COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.7.2008
SEC(2008) 2190

COMMISSION STAFF WORKING DOCUMENT

accompanying the

Proposal for a

COUNCIL DIRECTIVE

amending Directive 2006/112/EC as regards reduced rates of value added tax

Impact Assessment

{COM(2008) 428}
{SEC(2008) 2191}

This report commits only the Commission's services involved in its preparation and the text is prepared as a basis for comment and does not prejudge the final form of any decision to be taken by the Commission.

TABLE OF CONTENTS

1. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

1.1. Background, organisation and timing

In 2003, the Commission tabled a proposal for a review of reduced VAT rates[1] resulting in Council Directive 2006/18/EC of 14 February 2006. This Directive provided for a third extension of the experiment on reduced rates for labour-intensive services[2] to the end of 2010, and the option of applying a reduced VAT rate to district heating under the same procedure as for natural gas and electricity. Directive 2006/18/EC also included a mandate from the Council to the Commission to present to the European Parliament and to the Council, by the end of June 2007, an overall assessment report on the impact of reduced rates applied to locally supplied services, including restaurant services, notably in terms of job creation, economic growth and the internal market. This report was to be based on a study carried out by an independent economic think-tank. The study was conducted by Copenhagen Economics[3].

Subsequently, and in response to the Council mandate, on 5 July 2007 the Commission presented a Communication to the Council and European Parliament on VAT rates other than standard VAT rates[4].

In its Communication, the Commission expressed the view that a new legal framework for reduced VAT rates should rationalise and simplify the present system, without excluding the possibility of giving Member States more flexibility to adopt reduced rates, in particular for locally supplied services. The Communication presented material for discussion and explored ways forward in the field of reduced VAT rates, for the purpose of opening a broad debate on the future of reduced rates, taking into account the conclusions of the study.

The Commission considered that launching a broad debate in the Council, the European Parliament and with other stakeholders to obtain all relevant views before initiating a more far-reaching proposal on reduced rates was the most effective approach to developing a sustainable and well balanced proposal in the medium term.

To allow calm debate in parallel with this general discussion, on 20 December 2007 the Council adopted Directive 2007/75/EC prolonging until 31 December 2010[5] most of the

---

1 COM (2003)397 final.

2 See: EUROPA — Taxation and Customs Union / Labour-intensive services.

3 Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007. See: EUROPA — Taxation and Customs Union / Rates and SEC(2007) 910; http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/SEC(2007)910_en.pdf.

4 COM (2007)380 final; http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/COM(2007)380_en.pdf.

5 COM (2007)381 final; http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/COM(2007)381_en.pdf.

temporary provisions on VAT rates granted to Member States that joined the EU after 1 January 1995.

The Council debate has not yet settled the fundamental questions about simplifying and rationalising the overall framework or the impacts and usefulness of reduced rates to achieve specific policy objectives.

However, the Commission faces some urgent questions regarding the introduction of new scope to apply reduced VAT rates, which should be addressed promptly and/or for which it is felt there are sufficient grounds to include them in a legislative proposal already.

This proposal should nonetheless respect the need for simplification on the one hand and the need for flexibility for Member States where the proper functioning of the internal market is not affected on the other hand, as set out in the Communication. The second need will be reflected in the first objective (section 3) of the Commission initiative. The first need is not an objective as such, but the extent to which this need is met, will be discussed in the impacts section, in particular in the section relating to compliance costs (5.2.5). Indeed, simplification and reduction of compliance costs are closely linked.

It is against this background that the Commission decided to submit an initial proposal in the summer of 2008 (agenda planning item 2008/TAXUD/002; CLWP 2008 priority initiative). Consequently, the scope of this proposal will be limited. It will not include an in-depth review of the current VAT rate structure: in particular, it will not change the current basic rules (one standard rate of at least 15% and two optional reduced rates of at least 5% which may be applied to a limited list of goods and services). Neither will it tackle the problem of the numerous derogations granted from the general rates framework, just mentioned, nor the question of expanding the scope of reduced VAT rates for environmental purposes. This possible action is left to a later stage, when the current in-depth debate and further study work has finished.

The proposal should also deal with some urgent technical adjustments in the field of reduced VAT rates. For the sake of coherence and clarity the 2008 Commission proposal might address, for example, the case of audio books and baby nappies. In the former case, an audio book (recorded on a cassette or CD or any similar physical medium) should be considered as a book where its content is identical to that of the paper format of a book and, consequently, should be eligible for reduced rates. In the latter case, category 3 of Annex III to the Council Directive 2006/112/EC[6], the VAT Directive, needs to be to be made more consistent. Because of the technical nature of these issues, they will not be included in this impact assessment. Indeed, the purpose of the changes is to adapt, in a very restrictive way, already existing categories of goods and services eligible for reduced rates in order to improve their coherence (cover not only adult nappies and feminine sanitary protection, but all absorbent hygiene products, including children nappies; not only books on paper, but also books read out aloud and recorded on a cassette, CD or any similar physical support;). Given the very narrow scope of these changes, no impact assessment can be usefully carried out for these improvements of the current rules.

---

6 EUR-Lex - Official Journal - 2006 - L 347.

This situation calls for a proportionate impact assessment strictly focusing on particular problems identified in section 2. Further work needs to be done to be able to come to conclusions as to a global review of Community legislation on reduced rates.

An inter-service steering group was set up by DG TAXUD. The following DGs participated: SG, LS, ENTR, EMPL, MARKT, and ECFIN. Meetings were held on 21 February and 15 April 2008.

1.2. Consultation and expertise

1.2.1. Stakeholder consultation

To coincide with this impact assessment a public consultation of all interested parties was launched on 11 March 2008. The objective of the consultation was to gather stakeholders' views on the review of existing legislation on reduced VAT rates in the context of both a first limited proposal to be presented in the summer of 2008 and also in the framework of a more global review of the scope and structure of reduced VAT rates at a later stage. The consultation document presented possible short term changes to the Community legislation on reduced VAT rates and proposed 19 questions to evaluate stakeholders' opinion and their experience with the application of reduced VAT rates in different economic sectors.

The consultation was closed for replies on 12 May 2008 and, although the deadline for sending contributions had not been extended, late replies were also accepted. More than 500 contributions were received from citizens, businesses, national and European federations, universities and public authorities. Most of the replies were focused on particular sectors of economic activity and therefore addressed only questions that appeared relevant to that specific area of activity. There was a massive campaign of around 150 contributions received from businesses and various chambers of commerce in Germany, all supporting the application of reduced VAT rates to labour-intensive and locally-supplied services. Another campaign of almost 40 contributions by businesses and private individuals in Spain asked for reduced VAT rates to be introduced so as to promote the use of environmentally-friendly cars in Europe. 10 contributions by both European and national associations from Germany, France, Italy, the Netherlands, Finland and Denmark were received asking for the extension of reduced VAT rates to 'all bicycle products and services'.

As contributions are predominantly sector-specific and address the application of reduced VAT rates in particular sectors, for instance the labour-intensive services sector, the publishing sector, the sector of performing artists, funeral activities, the tourism sector, the construction sector, the pharmaceutical sector, etc, only part of them are relevant for the purposes of this impact assessment. A lot of other issues that were touched upon in the public consultation, such as the optional or compulsory character of reduced rates and the need for rationalisation, the use of reduced rates for environmental, social and cultural purposes and in the framework of a knowledge society, will be relevant for the later stage of the review of the Community framework on reduced VAT rates.

In general, the consultation did not reveal arguments which are not already covered by or which are relevant for the purposes of this impact assessment. Moreover, there were almost no relevant data assessing the positive or negative effects of reducing VAT rates for the sector for which a reduced rate is claimed. The majority of replies support the analysis and the reasoning presented in chapters 3, 4, 5, 6 and 7 of the consultation document, related to labour-intensive services, other locally supplied services, restaurants, housing and some potential technical adaptations.

The public consultation document itself can be found at the following address: http://ec.europa.eu/taxation_customs/common/consultations/tax/article_4850_en.htm. A detailed summary report of the results of the public consultation will be published soon.

1.2.2. Expertise

As stated in 1.1 above, a study was conducted, from July 2006 to April 2007, by an independent think-tank, Copenhagen Economics, to assess the impact of reduced VAT rates to allow the Council to come to well founded conclusions on reduced rates. These conclusions were primarily expected to refer to reduced rates for labour-intensive services and — in more general terms — to locally supplied services and restaurant services, since no final, far-reaching solution was found in the Council on the basis of the 2003 Commission proposal on reduced rates. The findings and conclusions of this comprehensive study will be used for the purposes of this impact assessment.

On 2 June 2003 the Commission presented a report on the experimental application of a reduced rate of VAT to certain labour-intensive services[7]. The findings of the report are also taken into account in this impact assessment.

Figures provided by Eurostat and by the relevant sectors are also used. Note, however, that the latter figures and conclusions focus on particular sectors of relevance and need to be seen in perspective.

1.3. Inclusion of the Impact Assessment Board's recommendations

On 20 June 2008 the Impact Assessment Board (IAB) adopted its opinion on the draft version of this impact assessment.

The recommendation of the IAB to give more illustrations of the importance of the effects of the proposed options has not been followed. The view of the author DG is that the impacts mentioned in the IAB opinion, i.e. economic activity, employment income distribution, compliance costs, internal market are properly and proportionately discussed and illustrated at EU level in the report and the underlying references (which are a part of the impact assessment).

Macroeconomic impacts discussed in this report are long-term impacts. It should be noted that most sectors analysed in the policy change options are labour-intensive and as such short-term effects will largely depend on the labour market situation in a given Member State.

Moreover, as the underlying assumption of presenting policy change options was to ensure the optional character of the reduced VAT rates, no further specifications regarding individual Member States were made. This ties in with the flexibility objective mentioned under section 3(1) of this report.

---

[7] COM (2003) 309 final; http://ec.europa.eu/taxation_customs/resources/documents/com_exp_en.pdf.

As regards the budgetary impacts of the policy options the author DG stresses that it is the role of the Member States to assess the impacts, referring to the same flexibility principle. However, some purely indicative values were already presented in the report.

In respect of the recommendation on budgetary compensatory measures for reduced VAT rates, a general comment relating to the use of alternative financing instruments has been added to section 5.2.6 of this report.

In reply to the recommendation on the linkage between the current initiative and the overall objective to simplify the reduced rates system, clarification has been added to section 1.1 of this report.

As to the recommendation on monitoring and evaluation section 7 of this report has been completed with a specification of additional information and analysis needed from the Member States to assess the impacts of a more comprehensive reform of the reduced rates framework.

Finally, some further clarifications have been added to section 3 (objectives) and 1.1 (technical adjustments part).

1.4. Difficulties in sourcing data

In recent years, obtaining data from the Member States concerning the effectiveness of reduced rates in terms of the objectives set has proved difficult, in particular regarding the experiment on reduced rates for certain locally supplied services.

It has also been difficult to find separate/disaggregated statistical data on small locally supplied services.

Further difficulties were encountered in finding statistical data on the delimitation of sub-sectors in the construction sector between house building, non-residential building (public and private), and renovation and repair.

In general, statistical data do not fully match the categories of goods and services required for an impact assessment on reduced VAT rates.

2. PROBLEM DEFINITION

The problems identified mainly relate to political constraints.

First, a large number of Member States ask for flexibility to set reduced rates as they see fit in areas where the internal market is not affected by differences in rates between Member States. The question is whether such flexibility could be offered and in which areas. Second, the unequal possibilities offered to the Member States in some of these areas are another part of the problem. Again, this rather limited set of problems calls for proportionate analysis, taking account of the strong political and legal rationale behind the reduced VAT rates debate, rather than pure economic principles.

Note, therefore, that here we refer only to reduced VAT rates. The impact assessment does not discuss whether reducing direct taxation and social security contributions might be more appropriate to achieve certain (in this context secondary) employment objectives (see section

3). On this point, we refer you to a study carried out for the European Commission by Cambridge Econometrics and the University of Warwick (1996)[8], which concluded as follows: "The policy of a compensated reduction of VAT on selected services 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. In contrast, the compensated reduction in social security contributions does, on the whole, produce most positive effects on employment." A country-by-country review of the various existing studies confirmed these findings.

On the other hand, according to the Copenhagen Economics study referred to above and the explanation below, reduced VAT rates for well-targeted sectors might potentially help economic growth, employment and the fight against the black economy.

Again, given the restricted problems addressed at this stage, neither does the impact assessment discuss broader issues such as the balance between indirect and direct taxation. In the current general Community framework for VAT rates — which is neither part of the problem nor the subject of this initiative — reduced rates are optional for the Member States at this stage and consequently it is certainly not the purpose of this Commission initiative to interfere with the Member States' overall powers to decide the balance between indirect and direct taxation on their territories. Their policy choices will be reflected in the use they make of reduced rates, subject to internal market rules.

2.1. What issues require immediate action?

2.1.1. Labour-intensive services

For a number of labour-intensive services, Member States may temporarily apply reduced rates if authorised to do so[9].

As the application of a reduced VAT rate on certain labour-intensive services was experimental, Annex IV to the VAT Directive contains only a limited list of categories of labour-intensive services to which certain Member States were authorised to apply a reduced rate. These services include:

- Minor repairing of:
    - bicycles;
    - shoes and leather goods;
    - clothing and household linen (including mending and alteration);
- Renovation and repairing of private dwellings, excluding materials which account for a significant part of the value of the service supplied;
- Window-cleaning and cleaning in private households;

[8] Cambridge Econometrics and the Institute for Employment Research of the University of Warwick, *The Potential Impact on Employment Creation of Fiscal Instruments*, September 1996.

[9] Council Decision 2006/774/EC of 7 November 2006 (OJ L314, 15.11.2006, p.28) and Council Decision 2007/50/EC of 30 January 2007 (OJ L 22, 31.1.2007, p.14).

- Domestic care services such as home help and care of the young, elderly, sick or disabled;
- Hairdressing.

Member States may apply reduced rates to at most three of those categories.

The initial objectives of the experiment were to increase employment and reduce the black economy.

