapter 4.

The rules concerning the rates applied to works of art, antiques and collector's items are determined in a separate Directive² amending the sixth VAT Directive. The taxation of agricultural outputs other than those falling within category 1 of Annex H (mainly cut flowers, ornamental foliage, bulbs, roots and the like, firewood) was settled in 1996 by the Council in the framework of the transitional arrangements of the sixth VAT Directive³. As far as the regime and the rates applied to gold are concerned a proposal from the Commission is pending in the Council⁴.

Article 28 (2) sets out various VAT rate measures which Member States are permitted to maintain in force during the transitional period referred to in Article 28 1. As stated above, the Commission will tackle these arrangements in the context of the new common system of VAT for the Single Market.

¹ Directive 96/95/EC of 20 December 1996 amending, with regard to the level of the standard rate of value added tax, Directive 77/388/EEC on the common system of value added tax. OJ No. L 338 of 28 December 1996, p. 89.

² Directive 94/5/EC of 14 February 1994 supplementing the common system of value added tax and amending Directive 77/388/EEC. OJ No. L 60 of 3 March 1994, p. 16.

³ Directive 96/42/EC of 25 June 1996 supplementing the common system of value added tax and amending Directive 77/388/EEC. OJ No. L 170 of 9 July 1996, p. 34.

⁴ COM(92) 441 final.

Under the transitional arrangements of 28 (2) (a) to 28 (2) (f), some Member States are allowed to apply to a limited number of goods and services exemptions with refund of the tax paid at the preceding stage (so-called zero-rates) or reduced rates lower than the minimum laid down in Article 12 (3) (so-called super-reduced rates). Some Member States were also allowed to keep a reduced rate not lower than 12% applicable to supplies of goods and services other than those specified in Annex H provided these rates were in force on 1 January 1991 (so-called parking rates). Those Member States which applied a reduced rate to restaurant services, children's footwear and clothing and housing on 1 January 1991 were permitted to continue to apply these rates for the transitional period of the present VAT arrangements. Finally Greece was allowed to continue to apply specially reduced rates to certain Islands and Departments. Being part of the transitional VAT arrangements these provisions are not examined in detail.

A detailed table describing the development of VAT rates in Member States (except the ones from Article 28 (2)) since the end of 1994, the date of the last Commission report on the subject, is set out in Annex 1. It will be seen that the levels of rates still vary significantly: standard rates between 15% and 25%, reduced rates between 5% and 17%⁵. The simple average of the standard rates applied across the Community is around 19.5% while the average reduced rate is slightly above 8%. In comparison to the 1994 figures this is a significant increase of average VAT rates which is mainly due to the enlargement of the Community to 15 Member States and the on average higher rates of the three new Member States.

The weighted average rate for the Community as a whole shows a similar trend; Commission estimates stemming from Member States' Own Resources Statements and statistics on VAT receipts reveal the following picture:

Weighted average rate	1994	1995 EU 12	1995 EU 15
All rates	14.03%	14.25%	14.61%
Standard rate	17.07%	17.28%	17.62%
Reduced rate ⁶	5.71%	6.17%	6.57%

⁵ The rate of 17% is applicable in Finland to a limited number of foodstuffs. It is applicable on a transitional basis only (until 1998); anyhow it constitutes a third reduced rate in this country. The Commission has officially addressed the Finnish authorities to reduce the number of reduced rates to two. Apart from that, the highest reduced rate in the Community amounts to 12.5%.

⁶ In this context all kinds of reduced rates are included: zero-rates, so-called super-reduced rates, parking rates, permanent reduced rates.

The Commission takes it for granted that the existing degree of harmonisation of VAT rates is the very minimum which has been considered by Member States as essential for the Single Market to function. It is obvious that widening discrepancies between the VAT rates of various Member States can, in principle, always give rise to structural imbalance and distortions of competition in certain sectors of economic activity. The Commission is determined to deal with such problems when tabling new proposals on VAT rate harmonisation. The first proposal in this area is scheduled for late 1997 or the beginning of 1998.

In this context it is once again it should be noted that the following is only to examine the present functioning of the Single Market within the structure of reduced VAT rates in force.

3 VAT RATES AND THE FUNCTIONING OF THE SINGLE MARKET

In examining the effects of the present VAT rate disparities on the functioning of the Single Market, the Commission has tried to assess (i) whether differences in VAT rates as between Member States influence behaviour of private persons and businesses (taxable persons) and (ii) whether reported cases of such influence are inherent in the present VAT rate structure.

3.1 The influence of VAT rates on cross-border purchasing and supply patterns: general trends

In the aforementioned 1994 report the influence of VAT rates both on cross-border purchasing patterns by private customers and on intra-Community trade by taxable persons were carefully investigated. In order to do so a number of studies had been commissioned the results of which revealed that, generally speaking and subject to a number of specific exceptions, unexpected VAT-induced distortions of competition or deflections of trade had not taken place. The reasons for this result are basically twofold. Firstly, non-tax factors very often seem to outweigh a possible VAT-induced incentive for cross-border shopping. Secondly, the transitional system seeks to ensure, by applying the destination principle in trade between taxable persons and by using a number of special taxation regimes (e.g. distance selling scheme), that VAT rate disparities are not really exploitable.

VAT is levied in the Member State of origin on supplies made by taxable persons in one Member State to particular types of purchasers in other Member States i.e flat rate farmers, exempted small businesses, taxable persons carrying out transactions which are exempt according to Article 13 of the sixth VAT Directive, non-taxable persons purchasing goods under an annual threshold of 10,000 ECU. The same is true for supplies of goods to travellers carried away by themselves⁷, supplies under the distance selling arrangement below a ceiling fixed by the Member State of supply and supplies of certain services. The supply of exciseable goods is evidently largely influenced by the way the excise duties are levied and by the level of rates applied.

To the best of its knowledge the Commission, is not aware of any significant or widespread distortions of competition or deflections of trade caused by these arrangements. One major case which has again come to the Commission's attention has already been assessed in the 1994 report: This involves German farmers, subject to flat rate VAT schemes, who purchase fertilisers and pesticides etc., which in Germany are subject to the standard rate, directly from neighbouring Member States where such products are taxed at reduced rates. Similarly, French customers tend to buy their domestic fuel such as coal in Belgium where the applicable rate is significantly lower. Other cases of VAT induced deflections involving sales of beverages like soft drinks and mineral water from France to Belgium or from France to Britain do not generally have a major impact. The sum of such minor cases may, however, be worth considering. Moreover there is always the possibility of a significant regional impact which may need to be assessed. In any case it is important to note that where different (reduced) rates are applied in different Member States or where there is a reduced VAT rate in some Member States but not in others, this will have a negative effect on the sales of those businesses which do not benefit from a reduced rate or which are competing with similar businesses in another Member State where a lower rate is applied.

The supply of telecommunication services across borders is an example of an area where providers have the opportunity to choose in which countries to be established (i.e. for the place of taxation) to benefit from low rates and/or advantageous arrangements with respect to the deduction of input tax. This incentive will be reinforced under the new taxation schemes recently introduced by Member States consequent upon the legislative initiatives by the Commission in this area⁸.

⁷ Except new means of transport.

⁸ COM(97) 4 final; see also Council decisions 97/200-214/EC, OJ No L 86 of 28 March 1997, p. 5.

