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accompanying the

Proposal for a

COUNCIL DIRECTIVE

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

Summary of the Impact Assessment

{COM(2008) 428}
{SEC(2008) 2190}

This condensed text merely summarises the analysis which is contained in the full text, which is available only in the original language version and accordingly presented only with the English language version of the proposal.

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.

Executive Summary

On 5 July 2007 the Commission presented a Communication to the Council and European Parliament on VAT rates other than standard VAT rates¹. In the Communication, based on a study carried out by Copenhagen Economics², the Commission took 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 purpose of the Communication was to open a broad debate on the future of reduced rates, taking into account the conclusions of the study. 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. Some technical adjustments are also needed.

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 and will not include an in-depth review of the current basic VAT rate structure (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, nor the question of expanding the scope of reduced 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.

This situation calls for a proportionate impact assessment strictly focusing on the following problems to be dealt with in the short term.

- (1) For certain labour-intensive services laid down in Annex IV to the VAT Directive (2006/112/EC), Member States can temporarily apply reduced rates provided they have been authorised to do so. The provision concerned expires at the end of 2010.

¹ COM (2007)380 final, available at: [http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/COM\(2007\)380_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/COM(2007)380_en.pdf).

² “Study on reduced VAT applied to goods and services in the Member States of the European Union” Copenhagen Economics, 21 June 2007. See [EUROPA — Taxation and Customs Union / Rates](#) and SEC(2007) 910, available at: [http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/SEC\(2007\)910_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/SEC(2007)910_en.pdf).

The first question is whether the option of applying reduced rates should be made — wholly or partially — permanent or should be abolished altogether.

- (2) A logical second question is whether Member States' licence to apply reduced rates should be extended to services similar to labour-intensive services that are not listed in Annex IV, where there is no impact on the internal market. The basic characteristics of such "locally supplied services" are that they cannot be supplied from a distance, are largely directed to local final consumers, and the supplier and customer are located in the same small area.
- (3) Restaurant services are generally considered to be one kind of locally supplied service as they are largely directed at the local market. However, there might potentially be an internal market distortion in border regions or for the distribution of tourism among certain Member States, because of differences in VAT rates applied in the Member States. Moreover — because of derogations — a large number of Member States have the right to apply reduced rates to restaurant services, while others do not. Some of these derogations will end on 31 December 2010. A third question thus arises: should all Member States be authorised to apply reduced rates to restaurant services?
- (4) 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 Member States interpret this in different ways. 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" (in the list of labour-intensive services in Annex IV) and a number of Member States have been granted derogations allowing them to apply reduced rates (or a zero rate) to supplies relating to buildings regardless of social policy. Some of these derogations expire at the end of 2010. Consequently, the fourth question is whether there are grounds to allow reduced rates more generally for this sector and add the whole housing sector to the list of goods and services eligible for a reduced rate. In this way, Member States could choose to restrict the scope of the reduced VAT rate or not, according to their national budgetary and fiscal choices.

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. Second, the unequal possibilities offered to the Member States in some of these areas are another part of the problem. 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 employment objectives. Neither does it discuss broader issues such as the balance between indirect and direct taxation.

The objectives of the forthcoming Commission initiative on reduced VAT rates are the following.

- (1) The first 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. The objective is to give all Member States room for policy manoeuvre and assure flexibility in such areas where the proper functioning of the internal market is not affected.

- (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.

In the light of the above problem definition and objectives, the policy options are by definition very limited.

- (1) The first is “no policy change”. Under this option the temporary provisions of the VAT Directive allowing reduced rates for certain labour-intensive services would automatically expire by the end of 2010, as would the temporary derogations granted to the new Member States to apply reduced rates to restaurants and the housing sector. The same derogations granted to old Member States would continue to apply, as they have no deadline. Member States that currently apply reduced rates to certain labour-intensive services or new Member States applying derogations to the restaurant and housing sector would (in principle) have to increase the VAT rate for them to the standard rate.
- (2) 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 can also be considered separately):
 - (a) Reduced rates for certain labour-intensive services: the only change is to make the current provision on reduced rates for certain labour-intensive services permanent.
 - (b) Reduced rates for an extended list of labour-intensive services:
 - for private households only: 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), and cleaning services relating to tangible movable property;

- for private households and other non-commercial customers: 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.
- (c) Reduced rates for an extended list of labour-intensive services and restaurant services: Member States could also apply reduced rates to restaurant services.
 - (d) Reduced rates for an extended list of labour-intensive services, restaurants services and the complete housing sector: Member States could also apply reduced rates to the construction and (significant) alteration of private dwellings and to the supply of thereof.
 - (e) Reduced rates for an extended list of labour-intensive services, restaurant services, the housing sector, and certain other parts of the building sector: 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.