This Community provision expires at the end of 2010. After more than 10 years of application, conclusions regarding its relevance should be drawn and the obvious first question is whether the possibility to apply reduced rates should be made — wholly or partially — permanent or should be abolished altogether.

At present, 18 Member States (Belgium, the Czech Republic, Greece, Spain, France, Italy, Cyprus, Latvia, Luxemburg, Hungary, Malta, the Netherlands, Poland, Portugal, Romania, Slovenia, Finland, and the United Kingdom) are allowed, until 31 December 2010, to apply reduced VAT rates to the specified labour-intensive services. Information on their take-up of the reduced VAT rates is given in Table VII of the document "VAT rates applied in the Member States of the European Community"[10] .

2.1.2. Other locally supplied services

A logical second question arises from the problem identified in 2.1.1: should the option for Member States to apply reduced rates be extended to services similar to labour-intensive services, not listed in Annex IV, where this does not distort the internal market? Article 107 of the VAT Directive lays down some criteria: the services must be labour-intensive, largely be provided direct to final consumers and be mainly local and not likely to cause distortion of competition. However, these services could be referred to in more general terms, as (other) locally supplied services, their basic characteristics being that they cannot be supplied from a distance, are largely directed to the local final consumer market and the supplier and customer are located in a geographically limited area. One subsidiary problem is the exact definition of these services. The absence of a clear definition might lead to legal uncertainty in the Member States and possible distortions in the internal market (if these services were not strictly limited to real local services).

According to the Copenhagen Economics study, locally supplied services[11], including a large part of the labour-intensive services covered by Annex IV to the VAT Directive and some

---

10 See http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf.

11 Locally supplied services were identified for use in the Copenhagen Economics VAT Model (a global, multi-regional, multi-sector general equilibrium model specially designed to study the economic effects of VAT policies) and included 'Cleaning, repair and hire of clothing', 'Maintenance and repair of personal transport equipment', 'Other services relating to the dwelling n.e.c', 'Repair and hire of footwear', 'Domestic services and household services', 'Hairdressing salons and personal grooming establishments', 'Materials for the maintenance and repair of the dwelling', 'Services for the maintenance and repair of the dwelling' (p.69, Table 17 of Part B — Appendices to the Copenhagen Economics study and p.25, Table 9 of the study). The data used originate from the GTAP database (version 6), reference year 2001. Coicop and Nace data were used to calculate the shares of demand and supply.

other locally supplied services, represent 4.8% of private consumption in the EU-25 (all 27 Member States except Bulgaria and Romania) and 2.1% of the value added. It may be assumed that individually these locally supplied services have little weight in the economy, except for renovation and repair of buildings.

2.1.3. Restaurant services

Restaurant services are generally considered to be a kind of locally supplied service as they are largely directed to the local market. However, there might potentially be an internal market distortion in border regions and in tourism between certain Member States, because of differences in the VAT rates they apply.

Moreover a large number of Member States have the right to apply reduced rates to restaurant services, whereas others do not. The general Community provisions on reduced rates do not allow reduced VAT rates to be applied to restaurant services, but there are specific derogations for some Member States. Some of these derogations will end on 31 December 2010, which will lead to tensions if Member States are not treated equally. A <u>third question</u> thus arises: should <u>the Member States as a whole be given the option of applying reduced rates to restaurant services</u>?

Currently, for restaurant services 11 (Greece, Spain, Ireland, Italy, Cyprus, Luxemburg, Netherlands Austria, Poland, Portugal, Slovenia) of the 27 Member States are allowed to apply a reduced rate, whilst 16 are not.

According to the Copenhagen Economics study, restaurant services (cafés and the like included) represent 6.1% of private consumption in the EU-25 (all 27 Member States except Bulgaria and Romania) and 1.9% of the value added[12].

The entire hotel and restaurant sector accounts for 4.4% of total employment in the EU-27[13]. Restaurants, bars and catering account for around 75% of the sector workforce[14], i.e. 3.3% of total employment.

2.1.4. The housing sector

Currently, Member States are allowed to apply a reduced rate to the "provision, construction, renovation and alteration of housing, as part of a social policy". However, experience has shown that given their different fundamental approaches to the housing sector, the current reference to housing as part of a "social policy" has been interpreted in very different ways by Member States. Moreover, some Member States apply a reduced rate to the "renovation and repairing of private dwellings, excluding materials which account for a significant part of the value of the service supplied" (labour-intensive services under Annex IV to the VAT Directive).

---

12 Restaurant services were identified for use in the Copenhagen Economics VAT Model and included canteens, restaurants, cafés and the like (p.68, Table 17 in Part B — Appendices to the Copenhagen Economics study and p.25, Table 9 of the study). The data used originate from the GTAP database (version 6), reference year 2001. Coicop and Nace data were used to calculate the shares of demand and supply.

13 Eurostat database, national accounts, employment data, EU-27, 2005.

14 Eurostat statistical books, *European business: Facts and figures*, 2007 edition, 19.2, p. 321 and Eurostat, 'Hotels and Restaurants in Europe', *Statistics in focus*, No 38/2004, p.2.

In addition, a number of Member States (the Czech Republic, Spain, Ireland, Italy, Poland, Portugal, Slovenia and the United Kingdom) were granted derogations and apply reduced rates (or a zero rate) to supplies relating to buildings other than as part of a social policy. Some of these derogations expire at the end of 2010.

Consequently, the fourth question is whether there are grounds for allowing reduced rates more generally for this sector and adding the whole housing sector to the list of goods and services eligible for a reduced rate. In this way, Member States could restrict the scope of the reduced VAT rate or not according to their national budgetary and fiscal choices.

The entire construction sector accounts for 6.2% of the total value added in the EU-27. Housing roughly accounts for 50% of construction activities, or 3.1% of total value added. Housing is in turn roughly divided into 50% for new house building and 50% for renovation and maintenance[15].

The sub-sectors ‘building installation’ (e.g. plumbing, insulation and electrical cabling) and ‘building completion’ (e.g. plastering and painting) account for respectively 23% and 15% (total 38%) of the construction sector’s value added in the EU-25 (2002), while ‘buildings and civil engineering’ accounts for 58%. In terms of employment these figures are respectively 24% (‘building installation’), 18% (‘building completion’), and 54% (‘buildings and civil engineering’)[16]. Civil engineering roughly accounts for 20% of the sector. Consequently, in terms of value added, building completion and installation is as important as building of complete constructions and in terms of employment the former is more important.

The entire construction sector accounts for 7% of total employment in the EU-27[17]. If we apply the same approximate value of 50% for the housing sector, the house building part of the construction sector would be responsible for 3.5% of total employment in the EU.

Overall, if locally supplied services, including restaurant services, and services relating to the whole housing sector were to be definitively and generally (for all Member States) added to the list of goods and services eligible for reduced rates (Annex III of the VAT Directive), rough estimations show an additional 5.4% of the EU economy (in terms of value added) could be subject to reduced rates. The figure does not take account of the fact that certain Member States already apply reduced rates in the areas concerned on the basis of derogations or the temporary provisions on labour-intensive services (Annex IV services).

---

15 Eurostat database, national accounts, aggregates at current prices, EU-27, 2006. The construction sector comprises the complete NACE Section F.45 Construction: Site preparation, Building of complete constructions or parts thereof; civil engineering, Building installation, Building completion, and Renting of construction or demolition equipment with operator. According to the European Construction Industry Federation (2008), new house building (25.6%) and maintenance and rehabilitation of houses (24%) accounted for 49.6% of total construction activities in terms of output in current prices in 2006 in the EU-10 (Germany, the United Kingdom, France, Italy, Spain, the Netherlands, Belgium, Sweden, Finland, and Portugal). The same source indicates that non-residential building (new, maintenance and rehabilitation) accounted for 30.6% (private 23.3%, public 7.4%) of total construction activity in the EU-10 in 2006. Civil engineering accounted for the remainder, 19.7%.

16 Eurostat, ‘The construction industry in the European Union’, 2002, *Statistics in focus*, No 26/2005, pp.2-3.

17 Eurostat database, national accounts, employment data, EU-27, 2005.

2.2. What are the underlying drivers of the problem?

Member States have different fiscal policy approaches. Some prefer to use indirect taxes (e.g. VAT) to finance their social security systems, for example, and to put more weight on indirect taxation than on direct taxation; others prefer to put the emphasis on direct taxation or social security contributions. This policy choice will obviously be reflected in Member States' approaches towards reduced VAT rates.

As regards locally supplied services, more particularly certain labour-intensive services, the Community provision allowing reduced VAT rates is only temporary. It has yet to be decided whether to maintain or abandon it; this situation leads to uncertainty for the business sector and consumers and might give rise to sub-optimal behavioural changes in terms of the objectives set.

It is uncertain what effects reduced rates of VAT on such services have on prices, subsequent demand and employment responses in the sectors concerned and other sectors of the economy, on the functioning of the internal market and on overall tax revenues in the Member States. This uncertainty raises serious questions as to the usefulness of introducing and/or maintaining the measure. Consequently, no firm conclusions were drawn in the Council.

Another factor of uncertainty relates to the concept of distortion of competition in the internal market as a consequence of VAT rate differences among the Member States. Some Member States and observers consider that even in the case of local activities different VAT rates (reduced or standard) may give consumers incentives to cross the border and consume in the low-VAT country, especially in border regions. Others say this possible cross-border trade is not caused by VAT differences and that internal market impacts will be minor anyhow.

There is some political fear that if Member States are all given the option of applying reduced rates, there will be public pressure to introduce them in Member States which do not currently apply a reduced rate and do not wish to do so.

A large number of Member States want to use reduced VAT as a policy instrument to stimulate growth, address unemployment and combat the black economy, and these Member States ask for flexibility in order to be able to use reduced rates at their own discretion especially in areas where no tax-driven distortions of the internal market are to be expected.

The Community, however, has to consider whether it can tolerate flexibility for the Member States: is harmonisation and rationalisation preferable? It needs to consider possible internal market impacts, including compliance costs for businesses resulting from the multitude of rates applied across the Member States (which might also constitute a barrier to entry into the internal market). And if there are such impacts, should the Community propose standard rates or obligatory reduced rates instead of optional ones, to reduce rate differences between the Member States for the services concerned?

The Member States' legal options to apply reduced rates differ, most notably for the restaurant and construction sectors. This is perceived as unjustified or even unfair. On the other hand, these differences need to be assessed on their own merits against the overall rates or even VAT framework.

2.3. Key players: who is affected, in what ways and to what extent?

2.3.1. Member States

First, Member States are affected. If all Member States are allowed to apply reduced rates for the sectors concerned, those that have not applied a reduced rate up to now and decide to apply one are likely to see VAT revenues fall — certainly in the short term — in the sectors concerned. The overall impacts on VAT and other State revenues or public spending (e.g. unemployment allowance) are uncertain, partly because of the difficulties of measuring the indirect effects in other sectors. Moreover, budget neutrality might need to be guaranteed by, for example, increasing the standard rate of VAT, increasing environmental taxes, or reducing public spending. This would in turn impact on revenues and give rise to social, economic and possibly environmental effects.

2.3.2. Final consumers

Second, final consumers are affected: to the extent that the VAT charged to these customers is not deductible, they bear the burden of VAT. Introducing a low rate of VAT would normally (other factors being unchanged under competitive market conditions) have a positive impact on the purchasing power of consumers of the products. However, VAT reductions need to be passed through in final consumer prices for this to happen. Final consumers might also benefit from more employment or better salary and work conditions as a consequence of more demand for the products concerned. To the extent that more consumption of these products leads to less consumption of other products, consumer welfare will be reduced again. The income distribution among households might be affected as well.

2.3.3. Business

Third, the businesses sectors directly involved (local activities, restaurants and construction sector) and suppliers to the sectors concerned are affected: they will benefit from reduced rates if demand is boosted and/or if the reduction is not fully passed through in the price. Other businesses indirectly involved (because of substitution effects in consumption patterns) might also be (adversely) affected.

2.4. How would the problem evolve all things being equal?

All things being equal, the problem and situation would evolve as follows.

The temporary provisions of the VAT Directive allowing reduced rates to be applied to particular labour-intensive services automatically expire at the end of 2010.

The temporary derogations granted to the new Member States to apply reduced rates to restaurants and in the housing sector expire at the end of 2010. The same derogations granted to old Member States continue to apply, as they have no deadline.

Member States using the possibility to apply reduced rates to certain labour-intensive services or new Member States applying derogations to the restaurant and housing sector have to increase the VAT rate applicable to its standard level (in principle). A short-term increase in VAT revenues in these Member States seems logical, but might be offset over time by revenue losses due to reduced activity and employment, more DIY and black economic activity. It is thus not evident that increasing the VAT rate in this way implies proportionally raising tax revenues. The price effects of raising VAT rates are likely to be stronger and faster than those of reducing VAT rates. Unless other policies are put in place to compensate for these effects, raising rates is likely to lead to consumer price increases, negative demand and employment effects, and impacts on salaries, business profitability, investment, quality of service and competitiveness in the sectors concerned, certainly in the short run, as well as making going "underground" increasingly attractive.

A return to the old situation would mainly affect SMEs, as this type of enterprises accounts for the bulk of enterprises in the sectors concerned, as will be explained below.

The discussion on the usefulness of reduced rates for locally supplied services and restaurant services would not be concluded.

Flexibility for the Member States to apply reduced rates would be reduced (for certain labour-intensive services) and ruled out (for locally supplied services and services relating to housing) in areas where distortions of the internal market are unlikely to occur or likely to be minor (restaurants). There would also be uncertainty about whether Member States were foregoing possible positive (long-term) effects on overall economic productivity, growth, structural unemployment.

The unequal treatment of Member States would remain for the restaurant and housing sector: derogations would continue to be valid for old Member States; other Member States (old and new) would be forbidden to introduce a reduced rate in these sectors.

2.5. Does the EU have the right to act?

2.5.1. Subsidiarity principle

The subsidiarity principle applies insofar as the proposal does not fall under the exclusive competence of the Community. The objectives of the proposal cannot be sufficiently achieved by the Member States for the following reasons.