It goes without saying that VAT rate differentials are more important in certain industries than in others. In the horticultural and floricultural sectors, for instance, big rate differences have clearly given rise to fraudulent activities. Moreover the Commission is aware of cases in which the application of the flat-rate-scheme to intra-Community trade in this sector creates distortion between competing traders.

It will be seen from the table set out in Annex 1 that VAT rates in Member states did not change enormously from 1994 to 1996 which is why it appears to be likely that the 1996 situation in this respect will be comparable to 1994. It has to be stressed, however, that the conclusions drawn in 1994 depended on the special conditions of the transitional system referred to above. Thus, it is self-evident that the changeover to the new common system of VAT for the Single Market will create a completely new situation which will have to be taken into account in the making of proposals for that system. Moreover, non-tax factors which influence the behaviour of businesses and private persons are continuously changing.

In order to assess the effect of the latter aspect, the Commission subsidised a study by an outside consultant on this question⁹. The study focused on border regions which have been identified as "sensitive" in previous studies, namely border regions between Germany and Denmark, the Netherlands, Belgium, Luxembourg, France and Austria. The focus of the study was on the determinants of consumer decisions, general trends in cross-border-shopping as well as incentives for and strategies of the retail sector. The investigation was carried out by means of an exhaustive written survey and expert interviews. The scope of the study included VAT and excise duties; distance sales (mail order) were also separately analysed.

Basically, the study confirms the results of previous studies which were included in the 1994 report. However, some particular results warrant special mention. The main findings of the study can be summarised as follows:

- Retailers in regions of relatively intense cross-border shopping actually tailor their advertising, and the varieties goods stocked, and also adapt their systems to accept foreign currencies etc. to accommodate shoppers from the neighbouring states. There are clear examples where such active cross-border operations have lead to the mobilisation of EU customers.
- Price differentials attributable to different tax rates is not the only factor affecting the volume of cross border shopping between neighbouring Member States Product variety, attractive shopping atmosphere, favourable customer services complement the price advantage. Language barriers are much less important than might have been expected.

⁹ "Retail strategies to benefit from indirect tax differences" (Jürgen Ratzinger, Ifo Institute for Economic Research) - March 1996

- For the future an ongoing integration process is expected, leading to growing competition, to the further approximation of price levels and a possible changes in purchasing patterns.
- Cross border distance sales contribute significantly to the turnover of German retailers. Around 5% of consumption demand is supplied by mail order sellers and approximately 3% of the mail turnover of German companies is carried out with EU-consumers in neighbouring countries.
- At the various borders, in general, the volume of cross-border shopping has not change significantly since 1993. Two particular cases are noteworthy, however: (i) In the German border region near Luxembourg customers from beyond the border play an extremely important role which has even grown during the past years. (ii) The German-Austrian border region turned out to have been traditionally highly integrated, prior to accession. In fact, Bavaria and North-Italy absorb a significant share of the Austrian purchasing power (e.g. around 5% of the *Länder* Kärnten, Tirol, Salzburg and Oberösterreich, without accounting for tobacco, petrol and vehicles. This represents an increase of cross-border shopping from 1994 to 1995 of around 23%).

These conclusions - which are not particularly surprising - reveal two basic general trends regarding the influence of VAT rates on cross-border purchasing and supply patterns. Firstly, notwithstanding the existing rate differentials, the degree of integration of markets is still increasing and retailers are continuing to improve their strategies. Although, the Single Market does not work perfectly in economic terms its functioning is, nevertheless, steadily improving. Secondly, it is obvious that where conditions for cross-border shopping are favourable (no language barriers, common traditions etc.) VAT-induced deflections of trade do take place and they might be viewed as distortions of competition. Thus the study clearly confirms the numerous complaints of Austrian operators about VAT induced deflections of trade towards Germany (e.g. for electric appliances). With the exception of some limited areas it is unfortunately impossible to reliably estimate the magnitude of cross-border shopping flows broken down by product.

In consequence both the assessment of general trends regarding cross-border transactions and the particular results of the study provide insufficient evidence to justify major changes of the current VAT rate system. However, this assessment relates to the present situation only and is based on the assumption that the current taxation arrangements are applied and that operators' and customers' behaviour does not change significantly.

At the same time, it is clear that the present taxation system as such - being based on a broad application of the destination principle and a number of special regimes - obstructs full exploitation of the Single Market. The current complicated and uneven rate structure is a consequence of Member States insistence on retaining, for domestic political and economic reasons, their existing diversity of rates. The predicted ongoing integration of markets will increase competition, lead to further approximation of price levels and, at the end of the day, provide for the adjustment of purchasing patterns. It is probable that these trends will be considerably boosted by the advent of the Single Currency and by the increasing use of electronic commerce. It is therefore likely that the restrictive effects of the current VAT rate structure will become even more aggravating in the future. Even under the current transitional arrangements further VAT rate harmonisation will probably prove to be necessary as industries (products and services) become more and more competitive in cross-border trade.

3.2 The influence of VAT rates on cross-border purchasing and supply patterns: analysis of specific cases

The Commission regularly receives reports on and complaints about specific cases where VAT rate discrepancies are said to be the reason for significant distortions between operators. Clearly in this report it is not possible to deal with the details of all the various cases which have been referred to the Commission (many of which are confidential or are subject to data protection). Where appropriate, the Commission has in specific cases contacted the responsible national authorities in order to obtain more information and explanation.

However, two intrinsic problems resulting from the present VAT rate structure can be identified as the basic cause of certain distortive effects on the competitive situation of taxable persons (which, in turn, prevents final consumers from benefiting from the Single Market to its full extent): (i) the optional character of Annex H and (ii) the lack of common definitions within the categories listed in Annex H.

For the time being, the application of either one or two reduced rates to supplies of the categories of goods and services specified in Annex H is an option for Member States. They may or may not apply a reduced VAT rate to the various items. A table showing to what extent Member States have used their option to apply a reduced rate to the 17 different categories of Annex H is set out in Annex 2 to this report. It is self-evident that the unequal VAT treatment of identical goods and services throughout the Community is likely to create a situation in which there is distortion of competition.

It is certainly true that the categories of services in Annex H by their very nature are not the kinds of economic activities which lend themselves to significant cross-border applications. Also the goods referred to in Annex H are not of the types which private persons would usually travel significant distances to purchase. In the Commission's opinion, however, this assessment does not necessarily give the complete picture of the situation in 1996. Before examining each of the categories (see chapter 4) it is worth giving some thought to the following: VAT rate discrepancies within Annex H vary at least 20%-points (between 5% and 25%), taking into account super-reduced rates and zero-rates this divergence widens to 25%-points. Thus the potential substantial savings involved create an incentive to purchase goods and, to a minor extent, services abroad even when considerable inconveniences are to be faced. In the medical sector, for instance, there are opportunities for businesses and operators to exploit differences in international prices where such price differences have been influenced by VAT rates.

Moreover, Member States tend to select goods and services from within a category of Annex H rather than including the whole of the category in their reduced rate. In a number of cases such distinctions are even made when the combined tariff nomenclature is used to establish the precise coverage of a given category. The Commission is aware of a number of cases where Member States make distinctions within a determined category of Annex H which appear to be arbitrary.

One could argue that although such unequal treatment of basically identical goods or services is difficult to understand there is no resultant intra-Community distortion between national and foreign suppliers because the treatment applies equally to both of them. In practice, however, the responsible tax authorities become aware of such distinctions only when additional declaration obligations are fulfilled (e.g. intra-Community acquisition). Thus it may happen that national producers always benefit from the reduced rate, regardless of the very character of the goods produced or services rendered, whereas their foreign counterparts suffer the correct standard rate of VAT.

