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VAT: European law on VAT rates

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Summary

The harmonisation of VAT systems across Member States has been seen as an important part of achieving a Single European Market for many years. In October 1992 the European Council agreed Directive 92/77/EEC which established new rules limiting the discretion of all States to set VAT rates. Member States must apply a standard VAT rate of 15% or more, and have the option of applying one or two reduced rates, no lower than 5% to certain specified goods (this list is now consolidated in Annex III to VAT Directive 2006/112/EC). Member States may continue to charge any lower rates, including zero rates, that were in place on 1 January 1991, though they cannot introduce any new rate under 5%. In October 1999 the Council agreed an amendment to these rules giving States the option to apply a reduced VAT rate to certain 'labour-intensive' services. Any amendment to these rules – as with any VAT directive – must be agreed *unanimously*.

In July 2003 the European Commission published proposals for simplifying the EU rules on reduced VAT rates.[1] From the UK's perspective the proposals were controversial as they would not have allowed for certain zero rates to be maintained, including the zero rate on children's clothing. Other Member States also had strong objections, and a final agreement was only reached in February 2006: a minimalist package that allowed for existing reduced and zero rates to continue.[2] In July 2008 the Commission suggested some additions to the list of goods and services eligible for reduced rates,[3] but the next year European Finance Ministers agreed to make just two minor changes.[4] No further changes have been made to these rules to date.

In April 2016 the Commission published its 'VAT Action Plan' for reforming the EU VAT system, including possible changes to the rules regarding VAT rates, and the treatment of cross border trade.[5] Specific proposals to reform the EU rules on VAT rates were published in January 2018 – in effect, to reverse the current approach:

> In addition to a standard VAT rate of minimum 15%, Member States would now be able to put in place:
>
> - two separate reduced rates of between 5% and the standard rate chosen by the Member State;
> - one exemption from VAT (or 'zero rate');
> - one reduced rate set at between 0% and the reduced rates.
>
> The current, complex list of goods and services to which reduced rates can be applied would be abolished and replaced by a new list of products (such as weapons, alcoholic beverages, gambling and tobacco) to which the standard rate of 15% or above would always be applied. To safeguard public revenues, Member States will also have to ensure that the weighted average VAT rate is at least 12%. The new regime also means that all goods currently enjoying rates different from the standard rate can continue to do so.[6]

In answer to a PQ at the time Treasury Minister Mel Stride welcomed the proposal, but made no commitment for any specific changes to the schedule of UK VAT rates, stating, "it is right that Member States have flexibility in applying VAT on different products"

1 COM (2003) 397 final, 23 July 2003
2 Directive 2006/18/EC of 14 February 2006
3 COM(2008) 428/3, 7 July 2008
4 Directive 2009/47/EC of 5 May 2009
5 European Commission press notice IP16-1022, 7 April 2016; see also *Action Plan on VAT: Questions and Answers* (MEMO16-1024), 7 April 2016.
6 European Commission press notice, *VAT: More flexibility on VAT rates, less red tape for small businesses*, 18 January 2018. The draft proposal is COM(2018) 20 final. Full details are on the Commission's site.

while adding, "the proposal will need to be discussed and unanimously agreed by the Member States."[7]

There is no firm timetable for these proposals to be agreed, and there is considerable uncertainty as to their relevance for the UK's discretion in setting VAT rates, given the outcome of the EU referendum and the Government's decision in March 2017 to trigger Article 50 – the two-year period for the UK to leave the EU.[8]

To date the Government have not published any specific details as to the UK's post-Brexit relationship with the EU on VAT, beyond stating its ambition for an agreement on "common processes and procedures" to avoid the need for any new VAT-related border controls on goods moving between the UK and the EU.[9] It has also confirmed that, under the draft Withdrawal Agreement concluded in November 2018, the UK would remain compliant with EU law, including VAT law, during the 'transition period' prior to the implementation of the new, yet to be negotiated, UK-EU partnership arrangements.[10] On the question of any possible changes to UK VAT rates in the future, Treasury Minister Mel Stride said, in answer to a PQ in September 2018, "while all taxes are kept under review, the application of further zero rates is strictly limited by EU law. Future VAT rules will depend on the outcome of negotiations with the EU. Any future decisions on VAT will continue to be taken as part of the normal Budget process."[11]

This note discusses the development of EU VAT law, and the implications for the UK in setting its own VAT rates.

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7 PQ125204, 31 January 2018
8 For details see, *Brexit timeline: events leading to the UK's exit from the European Union*, Commons Briefing paper CBP7960, 16 January 2019.
9 HM Government, *The future relationship between the UK and the EU*, Cm 9593, July 2018 p18
10 Letter from the Financial Secretary to the European Scrutiny Committee, "EU legislative proposals on VAT", 5 December 2018
11 PQ169374, 10 September 2018; see also, PQ193519, 28 November 2018

1. VAT: an introduction

VAT is charged on the supply of all goods and services made in the course of a business by a taxable person, unless they are specifically exempt. All businesses must register for VAT if their turnover of taxable goods and/or services is above a given threshold, which is currently £85,000.[12] VAT is charged on the additional value of each transaction, and is collected at each stage of production and distribution. A business pays VAT on its purchases - known as input tax, and charges VAT on its sales - known as output tax. It will settle up with HM Revenue & Customs for the difference between the two. In the end the cost of the tax is borne by the final consumer.

In the UK VAT is charged either at the basic rate – currently 20% – or the zero rate, though there is limited use of a reduced rate of 5%.[13] Zero-rated supplies include: food; construction of new dwellings; domestic and international passenger transport; books, newspapers and magazines; children's clothing and footwear; water and sewerage services; drugs and medicines on prescription; and certain supplies to charities.