The Community has already laid down harmonised provisions on the application of VAT reduced rates, namely in the VAT Directive, based on Article 93 of the Treaty establishing the European Community. These provisions may only be amended or extended by a Community act and the legislations of the Member States cannot deviate from the harmonised rules. It is very important to bear in mind this legal approach and the fundamental objective of the VAT legislation, i.e. setting a **common** system of value added tax and a uniform basis of assessment, as it inherently limits any far-reaching autonomy on VAT issues by Member States.

For the reasons outlined above, only Community action can achieve the objectives of the proposal. The proposal therefore complies with the subsidiarity principle. The EU clearly has the right to act. However, under an optional system of reduced VAT rates, the Member States then have the choice to either apply a reduced rate or to decide not to do so.

2.5.2. Proportionality principle

The harmonisation of legislation concerning turnover taxes is based on Article 93 establishing the European Community. This Article requires the Council to adopt provisions for harmonisation to the extent necessary to ensure the establishment and the functioning of the internal market. In areas where Member States' option to apply reduced rates does not affect the proper functioning of the internal market, giving Member States this option is thus proportionate to the goal set in Article 93. Member States are not obliged to apply reduced rates.

3. OBJECTIVES

(1) A first policy objective is to create a level playing field in the Union for all Member States as regards applying reduced rates to restaurant services, locally supplied services and services relating to housing (and similar non-commercial buildings) and to create a more coherent VAT rates structure in this field. In other words, the objective is to give the Member States room for policy manoeuvre and assure flexibility in such areas where the proper functioning of the internal market is not affected. The impact assessment of policy options will have to identify whether VAT rate differences across the EU affect the proper functioning of the internal market in the areas mentioned.

(2) Second, the policy should reduce legal and economic uncertainty. At present, economic operators are uncertain about the future of reduced rates applied to labour-intensive services. Moreover, discussions on extending reduced rate possibilities to restaurants and local services have been ongoing for years, creating uncertainty and possibly holding business back from investing and recruiting workers.

(3) Third, there are social-economic objectives:

(a) to reduce compliance costs for business, notably in the housing sector — this ties in with the second objective of ensuring legal certainty;

(b) to bring about a shift from the black and informal economy to the formal economy, so as to encourage economic growth and formal recruitment/employment and — to a limited extent — overall employment, by reducing do-it-yourself (DIY) activity by households and helping to curb black activity for certain services. This is in line with the Community's 'Lisbon' and sustainable development strategies. The sustainable development strategy encompasses issues as maintaining and increasing long-term prosperity, or working towards a safe, healthy and socially inclusive society. The encouragement of overall economic growth, formal and overall employment and the fight against the black economy will serve these goals. Obviously, these socio-economic objectives of a forthcoming initiative on reduced VAT rates will also support the Lisbon Growth and Jobs Strategy aiming at long-term prosperity in the EU among other things by fostering development and growth of SMEs, in particular since the sectors at issue are those in which many of them are active.

4. POLICY OPTIONS

In the light of the above problem definition and objectives, the possible policy options are by definition very limited. A narrow approach which follows the logic of the current Community VAT legislative framework is to be followed. The options combine both economic efficiency (see objective 3) and distinctions which refer to a political, legal and VAT logic (objectives 1 and 2).

4.1. No policy change (option 1)

The first option is "no policy change". See section 2.4 on this option.

4.2. Policy change

The second option implies policy change and entails **changing Community VAT legislation on reduced rates**. Different sub-options can be envisaged; these could go from a limited change in the legislation to the widest possible change in accordance with the different issues referred to in the problem definition. In order of increasing magnitude, the change could encompass the following options (different aspects may also be considered separately):

4.2.1. Reduced rates for certain labour-intensive services (option 2)

The only change is to make the current provision on reduced rates for certain labour-intensive services (laid down in Annex IV to the VAT Directive) permanent.

4.2.2. Reduced rates for an extended list of labour-intensive services

4.2.2.1. For private households only (option 3)

All Member States could apply reduced rates to Annex IV categories of services and to a limited list of similar (small) services for private households: gardening, or landscaping and maintenance of gardens for private households, personal care services other than hairdressing (services provided in personal grooming establishments), minor repair of tangible movable property (excluding motor vehicles, which are exceeding the scope of small services), and cleaning services relating to tangible movable property. As stated above, this list would have to be exhaustive to avoid possible distortions and for the sake of legal certainty.

4.2.2.2. For private households and other non-commercial customers (option 4)

Under this option the limited list of similar (small) services additionally could include services provided to final consumers other than private households: gardening, landscaping and maintenance of gardens and parks for public authorities and non-commercial use, (small) renovation, repair, maintenance and cleaning of places of worship, cultural heritage, historical monuments or other non-commercial buildings.

4.2.3. Reduced rates for an extended list of labour-intensive services and restaurant services (option 5)

Member States would also have the option of applying reduced rates to restaurant services.

4.2.4. Reduced rates for an extended list of labour-intensive services, restaurants services and the complete housing sector (option 6)

Member States could also apply reduced rates to the construction and (significant) alteration of private dwellings and to the supply thereof.

4.2.5. Reduced rates for an extended list of labour-intensive services, restaurant services, the housing sector, and certain other parts of the building sector (option 7)

Under this option Member States could also apply reduced rates to the construction and significant renovation or alteration of non-commercial buildings such as places of worship or cultural heritage, historical monuments or other non-commercial buildings and to the supply thereof.

4.2.6. Further combination of the policy options

The above sub-options are presented in order of increasing magnitude, but other combinations could be added. For example, options 6 and 7 could be considered without the inclusion of restaurant services.

However, the impact assessment of the options presented should enable conclusions to be drawn without listing all the mathematically possible combinations.

5. ANALYSIS OF THE IMPACTS

5.1. Some background: the current Community legislative framework

Articles 93 to 130 and Annex III and IV of Directive 2006/112/EC of 28 November 2006 (Official Journal L 347, 11.12.2006, p.1) provide a legal framework for the application of VAT rates in Member States.

The basic rules are simple, i.e. one standard rate of at least 15% and one or two reduced rates — optional for Member States — of at least 5% to a limited list of goods and services, but they are complicated by a multitude of derogations granted to certain Member States and in some instances to a majority of Member States. Overall, such derogations do not give equal opportunities to all Member States.

Currently, the reduced rates (derogations excluded) applied in the Member States vary from 5% to 17% and the standard rate from 15 to 25%. Consequently, differences between standard and reduced rates differ among Member States and the strength of impacts is likely to differ accordingly. The smallest difference applies in Ireland (21% standard rate and 13.5% reduced rate) and the largest in Portugal (standard rate 21% and lowest reduced rate 5%)[18].

5.2. Economic impacts

Note that this section discusses employment impacts, when in fact these also have a clear link to the social impacts of policy options. Consequently, the sections on economic and social impacts have to be considered in conjunction to assess the 'socio-economic impacts' of the options.

---

18 *VAT Rates Applied in the Member States of the European Community: Situation at 1 January 2008*, http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf.

5.2.1. Sector impact on demand, employment and prices

Reduced rates meet their objectives most effectively where the goods and services concerned are supplied directly to final consumers. Applying a reduced rate to the supply of goods and services to the business sector has no impact. The business sector is in principle entitled to deduct input VAT and cannot be considered a final consumer. By contrast, public sector activities and other basically non-commercial activities, such as school education, medical care, welfare and social security work and supplies linked to religion and philosophical convictions are as a rule outside the scope of VAT or exempt from VAT, without giving rise to deduction of VAT charged on the input relating to such activities. Institutions carrying out such activities, just like private consumers, are to be considered as final consumers for VAT purposes. Consequently, reduced VAT rates will be effective in sectors mainly or largely directed to final consumers defined above.

The link between reduced rates of VAT and growth and job creation is not a direct one. For the mechanism to work, a reduction in VAT must lead to a fall in the price charged to the consumer of the service/good concerned. The price must fall sufficiently to generate increased demand for the good/service. Increased demand should in turn lead to increased production. The increased production must then be covered by hiring new staff, and not by raising productivity or increasing the working time of the staff already employed. If the fall in the VAT rate is used by the supplier to increase his profits or the wages of the labour force, or to increase investment, etc., the mechanism no longer works as intended. In that case, the reduced VAT rate acts as a subsidy to a particular sector (by reducing a tax which does not represent a cost to the firm).

The Copenhagen Economics study[19] indicates that there is little doubt that permanently lowering the VAT rate on a particular good or service will sooner or later lead to a reduction in the price of the good or service more or less corresponding to the monetary equivalent of the lower VAT rate. The VAT reduction is likely to be passed through in the price.

There appears to be also little doubt that as prices go down, consumer demand for the particular good or service will sooner or later increase[20]. Subsequently, production and employment in the sector concerned will correspondingly expand to meet the higher demand. However, the strength and the swiftness of the production and employment response depend on a number of specific sector characteristics.

The <u>strength</u> of the impact of lower VAT rates on production and employment depends significantly on the consumer response to lower prices and the level of competition[21] within the sector.

---

19 Copenhagen Economics study, p. 9, and Appendix I and II to the study, including empirical analysis.

20 Pass-through to the final consumer price might be full and immediate in cases where the amount of VAT is directly visible on an invoice, for example in the construction sector. Commission report COM(2003) 309 final on the experimental application of a reduced rate of VAT to certain labour-intensive services stated that renovation and repair of private dwellings seems to be the sector in which service providers most readily pass on the VAT reduction. Nevertheless, the price reduction is often only temporary (p.4).

21 Note that local suppliers rely on a close buyer-seller relationship which restricts the exploitation of consumers, which would imply that VAT reductions are at least partially passed on to the consumer. At the same time, local suppliers often have power due to travel costs, which limits pass-through. Pass-

If consumers react only weakly to lower prices, production and employment will not increase significantly.

In sectors with limited competition, pass-through to prices may be less than full, and thus the impact on production and employment may be muted[22].

Restaurants and personal care services are considered to be much more price-sensitive services (higher price and also income elasticity), than housing maintenance and repair, for example. Demand responses to price changes will tend to be higher for goods which are not (or to a lesser extent) necessities.

Moreover, if production is very labour-intensive there seems to be a stronger production and employment response to lower VAT rates in the industries affected. However, many labour-intensive goods and services are also somewhat price elastic. Results are more likely to be driven by underlying differences in price elasticity than labour intensity. Labour intensive sectors such as restaurants, hairdressers, and domestic care thus seem to react more significantly to demand changes.

The swiftness of the production and employment response to lower VAT rates differs significantly between sectors depending on the technology and the labour market. If the technology is capital intensive or if the labour market is tight or rigid, there may be a delay before firms are able to adjust to the new market situation. It may take time, be costly or otherwise be problematic to buy and install more machinery or to hire and train qualified staff to meet the new demand.

All sectors envisaged in the policy change options (labour-intensive services, locally supplied services, restaurant services, services in the construction sector) are rather labour-intensive[23]. However, there are differences. For the construction sector, the share of personnel costs in total expenditure is relatively high, but is significantly higher for building installation and completion activities (including renovation, repair and maintenance markets) than for general construction activities (including building of complete constructions or parts thereof).

As an illustration of sector impacts, we refer you to a study from Mannheim University carried out for the VAT Club Jacques Borel on the impacts of reducing VAT from 19% to 7% in the hotel and restaurant sector (excluding canteens and caterers, but including alcoholic beverages) in Germany based on 2003 figures[24]. The study presents the following results depending on the different hypotheses taken as regards demand elasticities and assuming that approximately half of the VAT reduction is passed on in the price (48.4%) and the remainder

through for local supplied services could be influenced by these factors. See: Copenhagen Economics study, Part B, Appendix 1, p. 11.

22 Conversely, in competitive markets low pass-through should not necessarily be given a negative interpretation: services /products with higher demand elasticity will obtain a large demand and production response in cases where price pass-through seems to be low.

23 For restaurants and construction: Eurostat Statistical Books, *European business: Facts and figures*, 2007 edition, pp. 261, 266, 267, 322 and 328.

24 *Ermäßigter Mehrwertsteuersatz im Gastronomiegewerbe. Wirkungsanalyse einer Mehwertsteuerreduzierung*, study by the Universität Mannheim, Institut für Mittelstandsforschung, for VAT Club Jacques Borel with assistance from DEHOGA, November 2006.

of the reduction is used to increase salaries (13.3%), improve employee qualifications (11.1%), modernise investments (20.1%) and slightly increase profits (7.1%):

- the estimated increase in sector turnover varies from EUR 2.943 billion (2 943 million) in the worst case scenario to EUR 5.742 billion in the best case scenario compared with EUR 33.435 billion estimated as the initial turnover. Consequently, this increase varies between 8.8 and 17.2%;
- the estimated increase in sector employment (FTE) varies from 57 055 (worst case) to 111 304 (best case) compared with 648 142 jobs (FTE) estimated as the initial employment situation. This increase represents a variation of between 8.8 and 17.2%;
- the fiscal impacts, taking account of the net loss of VAT revenue, the additional revenue from taxes and social security contributions resulting from newly created jobs and increased business profits, and the savings in unemployment allowances (two cases were considered: either 30% or 50% of new jobs are filled by unemployed people) were estimated at a budgetary loss of EUR 3.050 billion in the worst case and EUR 1.876 billion in the best case. A simple calculation of the short-term loss of VAT revenue, i.e. the initial turnover multiplied by 12%, results in a loss of EUR 4.012 billion.

The calculations as to a VAT reduction under the same conditions, but excluding alcoholic beverages, resulted in the following estimations: a turnover increase which varies from EUR 2.577 billion (9.5%) to EUR 4.676 billion (17.2%) compared with EUR 27.226 billion initially and an employment increase varying from 46 486 (8.8%) to 90 684 jobs (17.2%) compared with 528 069 initially. Budgetary losses vary from EUR 2.437 billion to EUR 1.528 billion. The short-term loss of VAT revenue is estimated at EUR 3.267 billion.

As will be discussed below (section 5.2.4), these sector impacts do not (fully) take account of impacts on other sectors of the economy, additional measures to offset State revenue losses or impacts on the black economy.