Also, the Commission often receives complaints about distortions of competition within a Member State that stem from an uneven transposition of Annex H categories. Such distortions are equal for all Community operators and citizens which is why they do not fall into the Commission's responsibility under single market competition rules but their existence is certainly worth reporting. It should be noted that according to basic principles of the sixth VAT directive identical goods and services cannot be taxed at different rates; if there is a rate difference it has to be justified by an objective difference. The Commission has already insisted on this fundamental principle in other areas and in one case this has reached the stage of an infringement procedure.

The lack of clear common definitions of Annex H's categories also leads to an impressive number of "border-line" cases. Many Member States do, for instance, apply a reduced VAT rate to tea and coffee and the standard rate to soft drinks. It is legitimate question to ask however, whether ice-tea in cans is to be viewed as tea or as a soft drink and this is equally the case for number of ready to drink coffee products. When two products which are liable to different VAT rates are sold together and cannot be separated, again the question is which rate to apply. Similarly, there are no conclusive criteria for establishing, for example, whether the CD or the book is more important when both are sold together as one item constituting a dictionary. All this reveals the basic problems of the current VAT rate structure which both run contrary to basic principles of VAT and almost certainly create distortions of competition.

Unfortunately, the Commission is not in a position to determine the exact quantitative effect of distortions arising from the above basic problems. It is true that at the time of the adoption of the Rates Directive 92/77/EEC the Council was aware of the fact that minor distortive effects might result from the way Annex H was designed. However, the present situation does not - as outlined above - call for urgent action, all the more so as the whole matter of rates harmonisation will in any case be tackled in the context of the new common system of VAT for the Single Market. The growing number of problematic cases, however, leads the Commission to think that a close monitoring of the situation is absolutely necessary and that separate future initiatives in this area might prove to be inevitable. Member States are explicitly requested to try to overcome the above-mentioned difficulties.

4 REVIEW OF THE SCOPE OF THE REDUCED VAT RATE

4.1 Criteria for reviewing the scope of the reduced VAT rate

The legal basis for this report, Article 12 (4) second paragraph of the sixth VAT Directive, reads as follows:

"On the basis from a 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."

As seen above, in the context of the transitional VAT arrangements the present interrelation between the structure of VAT rates and the overall functioning of the Single Market (in terms of cross-border transactions) does not call for a systematic change of VAT rates. Specific complaints, however, do reveal problems with some aspects of the present situation.

This chapter is to examine the various categories of Annex H, the requests to enlarge Annex H and the special case of certain energy supplies (Article 12 (3) (b)) in detail. In this context, the Commission has received numerous representations from various trade and industry federations pleading for the inclusion of their sectors in the scope of the reduced rate on the occasion of the next review.

As stated above, the basic criterion for reviewing the scope of the reduced VAT rate and for examining Annex H and Article 12(3)(b) is the one set out in Article 99 of the EC-Treaty which refers to harmonisation of legislation to the extent that such harmonisation is necessary and specifies that harmonisation is necessary to ensure the establishment and the functioning of the Single Market. Thus the focus of the analysis is on whether any change to the present provisions is required to overcome problems of distortions of competition.

It follows that any assessment of the merits of applying a reduced VAT rate to a particular sector, good or service, can only be made in the light of this overall guideline of the Treaty in the area of indirect taxation. In other words: even if there are no clear distortions of competition ascertained in a specific case, all pros and cons of reducing VAT have to be evaluated in the light of their overall effect on the functioning of the Single Market. As far as VAT is concerned the Council has made it absolutely clear that the completion of the Single Market requires the switch to a VAT system based on the taxation in the Member State of origin of supplies of goods and services (Article 28 I of the sixth Directive). Hence any reflection on the scope of the reduced VAT rate cannot neglect the possible impact on the aforementioned programme for a common system of VAT for the Single Market.

The background of Annex H and the historical context of the appropriate Council decisions are not explained in this report as this was detailed in the last report.

4.2 Reviewing the various categories of Annex H

As outlined above, the optional character of Annex H and the relatively wide definition of its categories creates basic technical problems which need to be closely monitored and analysed. For a number of categories, however, the Commission has been addressed by various interest groups with a view to including certain goods or services in the scope of a reduced VAT rate. The major cases of this kind are dealt with in this chapter and the general discussion on certain categories is described. The following sectors are the most important ones: agriculture, health, passenger transport, culture, social policy.

Agriculture

The agricultural outputs in question are those which are not included in Annex H, (category 1) namely cut flowers, ornamental foliage, bulbs, roots and the like and firewood. In the Council discussion on the relevant Commission proposal¹⁰ it appeared that Member States have diverse opinions on which VAT rate should in principle apply to agricultural outputs. Some Member States want to extend the scope of the reduced VAT rate to all agricultural outputs, whereas others would prefer to retain the existing list.

There is intense cross-border shopping in the category of foodstuffs. Such shopping has always been a feature of intra-Community trade in this sector but according to the evidence from all the studies of which the Commission is aware, it is not primarily influenced by VAT rate differences. Very often purchases of foodstuff are made from neighbouring Member States although the rates applicable are higher. At present a targeted modification of Annex H in this area is not considered appropriate.

Health

The reduced VAT applicable to pharmaceutical products (category 3) or medical equipment (category 4) illustrates the above-mentioned problem of vague definitions very well. What is "normally used for health care", what is "normally intended to alleviate or treat disability"? In a number of Member States these questions currently cause disputes between the responsible authorities, and the businesses involved as to whether or not their sectors or products are within Annex H; This is hardly surprising in view of the unclear wording of the provision;

Passenger transport

The taxation of passenger transport (category 5) is a very complicated and special matter. Member States currently tax "transport" in very different ways and they apply VAT rates which vary from zero (exemption with refund of input tax) to 25%. In doing so, most Member States make distinctions between various means of transport, between domestic transport and intra-Community or international transport etc. The Commission is mindful that the current situation creates a number of practical problems for the businesses involved and that there are major distortions of competition. The Commission is moreover aware of the fact that the transport sector is a special one which possibly requires a special VAT treatment.

¹⁰ See footnote 3.

A study has therefore been commissioned with the following objectives. To assess the effects of using different techniques for applying VAT to passenger transport services. To investigate whether competitive imbalances exist between different modes of transport on similar routes (especially: high-speed rail transport vs. air transport). To predict the influence on price (absolute and relative) of a modification to the current territoriality regulation, depending on all possible taxation methods (taxation at the place of departure, of arrival, of establishment or where the buyer is taxed?), To investigate problems involving tax deduction in the place in which the transport service buyer is established.

Culture

The most widely discussed category of Annex H is that containing books, newspapers and periodicals (category 6). However often this discussion is widened to include the taxation of cultural events in general (category 7). In this context, there are essentially two lines of reasoning pleading for widening the scope of the reduced VAT rate:

Firstly, the record and video industry demands that CDs, records, cassettes and videos should be eligible for a reduced VAT rate. It is claimed that CDs etc. are discriminated against in comparison with other cultural media such as books, newspapers, museums, cinema, theatre etc. Moreover, it is maintained that in the medium term, a reduction in VAT would be compensated for by an increase in revenue as overall sales of CDs etc. would increase thanks to the reduced level of taxation.