The exemption of goods and services from VAT should be distinguished from their being charged a zero rate. In the latter case these supplies are technically taxable, and though no actual tax is paid on them, they still count as part of a business' taxable turnover. VAT charged on inputs relating to zero-rated activities can be reclaimed, unlike the VAT incurred by a business in the course of an exempt activity.

VAT was introduced in the UK on 1 April 1973 at two rates: a standard rate of 10%, and a zero rate on selected goods and services (such as food, books, children's clothing, and certain supplies for charities). The main changes to the VAT structure since the introduction of the tax are:

- The standard rate was cut to 8% on 29 July 1974.
- A higher rate on selected goods and services was introduced on 18 November 1974, set at 25%. Initially this was applied to petrol only; it was extended to a list of other supplies from 1 May 1975. The higher rate was cut to 12.5% from 12 April 1976.
- The standard rate was increased to 15% on 18 June 1979; at this time, the higher rate of VAT was abolished.
- The standard rate was increased to 17.5% from 1 April 1991.
- Domestic supplies of fuel and power were charged VAT at a reduced rate of 8% from 1 December 1993. This was cut to 5% from 1 September 1997.
- The standard rate was cut to 15% between 1 December 2008 and 31 December 2009.
- The standard rate was increased from 17.5% to 20% from 4 January 2011.

[12] With effect from 1 April 2017 (HMRC, *VAT registration thresholds*, April 2017)

[13] principally, the supply of domestic fuel and power, the installation of energy saving materials, women's sanitary products, children's car seats and certain types of construction work. For more details see, HMRC, *VAT rates on different goods and services*, May 2017.

Over the last 25 years there have been a number of changes to the coverage of the zero rate, affecting individual supplies. In addition, since its introduction in September 1997, the coverage of the 5% reduced rate has been extended to a small number of other supplies, including the installation of energy saving materials. Statistics on VAT are provided in HMRC's publication, *VAT Annual Statistics*.[14]

[14] The latest edition, for 2017/18, was published in December 2018.

2. EU VAT law

The first steps toward harmonising the VAT systems of Member States were taken in the late 1960s. However, it was the sixth VAT directive (77/388/EEC), adopted on 17 May 1977, which marked a turning point in the development of EU VAT law – as governments agreed on common criteria for the VAT base in all Member States (ie, specifying those goods and services which could be exempted from tax).[15]

Initially the sixth directive focused on the VAT base rather than VAT rates, though it did have implications for the UK's zero rates.[16] Article 28(2) allowed Member States to maintain "reduced rates and exemptions... which are in force on 31 December 1975 and which satisfy the conditions stated in the last indent of Article 17 of the second council directive of 11 April 1967." Article 17 refers only to exemptions maintained for "clearly defined social reasons and for the benefit of the final consumer." As a result the UK was allowed to maintain its zero rates, *provided* they satisfied these criteria.[17] Of course, all Member States are governed by these directives on decisions they take on the coverage of VAT, and - under the terms of later amendments to the sixth directive - on decisions taken about their VAT rates. Though the UK and Ireland are the only countries to use zero rates very much, there is considerable variety in VAT rates on certain goods and services across the EU. [18]

Agreement on harmonising the rates of VAT took much longer, but was reached in June 1991, and encompassed by directive 92/77/EEC of 19 October 1992.

In brief, all Member States:

- must apply a standard VAT rate of 15% or more from 1 January 1993.
- have the option of applying one or two reduced rates, no lower than 5% to certain specified goods, as listed in Annex H of the directive.[19]
- are able to continue charging any lower rates, including zero rates, that had been in place on 1 January 1991 for the duration of the "transitional period", assuming these rates were in accordance with Community law.[20]

In November 2006 the European Council of Finance Ministers adopted a new principal EC VAT directive (2006/112/EC), which revised or recast

[15] The main provisions are transposed into UK law by the *VAT Act (VATA) 1994*.

[16] Zero-rated supplies are set out in schedule 8 of *VATA 1994*.

[17] In June 1988 the European Court of Justice found that certain zero-rated supplies – including supplies of fuel and power to industry – did not meet these criteria. As a result the UK was required to standard-rate these supplies, which it did on 1 July 1990.

[18] For details see European Commission, *VAT rates applied in the Member States of the European Community*, July 2018.

[19] The UK made use of this provision – in particular, item 4 in Annex H – by introducing a 5% VAT rate on children's car seats from 12 May 2001, under section 96 of the *Finance Act 2001*.

[20] The directive came into effect on 1 January 1993, and its provisions were incorporated in Article 12(3a) & Article 28(2) of the sixth directive.

both the first and the sixth EC VAT directives, to reorganise the provisions and set them out in a clearer way.[21] The new directive made no change to EC or UK VAT law. Annex H to the revoked sixth directive is now recast as Annex III to the new directive; this is reproduced in full at the end of this note.

Certain other aspects of directive 92/77/EEC should be highlighted. First, provision was made for States to apply a reduced rate to supplies of natural gas and electricity, should they so wish, "provided that no risk of distortion of competition exists."[22] In addition, for those Member States who had reduced rates in force on 1 January 1991 covering items which were not in Annex H, provision was made for the use of a "parking rate" - between 12% and their standard rate - rather than the immediate imposition of the standard rate. Clearly, this allows those countries who wish to reduce the scope of their reduced rates to move gradually towards standard-rating them.