For another illustration of sector impacts we refer you to the European Construction Industry Federation (FIEC)[25], which claims that the experiment of reduced VAT rates for activities relating to the restoration and maintenance of dwellings in Belgium, Spain, France, Italy and Portugal created almost 170 000 permanent additional jobs.

FIEC[26] estimated that, if all Member States decided to reduce their current VAT rates to 6% for renovation and maintenance work in the construction industry, the workforce in the industry could increase by about 240 000 to 270 000 in the EU-15 as a whole (on the basis of a price elasticity of 1). FIEC also stressed that to this would be added the positive impact of having undeclared work become declared, as well as the extra job creation in upstream and downstream sectors.

<u>In conclusion</u>: in all policy change options, the sectors affected by the change are likely to experience demand and employment boosts; differences between sectors seem to depend largely on price sensitiveness, which may be somewhat weaker in the construction sector (maintenance, repair, and building). There might be differences among the Member States as

25 FIEC estimate, March 2005, in FIEC press release, ‘The reduced rate, a European challenge for the building sector: 250 000 jobs threatened in 2006’, 19 April 2005.

26 FIEC, ‘How can undeclared work be reduced in the construction industry in Europe?’ Alain Sionneau, President of the French Building Federation and Vice-President of FIEC, June 2000, p.15.

regards the timing of the impacts depending on the rigidness and tightness of the labour market at issue. In the restaurant sector and some locally supplied services (such as cleaning) low-skilled workers might be easily absorbed with adequate professional training. In other sectors there might be more problems recruiting qualified labour[27] and meeting additional demand; labour supply-side structural measures might be needed (e.g. measures to improve educational attainment levels).

The no-policy-change option would mainly increase the VAT rate for certain labour-intensive sectors in the Member States applying reduced rates to these services. An increase in VAT rates is likely to have greater effects (in the opposite direction) than a reduction. New empirical studies reveal an asymmetric price response as higher VAT rates have a stronger and faster response on prices than lower VAT rates[28].

5.2.2. Sector impact on the black and informal economy

The problem with evaluating this impact is that of measuring activity which, by definition, evades the obligation to submit returns. Generally speaking, motives for operating in the black economy are mainly financial, to do with avoiding income, value-added and other taxes, social security contributions, and labour market and other regulations (such as those on minimum wages and maximum working hours, and administrative procedures).

Reduced VAT measures will in theory only have an impact on firms which already have a VAT identification number but which operate partly in the black economy. The black economy is reduced here by limiting the convergence of producer and consumer interests. A high rate of VAT encourages final consumers to request that VAT is not invoiced. Income tax and social security contributions encourage suppliers to suggest to their clients that they do not invoice them. Consequently, it is generally accepted that lower VAT rates tend to induce consumers to shift consumption subject to a reduced rate from the black to the formal economy.

For businesses whose existence is not declared, in theory reducing the VAT rate does not offer an incentive to leave the black economy; they pay no production-related taxes. The main reason why they operate in the black economy is not VAT, but rather the desire to pay no taxes or social security contributions at all[29].

It is difficult to find qualitative data on the black and or informal economy, because definitions, data and methodologies used to quantify these activities differ across countries or over time.

In 2005, the United Nations Economic Commission for Europe (UNECE) secretariat carried out a survey of national practices in estimating non-observed economic activities (NOE) in

---

27 See Commission report on experimental application of a reduced rate of VAT to certain labour-intensive services. COM(2003) 309 final, regarding the situation in France in the construction sector in 1999, p.20.

28 Copenhagen Economics study, p. 9.

29 Commission report on experimental application of a reduced rate of VAT to certain labour-intensive services, COM(2003) 309 final, p.4.

National Accounts[30]. NOE cover all productive activities that may not be captured in the basic data sources used for national accounts compilation. Illegal activities (e.g. trade in drugs), deficiencies in data collection, informal activities (e.g. own account construction) that are not registered or recorded, and misreporting of production (to avoid taxes or social security contributions) are examples of reasons associated with measurement difficulties. The objective of the survey was to draw up an inventory of current practices in covering and estimating NOE and to provide a platform for comparison across countries. Some preliminary results of the survey indicate that the adjustments for non-observed activities are largely concentrated in the informal sector typically operated by small (household) units, followed by the hidden economy. Within these two sets of activities, one of the most common sectors was the construction sector (informal activities/clandestine production in construction, own account construction)[31].

Not only are differences between sectors to be noted, but the size of the adjustments for the non-observed economy varies widely by group of countries. In the EU member countries the adjustments for NOE estimates range from 1% (Netherlands, year 1995) to 18.9% (Lithuania, year 2002). However, data sources and estimation techniques are not always equal. Calculations relating to 2002/2003 from Prof. F. Schneider of the University of Linz on the size of the black economy show figures varying from 10.9% (of official GDP) in Austria to 28.2% in Greece[32].

In its Communication of 24 October 2007 on stepping up the fight against undeclared work (COM(2007) 628 final)[33] the Commission stated that the best available estimates of undeclared work in the Member States were collected through a study carried out for the Commission in 2004 which indicated that the extent and characteristics of undeclared work appeared to differ widely in the Member States, with highs of 20% of GDP or more in some southern and eastern European countries. Recent stocktaking by experts of the European Employment Observatory network indicates that undeclared work is still on the rise in several Member States, whilst in a number of new Member States strong job creation in recent years and the emergence of labour market shortages has led to a decline of the phenomenon.

As regards sectors, also according to FIEC[34], the construction sector accounts for a large proportion of undeclared work[35]. It is suggested that a proportion of one third should be

---

30 United Nations Economic Commission for Europe, Statistical Commission, Conference of European Statisticians, Group of Experts on National Accounts, Non-Observed Economy in National Accounts, ECE/CES/GE.20/2006/7, Rev.1, 18 April 2006.

31 The substantial share of the construction industry and artisanal-type enterprises in the black economy is confirmed by Prof. F. Schneider from the University of Linz in a January 2005 report on the regression of the black economy in Germany, Austria and other OECD countries: this sector appears to account for 38% of the black economy in Germany (39% in Austria) (2005), compared with 17% in the tertiary sector, including hotels and restaurants (16% in Austria) and 15% (17% in Austria) for other artisanal enterprises and local services (domestic care, hairdressing).

32 Prof. F. Schneider, *Shadow Economies of 145 Countries all over the World: What do we really know?*, May 2006, p.26 and *Consequences de la baisse de TVA de 19,6% à 5,5% (hors alcools) sur les ventes, l'emploi et les revenus du Trésor français dans la restauration*, Volume III, France: Jacques Borel, May 2007, p.45.

33 See: http://ec.europa.eu/employment_social/news/2007/oct/undeclared_work_en.pdf.

34 FIEC, *How can undeclared work be reduced in the construction industry in Europe?* Alain Sionneau, President of the French Building Federation and Vice-President of FIEC, June 2000, p.4.

adopted as a European standard for undeclared work in the construction sector. All the countries involved seem to agree that the markets most affected by undeclared work are private new dwellings and renovation of private dwellings. In Italy undeclared work seems to be practised in all types of renovation work (public housing, private dwellings and non-residential construction). In France the whole housing sector appears to be one of the most affected. It is stated that in France, it seems that the greater theoretical extent of tax fraud in the construction sector is mainly a direct consequence of the prevalence of one-man businesses and not any culture specific to the sector. Prof F. Schneider[36] indicates that, congruent with other empirical results on shadow economies (see e.g. Dallago, 1990), shadow economic activities in Germany seem to be mostly concentrated in the areas of house construction, renovation, car repairs and servicing.

As regards the hotel and restaurant sector, according to estimates by Prof. Schneider the black economy accounted for a turnover of almost EUR 9 billion in Germany (2003), which appears to be in the range of 17% of total official turnover. Others have indicated a figure of 20% as the size of the black economy. This would be slightly above the German average[37].

As regards locally supplied services, the Commission communication on setting up the fight against undeclared work, referred to above, points to the existence of a large market for undeclared work throughout the EU, especially in household services. This is one of the findings of a survey on undeclared work carried out in the EU-27 in the second quarter of 2007. As mentioned earlier, Prof. Schneider also pointed to the service sector as regards fraud concentration.

Copenhagen Economics[38] summarises the economic literature in this respect as follows: apart from ethics, the choice of working in the formal or black economy relies on a trade-off between enforceable contractual terms, the risk of punishment, administrative costs, and tax expenditure. In this calculus, the VAT rate is of some importance. Small, labour-intensive firms are most likely to engage in undeclared activities.

It is obvious that most of the (sub)sectors at issue in the policy change options will be significantly affected by the black economy, especially the construction and restaurant sector, but it may be assumed that in all sectors mainly addressing final consumers, such as maintenance and repair of private dwellings, cleaning and other repair for private households, etc., both consumers and producers are likely to be more attracted to keeping transactions off the books.

It is generally recognised that reducing taxes and social security contributions will reduce the black economy or at least cause it to stop growing[39]. Indeed, the larger the direct and indirect

---

35 The Commission Communication of 24 October 2007 (COM(2007) 628 final) points to the importance of ‘envelope’ wages, especially in the construction sector; this finding is indicated as one of the results of a survey on undeclared work carried out in the EU-27 in the second quarter of 2007.

36 Prof. F. Schneider and Dr Annette Mummert, *The German Shadow Economy: Parted in a United Germany?,* March 2002, p.7.

37 *Ermäßigter Mehrwertsteuersatz…,* p.31 and *Consequences de la baisse de TVA…,* p.46.

38 Copenhagen Economics study, Part B, Appendix 1, p.13.

39 Prof. Schneider states that an increased burden of taxation and social security contributions, combined with labour market regulation are the driving forces of the shadow economy, (*Shadow Economies…*, p.1).

taxation cost, the stronger the incentive to work in the black economy. However, a number of other both preventive and repressive measures are needed to combat undeclared work.

FIEC indicates that apart from the number of jobs created, the reduced VAT rates measure has proved to be particularly effective in combating undeclared work in France[40].

In France, where a VAT reduction from 19.6% to 5.5% for the renovation and repair of housing more than two years old was introduced, the reduction in the black economy appears to total 1/5 to 1/3 in the third year[41].

As explained below, the Copenhagen Economics model simulations show that in those sectors where households have considerable scope for buying from the black economy (and carrying out DIY), such as locally supplied services and restaurant services, lowering VAT rates is likely to lead to overall productivity and GDP increases in a Member State, because activity shifts to the formal economy.

From this analysis, we conclude that reduced rates are likely to be most effective in combating the black economy in those sectors that serve final consumers, especially households. Consequently, the objective of combating the black economy would be best met by the policy change options excluding those which serve non-commercial customers that are not households.

The no-policy-change option is likely to lead to an increase of activity in the black economy.

5.2.3. Effect of temporary measures. Legal and economic certainty

In its report COM (2003) 309 final on the experimental application of a reduced rate of VAT to certain labour-intensive services, the Commission concluded that lower VAT rates are passed on in consumer prices only partially or not at all. The impact on prices appeared to be only slight and did not appear to last. Moreover, it was not possible to find solid evidence of reduction of the black economy or of boosting job creation.

These conclusions might at first sight seem at odds with the conclusions above drawn up regarding long-term pass-through of VAT reduction in the price and demand and employment responses. Copenhagen Economics[42] reconsidered these experiments and their evaluation and — despite variations in their ambition and thoroughness — found no major flaw in the evaluation of these experiments and shared the Commission's view that they had produced no solid evidence to indicate that reducing VAT rates had a positive impact on employment.

However, Copenhagen Economics did not expect to find any impact, given that they were experiments. All experiments are temporary in nature, not permanent. If firms know that a lower VAT rate is temporary, why should they spend time and money on expanding production capacity, only to revert to their previous production level within a few years? By being experiments, the experiments by themselves begged to be ineffective with respect to job creation. Moreover, insufficient supply side reactions might lead to price increases.

[40] FIEC, *Guide of good practices to combat undeclared and illegal work*, June 2006, p.12.

[41] According to findings by the VAT Club Jacques Borel cited in the study on Germany, p.32.

[42] Copenhagen Economics study, p.10.

It can be concluded that the policy change options introducing permanent changes to the legislation are by far preferable to continuously extending temporary measures and meet the objective of providing legal and economic certainty. Policy change options would clearly and permanently give Member States the option of applying reduced rates in the areas concerned. Permanent solutions, in particular for the Annex IV labour-intensive services and restaurant services, would improve legal and economic certainty, as the discussion on these issues has been ongoing for a long time. The no-policy-change option would also offers some certainty, by clearly excluding further extensions of temporary measures (especially as regards certain labour-intensive measures), but because derogations (for example for restaurant services) would still be in place, the discussion on the extension of reduced rates for locally supplied services and restaurants would not be over and would leave room for uncertainty.

5.2.4. Macroeconomic performance

Under all options relating to policy change, reduced rates introduced for the sectors concerned are likely to boost activity in these sectors, but impacts on other sectors need to be considered, as do impacts due to budget constraints. Indeed, against the background of the Stability and Growth Pact, the budget neutrality of VAT reductions will have to be reflected on.

If budget neutrality is to be assured, the lost tax revenue must be compensated for, for example by other taxes. Copenhagen Economics assessed global impacts by means of its CVEM Model[43] and assured budget neutrality of VAT reductions for certain sectors by increasing the standard VAT rate so that the combined effect on the government budget was zero. However, higher VAT rates work in the same way as lower VAT rates. For this reason, the overall long-term effect on total employment and growth does not equal the sum of short-term industry-specific impacts. For lower VAT rates to be economically beneficial there must be significant and important differences between favoured and disfavoured goods/services. If these differences exist, shifting activities between sectors might lead to permanent changes in the economic structure of a Member State[44].

It is obvious that if VAT rates are lowered on particular goods/services, even without taking account of budget neutrality, consumption patterns will most likely change somewhat. Overall economic results should be considered before coming to conclusions.