Furthermore, some Member States, especially France, table essentially the same request, in a broader context. It is argued that the character of compact disks, records, cassettes, videos etc. as means of communication and the spread of cultural values is comparable to that of books and that historic reasons for favouring books to records etc. are no longer valid in the "information society". A reduced VAT rate would boost the demand for records etc. and thus encourage the production of art, music etc in Europe. The potential educational benefits are also stressed.

For the time being, the Commission is not entirely convinced by that reasoning. Most Member States consider the majority of sales in this sector to be leisure or entertainment purposes, rather than being cultural in nature. In practice such distinctions are difficult to make. The same could be said of books. Historically, however, books were first on the scene, and acquired a privileged status which has not been extended to newer media of transmission. Obviously, books are still widely seen as the priority means of cultural communication. Arguments along these lines are however somewhat futile since any criteria for judging what is "leisure" or "culture" are largely subjective.

The major difference between books and CDs etc. is that books can be read immediately while CDs etc. always require further technical equipment to give access to the information. If a reduced rate is to be considered the question arises as to whether the equipment should also be included. Other problems concern support for information like video-cassettes, fees to be paid for accession to information on networks like INTERNET and so on. Any extension of the reduced rate would therefore require the development of a new philosophy for its justification and it is likely that the cultural and educational consideration alone will not provide a practical criterion.

Secondly, the publishing industry and editor federations advocate an extension of the current option, to tax books at a reduced VAT rate, to corresponding modern products like CDs which contain information that is usually (and was formerly) published in books only. The Commission considers such substitution to be extremely difficult if not impossible to define. Even a CD-ROM, the content of which is identical to a book, is a different product. CDs require the use of further equipment which offers facilities to access the information (indexing, subject searching etc.) superior to those available to the user of a normal book. Moreover, no CD-ROM is really only limited to the contents of a book of the same title; it is easily possible and certainly convenient to add further background information (photographs, pictures, music etc.).

Applying essentially the same reasoning, a similar move is being made in France to reduce the VAT rate on CD-ROMs, on-line-services, software "multi-média" etc. from 20,6% to 5,5%. Such questions will in any case have to be assessed in the broader context of the impact of technological change on taxation systems (e.g. electronic commerce etc.).

Social Policy

Regarding the supply, construction, renovation and alteration of housing provided as part of social policy (category 9) it seems that some Member State tend to include all kinds of services in the construction sector in this item. The Commission is currently examining the appropriate legislation. It is important to note that the lack of common definitions does not allow for an extensive application of the category; in this particular case it is strictly limited to *social* housing and that lack of common definitions should not be used to justify more extensive application of this reduced VAT rate.

Conclusion

In conclusion, all requests for widening the scope of the existing Annex H' categories raise a number of specific technical problems which should not be underestimated. An overall evaluation in the light of the criteria set out above reveals the serious fundamental issues raised by such requests. To start with, the revenue effect of widening the scope of the reduced VAT rates would be in all cases substantial. Probably compensatory measures would be needed, the introduction of which would be unpopular and, what is more, counter-productive.

From a theoretical standpoint, it has to be underlined that VAT is a neutral multi-stage broad-based consumer tax which is as such not best suited as a means of selectively targeting social, cultural, etc., activities for favourable treatment. In economic terms it is a fact that other means (such as direct subsidies or reductions in direct taxation¹¹) are much more effective and efficient and do not cause so many undesirable side-effects. This is, of course, also true for the existing reduced VAT rates in Annex H for goods and services. The question is, however, whether the Commission should propose any alterations to Annex H. The answer is that so far there is little evidence of a compelling need to enlarge the scope of the existing categories.

4.3 Reviewing requests to introduce specific new categories to Annex H

Discussions with Member States and industries

Industries and/or other representative organisations of various kinds, from a number of Member States, campaign for enlargement of the scope of Annex H. The most important issue in this context is the request to apply the reduced VAT rate to so-called labour-intensive and environmentally friendly services. This request originated from a particular Dutch problem in relation to the taxation of the repair of footwear and clothing. After 1 January 1993 the Netherlands had to tax these services at the standard rate which created an internal political problem in the Netherlands. At the time, no immediate solution was found and so the Netherlands insisted on a declaration in the Council Minutes regarding a re-examination of Annex H in this respect at a later date.

There is also pressure for the application of a reduced VAT rate to supplies of environmentally-friendly and energy-saving goods and services. In fact a number of Member States do apply a reduced VAT rate to supplies of (presumably polluting) energy whereas energy saving material is taxed at the standard rate. Not surprisingly there is a strong lobby for equalising the tax treatment of both. Similarly, France put forward the idea of applying a reduced VAT rate to electric vehicles and vehicles using gas engines.

¹¹ In any case, direct subsidies and reductions in direct taxation do generally constitute State aid within the meaning of Article 92(1) EC-Treaty and need to be examined by the Commission in accordance with the procedure set out under Article 93 EC Treaty.

The case in favour of applying a reduced VAT rate to labour-intensive goods and services in general (and not just clothing and shoe repairs) has been taken up by a number of associations, including UEAPME¹² - the organisation representing small and medium-sized enterprises in the Community. They argue that the application of a reduced VAT rate would help reduce the level of unemployment in Europe by providing a stimulus to sectors which employ labour-intensive production methods or services. The other argument used by the sector concerned to support a low VAT rate is essentially a black economy argument. It is argued that the VAT mechanism does not function particularly well in sectors which have few deductible VAT inputs and where most of the customers are private individuals without a right of deduction. Applying a high VAT rate to such sectors tends to encourage recourse to non-declaration with a consequent loss of direct tax revenue (income or corporation tax) and of social security payments. Exactly the same effect is said to increase do-it-yourself activities by households.

Other organisations develop a similar line of reasoning which is limited, however, to a given sector. For example, a number of organisations working for the preservation of the cultural, architectural and natural heritage of Europe advocate a reduced VAT rate for the repairs and maintenance of historic houses, gardens, vernacular buildings etc. It is maintained that not only the social and cultural importance of buildings and landscapes justify such a measure but that there is a strong economic rationale for reducing the appropriate VAT rate. Firstly, the reduced VAT rate would give a significant incentive to renovate and to repair historic buildings etc. and thus increase the appropriate demand for (mostly relatively low-skilled) services. Secondly, it is argued that the nature of the countryside or the cultural landscape are decisive for attracting tourists of all kind. Travel and tourism being the world's largest industry, the indirect impact of a reduced VAT rate on the repairs and maintenance of the man-made and cultural heritage would, therefore, be far-reaching and wide-spread throughout the business community of a local economy. Not surprisingly, there are also efforts being made for attributing a reduced VAT rate to the whole tourism business.

Similar arguments stressing the positive effect both on employment and environment are put forward in other sectors¹³ or for differently defined services¹⁴. Due to their very nature such services are said not to be subject to cross-border competition. It is, therefore, argued that this fact would be sufficient to justify their insertion into Annex H - which would enable Member States to apply a reduced VAT rate or not.

¹² Union européenne de l'artisanat et des petites et moyennes entreprises - Europäische Union des Handwerks und der Klein- und Mittelbetriebe - European Association of Craft, Small and Medium Sized Enterprises

¹³ It is virtually impossible to establish an exhaustive list of the sectors concerned which range from the biking industry to removal services or textile care and dry-cleaning.

¹⁴ E.g. so-called "*services de proximité*" in France: labour-intensive services, typically carried out by self-employed or family businesses and usually taking place at the customer's home (tuition, nursing, home industry etc.).