The UK secured a special right to bring any of its zero rates into a reduced rate band, even if they were not in Annex H.[23] Children's clothing and footwear is not listed in Annex H, and without this provision the UK would have to standard-rate these supplies, if it ever decided to end zero-rating them. However, the UK would not be allowed to reintroduce a zero rate that had been in place on 1 January 1991 which it had then withdrawn.

Naturally most attention in this country is paid to the aspects of the directive which directly affect the UK. Even so, it is worth noting one aspect of this agreement: no Member State can, under any circumstances, introduce a new zero rate, though there is limited provision for those countries whose standard rate was below 13% at 1 January 1991 to charge a rate below 5% on certain supplies.[24]

In the absence of any new agreement, these 'transitional' arrangements may continue indefinitely – and, in fact, this is what has happened. (Initially it was anticipated that the 'transitional period' would only last until 31 December 1996.) As with any VAT directive, and EU tax law generally, any amendment to these rules must be agreed *unanimously* between the Member States.[25]

[21] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (OJ L 347, 11 December 2006). Annex XII provides a correlation table that shows the destination of all the articles in the sixth VAT directive. HM Revenue & Customs Business Brief BB22/06, 11 December 2006.

[22] This is now contained in Article 102 of Directive 2006/112/EC

[23] Under Article 113 of Directive 2006/112/EC. The UK is also entitled to exempt from VAT burials & cremations and building land under Article 371 of the directive (previously Article 28(3)(b) of the sixth directive); see, HL Deb 9 December 1998 cc95-6WA.

[24] At the time the UK's standard rate was 15%, introduced on 18 June 1979. The provision is now made under Article 114 of Directive 2006/112/EC.

[25] The Treaty base for all proposals to harmonise excise duties and turnover taxes is Article 113, which requires unanimity.

3. Review of the structure of VAT reduced rates (1995-99)

The 1992 agreement on VAT rates anticipated that European Finance Ministers would review the scope of reduced VAT rates every two years, on the basis of a report from the Commission. In January 1995 the first such report was published; an explanatory memorandum by HM Customs & Excise summarised it as follows:

> The Commission concludes that the position with regard to VAT rate approximation is generally satisfactory in that no significant distortions of competition or deflections of trade have resulted from differences in VAT rates between Member States. There is therefore no justification for introducing major changes to the scope of the reduced rate list, nor is there any reason to amend the provisional VAT rates which are due to be phased out at the end of the transitional period.
>
> Although numerous representations have been received from trade and other interests to include their particular goods and services in the reduced rate list the Commission feels that such broader issues of rate coverage will be better addressed in the context of conclusions on the VAT definitive system.[26]

A second report was published in November 1997.[27] The delay was attributed to the fact that "in practice, because the Commission has committed its resources to other work and there is little pressure from Member States for changes, the Commission has not undertaken such a review."[28] The Commission found that the disparity in VAT rates had not distorted competition significantly, and made no formal proposals for revising Annex H, though it made a number of comments on the problems arising from reduced rates:

> The report identifies two underlying problems with reduced VAT rates which are believed to cause distortion of competition. These are the fact that it is for Member States to decide whether or not to apply a reduced rate to the goods and services listed in Annex H; and the lack of any common definitions of the categories of goods and services listed in Annex H. The report encourages Member States to consider the possible difficulties caused by these identified problems.
>
> The report puts forward the following guidelines for the use of reduced VAT rates in the Community:
>
> - close approximation of rates is a technical necessity;
> - the scope for the application of reduced rates should be determined by social considerations (to offset the sometimes regressive character of VAT);

[26] HM Customs & Excise, *Explanatory memorandum on … CONS DOC 4079/95*, 20 February 1995. The department was merged with the Inland Revenue to form HM Revenue & Customs in April 2005.

[27] EC CONS DOC 12315/97, 20 November 1997

[28] HL Deb 11 March 1997 c18WA

- generally reduced VAT rates are a very imprecise tool for policy making and they should not be used as a substitute for direct subsidies;

- reduced VAT rates should not touch on the general neutrality of VAT.[29]

In the explanatory memorandum on the report, Dawn Primarolo (then Financial Secretary) stated "in general, the UK believes that the widespread use of reduced VAT rates is likely to result in unnecessary complication of the tax, to the detriment of both business and the integrity of the tax itself. The UK does, however, accept that there are some circumstances where a reduced VAT rate may be a useful tool to address specific problems - the recent announcement on the VAT treatment on energy-saving materials is a case in point."[30] (A 5% VAT rate was extended to energy-saving materials supplied under the Home Energy Efficiency Scheme and similar schemes from 1 July 1998. Subsequently the Labour Government extended the scope of this 5% rate over the next few years.[31])

[29] HM Customs & Excise explanatory memorandum, 17 December 1997. For a summary of the report's conclusions see, HC Deb 25 February 1998 cc233-234W.
[30] HM Customs & Excise explanatory memorandum, 17 December 1997
[31] For details see, HM Customs & Excise Budget Notice CE13, 16 March 2005

4. The Commission's proposals on reduced rates (1999-2003)

In October 1999 the European Council agreed to an amendment to these rules, to give Member States the *option*, should they so wish, to apply a reduced VAT rate to certain 'labour-intensive services', as a means to reduce unemployment. Member States could choose up to three items from a list of supplies – set out in Annex K to the sixth EC VAT directive – to apply a VAT rate as low as 5%. Initially the scheme was to last three years until 31 December 2002, but was subsequently extended to the end of 2010.[32] The list of services was: small services of repairing; renovation and repairing of private dwellings; window cleaning and cleaning in private households; domestic care services; and, hairdressing. For its part the UK Government showed no interest in making use of this provision.[33]