5.2.4.1. Overall productivity[45]

Lower VAT rates can increase overall productivity and GDP in a Member State if they can induce consumers to spend fewer hours on do-it-yourself (DIY) activities and more hours on their ordinary job and thus shift activity from DIY to the formal economy. The reason is that a trained worker typically is more productive on his job than doing DIY. In addition, tax revenue is likely to increase.

The extent to which formally produced goods and services are replaced by DIY varies considerably across industries, and between Member States. It is relatively easy to substitute a visit to a restaurant for domestic cooking, while few consumers would venture into producing

[43] Copenhagen Economics VAT CGE Model: see footnote 12.

[44] Copenhagen Economics study mentioned above, pp. 10-11 and 20.

[45] Defined as production per hour worked, including DIY and undeclared work, see Copenhagen Economics study, pp.20-25.

their own PC. Other activities particularly suitable for this type of substitution might be cleaning, washing, gardening, window cleaning, domestic services, hairdressing, and repair and maintenance of other consumer durables: in short, locally produced services. In contrast, most manufacturing activities and many other services are much too complicated to be candidates for DIY.

The same productivity argument holds, albeit to a lesser degree, if lower VAT rates can induce consumers to spend less money in the underground (black) economy. Productivity gains are probably more limited, as many underground workers are the same workers that would carry out the work if the activity were declared, particularly for construction and repair work. However, the gains in tax revenue are similar. The productivity argument is intimately linked to the so-called tax wedge. The tax wedge is a measure of the distance between the labour costs to the employer and the net wage an employee receives (or the number of hours a person has to work in order to earn sufficient money to pay another person for one hour's work: if the tax wedge is 2.4, for example, then a person has to work for 2 hours and 24 minutes to earn sufficient after-tax income to be able to pay another person to do one hour of work including VAT). Clearly, the larger the tax wedge is, the more inclined she/he will be to do the job her/himself or to buy it undeclared.

Copenhagen Economics general equilibrium model (CEVM) simulations show that there is a sound economic argument for lowering VAT rates on locally supplied services and restaurants in both southern and northern Member States (there is a larger tax wedge and more DIY in the latter). In both types of Member States, consumers shift about 2 percent of their man-hours from DIY to formal work if VAT is lowered by 10 percentage points; the shift leads to significantly higher productivity in the range of 0.5 percent, and to higher tax revenue in the range of 0.5 percent due to the larger tax base.

The argument for lowering VAT rates on locally supplied services and restaurants is significantly stronger in Member States that are more 'northern' than 'southern'. The higher marginal income taxes and the larger initial VAT rate (in short, the larger tax wedge) in the northern country drives more activity into DIY, where it is less productive, thus generating greater potential in terms of hours to be shifted back to the formal economy, in terms of productivity growth to be gained, and in terms of extra tax revenue.

Other illustrative CEVM simulations including an extension of reduced rates to locally supplied services (including restaurants) to all Member States currently using reduced rates, whilst keeping other reduced rates unchanged and raising the standard rate (to maintain budget neutrality) and taking into account the shift in activity between the informal and formal economic sectors, show that overall EU-25 measured GDP would be likely to increase by just over 1 per cent.

Lower VAT for locally supplied services and restaurants predictably boosts demand for these services — demand for locally supplied services and restaurants grows significantly by 1.8%. For the rest of the economy it is suggested that demand would decrease by 0.2%.

The changes in consumption structure hide underlying changes in observed GDP and in non-observed overall productivity in the formal and informal sectors. As said, measured GDP increases by about 1 per cent. It increases because some activities previously in the (unmeasured) informal sector (here DIY and undeclared activity) are now being carried out in the (measured) formal economy. The increase in GDP overstates the real change as the activity is measured as if it had not been carried out previously. But it is still a very considerable number. A more targeted model calculation would suggest an increase in overall productivity of about three quarters of one per cent.

As explained, overall productivity and GDP gains are likely to be stronger in Member States where high overall VAT rates and high marginal income taxes have inflated the tax wedge (the largest tax wedge is in Member States such as Belgium, Denmark, Finland, and Sweden, the lowest in Member States such as the United Kingdom, Greece, Portugal, Luxemburg, and Spain).

The productivity argument is, in particular, strong for activity with a limited need for formal training and specialised machinery. Thus, domestic care, cleaning, home repairs and laundry — all examples of locally supplied services — are more attractive candidates for lower VAT rates than computer manufacturing. Such sectors are typically characterised by a higher share of low-skilled employment relative to the average share of low-skilled employment (see column 4 of Table 1 below). However, other sectors with equally high shares are less relevant as they are not obvious candidates for DIY work.

Table 1: Average low-skill employment, EU-25

Groups (1)	**CEVM-Sector (2)**	**Value added, (shares %) (3)**	**Low-skill employment (shares %) (4)**	**Relative* low-skill employment (shares %) (5)**
1. Food	Hotels	1.1	31.9	1.18
	Restaurants	1.9	30.5	1.17
	Food	1.5	27.0	1.00
2. Merit	Medical and pharmaceutical	0.5	22.3	0.82
	Books and newspapers		25.0	0.92
	Culture and entertainment	1.4	25.0	0.92
3. Network	Electricity and heating	1.5	23.2	0.85
	Postal, telecom and financial services	3.4	16.8	0.62
	Passenger transport	1.3	26.2	0.97
	Social housing	0.4	26.3	0.97
4. Local	Locally supplied services	2.1	32.1	1.18
5. Public	Government services	17.6	14.9	0.56
	Street cleaning	0.2	32.3	1.19
6. Rest of the Economy	Rest of the economy	67.0	27.1	**1.00**
	Total	100.0	-	-
	Average	-	**26.2**	-

** Relative low skill employment share is calculated as the relative deviation from the sector "Rest of the Economy"*
Source: Luxembourg Income Study (2007) and Copenhagen Economics

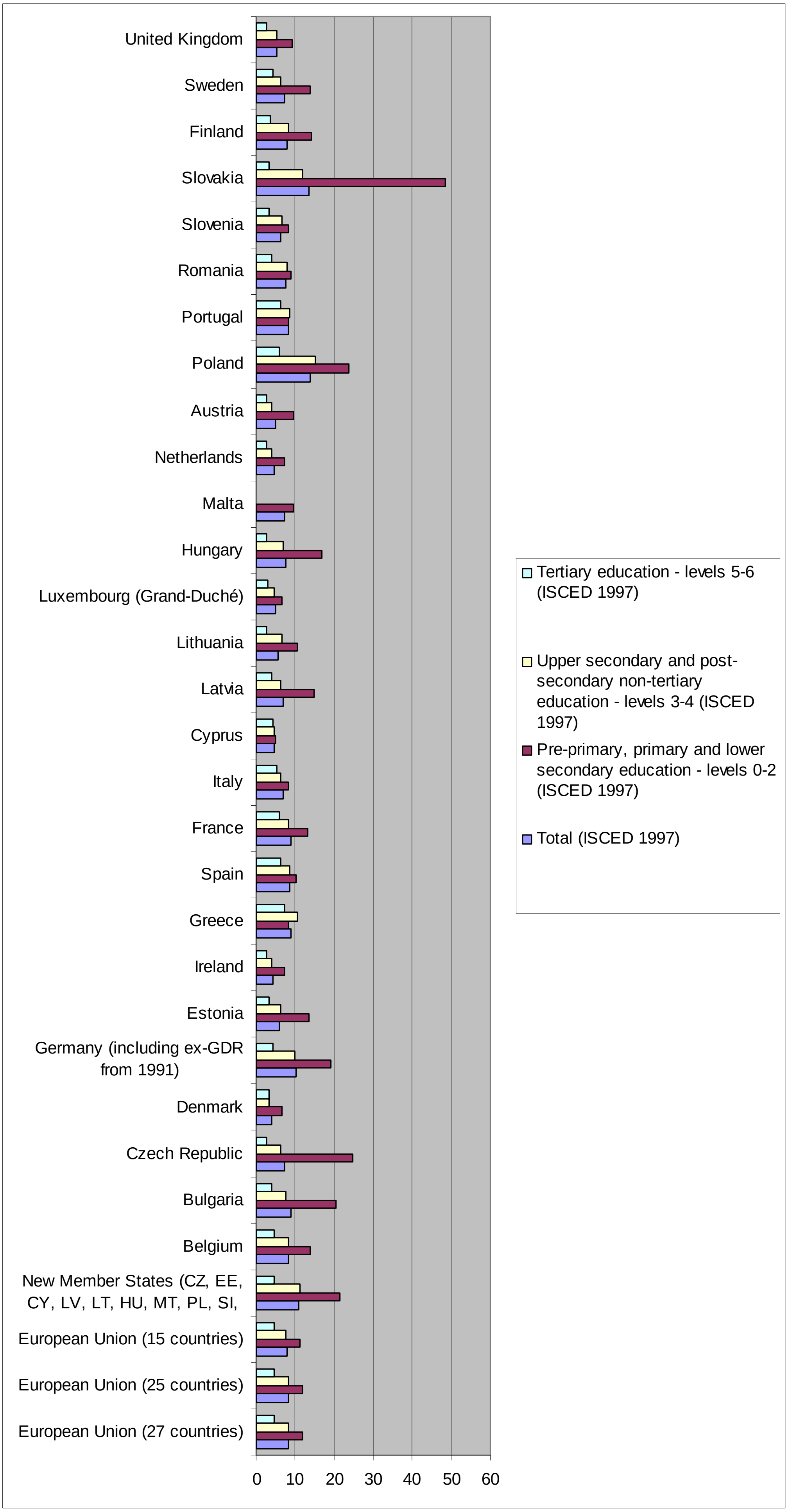
5.2.4.2. Reducing structural unemployment[46]

Lower VAT rates can reduce structural unemployment among low-skilled workers in a Member State if they can induce consumers to shift demand towards sectors employing more low-skilled workers than the rest of the economy such as hotels, restaurants and locally supplied services (see column 5 of Table 1 above). Such a shift in demand is likely to boost the wages of low-skilled workers and increase incentives for employment on both sides of a rigid (low-skilled) labour market. In most Member States, unemployment among those with low qualifications constitutes a serious labour market problem as can be seen from Figure 1[47].

Figure 1: Unemployment rates by education attained (% — year 2006)

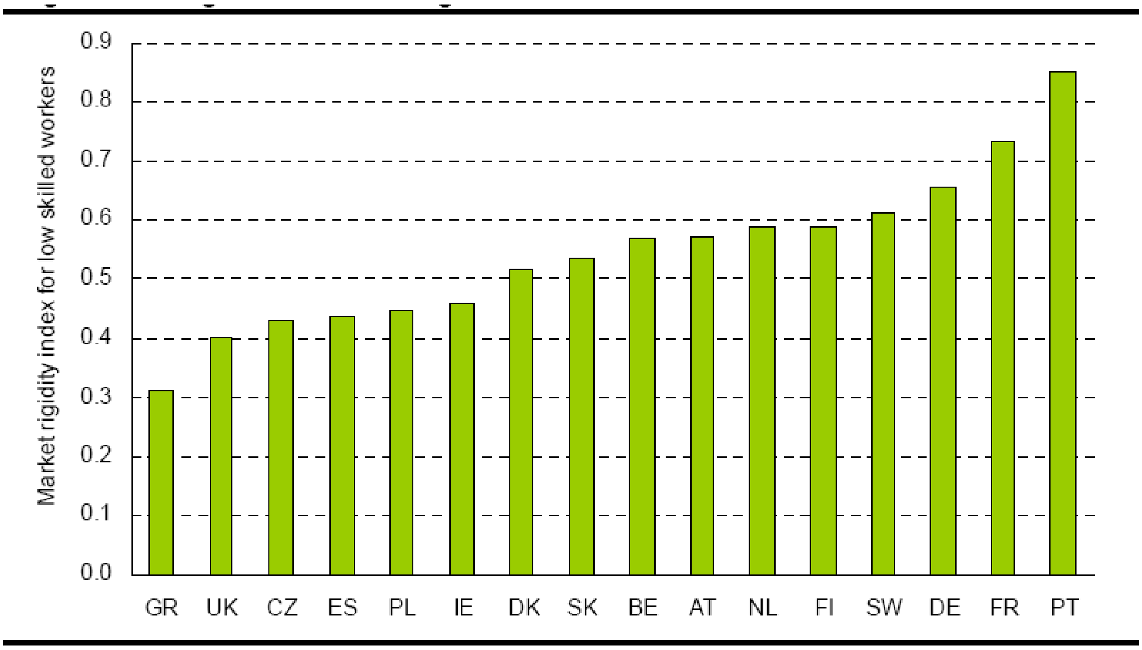
[46] Copenhagen Economics study, pp.26-28.

[47] Eurostat database (Labour Force Survey).


United Kingdom
Sweden
Finland
Slovakia
Slovenia
Romania
Portugal
Poland
Austria
Netherlands
Malta
Hungary
Luxembourg (Grand-Duché)
Lithuania
Latvia
Cyprus
Italy
France
Spain
Greece
Ireland
Estonia
Germany (including ex-GDR from 1991)
Denmark
Czech Republic
Bulgaria
Belgium
New Member States (CZ, EE, CY, LV, LT, HU, MT, PL, SI,
European Union (15 countries)
European Union (25 countries)
European Union (27 countries)
0 10 20 30 40 50 60
Tertiary education - levels 5-6 (ISCED 1997)
Upper secondary and post-secondary non-tertiary education - levels 3-4 (ISCED 1997)
Pre-primary, primary and lower secondary education - levels 0-2 (ISCED 1997)
Total (ISCED 1997)

The reduced structural unemployment argument is particularly strong in Member States where the labour market for low-skilled workers is markedly more rigid than for high-skilled workers in terms of high replacement rates, unemployment benefits, minimum wages and hiring and firing costs (see Figure 2 below).

Figure 2 Average labour market rigidities in selected EU Member States



Notes: The market rigidity index is a simple weighted average of indices for the net replacement rate and hiring and firing costs. Unity corresponds to maximum rigidity and nought to total market flexibility. Data is missing for CY, EE, HU, IT, LT, LU, LV, MT and SI.