The idea of using VAT rates as a policy tool for attaining specific economic objectives such as higher employment or improved protection of environment to a certain extent finds favour with the European Parliament and the Economic and Social Committee¹⁵.

In some cases, the option to tax certain supplies at the reduced VAT rate is seen as a remedy to a specific problem. For instance, exempted bodies like charities often suffer from irrevocable input VAT which means that taxation at a reduced VAT rate would be much more beneficial for them. In the Commission's opinion such cases have to be separated from those mentioned so far. In fact, the Commission is mindful of the problems of the current taxation system including those relating to exemptions and the right of deduction. These are issues which will be addressed in the proposals for the new common system of VAT. In any event introducing specific new categories to Annex H would run contrary to the basic goal of simplifying the VAT system and reducing compliance costs. On this behalf reference is made to the ongoing SLIM initiative which is also important for VAT.

The Commission has however serious doubts on the suitability of VAT as a means of targeted economic policy: Economic research suggests that VAT has, in the end, only a limited effect on sales prices. The demand for services (including the labour-intensive ones) depends much more on other factors, such as consumer habits, general economic trends etc. Furthermore, lowering the VAT rate would no doubt cause budgetary losses. Therefore compensatory measures like increases in direct taxation are needed and the overall effect on the demand in a specific sector and on the job market as a whole are at least uncertain. So far, there is no empirical evidence suggesting otherwise.

The taxation system would again be made more complex to operate and serious problems would arise in defining the exact scope of the reduced rate and in controlling its application. There is no easy way to solve this problem. Even reliance on supposedly objective non-tax criterion is problematic and additional problems arise moreover when such criteria are built into the tax system. Generally speaking, such measures would run contrary to the very important basic concept of neutrality of VAT and they are incompatible with the idea of a general consumption tax.

¹⁵ See European Parliament resolution on the Commission work programme for a new common system of VAT adopted on 10 June 1997 and the appropriate opinion by the Economic and Social Committee, adopted by its Plenary Session on 9 July 1997. Both institutions endorse the objectives and the broad concept of the work programme.

The black-economy certainly gives rise to great difficulties within the current taxation systems. The Commission is, however, of the opinion that it would be premature to change Community VAT legislation only with a view to dealing with this problem and regardless of the effects of other possible changes. As far as the supplier is concerned, VAT is most probably not the main driving force for tax avoidance. The financial benefits of tax planning are very much greater in the fields of direct taxes and social contributions. It is true however that there is an obvious incentive for consumers to buy goods and services VAT free. In any event the Commission is mindful of the problem and will be pleased to intensify its discussion on counter-action with Member States.

Studies on the employment effects of a reduced VAT rate on selected sectors

In order to assess the effect of reduced VAT rates in comparison to other fiscal measures, the Commission contracted with an outside consultant to study the "Potential impact on employment creation of fiscal instruments (namely of a reduced VAT rate for selected sectors)"¹⁶. This was also done in order to fulfil a commitment taken in the European Parliament in the context of the debate on the VAT rate applicable to floricultural and horticultural outputs in autumn 1995¹⁷.

The study examines three possibilities for boosting employment by means of fiscal measures: a reduced VAT rate for selected (presumably labour-intensive) sectors, a reduction in the direct tax rate and reduction in employer's social security contributions. All possibilities were designed to be revenue neutral and to this end two compensatory measures were investigated: a general rise in the VAT rate and a rise in fuel duties. Thus six scenarios for five selected Member States (Belgium, Western Germany, Italy, Spain, United Kingdom) were produced in total. The tool used for the analysis was an econometric input-output model covering the Member States before the 1995 enlargement and disaggregated both by region and by sector. The model has been adjusted to the specific objectives of the study.

The overall results of the study are of course subject to a number of assumptions inherent to the model or needed to permit the comparison of simulations (size-wise and country-wise). The study concludes, however, in a clear statement which reads as follows:

"The policy of a compensated reduction of VAT on selected services (Simulation 1) can generally be said to have only marginal employment effects, while no perceptible effects are obtained by the policy of a compensated reduction in direct taxation (Simulation 2). In contrast, the compensated reduction in social security contributions (Simulation 3) does, on the whole, produce the most positive effects on employment."

¹⁶ "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, University of Warwick - September 1996.

¹⁷ The Directive in question has been adopted by the Council of Ministers in 1996. See footnote 3.

For the total of the five Member States examined the three basic measures show the following results that differ only slightly according to the compensation chosen:

1. A 50% reduction of VAT on selected sectors results in a small overall increase of employment of 0.1% higher than the base case (no change of taxation policy). The sectoral distribution of the small employment gains indicates that Other Market services, Manufacturing and Construction benefit more while Banking, Finance and Insurance and Distribution register losses¹⁸. The national distribution is uneven.
2. The model results for a 5% reduction of direct taxes suggest that this policy option has virtually no effect on employment (only 0.05% above base in the long run).
3. A 5% reduction in social security contributions would provide for a modest increase of employment (long-term effect of 0.3% higher than the base case). The sectoral distribution of the employment gains is skewed towards services and presumably to small and medium sized enterprises. It is noteworthy, however, that the employment gains in some countries actually outweigh small decreases in others.

As in all economic modelling, when assessing the study a number of caveats should not be overlooked and it is obvious that economic research cannot be substituted for political decisions. The results of the study do not, however, give any evidence whatsoever that reducing VAT on labour-intensive services is a recommendable option of fiscal policy that justifies the considerable problems and difficulties linked to this measure. This assessment is reinforced by a comparison to the alternative which has already been advocated by the Commission in its White Paper on Growth, Competitiveness, and Employment (chapter IX): a reduction in social security contributions which might in some cases be compensated through increases in taxation and, more particularly, through increases in environmental taxes or taxes on consumption. The Commission continues to believe that measures touching more directly the labour market as, e.g., reduction of employers' and/or employees' social security contributions, direct incentives to employers etc. are more likely to have a positive impact on job creation than indirect ones like VAT reductions. Such measures may also contain State aid elements.

¹⁸ Other market services comprise the wide range of business that is not linked to distribution, lodging and catering, transport, communication or banking, finance and insurance. Distribution and Other Market Services have low wage rates and unit labour costs which are typical characteristics of low-skill, labour-intensive sectors.

The Commission is aware of the fact that this view is shared neither by all Member States nor by all operators. For instance, UEAPME has commissioned, through its Dutch member MKB, a "counter-study", a "second opinion" to the above study by Cambridge Econometrics/University of Warwick. This study, which was issued only recently, was carried out by the Dutch institute EIM¹⁹ under the name "Stimulation of labour-intensive services - The employment effects of a reduction of VAT rates"; on this basis MKB has also produced an information leaflet "White on black"²⁰.

The methodological approach taken in this study is different from the one in the Cambridge/Warwick-study. It is also based on an econometric model but no compensatory measures for budget neutrality are taken into account as it is maintained that effective job creation may cost money. For the Netherlands the effects of the VAT reduction are calculated relative to a base variant (which reproduces the anticipated developments arising from unaltered policy) and a break-down for sectors is provided for. For Germany, Italy and the United Kingdom, which are covered in a much rougher calculation, the expected employment growth is bench-marked with total employment in industry. For the Netherlands the application of the reduced VAT rate of 6% (instead of the currently applied standard rate of 17.5%) to up to 24 selected sectors is tested, in five scenarios establishing various limits of labour-intensiveness (all 24 sectors, at least 60, 70, 80 or 90%); for the other countries Dutch elasticities and ratios were applied to national data on industry turnover, employment levels, VAT rates, etc.