Member States who participated in the scheme were requested to submit a report on the operation of this measure to the Commission by 1 October 2002, to be used to evaluate the experiment and draw conclusions for future practice.[34] In October 2001 the Commission published its third report on reduced VAT rates,[35] in which it acknowledged that "the current optional nature of the reduced rates and the lack of common definitions of the categories on which reduced rates are allowed could be obstructing the smooth working of the internal market and distorting competition."[36]

The report did not make any suggestions for change. However in September 2002 the Commission proposed that the scheme should be extended by one year, to ensure 'certainty and continuity in the sectors concerned' while the Commission prepared a general review of reduced VAT rates, to be presented in 2003.[37] A press notice gave details of this review:

> The Commission intends in 2003 to present proposals to overhaul the structure of the reduced rates of VAT so as to improve the functioning of the Internal Market, while having regard to the use of reduced VAT rates in Community policies such as protecting the environment and promoting employment. Under the 6th Directive on the common system of value-added tax, Member States are normally required to apply to the supply of both goods and services a single standard rate of VAT of a minimum of 15%. However, Member States are allowed to apply one or two reduced rates which may not be lower than 5% to supplies of

32 Directive 1999/85/EC. This was consolidated in Articles 106-8 & Annex IV of Directive 2006/112/EC. As noted below, the scheme was made permanent in June 2009.
33 HM Customs & Excise explanatory memorandum, 30 March 1999
34 HM Customs & Excise explanatory memorandum, 25 January 2000
35 COM(01)599, October 2001
36 European Scrutiny Committee, *Eleventh Report*, 17 January 2002 HC 152-xi 2001-02
37 The Commission had first proposed a general review once the scheme for labour-intensive services had run its course in June 2000 (*A strategy to improve the operation of the VAT system within the context of the internal market* COM(2000) 348 final, June 2000 para 2.10).

> categories of goods and services specified in Annex H to the 6th VAT Directive (77/388/EEC).
>
> This list of goods and services, mainly of a social or cultural nature, was last revised in 1992. Many additional reductions and special provisions also apply to individual Member States. The optional nature of the arrangements for reduced rates and the discretion left to Member States can lead to situations that threaten the principle of neutrality, situations which traders perceive as a source of distortions of competition.[38]

In June 2002 Treasury Minister John Healey stated that the UK intended to "play a full and active part" in this review, and was "considering carefully the merits of changes to the existing list of products to which a reduced rate may be applied."[39] During this period the Labour Government announced it would press for reduced rates on two supplies: repairs to listed places of worship;[40] and, the purchase of energy saving materials for DIY installation.[41]

In June 2003 the Commission published a report on the effectiveness of the scheme for reduced rates on 'labour-intensive' services, concluding that "it was not possible to find solid evidence of such reductions … boosting job creation."[42] The next month it issued the conclusions to its general review of reduced rates, arguing the range of reduced rates should be harmonised, and that the automatic right of Member States to maintain their transitional derogations should be withdrawn, so as to improve the functioning of the internal market.[43]

The Commission proposed that Member States should only be entitled to charge a reduced rate on supplies listed in Annex H, though a number of items would be added to the list (cut flowers and plants, restaurants, housing, and the supply of gas and electricity). In addition, the wording of two existing items to Annex H would be amended: item 4 (equipment for the disabled) and item 17 (sewage and waste treatment). Finally Member States might maintain existing zero and 'super-reduced' VAT rates (those below 5%) *provided* these supplies were included in Annex H. The Commission anticipated that these provisions would be reviewed every five years.[44]

From the UK's perspective, the main problem was that the new version of annex H did not include a number of the reliefs currently applied under the UK's transitional derogations, in particular for children's clothing and footwear, protective helmets (including motorcycle helmets), and a number of zero rates targeted at charities and disabled people.[45] When the proposals were discussed by European Finance Ministers on 15 July 2003, the Government stated that the UK "would

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38 European Commission press notice IP/02/1367, 25 September 2002
39 HC Deb 20 June 2002 c461W
40 HC Deb 8 November 2000 c318
41 HC Deb 10 April 2001 c524W). see also, *Explanatory memorandum on … COM(2003) 397 final*, 29 August 2003 para 18.
42 COM (2003) 309 final, 2 June 2003 p25
43 COM (2003) 397 final, 23 July 2003
44 see, European Commission press notice IP/03/1024 & memorandum MEMO/03/149, 16 July 2003
45 At the time the motorcycle lobby was particularly concerned about helmets ceasing to be zero-rated.

not accept any proposal which would remove its zero rates on children's clothes and shoes."[46]

The Commission addressed the specific question of removing VAT relief from children's clothes and footwear in a memorandum published with its proposals:

> **Why is the Commission proposing to abolish the optional zero rate (or super-reduced rate) on children's clothing and footwear?**
>
> Only two countries, the UK and Ireland, currently apply a zero rate on these goods, while Luxembourg applies a rate of 3%. Every other Member State applies the standard rate. In the interests of consistency and simplification of the system, the Commission believes it is time to put an end to reduced rates for non-Annex H categories of goods and services, for which only a minority of Member States have been granted a specific derogation, for the following reasons:
>
> - a survey of prices in the Community shows that zero or super-reduced rates do not mean a better price to the consumer: for example, if the average price of children's shoes in the EU is 100 (taking purchasing power parity into account), in Luxembourg (rate: 3%) the same shoes are 126, 119 in Denmark (rate: 25%) and 116 in the UK (rate: 0%)!
> - Given that only three Member States apply these derogations, to maintain them would go against the objective of simplification and rationalisation pursued by this proposal.
> - They are also liable to cause distortions of competition as they allow businesses in the Member States concerned to undercut the prices of businesses in other Member States which apply the standard rate or they allow them to maintain higher profit margins because of the advantage they enjoy in terms of VAT rates.
>
>   Findings also show that children's clothing and footwear in the countries concerned are not significantly cheaper than adults' clothing and footwear despite the much lower rate of VAT. The same trend can be found in all the other Member States where the standard rate applies to all these goods.
> - There is no definition of "children's clothing and footwear" at Community level and so the concept is interpreted differently in each of the three Member States concerned. They cannot be tied to a specific tariff heading in the common customs tariff which also leads to complications.[47]