The impact assessment for these options is mainly based on the conclusions of the Copenhagen Economics study. However, other data sources were also consulted. In parallel with the present impact assessment a public consultation took place from 11 March to 12 May 2008. Generally, the consultation did not reveal arguments not covered by or relevant to this impact assessment.

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) and where services are not supplied to households. The strongest effects are likely to be observed in **options 2, 3 and 5** in Table 1. There might be differences between the Member States as regards the timing of the impact, depending on the rigidity and tightness of the relevant labour market. 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. The increase in VAT rates is likely to have greater effects (in the opposite direction) than a reduction.

The reduced rates envisaged in the policy change options are likely to be most effective in terms of countering the black economy, in sectors serving final consumers, especially households. (i.e. in **options 2, 3, 5 and 6** in Table 1). The no-policy-change option is likely to lead to increased activity in the black economy.

As regards legal and economic certainty, policy change options which clearly and permanently set out the scope for Member States to apply reduced rates to labour-intensive services and restaurant services (**options 2, 3 and 5** in Table 1) would improve the situation. The no-policy-change option would also offer certainty by excluding further extensions of temporary measures (especially as regards certain labour-intensive services), but, as derogations (for example for restaurant services) would still be in place, the discussion on

extending reduced rates to locally supplied services and restaurants would not be over and would leave room for uncertainty.

Overall economic growth is likely to be more significant in the policy options (**options 2, 3 and 5** in Table 1) where a shift occurs from do-it-yourself and black economy activities to the formal economy (activities with limited need for formal training and specialised machinery), i.e. locally supplied services for households, especially domestic care, cleaning, small repairs and maintenance, and restaurants. Overall reduction of (structural) unemployment is likely to be almost non-existent in all policy options, except where reduced rates are introduced for services for households involving a relatively high share of low-skilled workers, such as small repairs and maintenance, cleaning and restaurant services. The strongest effect is likely to occur in **options 2, 3 and 5** in Table 1. However, as regards overall growth and employment, impact differences between Member States need to be taken into account.

The different policy options are not expected to have a significant impact on compliance costs for business, unless reduced rates are introduced for the whole housing sector and for restaurants (**options 2+6 and 5** in Table 1).

Moreover, none of the policy options is likely to have significant impacts on the functioning of the internal market. Reduced rates for restaurants and services in personal grooming establishments might have impacts in border regions or on tourism but, generally speaking, compared to the current situation (and the no-policy-change option), the internal market might work better if all Member States have equal opportunities to introduce reduced rates.

Because all the sectors affected by the policy change options are dominated by SMEs, all of these options which boost activity in these sectors are — to varying extents — likely to have beneficial effects on SMEs.

In terms of environmental effects, options allowing reduced rates in the building sector (**options 2, 4, 6 and 7**) are likely to have most beneficial impact.

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 positive impacts on social integration are possible where, overall, more employment of low-skilled workers is likely (**options 2 to 5**).

Table 1: Comparing the impacts of the policy options (additional parts of options considered)

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

As to compliance with the objectives (Table 2), 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; **options 2, 3, and 6** meet all but one objective, while **option 5** meets all objectives.

Table 2: 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	Reduction of legal economic uncertainty and	Reduction of compliance costs	Shift from black and informal economy to formal economy
1. No policy change	no	no	minor	no
2. Reduced rates (RR) for certain 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	no	minor
5. RR for restaurant services	yes	yes	yes	yes
6. RR for significant works and supply in the housing sector	yes	no	yes	yes
7. RR for significant works and supply of non-commercial buildings	yes	no	no	minor

Without taking account of the budgetary impacts on Member States, which, given the principle of flexibility, are for them to assess in the first place, overall preference goes to options 2, 3, 5 and 6, which could be combined.