The key results of this study are a reduction of the level of unemployment in the Netherlands of about 0.5% until 2004 when the reduced VAT rate is applied to all 24 sectors; at the same time the public sector deficit would be 0.4% bigger. Similar (but less reliable) effects are expected in Germany and, for the construction industry, in Italy; for the UK the relative employment effect is significantly bigger.

The Commission is of the opinion that the results of both studies are difficult to compare directly. The condition of revenue-neutrality obviously makes an enormous difference. It is evident that tax reliefs without compensation impact much more on economies than compensated ones but this is not only true for VAT. In this sense, the basic result of the Cambridge study, which says that cuts in non-wage labour costs (namely social contributions) are by far most efficient and effective fiscal measure for boosting employment, is by no means challenged by the result from the MKB/EIM-study.

¹⁹ Economisch Instituut voor het Midden- en Kleinbedrijf
²⁰ Thus focussing on the underground economy aspect.

In any event, the Commission is prepared to intensify the discussion both on the theoretical side of the interrelation between taxation and employment and on the political and practical rationale for addressing VAT reductions in this context.

4.4 Reviewing the special case of Article 12 (3) (b)

Article 12(3)(b) of the sixth VAT directive states that

"Member States may apply a reduced rate to supplies of natural gas and electricity provided that no risk of distortion of competition exists. A Member State intending to apply such a rate must, before doing so, inform the Commission. The Commission shall give a decision on the existence of a risk of distortion of competition. ..."

Under current Community legislation all other supplies of energy except the ones mentioned in Article 12 (3) (b) and except firewood (Article 28 (2) (i)²¹) are not eligible for a reduced rate of VAT. Article 12 (3) (b) is generally interpreted restrictively. Some Member States are also entitled to continue to apply a lower rate in this area for the transitional period before the entry into force of the new common VAT system.

On this basis, the opinions on the interrelation between VAT and energy obviously differ a lot, between Member States and within Member States:

- In the United Kingdom and some other Member States a lower VAT rate on energy saving materials and similar is actively campaigned for. In its budget 1997 the UK Government announced that one of its objectives is to help the less well off to save energy, and that it will consult about the best means of achieving this. The Finance Act 1997 requires the Treasury to produce a report on the consequences to the Exchequer of VAT relief for energy saving materials by May 1998". Anyhow, this report will also thoroughly assess other fiscal measures than VAT for favouring energy-saving materials.
- The Netherlands intent to make use of Article 12 (3)(b) by applying the reduced VAT rate to electricity produced by "wind energy, solar energy, energy from small hydraulic plants, biomass energy (green energy or energy produced by non-polluting methods)". This is expected to encourage private households to consume energy produced this way.

²¹ Introduced by the Directive on the taxation of agricultural outputs other than those falling within category I of Annex H: see footnote 3.

- The United Kingdom has also reduced, as from 1 September 1997, the VAT rate applicable to domestic fuel and power from 8% to 5%, this being based on Article 28 (2) (b). The rationale of this move is to ease the tax burden on a socially sensitive good.
- Germany has launched the idea of a special VAT rate on the consumption of energy. The underlying idea is to introduce an environmental element into the VAT system by applying a special rate the level of which should be above the standard rate to all kinds of energy supplies.
- In general the level of the VAT rate applied to energy supplies (gas, electricity) differs between 5% and 25% within the Community.

It follows from the foregoing that the taxation of energy is a very complex area in the sense that environmental and social aspects play a conflicting role in determining the "justified" rate, the one pleading for a generally higher, the other for a generally lower rate. For the time being, there is obviously little room for distortions of competition as energy markets to a large extent continue to be characterised by national distribution monopolies. These national monopolies are, however, subject to rapid change in the real single market. This trend will certainly increase the likelihood of distortion of competition in the near future and this tendency needs to be taken into account while reflecting on the future VAT regime in this field.

In the Commission's opinion the current arrangements which are explained above are difficult to operate and do not provide for a coherent approach, whether from a social, environmental or fiscal point of view. Their revision should therefore be addressed in the context of the new common system of VAT while following in the first instance the general lines adhered to for that exercise.

It is noteworthy, however, that excise duties are in fact a much more targeted levy on energy supplies of all kinds. Also, their impact on consumer prices is much higher as the level of rates is relatively high (especially compared to VAT rates) and as input tax cannot be deducted by companies (which is a characteristic of VAT). Therefore, it seems logical to use this instrument, if necessary, for policy purposes rather than VAT. The Commission proposal for an overall approach to the taxation of energy products is a first step in this direction [COM(97) 30 final]. This proposal sets new Community minimum rates of taxation for all energy products, thus providing Member States with the possibility of differentiating the levels of taxation according to the environmental quality of products. It also lays down a number of options enabling them to exempt or to tax at a reduced rate fuels (such as renewables) or uses which are environmentally friendly.

5 HARMONISING THE SCOPE OF THE REDUCED VAT RATE: THE WAY FORWARD

When Annex H was negotiated by Member States and decided by the Council of Ministers the compromise chosen was not based on a absolutely coherent and conclusive approach²². Thus Member States provided for what they estimated to be the absolute minimum for the transitional regime to function. It is however self-evident that some of the problems mentioned above stem from this incoherence regarding the scope of the reduced VAT rate. It is therefore clear that in considering the new origin-based common system of VAT it will be necessary to review the level of rates and to produce a coherent structure for the future scope of the reduced rates.

Such coherent rate structures and future harmonisation cannot be based only on the discussions and requests of the day. This chapter endeavours to give some hints from a broader standpoint and reflects on possible ways forward in harmonising the scope of the reduced VAT rate.

The appropriate Commission proposals are referred to in the various rounds of VAT rate harmonisation scheduled in the Commission working programme for the new common system of VAT. When the assessment of rates harmonisation is eventually on the agenda, in the first place it will be up to the Council and to Member States to decide to what extent approximation of rates is needed in order to avoid major distortions of competition. When the Commission working programme is subsequently realised, such distortions are likely to come up but they may remain limited or possibly Member States may regard them simply as a positive element of tax competition. In this sense the Commission's plans are biased neither one way nor the other. It is however too early to examine this situation in detail.

Notwithstanding this approach the Commission believes that its review on the scope of the reduced VAT rate should include a preparatory evaluation and stimulate discussions in Member States.

5.1 Analysis of the current situation in Member States

Member States apply Article 12 (3) (b) of the sixth Directive and its Annex H very differently. The data set out in the table of Annex 2 reveal to what extent Member States make use of the option to tax the various categories of Annex H at a reduced rate. The information in the table is, however, too detailed to give an overview of basic decisions or common trends underlying the rates applied in the various Member States.

²² The historical context is outlined in chapter 2 of the previous report of 1994.

The following table forms a "snapshot" of the situation in 1996 and attempts to give some essential information in this context:

N°	Category	Number of Member States applying a reduced rate (Art. 12 (3)(b))	Number of Member States applying a special transitional rate (Art. 28 (2)) ²³
1	Foodstuffs	11	5
2	Water supplies	9	-
3	Pharmaceutical products	6	6
4	Medical equipment	7	4
5	Transport of passengers	11	2
6	Books, newspapers, periodicals	8	9
7	Admissions to shows and cultural events; broadcasting services	10	5
8	Royalties due to and services supplied by writers, composers, and performing artists	7	1
9	Social housing	5	4
10	Agricultural inputs	9	3
11	Hotel accommodation	9	2
12	Admission to sporting events	6	1
13	Use of sporting facilities	4	2
14	Social services	5	2
15	Services supplied by undertakers and cremation services	4	1
16	Medical and dental care; thermal treatment	7	1
17	Street cleaning, refuse collection and waste treatment	3	4

²³

This is without exemptions according to Art. 13 of the sixth VAT Directive.