Source: OECD (2007)

Moreover, the larger the share of low-skill employment in the sector relative to the rest of the economy (see column 5 of Table 1 above), the more pronounced the reduced structural unemployment argument will be, particularly if it is a non-tradable sector that is not very vulnerable to competition from abroad.

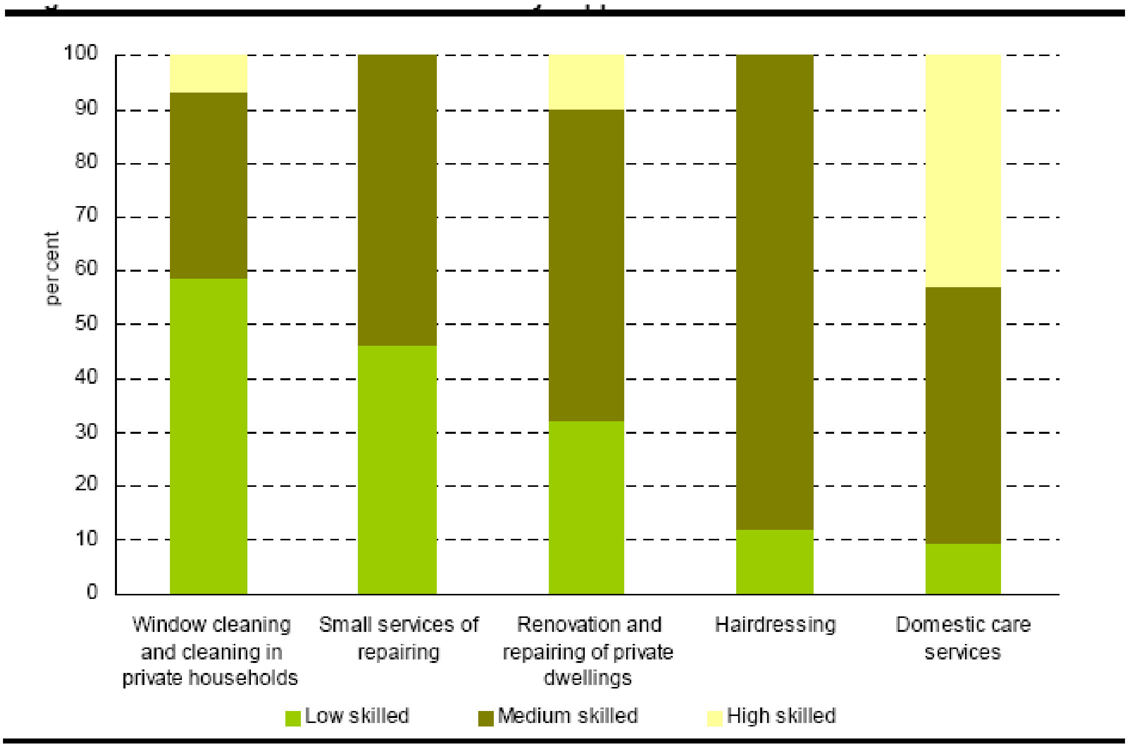
There is a clear interrelationship between the arguments for reduced unemployment and higher productivity, in that some of the sectors with a high share of low-skilled employment are also sectors with activities that can be performed with little training or use of specialised machinery.

Copenhagen Economics' general equilibrium model simulations regarding lower VAT for sectors with a high share of low-skilled employment (hotels, restaurants and locally supplied services and street cleaning) predictably show demand boosts for these sectors, i.e. a change in value added in the EU-25 for these services of 0.9%.

However, these changes in demand lead to only a minuscule increase (0.01%) in the overall demand for low-skilled labour. Indeed, the difference between employment shares for low-skilled workers in the sectors favoured by lower VAT rates and the rest of the economy is fairly modest and there are significant differences in low-skilled employment within locally supplied services. For example, data from Denmark indicates that the share of low-skilled employment is as high as 60% in cleaning for private households, close to 50% for small services of repairing, and above 30% for renovation and repair of private housing, but about

10% for hairdressing and domestic care services, well below the share in the rest of the economy (see Figure 3 below).

Figure 3 Distribution of skills within locally supplied services



Source: Copenhagen Economics

This insight indicates that there may be a better argument for targeted reductions in VAT rates for carefully selected parts of locally supplied services rather than general reductions for all locally supplied services.

In conclusion, there are strong (socio-) economic arguments for maintaining, introducing or even extending reduced VAT rates in sectors competing vigorously with DIY work (and undeclared work) such as locally supplied services; it is to a more limited extent relevant for sectors employing significant numbers of low-skilled workers. However, in all cases, the potential for reaping net economic benefits from reduced VAT rates does not rely solely on the characteristics of the sector but also on the particular economic environment of each Member State. For example, extending reduced VAT rates to sectors employing significant numbers of low-skilled workers is most adequate where there are rigid labour markets for the low-skilled.

The growth and employment impact of reduced rates is strongest in (sub)sectors with a limited need for formal training and specialised machinery which at the same time have a relatively high degree of low-skilled labour. These sectors include restaurants and a large number of locally supplied services: small repairs and maintenance, and cleaning services. Moreover, they largely serve final consumers, which is a pre-requisite for reduced rates to be effective. The arguments appear to be less valid for the construction and renovation of houses and non-residential buildings. Some locally supplied services such as domestic care and hairdressing might have less potential for reduced rates in terms of structural unemployment reductions, but might still be worthwhile from a productivity growth perspective.

Furthermore, the effects of VAT reductions might be emphasised by using compensatory budgetary measures other than increasing the standard VAT rate. However, compensating the loss by way of higher income taxes makes little sense according to Copenhagen Economics[48] as the whole rationale for the reduced VAT rate is to compensate for the adverse effect of high taxes on labour. VAT impacts can never be considered in isolation.

Generally, in terms of growth and employment, the options 2, 3 and 5 would be most suitable. However, differences between Member States as regards labour market and tax conditions have to be taken into consideration. Reduced rates are often one instrument applied in combination with many others.

In the no-change option, the automatic abolition of reduced rates is likely to lead to adverse effects: losses of productivity and growth and (very) small overall employments effects.

5.2.5. Compliance and administrative costs

Neither the Standard Cost Model to assess administrative costs imposed by legislation, set out in the Annexes to the Impact Assessment Guidelines of the European Commission, nor any other method of quantification was applied. The introduction of reduced VAT rates in new areas will, in principle, not give rise to any additional information obligations to which a cost can be allocated. It would just offer all Member States the option of applying a reduced rate to defined sectors. Their obligations, such as those relating to invoicing, accounting, and VAT returns, remain unaffected. However, it cannot be concluded that reduced rates therefore do not entail any compliance costs at all.

The Copenhagen Economics study referred to above points to empirical evidence indicating that the compliance costs associated with lower VAT are significant. In particular, differences in VAT rates between similar products may give rise to a substantial number of administrative and legal conflicts about the proper classification of specific goods. Swedish estimates indicate that such cases have very significant costs to society (e.g. businesses, tax administrations, and judicial institutions): a survey on compliance costs of VAT in Sweden[49] carried out by the Swedish Tax Board shows there is a clear correlation between the costs of handling VAT in businesses and the number of rates of VAT to be handled. Copenhagen Economics[50] roughly calculated that — on the basis of the Swedish findings — for the EU-25 the compliance costs for European enterprises and public authorities amount to nearly EUR 4 billion per year or 0.1% of EU-25 private consumption.

As indicated, in respect of compliance costs the issue is to focus on VAT rate differences between goods/services from the same sector or even more precisely, the same subsector. To determine whether the supply of food is to be qualified as the supply of take away (prepared) food subject to a reduced rate or the supply of a restaurant service, for example, might prove much more difficult and expensive than assessing the difference between the supply of a restaurant service and a cleaning service.

Legal certainty is to be assured by clear differentiations, certainly as the business sector is actually the (unpaid) tax collector in the VAT system. Administrative and court proceedings

---

48 Copenhagen Economics study, p.86.

49 *Compliance costs of value-added tax in Sweden*, report 2006:3B, Skatteverket.

50 Copenhagen Economics study, p.53.

on borderline cases are to be avoided if at all possible. The need for clear definitions applies equally to tax administrations. Consequently, clear definitions of the services subject to a reduced rate are likely to avoid extra compliance costs.

Copenhagen Economics' calculations suggest that extending reduced VAT rates for hotels, restaurants and locally supplied services is likely to leave compliance burdens unchanged.

However, as already explained, if rate variations in a particular sector — which supplies similar goods/services — are reduced, compliance costs are also likely to be reduced. For example, applying the same reduced rates in a particular Member State to restaurant services and take away food (or to the complete housing sector instead of only to social housing or to repair and maintenance of private dwellings) is likely to diminish compliance costs. The policy change options (5, 6 and 7) which could lead to smaller variation of rates within one sector (in a particular Member State) would in principle reduce the compliance burden. The no-policy-change option, mainly leading to the abolition of reduced rates (and application of the standard rate) for certain locally supplied services would result in less compliance costs compared with the current situation only in the construction and minor repair sector.

Another problem in respect of compliance costs is to be found in the rate differences between Member States. It is, however, not to be expected that all different policy options will further complicate the current situation. Indeed, currently Member States can apply reduced rates on an optional basis and derogations granted, for example in the restaurant sector, lead to rate disparities in the EU.

Under the policy change options the picture could even be slightly improved because all Member States would have equal opportunities to apply reduced rates for locally supplied services, restaurant services and certain services in the building sector. The no-policy-change option would leave the unequal treatment and rates variation unchanged in these sectors. Because of the abolition of reduced rates for certain labour intensive services, slight improvements in variations among Member States are possible for these sectors.

5.2.6. Budgetary cost

The policy change options would have a (negative) budgetary impact in the Member States, depending on the use they make of the flexibility offered. Indeed, policy change would not affect the optional character of reduced rates for Member States. The more reduced rates are applied in a particular Member State, the more (negative) budgetary impacts will be found. Moreover, a number of Member States already use parts of the policy change options. We refer to some examples cited in section 5.2.1. to illustrate fiscal impacts. It is clear that these cannot be limited to a simple calculation of the direct VAT revenue loss in a Member State because of the introduction of a reduced rate for a particular sector. There are a multitude of indirect impacts to be factored into the calculation. Moreover, as already explained earlier, most Member States will have to assure budget neutrality when introducing reduced rates and try to find the budgetary compensating instruments which support the goals aimed at with the VAT reduction. Furthermore, impacts are likely to be different in periods of high economic growth or recession or will depend on other measures in place.

Note that the macro-economic impacts discussed in section 5.2.4 of this report are based on Copenhagen Economics research, which assumed that reductions in VAT rate for specific sectors were compensated by an increase of the standard VAT rate. Alternative methods of financing VAT rate reductions may be based on tax and non-tax instruments and can range, for instance, from an increase of income taxes, social security contributions, property taxes to a reduction of the budgetary expenses. The selection of the suitable financing instrument should be accordingly balanced against the potential effects. For instance, an increase in income taxes or social security contributions could run counter socio-economic objectives set for lower VAT rates on locally supplied services (including restaurants), such as economic growth, combating the undeclared economy or employing more low-skilled workers.

Under the flexibility principle, referring to the application of reduced rates as Member States see fit in areas where the proper functioning of the internal market is not affected by rate differentiation across the Member States, it is the role of the Member States to assess the budgetary impact of VAT reductions.

As regards budgetary impacts of the policy change options relating to the construction (housing) and restaurant sector some purely <u>indicative</u> values are presented hereafter[51].

For the housing sector, the VAT revenue in the EU-27 for 2004 is roughly estimated at EUR 29 192 million out of EUR 722 319 million total VAT receipts, i.e. 4.04% and would be roughly about 1.05% of total tax receipts.

A reduction of VAT in the housing sector, in the Netherlands, for example, from 19% to 6%, would roughly result in a direct loss of total tax revenue of 1.24%. A reduction of VAT in the housing sector in Hungary from 20% to 5%, for example, would according to the same rough estimations decrease the total tax revenues by 0.70%.These figures do not take indirect effects and existing partial applications of reduced rates (for certain painting and plastering services in the Netherlands) into consideration.

For the restaurant sector, the VAT revenue in the EU-27 for 2004 is roughly estimated at EUR 15 641 million out of EUR 722 319 million total VAT receipts, i.e. 2.17% and would be roughly about 0.56% of total tax receipts.

If the VAT on restaurants were to be reduced in Finland from 22% to 8%, for example, it would roughly result in a direct loss of total tax revenue of 0.31%. The reduction of the VAT rate for restaurants in France from 19.6% to 5.5% for example, would roughly result in a direct loss of total tax revenue of 0.52%. These figures do <u>not</u> take into consideration .indirect effects and existing partial applications of reduced rates (e.g. in France for staff canteens) or VAT deductions on restaurant services and possible exclusions of (alcoholic) beverages.

The no-policy-change option would in principle result in an increase of budgetary means for Member States which have to give up the application of reduced rates for certain labour-intensive services or whose derogations expire. Again, the calculation of the impact cannot be limited to direct impacts.

For the Community, none of the policy options have an impact on its VAT own resources, as these are calculated on a uniform basis of assessment.

[51] The VAT revenue figures were calculated on the basis of Eurostat data, which contain figures on sectoral value added. The VAT revenue figures would be more precise if they were based on actual sectoral VAT receipts declared in the Member States.

5.2.7. Impact on final consumers and the business sector

5.2.7.1. Final consumers

According to the above Copenhagen Economics analysis the price pass-through effect of VAT rate reduction will sooner or later be (close to) full. Even if this pass-through effect is not full, all policy change options lead to price reductions in the sectors concerned and thus to an improvement in the purchasing power of final consumers. However, the economic context surrounding these reductions is more complicated. In the longer run, higher prices because of demand boosts for the sectors concerned are possible and price impacts on other sectors of the economy need to be taken into consideration, partly as a result of budget neutrality constraints. One group of final consumers might also benefit from more employment or better salaries and work conditions as a consequence of more demand for the services concerned, leading to more welfare for this group. As suggested in the Mannheim University study on impacts of reduced rates in the hotel and restaurant sector in Germany[52] (see also 5.2.7.2), reduced VAT could also lead to investment in modernisation and the improvement of staff qualifications. Reduced rates could thus result in improved quality of service to consumers in the sector concerned. The no-policy-change option would have opposite effects. However, in the sectors concerned these might be more pronounced than in the case of VAT reductions.