[46] HC Deb 8 September 2003 cc 100-1W

[47] European Commission, *Reduced rates of VAT: frequently asked questions MEMO/03/149*, 16 July 2003

5. Reactions to the Commission's proposals (2003-05)

The European Scrutiny Committee considered these proposals in September 2003, summarising the Commission's position as follows:

> The Commission argues that the objective of the Community's VAT system has been a simple, harmonised regime with a minimum normal rate of 15% and a minimum reduced rate of 5% for a very select group of goods and services to be used optionally (but widely) by Member States. It holds that if all goods and services were taxed at broadly the same rates throughout the EU, this would simplify the VAT system for businesses and remove any question of VAT rates distorting competition within the Single Market. The Commission sees no intrinsic value in the application of reduced rates as policy instruments and proposes that the use of reduced rates be rationalised.[48]

The Committee went on to quote the then Paymaster General, Dawn Primarolo, on the UK Government's position:

> "Zero rates have been a fundamental part of the UK tax system since VAT was introduced in 1973, and many of them were translated directly from the old Purchase Tax, which preceded VAT. They save consumers in the UK around £20 billion each year, and they give the greatest benefit as a proportion of income to the lowest-income households. As they stand, the Commission's proposals make no provision or inadequate provision for the continued zero rating in the UK of children's clothing and footwear, of several reliefs targeted at charities and disabled people, and of a number of other specific items. In total, they would add more than £1 billion of VAT to annual expenditure in the UK, with the biggest impact falling on low-income families, charities and disabled people. As the proposal stands the Government believes that there could be a damaging and regressive social impact of withdrawing reliefs on essential goods.
>
> The Government therefore considers the proposals as they relate to zero rates unacceptable in their current form ... However, as well as defending our zero rates, the Government will continue to press its long-standing proposals for reduced rates on repairs to listed places of worship and on the purchase of energy saving materials for DIY installation."[49]

The Committee recommended that European Standing Committee B should debate the issue, which it did on 27 October 2003. On this occasion the Paymaster General reiterated the UK's opposition to the proposals, and argued that the case for removing existing VAT reliefs – that they distorted the operation of the internal market – was unsupported by any hard evidence. An extract from the Minister's speech is given below:

> Before the Commission interferes in member states' affairs, it is for it to demonstrate that such interference is necessary to ensure the proper functioning of the internal market. In fact, the Commission has provided no evidence that our zero rates cause

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48 *Thirty-first report: Reduced rates of VAT*, 24 September 2003, HC63-xxxi para 1.4
49 HC 63-xxxi 2002-03 para 1.7

> distortion or that a reduced rate for restaurant services [or] cut flowers … would not create such distortion … The most recent data from EUROSTAT and the Office of National Statistics, which Customs and Excise collects, show [that] … prices for adult's clothing in the UK are about the average European level; prices for children's clothing are somewhat below the average European level …
>
> The argument that there is a distortion in the single market as a result of zero rates has not been substantiated. Indeed, the Commission goes slightly further and its argument is internally inconsistent. On the one hand, it argues that the zero rates produce a distortion, and, on the other, it argues that that distortion is being passed on to the consumer anyway in the price.[50]

European Finance Ministers discussed the proposals at an informal ECOFIN meeting on 13 September 2003 without reaching agreement,[51] and then again on 7 October 2003. A press notice issued after this second meeting summarised the views of Member States:

> The state of play may be described as follows:
>
> - some delegations cannot accept any extension of Annex H;
> - other delegations insist on maintaining their derogations and exceptions;
> - most delegations also consider that these derogations are linked to domestic problems of considerable political significance and do not pose any problem for the functioning of the internal market.[52]

ECOFIN had a further discussion on the proposals on 25 November, though; as Ms Primarolo explained in a second letter to the Scrutiny Committee, "Member States maintained their now entrenched positions on this difficult and unacceptable Commission proposal. Finance Ministers unanimously agreed however to a compromise solution that called upon the Commission to bring forward a proposal to extend the Labour Intensive Services (LIS) experiment for a further two years."[53]

In December 2013 the Commission brought forward proposals to extend the life of the LIS scheme to 31 December 2005, and legislation to effect this change was formally adopted in February 2004.[54] The issue was discussed at a number of ECOFIN meetings during 2004, though not to any concrete end.[55]

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50 European Standing Committee B, *Reduced rates of VAT*, 27 October 2003 cc9-10, c9

51 EC memorandum MEMO/03/176, 15 September 2003. see also, *Thirty-third report: Reduced rates of VAT*, 30 October 2003 HC 63-xxxiii 2002-03 para 1.2

52 European Council press notice 12677/03*, 2530th Council meeting*, 7 October 2003

53 Letter from the Paymaster General to the European Scrutiny Committee, *European Commission proposal … 11817/03 COM (2003) final*, 10 December 2003

54 Directive 2004/15/EC of 10 February 2004

55 ECFOIN considered the proposals in January, March and December 2004 (HC Deb 2 February 2004 c638W; HC Deb 24 March 2004 c844W; European Council press notice 15150/04, 7 December 2004 p15).