It will be seen that a majority of Member States (i.e. eight or more out of 15) use only seven out of the seventeen possible categories to apply a reduced VAT rate. Moreover, further analysis of the tables in Annex 1 and Annex 2 reveals that on the available evidence

- Few Member states apply a reduced rate to the whole of any category of Annex H;
- three Member States do not apply Annex H at all;
- four Member States have two reduced VAT rates²⁴;
- the levels of the reduced rates vary between 5% and 12.5% (respectively, on a temporary basis, 17% in Finland);
- some Member States make wide use of the “special” rates permitted for a transitional period until the introduction of the new common system of VAT;
- for eleven out of the seventeen categories a factual link to exemptions exists (insofar as within these categories at least some Member States exempt at least some of the appropriate transactions);
- generally speaking, categories 6, 7 and 8 fall into the scope of what one might call “cultural policy”;
- generally speaking, categories 3, 4 and 16 fall into the scope of what one might call “health policy”;
- generally speaking, categories 1, 2, 5, 9, 12, 13, 14 and 15 fall into the scope of what one might call “social policy” (wanting one could put cultural and health aspects also under this label);
- generally speaking, categories 1 and 10 fall into the scope of what one might call “agricultural policy”;
- generally speaking, categories 2, 5, 9, 10 and 17 impact on or fall within the scope of “environmental policy”;
- it is difficult to classify category 11 with a view to a general policy approach;
- that there is, for the time being, no mention made of other policy fields like economic policy or similar.

²⁴

As regards the three rates in Finland see footnote 5.

To complete the picture, it may be useful to repeat three key results elaborated so far:

- the optional character of Annex H and the lack of common definitions of its categories are, at least under specific circumstances, likely to create distortions of competition;
- there is a growing feeling in Member States that VAT rates may, under the condition that distortions of competition are avoided, be used as a means of economic policy;
- in some areas new technological developments appear to lead to unequal treatment of comparable goods and/or services in terms of the applicable VAT rate.

It follows from the foregoing that in general within the Community there is a need for a reduced VAT rate and that, very broadly speaking, streamlining of its scope is necessary, also for the sake of simplification and reduced compliance costs. Such streamlining is needed regarding the level of the reduced rate, the political criteria for its application, its suitability for the Single Market and the general topic of modernising the VAT system. The Commission has already set up the framework for this streamlining by adopting its working programme for the new common system of VAT which addresses, inter alia, precisely these issues.

5.2 Assessment in the light of the new common system of VAT

In any system of VAT based on taxation in the country of origin and enabling a taxable person to effect supplies to any destination in the Community, the VAT rate will be a significant price factor in determining the competitive position of operators. For the set-up of the new common system of VAT it must therefore be decided what degree of difference between rates will still be acceptable to avoid creating major distortions of competition.

One of the essential characteristics of VAT is, as stressed above, its neutrality vis-à-vis the conditions of competition. Consequently, maintaining the possibility of applying too many different rates from one Member State to another would jeopardise this neutrality and might also influence business locations, which would also be inconsistent with the very principles of the Single Market. It is also clear that the more VAT rates that are permitted to Member States, the more unwarranted complexity is added to the business of control.

In this context, it is worthwhile recalling the Commission's commitment in its work programme: Generally speaking and allowing for the fact that the ultimate solution of the problem is probably not achievable in the short term, the Commission considers that an approximation within a rather narrow band (e.g. two or three percentage points) might be sufficient in the case of the standard rate. Nevertheless, the introduction of a single standard rate should not be set aside since this would be the only way of guaranteeing that the tax is entirely neutral and could bring significant anti-fraud and anti-avoidance benefits. The question of the level of the standard rate must be settled by means of a political decision which cannot be considered without placing it in the much wider context of overall tax revenues and without taking account of the European Union's general objectives and in particular its global fiscal strategy. From this point of view there is a strong rationale for increasing VAT receipts in order to compensate for targeted reductions of non-wage labour costs.

As to the scope of the reduced rates, which are the subject of this report, the constraints are exactly the same as for the standard rate. The Commission remains convinced that the simplicity of the VAT system, and therefore its vulnerability to fraud as well as its effect on business, depends directly on there being as small a number of rates as possible. Therefore, on a purely technical level, the Commission considers that there should be only one reduced rate and that its scope should be defined restrictively and according to coherent criteria. It goes without saying that a reduced rate of this nature would ideally have to be compulsory in all Member States. This rate could then also be applied to the bulk of items which are currently exempt as exemptions necessarily hamper the neutrality of VAT.

As far as environmental aspects of the VAT rate structure are concerned, it is difficult to see how regressivity can play a role for justifying the application of a reduced VAT rate to certain goods or services. However, it is acknowledged that, as VAT influences the price of goods and services, it can contribute to changing consumer behaviour, both in making polluters pay, and in encouraging more environmentally friendly behaviour. Unlike "social" reasons for applying reduced VAT rates on basic necessities, but which also benefit the rich, fossil fuels, for example are just as damaging for the environment whoever uses them. Nevertheless, practical problems of definition would arise. It is not always easy to categorise products and services between environmental "goods" and "bads", and any more nuanced appreciation of the relative environmental advantages or disadvantages cannot easily be incorporated into a VAT system which wishes to avoid undue complexity.

In general, in the context of further harmonisation, various options can be considered. Given that widening the number of reduced rates is not a realistic option there are, in simple arithmetical terms, the following possibilities:

- the present situation of two reduced rates being applied on an optional basis;
- two reduced rates being applied on an compulsory basis;
- the ideal situation of one reduced rate being applied on an compulsory basis;
- one reduced rate being applied on an optional basis.

Making the application of the reduced VAT rate compulsory requires at the same time common definitions of the categories of goods and services to which such rate is to be applied.

Regarding the number of the reduced rates, the present divergence of rates within the Community might plead for a structure of two rates which would then be applied to separated lists of goods and services. As to the scope of the reduced rate(s) it seems that the currently implicit distinction of various categories should be explicitly elaborated and modernised. In all these categories the crucial underlying rationale is the regressive character of VAT which in fact can only be dealt with by applying a reduced VAT rate in socially "sensitive" sectors. The basic problem is, however, to define the social justification and to define the precise scope of the reduced rate. This appears to be relatively simple in the area of health, passenger transport and foodstuffs (and the appropriate agricultural inputs) whereas cultural activities are certainly difficult to distinguish from pure leisure.

In any event, decisions on the level of VAT rates are influenced by the level of VAT-induced distortions that Member States will judge to be acceptable under the new arrangements.

6 CONCLUSIONS

This report sets out to fulfil the reporting obligation laid down in Article 12 (4) of the sixth VAT Directive in order to review the scope of the reduced VAT rates. In fulfilling this obligation the Commission wishes at the same time to provide the Council and the Parliament with an adequate assessment of the impact of the present VAT rates structure on the functioning of the Single Market both with a view to the general framework of the transitional VAT arrangements and regarding the forthcoming changeover to the new origin-based common system of VAT.