Copenhagen Economics' CGE model calculations show that an extension of reduced VAT rates in the EU-25 to locally supplied services, hotels and restaurants (with an increase in the standard rate) is likely to result in extremely low impacts on overall consumer welfare (derived from overall price changes). These results imply that the overall consumer welfare (and price) effects both from the policy change options and from the no-policy-change option are likely to be negligible.

5.2.7.2. The business sector

Again, the business sectors concerned by all policy change options would benefit from reduced rates as demand in these sectors would be boosted. Assuming profit margins for the businesses concerned do not change, the increased turnover should result in higher profits for these businesses. All the sectors concerned are labour-intensive. It may take some time before hiring new staff is considered profitable. Moreover, depending on the specific sector (and certainly in rigid labour markets) it may take some time before new staff can be hired. The more labour-intensive the sector, the more relevant the problem will be. Certain sectors, for example the construction sector, might face more problems than others in recruiting qualified staff or training new staff at short notice.

From a survey conducted by DEHOGA (Deutscher Hotel-und Gaststättenverband) and other experts, cited in the Mannheim University study[53], it appears that some of the interviewees would use the VAT reduction to raise salaries (13.3%), to take staff training measures (11.1%), to invest in modernising premises (20.1%) or to increase profits (7.1%). The largest proportion said they would use the VAT savings to reduce prices (48.4%). Consequently, increased profits following VAT reductions may result in improving employee working conditions, modernisation and improvements in staff training, etc., in the sector concerned.

---

[52] *Ermäßigter Mehrwertsteuersatz…*

[53] *Ermäßigter Mehrwertsteuersatz…*, p.16.

Caledonian Economics[54] came to almost the same conclusion, i.e. that the 1986 VAT reduction from 25% to 10% in the tourist sector was used as follows by the hotel and restaurant business: 45% for price reductions, 25% for salaries and training, 10% for investments and 20% for increasing profit margins. Anecdotal evidence indicates that the increase in profit margins was larger.

Carbonnier (2006)[55] conducted the most recent econometric study on the effects of VAT changes on firms' profits. Analysing data from the French car sales sector and maintenance and repair of housing for the period 1990-2002, he found that approximately 23% of the cost changes arising from VAT changes in the housing repair sector and 48% in the car sales sector are borne by firms.

This shows that a VAT reduction might impact on sectoral investments, modernisation, salaries paid, increased job satisfaction and the financial structure of businesses in the sector. On the other hand, if there is less than complete pass-through, inefficient firms may use VAT reductions to hide unnecessarily high prices in order to conceal their high operating costs[56].

However, in competitive markets if the bulk of the enterprises in the sector concerned decide to reduce prices following VAT reductions, competitors will be under pressure to do likewise, meaning that in the longer run these other impacts are likely to fade away. This is borne out by the empirical findings of Copenhagen Economics that in the longer run VAT reductions will be fully passed on in prices. One should add that the price reductions in the sector, as indicated above, are likely to boost demand, which in turn should lead to more employment, and improved employment and investment conditions.

As already emphasised for the various impacts, the sectors concerned by VAT rate reductions cannot be considered in isolation. The impacts on other business sectors have to be factored into decisions on reduced rates. Substitution effects are likely to result in adverse effects in these sectors.

It can be concluded that the businesses operating in the sectors concerned in the policy change options are likely to benefit from the positive effects of reductions of VAT rates, as explained above. Other sectors might experience adverse effects.

In the no-policy-change scenario, the opposite will occur: the sectors affected (e.g. labour-intensive services, and restaurants in some Member States) are likely to experience adverse economic effects.

Impact on SMEs

In view of the nature of local services, it is obvious that the large majority of enterprises supplying these services will be SMEs which would benefit from the effects of any reduced rates applied to these services, but what about the restaurant and construction sector?

The construction sector is characterised by a large number of small enterprises, and relatively few large ones, with most enterprises serving a relatively small geographical market.

[54] According to *Consequences de la baisse de TVA…*, p.27.

[55] Copenhagen Economics study, Part B. Appendix 1, p. 23.

[56] Copenhagen Economics study, Part B. Appendix 1, p. 18.

Enterprises with fewer than 50 employees generated 65% of the EU-27's value added in the construction sector in 2004. On average micro-enterprises (<10 employees) accounted for 33% of total enterprises in construction (2002), i.e. 26 percentage points more than their share in manufacturing (7%)[57].

In terms of enterprise size, a large proportion of the wealth created in the EU-27's hotels and restaurant sector came from small and medium-sized enterprises (SMEs with less than 250 persons employed) as these enterprises generated about three quarters of the sector's value added in 2004. SMEs' contribution to employment in the sector was even greater than for value added, at 82.3% of the total workforce. Micro-enterprises (with less than 10 persons employed) provided 36.5% of the sector's value added in the EU-27 and 45.4% of the sector's workforce[58].

In the policy change options, all the sectors concerned are dominated by SMEs and activity boosts (and the impact on the underground economy) due to reduced rates will thus be greater for SMEs. In the no-policy-change option, adverse effects — which are likely to be stronger and faster — are to be expected. Moreover, any reduction in compliance issues (and improvement of legal certainty) in the restaurant and construction sector in the policy change option relating to these sectors would positively affect the administrative costs of SMEs more than those of other business entities.

5.2.8. Impact on competition

All services included in the policy change options are local by nature, meaning that they cannot be supplied from a distance, are largely directed to the local market of final consumers, and the supplier and customer are located in a geographically limited area, and/or their place of supply for VAT purposes and thus the VAT rate applicable is that of the country where the immovable property is located (supplies of services connected with such property, such as gardening, building, renovation and cleaning of buildings, under Article 45 of the VAT Directive). For these services, VAT rate differences between Member States will not therefore impact on the proper functioning of the <u>internal market</u>. There is one exception: restaurant services and services provided by personal grooming establishments.

Although restaurant services are mainly directed at local consumption, significant differences among the Member States in VAT rates applied to restaurant services might have an impact on the internal market in border regions and as regards tourism.

Accommodation and restaurants appear to account for 50% of total spending from incoming tourism in Germany and Spain and 35% in France. Lower VAT rates might lead to more incoming tourism[59]. However, any distortions caused by lower VAT are likely to differ in magnitude between Member States. The effect is likely to be stronger for smaller and tourist-oriented areas, and the degree of possible substitution of holiday destinations (between countries with similar characteristics) plays an important role.

---

57 Eurostat Statistical Books, *European business: Facts and figures*, 2007 edition, p.259 and Eurostat, 'The construction industry in the European Union, 2002', *Statistics in focus*, No 26/2005, p.6.

58 Eurostat Statistical Books, *European business: Facts and figures*, 2007 edition, p.322.

59 Copenhagen Economics study, p. 93.

It is worth mentioning that in terms of business consumption, the rules on VAT deductibility may also impact on the functioning of the internal market. Businesses account for approximately 10% of clients[60].

Possible distortions due to VAT rate differentiations are difficult to measure, because consumer choices will depend on prices and prices depend on a number of factors. The consumer price will not always be lowest in the country with the lowest VAT rate for the service.

Moreover, currently, all Member States can opt to apply a reduced rate to accommodation provided in hotels and similar establishments. From an internal market perspective these services are similar to restaurant services. The Commission has never received a complaint about VAT-driven internal market distortions in tourist accommodation. Additionally, the restaurant cost does not appear to be the major part of a holiday cost.

Consequently, distortions of the internal market due to rate differentiations in the restaurant sector are possible, but should not be overestimated.

The same arguments also apply to personal grooming services. These are considered local services but may be part of tourism packages.

On a worldwide scale, reduced rates in the EU tourism sector might avoid that the EU looses further ground in the international tourism sector.

The no-change policy would not affect the internal market compared with the current situation, except for abolishing the option to apply a reduced rate to restaurant services in some new Member States. The overall situation in the EU would remain unequal as other Member States would keep the reduced rate based on a legal derogation.

None of the policy change options would affect the internal market, except for those including the tourist sector (restaurant services, personal grooming), where the internal market could be affected due to the optional character of reduced VAT rates, but overall Member States would have equal opportunities to apply reduced rates, which should limit distortions in the internal market compared with the current situation.

Because most services affected by the policy change options are local by nature, the policy change options do not constitute barriers to entry into the internal market for enterprises, except possibly for the construction and restaurant sectors. However, for these sectors the rate disparities in the EU would not be worsened, but might be improved because of the equal opportunities offered to Member States and the extension of the option of applying reduced rates within the sector. The no-policy-change option would have no consequences in this respect.

Within a particular Member State, the policy change option that allows all Member States to apply reduced rates to restaurants could reduce competition distortion between similar or substitutable products (assuming amounts of food per person are constant): non-prepared food, take-away food and restaurant services. Moreover, distortions of competition between hotels (in the case of breakfast and half-board) and restaurants would be reduced. The no-policy-change option would, in certain Member States (with no derogation for restaurants),

60 *Ermäßigter Mehrwertsteuersatz …*, p. 7.

leave these distortions or could, in certain Member States (that currently have reduced rates for restaurants but are obliged to abolish them), increase such distortions.

5.3. Social impacts

5.3.1. Impact on income distribution[61]

Lower VAT rates can produce a more equal income distribution among households (after consumption) if they make goods and services which are mostly consumed by low-income groups cheaper. Income distribution (after consumption) improves because the price of a typical consumption basket for low-income groups goes down while the price of a typical consumption basket for high-income groups goes up.

The argument requires that low-income groups, over time, have stable consumption shares sufficiently different from high-income groups. If the products in question are solely consumed by low-income households, lower VAT rates will be very well targeted. However, if they are consumed equally by low-income and high-income households, reduced VAT rates will not change the income distribution by any noteworthy amount.

Copenhagen Economics' calculations of the average EU-15 consumption shares for household groups divided in quintiles for selected sectors show that consumption patterns are rather similar for most sectors, except for food and utilities like electricity and heating. In those sectors, low-income consumption shares are on average almost twice (1.83 and 1.71) the corresponding high-income consumption shares. It means that ceding reduced VAT rates to the food sector will benefit high-income households, but will be much more beneficial for low-income households because they spend a significantly larger share of their income on food. For hotels and restaurants, and locally supplied services, these differences in consumption shares are much less significant (respectively 0.76 and 0.82), which does not really differ from the rest of the economy.

Consequently, the Copenhagen Economics CGE model calculations show that the scenario where reduced rates are extended in the EU-15 to locally supplied services, hotels and restaurants (while assuring budget neutrality through higher standard rates) has almost no effect on income distribution; it slightly increases prices of the consumption basket for the lowest income category (0.03%) and slightly decreases prices for the highest income category (-0.02%).

Moreover, the effectiveness of reduced VAT rates is in practice linked to the initial level of income distribution in a country. The reason is that consumption patterns in the population tend to converge as equality increases. The more similar consumption patterns, the less suitable reduced rates on specific consumption goods are for improving income distribution. Consequently, in Member States with initially egalitarian income distribution, reduced rates in sectors such as food and utilities will have limited impact on income distribution. There are significant differences between Member States in this respect.

We conclude that none of the policy options is likely to have a noteworthy impact on income distribution.

[61] Copenhagen Economics study, p. 30-32.

5.3.2. *Other social impacts*

As explained in previous sections, the policy change options are likely to result in job creation, improved labour conditions (wages, training) in the sectors concerned. However, adverse effects in other sectors need to be taken account of.

The sectors concerned in the policy change options are all relatively labour-intensive[62], but the skills level differs between the sectors concerned. Again, a relatively low-skilled workforce is expected to be found in the restaurant sector and locally supplied services defined earlier (including Annex IV labour-intensive services). However, with regard to locally supplied services further differentiation is necessary: certain locally supplied services, such as cleaning services in private households, and small repair and maintenance services, have higher shares of low-skilled employment than significant construction renovation works, domestic care and hairdressing.

The hotel and restaurant sector labour force is much younger and less skilled than in other sectors and also includes more women. Of those working in the hotel and restaurant sector in 2002, less than one employee in ten had attained a high level of education and more than 41% of employees were relatively unskilled[63]. Low-skilled labour could be easily absorbed in this sector, as well as in locally supplied services, such as cleaning and small repair or maintenance works, provided adequate professional training is supplied.

Generally speaking, in the overall economy, reduced rates for (sub)sectors with little need for formal training and specialised machinery (restaurants and certain locally supplied services) are likely to lead to a reduction in structural unemployment of low-skilled workers and all the beneficial social effects (social integration) linked to this reduction. It might also contribute to the professional integration of young people. These effects are likely to be stronger in countries with a rigid labour market. From this perspective, options 2 to 5 are expected to be the most worthwhile. By contrast, the no-policy-change option is likely to have adverse employment and labour condition effects on the sectors subject to rates increases and could have overall adverse effects on employment for low-skilled workers.

Reduced rates as envisaged in options 2, 4, 6 and 7 (construction sector) could result in improvements in housing conditions, improved accessibility of buildings for disabled and older people. Reduced rates for domestic care, gardening, cleaning services, small repair and maintenance services and restaurant services (options 2, 3 and 5) are likely to result in more wellbeing for certain categories of the population (such as the elderly, sick, or disabled) or more generally, less DIY activity and more leisure time for the population. Options 4 and 7 are also likely to improve educational, cultural, etc. conditions. For some services, human health conditions could be improved (better housing, domestic care, etc.).

---

[62] Eurostat. Statistical Books, *European business: Facts and figures*, 2007 edition, pp.11, 261, and 322, and Eurostat, 'The construction industry in the European Union, 2002', *Statistics in focus*, No 26/2005, p.3; Eurostat, 'Hotels and Restaurants in Europe', *Statistics in focus*, No 38/2004, p.4. As regards the construction sector, building completion is the most labour-intensive segment (this includes renovation, repair and maintenance).

[63] Eurostat, 'Hotels and Restaurants in Europe', *Statistics in focus*, No 38/2004, p.4.