6. A deal on VAT rates (2005-06)

In May 2005 the Luxembourg Presidency published a draft for a compromise agreement, which significantly amended the Commission's original proposals:

> The compromise is significantly different from the original Commission proposal in the following respects:
>
> - the maintenance of the transitional reduced, super-reduced and zero rate derogations contained in Article 28 of Directive 77/388/EEC;
> - the extension until 31 December 2015 of the time-limited derogations provided for by the new Member States' accession treaties;
> - a limited flexibility mechanism, by which Member States would be able to apply for Council authorisation to use reduced rates for the labour-intensive services listed in points 1, 3 and 5 of Annex K of Directive 77/388/EEC (small repair services, window cleaning and cleaning in private households, and hairdressing) and restaurant services; and
> - extension of the minimum standard rate of 15% until 31 December 2015[56] …
>
> The compromise also proposes a limited extension of the list of permitted reduced rates in Annex H to cover the remaining Annex K categories (house repairs and domestic care services), supply of sewage and waste-recycling services, district heating, and apparatus and equipment (excluding means of transport) designed or specifically adapted for the disabled.
>
> Annex H would also include supplies of gas and electricity and of plants and wood for use as firewood. These reliefs are currently provided for elsewhere in the Directive. As a result of many Member States' concerns about the possible impact on the internal market, the Presidency has not included any additional goods in the compromise.[57]

The UK Government's view was set out in the Scrutiny Committee's report on the proposal:

> The Paymaster General (Dawn Primarolo) tells us the Government broadly supports the Presidency's compromise, which, unlike the Commission's text, does not threaten the UK's zero rates. She says that Member States could apply for flexibility additional to that already contained in Annex H and that the Government thinks the limited list of services involved strikes a balance between the interests of those Member States which want more flexibility and those which want less. But she adds that it will argue for a review of the system after five years. The Minister also says that the Government will continue to seek support for

[56] [This proposal was made separately – COM(2005) 136 final, 14 April 2005 – to which the UK Government had no objection: HC 34-I 2005-06 pp 206-8. In December 2005 Member States agreed to an extension up to 31 December 2010: Directive 2005/92/EC.]

[57] HM Treasury, *Explanatory memorandum on … Council Document 9125/05*, 7 June 2005 pp 2-3

> reduced rates for repairs to listed places of worship, memorials, energy-saving materials for DIY installation and energy-efficient products.[58]

In a letter to the Committee in September 2005 the Minister gave more detail of the views of other Member States on the proposals:

> In her letter … the Minister tells us that while many Member States have supported the Luxembourg Presidency compromise, a small group have remained opposed. All that could be agreed during that Presidency was that the 15% minimum standard rate should be extended to 2010. The Minister says that it is clear that Member States have divergent views on the matter of reduced rates.
>
> She summarises:
>
> - a group of Member States, either for philosophical reasons or in response to domestic budgetary pressure, are both opposed to new reduced rates and would like to limit the existing arrangements;
> - other Member States would prefer more flexibility in the system; and
> - recent discussion has confirmed that the great majority of Member States are opposed to new reduced rates for goods, because of the theoretical possibility of distortion of cross-border competition and consequent harm to the functioning of the single market.
>
> Therefore, the Minister continues, there is no prospect of agreement on the draft Directive if those few Member States who want new reduced rates for goods maintain that position. However, she adds that prospects for an agreement containing new reduced rates for locally delivered services, which might include, for example, repairs to listed places of worship and construction services related to memorials, are greater, albeit uncertain.[59]

In its response the Committee expressed concern that "the Minister makes no specific mention of reduced rates for energy-saving materials for DIY installation and energy-efficient products, the need for which the Government has previously emphasised to us." In her letter the Minister also noted that, given the "political importance of this negotiation to a number of Member States" the UK might be asked to agree to a draft text at short notice, without time to consult the Committee.[60] The 'scrutiny reserve' is a general undertaking by Government not to agree to proposals at Council level that have not been cleared by the Committee, without extenuating circumstances,[61] and the Committee expressed concern about this:

> It seems to us that, in the understandable desire, in the context of the UK Presidency, not to be seen to frustrate progress on this

58 European Scrutiny Committee, *First report*, 4 August 2005 HC 34-I 2005-06 pp115-6
59 European Scrutiny Committee, *Sixth report*, 3 November 2005 HC 34-vi 2005-06 para 12.11-13
60 *op.cit.* para 12.14
61 For details see, European Scrutiny Committee, *The European Scrutiny System in the House of Commons*, May 2015 pp17-18.