Based on available information, the Commission believes that, as an overall assessment, the present VAT rates structure is not, Community-wide, an obstacle which prevents the transitional VAT arrangements from functioning. In general the VAT rate differentials do not hamper cross-frontier purchases but there is evidence that they sometimes impact on consumer decisions in a distortive manner. Retailers increasingly tend to benefit from the existing purchasing potential beyond borders. Apart from specific regions and/or specific goods there have been no really significant broad Community-wide distortions of competition or deflection of trade brought about as a result of excessive disparities in VAT rates between Member States.

The analysis of the present VAT rates structure and of the scope of the reduced VAT rate in particular reveals, however, two intrinsic problems having certain distortive effects on the competitive situation of taxable persons (which, in turn, prevents final consumers from benefiting from the Single Market to its full extent). These are: the optional character of Annex H and the lack of common definitions of the categories listed in Annex H. Both aspects can lead to situations where the principle of neutrality of VAT is infringed. In this context the Commission wishes to encourage Member States to consider the possible difficulties caused by these basic problems.

The review of the various categories of Annex H shows that there are currently disputes over a number of categories and the Commission is mindful that the current wording of Annex H does not take account of all new technological developments, which have occurred since its adoption in 1992. Annex H does not follow a coherent and conclusive approach which can sometimes lead to particular difficulties in certain sectors. Such problems can only be solved step-by-step in the various stages of proposals to be made in the context of the introduction of the new common system of VAT.

The Commission and Member States therefore need to develop clearer ideas about what is to be achieved by short and long term harmonisation of the scope of the reduced rate of VAT. The results of this report strongly suggest the following guidelines:

- close approximation of rates is a technical necessity;
- the scope for the application of reduced rates should be determined by social considerations (in order to offset the sometimes regressive character of VAT);
- generally reduced VAT rates are a very imprecise tool for policy making and they should not be used as a substitute for direct subsidies;
- reduced VAT rates should not touch on the general neutrality of VAT.

The Council and the European Parliament are invited to express their opinion on the conclusions of this report and the Commission will be pleased to intensify the inter-institutional discussion in this respect.

ANNEX 1: EVOLUTION OF VAT RATES APPLIED IN MEMBER STATES 1994 TO 1996 (EXCEPT TRANSITIONAL RATES ACCORDING TO ARTICLE 28 (2))

Member State	Reduced rates			Standard rates		
	1994	1995	1996	1994	1995	1996
Belgium	6	6	6	20.5	20.5	21
Denmark	. / .	. / .	. / .	25	25	25
Germany	7	7	7	15	15	15
Greece	8	8	8	18	18	18
Spain	6	7	7	15	16	16
France	5.5	5.5	5.5	18.6	20.6 ²⁵	20,6
Ireland	12.5	12.5	12.5	21	21	21
Italy	9	10 ²⁶	10	19	19	19
Luxembourg	6	6	6	15	15	15
Netherlands	6	6	6	17.5	17.5	17.5
Austria ²⁷	10	10 / 12	10 / 12	20	20	20
Portugal	5	5	5 / 12 ²⁸	16	16	17
Finland ²⁹	5 / 12	6 / 12 / 17	6 / 12 / 17	22	22	22
Sweden ³⁰	12 / 21	12 / 21	6 / 12	25	25	25
United Kingdom	8	8	8	17.5	17.5	17.5

²⁵ Changeover from 18,6% to 20,6% on 1 August 1995.

²⁶ Changeover from 9% to 10% on 24 February 1995.

²⁷ Member State since 1 January 1995.

²⁸ The 12% rate has been introduced with entry into force on 12 July 1996.

²⁹ Member State since 1 January 1995. A comprehensive VAT system was introduced in Finland on 1 June 1994 only. Finland (like no other Member State) is not allowed to apply three reduced VAT rate and has already been addressed by the Commission on this behalf (see footnote 5).

³⁰ Member State since 1 January 1995.

ANNEX 2: APPLICATION OF REDUCED VAT RATES BY MEMBER STATES TO THE CATEGORIES OF GOODS AND SERVICES CONTAINED IN ANNEX H OF THE SIXTH VAT DIRECTIVE [SITUATION 1 APRIL 1997]

Note: Reduced rates in the sense of Article 12 (3)(a) are printed in bold.
ex = exemption without right to deduct input tax; 0 = exemption with right to deduct input tax

N°	Category	B	DK	D	EL	E	F	IRL	I	L	NL	A	P	FIN	S	UK
1	Foodstuffs	6	25	7	8	4	5,5	21	4	3	6	10	5	17	12	0
		12		15		7	20,6	0	10				12		25	
		21						12,5	16				17			
2	Water supplies	6	25	7	8	7	5,5	ex	10	3	6	10	5	22	25	17,5 0
3	Pharmaceutical products	6	25	15	8	4	5,5	0	4	3	6	20	5	12	0	17,5
		21			18	16	20,6		10	15	17,5		17		25	0
									19							
4	Medical equipment	ex	25	7	8	7	5,5	0	4	3	17,5	20	5	22	25	0
		6												ex	ex	
		21														
5	Transport of passengers	6	ex	7	8	7	5,5	ex	10	3	6	10	5	6	12	0
		ex		15		16			16	ex	ex				0	

N°	Category	B	DK	D	EL	E	F	IRL	I	L	NL	A	P	FIN	S	UK
6	Books, newspapers, periodicals	6 ex	25 0	7	4	4	2,1 5,5	12,5 21 0	4 19	3	6	10	5	12 0	6 25 ex	0
7	Admissions to shows and cultural events; broadcasting services	ex 6 21	25	7 15 ex	4 8 18 ex	7 16 ex	2,1 5,5 20,6	12,5 21 ex	4 10 19	3 15 ex	6 17,5	10 ex	5 17 ex	6 22	25 ex 6	17,5
8	Royalties due to and services supplied by writers, composers, and performing artists	ex 6 21	ex	7	8	7	5,5	21	10 19	3	17,5	10 20	17	ex	6	17,5
9	Social housing	6 12	25	15 7	8	4	5,5 20,6	12,5	4 10	3 15	17,5	20	5	22	25 ex	17,5 0
10	Agricultural inputs	6 12 21	25	7	8	7	5,5	12,5	4 10	3	6	10 20	5	22 17	25	17,5
11	Hotel accommodation	6	25	15	8	7 16	5,5	12,5	10	3	6	10	5	6	12	17,5
12	Admission to sporting events	6 ex	ex	15	8	7 16	20,6	ex	10	3 ex	6	20	5	6	ex 6	17,5

N°	Category	B	DK	D	EL	E	F	IRL	I	L	NL	A	P	FIN	S	UK
13	Use of sporting facilities	6	ex	ex	8	16 ex	20,6	12,5	19	3	17,5 6 ex	20 ex	5	12	ex 6	17,5 ex
14	Social services	6 21 ex	25	7	8	7	20,6	ex	19	3 15 ex	17,5	10 0	17 ex	ex	ex 25	ex
15	Services supplied by undertakers and cremation services	6	ex	15	8	7 16	20,6	21 ex	19	3	ex	20	ex	ex	25 ex	ex
16	Medical and dental care; thermal treatment	6 21 ex	ex	7 ex	8	7	5,5 20,6	21 ex	19	3 ex	17,5 ex	10 ex	5 ex	ex	ex	ex
17	Street cleaning, refuse collection and waste treatment	21	25	ex	8	7	20,6	21 ex	4	3	17,5 ex	10	ex	22	25	17,5 0

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