Reduced rates for renovation and repair of all housing (option 2 and 6) might enable those families that live in fuel poverty to upgrade homes to make them more energy efficient. It might for example help people to have basic repairs of central heating installed.

Generally speaking, all this could improve the wellbeing of the overall population.

The no-policy-change option would not result in these positive social effects and would even have adverse effects assuming reduced rates for some (locally supplied) services are abolished.

5.4. Environmental impacts

The options including reduced rates for locally supplied services (except renovation and building of dwellings and certain non-commercial buildings) and restaurant services are not expected to have environmental impacts (options 2 to 5). Consumption of food in restaurants is not expected to have a larger environmental impact than preparing meals at home. Note however that reduced VAT rates for restaurants might have some small impact on mobility. The importance of the impact of increased eating-out mobility on the environment is difficult to assess as it depends on the mode of transport used (car, walking, public transport...), the length of the trip and also on the impact of lower restaurant prices when deciding on longer holiday trips.

The options including reduced rates for the renovation, construction and supply of private dwellings and certain non-commercial buildings (options 2, 4, 6 and 7) could have beneficial environmental impacts.

By contrast, the no-policy-change option leading to the automatic abolishment of reduced rates for certain renovation and repair works and for the construction and supplies of new buildings relating to private dwellings in certain Member States might have a detrimental environmental impact.

According to FIEC[64] (2007) and Eurostat[65], the built environment accounts for some 41.1% of overall energy demand in the EU-27 (year 2005). Of these amounts about 64.4% relates to the residential housing stock (26.5% of energy demand) and the remainder relates to the so-called "tertiary sector" (offices, schools, hospitals, supermarkets, public buildings, etc.). In residential buildings, about 70% of energy demand is for space heating and cooling, 10% hot water, 7% cooking and 13% lighting, electrical appliances, etc. In addition, residential buildings appear to account for 9% of total GHG emissions in the EU-27 or 491.8 million tonnes of CO2 equivalent respectively (year 2005). The general application of a reduced VAT on renovation, repair and construction works relating to private dwellings and certain non-commercial buildings is likely to boost demand for these works. As these works include – without singling out — improvements of existing buildings with a view to energy saving and efficiency, as well as to saving other scarce natural resources such as water, a general reduced VAT rate is likely to have beneficial environmental impacts and additionally is likely to contribute to the goal of securing the energy supply. Taking account of these figures, the environmental impacts will be greater in the housing sector than in the non-residential building sector. Moreover, these works also include the construction of new buildings that

[64] FIEC, *Annual report 2007*, p.19; FIEC, *Memorandum on the impact of buildings on climate change* and FIEC's suggestions for raising the energy performance of buildings, December 2007.

[65] DG TREN and Eurostat, *Energy and Transport in Figures*, Statistical pocket book, 2007.

replace old buildings and will always perform much better from an environmental perspective. However, the construction of these new buildings also requires energy consumption. These impacts are likely to be generated even without making difficult distinctions in the construction sector.

Furthermore, works such as installation of thermal insulation, high-performance double glazing, water-saving equipment or solar panels where carried out by professionals would normally imply better assurance of proper and effective installation of the equipment leading to higher energy (and other resource) performance due to the supplier's expert knowledge. Additionally, it would favour the use of declared work.

Finally, the repair of domestic electric or electronic energy-intensive products might be environmentally disadvantageous, because it might be better to replace these products with technologically more advanced ones which are environmentally higher-performing. On the other hand, replacement would result in more production (and energy consumption) and waste to be recycled. The environmental life cycle cost of a product needs to be assessed. This locally supplied service included in option 3 could thus have environmental impacts.

6. COMPARING THE OPTIONS

6.1. Comparing impacts

The impacts of the policy options are summarised in Table 2. In section 4.2., the policy change options were presented in order of increasing magnitude. However, the different aspects of the options can also be assessed separately (to be combined in different ways afterwards). For ease of understanding and presentation, the latter approach was adopted in the table below.

The impacts of policy options are presented as being negative, neutral or positive (to a varying degree). In the no-policy-change option, impacts are compared to the situation today, and policy change options are compared to the no-policy-change option.

The budgetary impacts for Member States are not included, because, as explained in section 5.2.6, it is the role of the individual Member States to assess the consequences of a possible (optional) application or obligatory abolition of reduced rates for their revenues. In the case of new reduced rates, the decisions on the financing (or lack of financing) of the revenue losses due to additional reduced rates and the calculation of indirect budgetary impacts will play an important role in this respect. Obviously, the more important the sectors to which a reduced rate is applied, the more important the budgetary impacts will be. For overall figures on the economic importance of the sectors concerned we refer you to section 2.1. Note also that a number of Member States already apply reduced rates to sectors covered by the policy change options and that the Copenhagen Economics study conclusions, the main source of this impact assessment, are based on budget-neutral scenarios.

Table 2: Comparing the impacts of the policy options

Impacts / Options	Sector growth	Growth overall economy	Sector employment	Employment. Overall	Black economy	Compliance cost	Internal market	SMEs	Income distribution	Other social	Environmental
1. No policy change	-	-	-	-/**0**	-	**0** (1)	**0**	-	**0**	-	-
2. Reduced rates (RR) for certain labour-intensive services (LIS)	+++ (2)	+++ (2)	+++ (2)	+/**0** (3)	+++	**0**	**0**	++	**0**	++ (4)	+ (5)
3. RR for an extended list of LIS for private households only	+++	+++	+++	+ (3)	+++	**0**	**0** (6)	++	**0**	++ (4)	**0** (7)
4. RR for an extended list of LIS for other non-commercial customers	+ (8)	+/**0** (8)	+ (8)	**0** (9)	+/**0**	-/**0** (10)	**0**	+	**0**	++ (4)	+ (5)
5. RR for restaurant services	+++	+++	+++	++ (3)	+++	+	+(11)	++	**0**	++ (4)	**0**
6. RR for significant works/supply in the housing sector	++	+/**0** (12)	++	**0** (12)	+++	+(13)	**0**	++	**0**	+	+
7. RR for significant works/supply of non-commercial buildings	+ (14)	+/**0** (14)	+ (14)	**0** (14)	+/**0** (14)	-/**0** (10)	**0**	+	**0**	+	+

0= neutral

(1) Possible slight positive impact on the construction and minor repair sectors, because of less differentiation.

(2) Effects are likely to be weaker for renovation (and repair) of private dwellings.

(3) Effects on overall employment are likely to be positive for services involving a relatively high share of low-skilled labour, such as small repairs and maintenance, cleaning services and restaurant services.

(4) As regards absorption of low-skilled labour and social integration, reduced rates for cleaning services, small services of repairing and maintenance, gardening, and restaurant services are likely to have more potential. In general, most services are likely to have a positive impact on human wellbeing.

(5) Reduced rates relating to services in the building sector are likely to have the most beneficial effects.

(6) Possible small effect on personal grooming establishments (especially tourism).

(7) Possible adverse effect on repair of energy-intensive products.

(8) Demand is expected to be less price-sensitive compared to services for private households. Moreover, there is less scope for shifting activities from the DIY and black economy to the formal economy.

(9) Minor positive effect possible for gardening (maintenance) and cleaning, minor repairs, which have relatively higher shares of low-skilled labour.

(10) A minor negative impact is possible: additional reduced rates relating to some targeted non-commercial customers lead to more distinctions to be made in the building sector.

(11) Impacts as regards border regions and tourism possible, but the situation might be slightly improved compared to the current situation (or the no-policy-change option) as all Member States would have equal opportunities to apply reduced rates.

(12) The supply and construction of houses does not entail a lot of DIY activity (where reduced rates potentially lead to overall growth) but reduced rates are likely to reduce the black economy and result in a shift to the formal economy. As regards overall employment, the new building sector does not account for a relatively high share of unskilled labour.

(13) If reduced rates are applied to the whole housing sector (repair, renovation, alteration, construction, and supply of new buildings), compliance costs will obviously fall.

(14) The supplies concerned are likely to be less price-sensitive than others considered, with less scope for a shift from DIY and black economy to the formal economy. No relatively high shares of low-skilled labour.

Without taking account of budgetary impacts on Member States and the possibility of applying tools other than VAT rates to achieve objectives such as employment, the above table clearly indicates that the no-policy-change option has rather negative impacts. Under the policy change options, the table shows a clear preference for reduced rates for locally supplied services for households (meaning Annex IV services extended to similar — small — labour-intensive services), including restaurant services, in terms of overall growth, employment and reduction of black economy impacts (**options 2, 3 and 5**). As regards this last point, it is expected that for the more significant supplies to households in the building sector, similar positive effects may also be generated (**option 6**). Moreover, within the category of locally supplied services to households, impacts are likely to be even more positive for cleaning, small repair, maintenance (including of gardens) and restaurants. In general, these services require a limited need for training and specialised machinery and have a relatively high share of low-skilled workers. Furthermore, impacts might differ among Member States. In the options where reduced rates are introduced for non-commercial customers other than households these impacts are likely to be much smaller.

The sectors concerned in the policy change options have a large share of SMEs. Demand and other knock-on effects in the policy change options would thus positively affect SMEs.

In terms of environmental effects, options where reduced rates in the building sector are made possible (**options 2, 4, 6 and 7**) are likely to have most beneficial impact. In terms of compliance costs, reduced rates applying to the whole housing sector and to restaurants are expected to have positive effects (**options 2+6 and 5**).

Impacts on income distribution between households are likely to be non-existent or minor in all options. Some wellbeing effects are to be expected in all policy change options and possible positive impacts on social integration are linked to options where overall more employment of low-skilled workers is likely to occur (**options 2 to 5**).

In view of the Treaty establishing the European Community, the internal market impacts of the policy options are extremely important. As can be observed from Table 2, impacts on the internal market are expected be non-existent or even slightly positive (restaurants) compared to the current situation.

6.2. Meeting the objectives

Table 3: Comparing compliance with the objectives of policy options

Objectives / Options	Level playing field in EU as regards RR for restaurants, housing and LSS and flexibility for MS where no internal market impact (1)	Reduction of legal and economic uncertainty	Reduction of compliance costs	Shift from black and informal economy to formal economy
1. No policy change	**no**	**no**	**minor** (2)	**no**
2. Reduced rates (RR) for certain labour-intensive services (LIS-Annex IV)	**yes**	**yes**	**no**	**yes**
3. RR for an extended list of LIS for private households only	**yes**	**yes**	**no**	**yes**
4. RR for an extended list of LIS for other non-commercial customers	**yes**	**no** (3)	**no**	**minor**
5. RR for restaurant services	**yes**	**yes**	**yes**	**yes**
6. RR for significant works and supply in the housing sector	**yes**	**no** (3)	**yes** (4)	**yes**
7. RR for significant works and supply of non-commercial buildings	**yes**	**no** (3)	**no** (5)	**minor**

(1) For the internal market impacts, we refer you to section 6.1. None of the options is likely to have a significant impact.

(2) Possible slight positive effect for the construction and minor repair sectors, because of less differentiation.

(3) There is no real uncertainty currently

(4) The ‘yes’ refers in particular to the situation where the whole housing sector (repair, renovation, alteration, complete construction and supply of a new building) is subject to a reduced rate.

(5) To the extent that distinctions are made with other non-commercial customers, the impact on compliance burdens is likely to be adverse.

The no-policy-change option does not meet the objectives set, except for a possible small impact on compliance burdens. Indeed, numerous derogations for reduced rates in the restaurant and housing sector would still be in place.

The policy change options all meet the first objective and, of these, **options 2, 3, and 6** meet all but one objective, while **option 5** meets all the objectives. It is clear that if options where the objective set is met (“yes”) are combined the achievement of the objective will be optimised.

Without taking account of the budgetary impacts on Member States, which in view of the flexibility offered to them to apply reduced rates as they see fit are to be assessed by them in the first place, the impact assessment shows an overall preference for **options 2, 3, 5 and 6**, which could be combined.

7. MONITORING AND EVALUATION

It is envisaged that any legislative changes following the possible adoption of the policy change options will take the form of an amendment to the VAT Directive and Annexes III and IV thereto. Should Member States be granted the options contained in the policy change options (or parts thereof), the decision to apply or continue to apply the reduced rates at issue on their territory is the sole competence of the Member States. Consequently, it is primarily up to the Member States to monitor and evaluate the implemented measures in terms of effectiveness and efficiency.

Efficiency of tax concessions should be assessed on a systematic basis. If a tax concession does not achieve objectives that have been set for it, abandoning the tax concession or replacement with alternative measures should be considered[66].

At Community level, if policy change options are approved (to a larger or smaller extent) the first objective will be achieved. Moreover, the Council must review the scope of the reduced rates every two years on the basis of a report from the Commission[67]. This report and review provides a context within which the successful application of changes can be monitored and evaluated over time. However, given the sensitiveness of the reduced VAT rates and the complexity of the legislative process for tax issues, it is unlikely and inappropriate to revisit the Community legislation on the issues at stake in the foreseeable future, since one of the objectives of the policy is to reduce legal and economic uncertainty.

Finally, to assess the impacts of a more comprehensive reform aiming at simplification and rationalisation of the overall Community framework for reduced rates, it would be necessary

---

66 National Audit Office of the Republic of Lithuania, *Public Audit Report on the application of reduced value added tax rates*, 19 December 2006, No. 8000-7P-31, Vilnius, p.26. http://www.vkontrole.lt/en/docs/PVMataskaita_EN_RED.pdf

67 Article 100 of the VAT Directive.

for the Commission to receive comprehensive impact assessments from the Member States relating to (1) the effectiveness and efficiency of reduced (including zero and super reduced) rates applied to the sectors concerned in terms of the socio-economic (such as growth, employment, income distribution, social integration, undeclared economy), cultural, health and environmental goals set, (2) the compliance and administrative cost of reduced rates applied and barriers to entry of the (new) market, (3) their budgetary cost and the financing of reduced rates applied, (4) cross-border activity and the likely impact of the reduced rates applications thereon, and (5) domestic trade distortions due to reduced rates.