> draft Directive, the Government is inclined to override our scrutiny reserve, even though the reserve is based on UK interests which the Government itself has drawn to our attention and which remain unresolved. We invite the Government to reconsider this attitude and to keep us informed of developments on the draft Directive, particularly in relation to repairs to listed places of worship, construction services related to memorials, energy-saving materials for DIY installation and energy-efficient products.[62]

The Committee subsequently cleared the proposal, accepting the Government's view that "the deal now in prospect is, in the circumstances, the best obtainable."[63] However, Member States found it difficult to agree even to this compromise. Negotiations continued into the new year, under the Austrian Presidency – even though the end date for the LIS scheme had passed (ie, 31 December 2005). At an ECOFIN meeting on 24 January 2006 three Member States – Poland, the Czech Republic and Cyprus – blocked a deal in the hope of extending the list of permitted reduced rates, even though the Commission pointed out it was now legally obliged to consider legal action against Member States who continued to use the LIS scheme.[64]

In an editorial the *Financial Times* argued that "Poland is providing the European Union with a useful crisis … not because [their] demands have any merit but because Poland's refusal to fall in with the unanimity required on EU taxation would prevent many other countries extending their VAT loopholes … the surest way to stop such haggling is to abolish all VAT loopholes."[65] Nevertheless a final agreement was reached on 14 February 2006, which made very few changes of substance; a press notice summarised it as follows:

- In order to prolong the experiment, launched in 1999, of reduced VAT rates for certain locally provided labour-intensive services, the validity of annex K to directive 77/388/EEC is extended as from 1 January 2006 until 31 December 2010. All member states may opt for the application of annex K, on condition that they apply for authorisation to do so by 31 March 2006;
- Member states are authorised to apply a reduced rate to supplies of district heating, provided that this doesn't create a distortion of competition;
- The Council invites the Commission to present, by the end of June 2007, a report providing an assessment of the impact of reduced rates applied to locally supplied services, including restaurant services, in terms notably of job creation, economic growth and the internal market, on the basis of a study to be carried out by an independent economic think-tank.[66]

In a letter to the Scrutiny Committee the Paymaster General commented that "this has been a dossier which has aroused strongly-held opinions on all sides of the debate … the Government's priority … has always

[62] HC 34-vi 2005-06 paras 12.18-19
[63] HC 34-xii 2005-06 para 22.9
[64] "EU dispute plunges sales tax system into chaos", *Financial Times*, 25 January 2005; HC Deb 31 January 2006 c7WS.
[65] "Europe's VAT regime is like a Swiss cheese", *Financial Times*, 1 February 2006
[66] ECOFIN press notice 6052/06, *2707th Council meeting*, 14 February 2006 p14

been to preserve our much-valued zero rates. I am pleased to say that we have achieved this objective."[67]

In November 2006 the Council approved applications from 17 countries to adopt, or continue to use, reduced VAT rates on labour intensive services.[68] For its part the Labour Government did not take up the scheme on the grounds that its employment objectives were "better targeted through measures such as the welfare to work strategy and New Deal"[69]; it continued to lobby for a reduced rate for all 'energy-efficient products and energy-saving materials' – both to the Commission[70] and other Member States[71] - but without success.

67 Letter from the Paymaster General to the Chairman of the European Scrutiny Committee, 15 February 2006

68 Council Decision 2006/774/EC of 7 November 2006. Subsequently Romania was allowed to join the scheme (Council Decision 2007/50/CE of 30 January 2007).

69 HC Deb 30 March 2006 cc157-8WA

70 HM Treasury, *Correspondence between Gordon Brown MP and the European Commissioner for Taxation and Customs*, Commons Deposited Paper 07/869, 21 March 2007

71 "Brown calls for VAT cut on low-energy products", *Financial Times*, 14 March 2008

7. Minor changes to the agreement (2007-09)

On 5 July 2007 the Commission published a study on the economic impact of reduced VAT rates, with a view to "launching a broad debate … to obtain all relevant views before initiating a more far reaching proposal on reduced rates … [by] the end of 2008/beginning 2009."[72] The study concluded that, "there is a strong general argument for having uniform VAT rates in the European Union. Uniform rates is a superior instrument to maintain a high degree of economic efficiency, to minimise otherwise substantial compliance costs and to smooth the functioning of the internal market."

The authors went on to acknowledge the case for exceptions - "there are real and valid economic arguments for extending lower VAT rates to some very specific sectors in member states characterised by specific economic structures" – and recommended extending reduced VAT rates to "sectors whose services are easily substituted for do-it-yourself or underground work, e.g. locally supplied services and some parts of the hospitality sector":

> The argument is that high tax wedges (high marginal income tax and high VAT rates) make it very expensive to buy these services on the market and more attractive to do yourself. The implication is that high skill professionals spend time on low skill work at home instead of spending time with their families or increasing their more productive labour supply. Lower VAT rates serve to counter this development.
>
> Simulations indicate that the gains in welfare, productivity and GDP are sizeable in all member states, even though the largest gains by far will accrue to member states with high tax wedges. Reduced VAT rates are not expected to have negative implications for the functioning of the internal market as the relevant products are typically not traded across EU-borders. [73]

Finally, the authors suggested that there was a limited case for using reduced rates to boost employment for low skill workers (eg, in hotels and restaurants), to improve income distribution (ie, by cutting VAT on food, which accounts for a large share of the budget of lower income households), and increase the demand for goods that 'for some (good) reason are underconsumed' (eg, books, music, cultural events, and energy saving appliances).

The Commission gave details of its own views in a memorandum accompanying this report; on the use of reduced VAT rates to promote employment it noted:

> From a job creation point of view, there is a theoretical but not an empirical argument for extending reduced VAT rates to sectors employing many low skill workers in order to boost low skill demand, e.g. hotels, restaurants and locally supplied services.

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72 *Communication on VAT reduced rates MEMO/07/277*, 5 July 2007

73 Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, 21 June 2007 pp 3-4

> However, there may be a case for a limited, supplementary role via carefully targeted reductions in the context of grander labour market reform.
>
> The theoretical argument is that reduced VAT rates, by boosting demand for such services, stimulate demand for low skill workers, and push up their wages such that employment becomes a more attractive option than unemployment. However, simulations indicate that the overall impact on demand for low skill workers is unimpressive because differences in low skill employment between industries are limited.
>
> From an Internal Market point of view, reduced VAT rates may have some limited implications, in particular through tourism. Services provided by restaurants and hotels are mainly directed at domestic consumption, but may also affect distribution of tourism between Member States and may have a non-negligible impact in border regions. Possible distortion as regards restaurant and hotel services is likely to be different in magnitude across Member States (stronger for smaller and/or tourist oriented areas) and the degree of possible substitution of holiday destinations plays an important role. As far as the business consumption of these services is concerned, the rules on VAT deductibility may also impact on the functioning of the internal market.[74]

Member States were invited to respond to this study. The UK made its submission in May 2008. In the introduction to this submission the Government made the case for using reduced VAT rates to address certain social policy objectives:

> Reduced VAT rates benefit consumers by reducing the price of certain essential goods and services. They can also reflect consensus among citizens within a Member State, such as the UK, that VAT should be chargeable on such essentials at the lowest rate possible. In cases such as food, children's clothes, and domestic fuel and power, reduced and zero rates play an important role in addressing the regressivity of VAT, because the savings for consumers that arise from the VAT reduction will usually be higher — as a proportion of income — for lower income groups. Zero and reduced rates can thereby help to ensure that the VAT burden is not disproportionate for these groups.
>
> VAT can also be effective when combined with other (economic and non-economic) measures and incentives, as a means of providing cost-effective, targeted support for social policy objectives, and as an immediate and effective means of increasing citizen access to 'merit' goods. It may therefore be an appropriate policy tool where a merit good is under-consumed in a free market, resulting in some households — and society as a whole — consuming less than the quantity of the good that would maximise their welfare. This can occur when consumers either do not properly appreciate the utility that they gain from consumption of the good, or are unable to purchase the optimal amount due to credit constraints or some other restriction.
>
> Reduced VAT rates can also address externalities. The consumption of goods with environmental benefits, such as energy-saving materials and the most energy-efficient electrical appliances, has a positive externality. In addition to the benefit to

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[74] European Commission, *Communication on VAT reduced rates MEMO/07/277*, 5 July 2007

> the consumer from lower energy costs, consumption of energy saving materials and substitution from less to more energy efficient appliances have an external benefit to society by reducing energy usage and, hence, the CO2 emissions that give rise to global warming. Without an incentive such as a VAT reduction, the price that the consumer pays for such goods does not take account of the external benefit to society. A reduced VAT rate on goods with environmental benefits can ensure that prices paid by consumers more closely reflect the cost of the goods to society, which includes the external benefit.
>
> VAT reductions have certain advantages when compared with alternative instruments such as direct subsidies or incentives. Using VAT reductions minimises burdens, administration and other inconveniences for both consumer and retailer, which should maximise take-up and benefit. By reducing the retail prices available to all customers, VAT reduced rates work in a transparent and effective way at the point of transaction. Businesses across the EU are used to operating within the VAT system, and already deal with reduced rates in every Member State, usually with minimal difficulty. However, there may be cases where Member States could do more to provide clear and accessible guidance on the scope of reduced rates.[75]

At this time the case *against* the use of reduced VAT rates was made by a paper, prepared as part of the 'Mirrlees Review' of the UK tax system commissioned by the Institute for Fiscal Studies. The authors argued that, "differential commodity taxation is a very blunt instrument for the pursuit of equity objectives, with the zero-rating of food and children's clothing in the UK being a classic example":

> Take food, for example. It is indeed the case that the less well-off spend a higher proportion of their income on food than do the better off. But this is not in itself a good reason—even on distributional grounds, leaving the need to raise revenue aside—for subjecting it to a differentially low rate of tax. This is for two reasons.
>
> First, looking only at a snapshot of spending and income patterns in the population at any moment may be misleading given the variability of income over a lifetime: those with low incomes now may be the young or elderly who will be, or have been, amongst the high income groups at other times. Put differently, a commodity tax looks regressive when assessed relative to current incomes in part because those with high incomes tend to have high savings, and so appear to escape the tax—but they will face it when they come to spend those savings.
>
> One way to address these issues is to relate food spending not to income in any period but to total spending, since the latter may be a better reflection of household's perceptions of their own long-run spending ability. Doing so, as Kay and Davis (1985)[76] show for items zero-rated in the U.K.—and as subsequent studies have shown for a range of taxes on particular commodities—tends to greatly dampen the apparent distributional case for tailoring commodity taxation to consumption patterns.
>
> The second reason—perhaps potentially more persuasive to non-economists—is that even if the better off spend a smaller

[75] European Scrutiny Committee, *Twenty third report*, 23 May 2008, HC16-xxiii pp87-8
[76] Kay, John A. and Evan Davis (1985), "Extending the VAT base," *Fiscal Studies*, Vol.6, pp1-16.

> *proportion* of their current income on such items as food than do the less well-off, they are likely to spend a smaller *absolute* amount on them. If there were no other way of transferring resources to the poorest, setting a low tax rate on these items might be sensible policy. But it is unlikely to be so when, as in the U.K., there are a range of other instruments—not only the income tax, but tax credits and benefits—that could be targeted more directly upon them: it seems likely that, by such means, more than £11.50 of each £100 raised by eliminating the zero-rating could be channelled to the poorest, making that a better way of pursuing equity goals.
>
> Kay and Davis (1985) and Hemming and Kay (1981)[77] provided early illustrations of this point for the U.K., the latter showing for example that the distributional impact of eliminating zero-rating could be very largely offset by cutting the standard rate of income tax and increasing the tax threshold. We revisit this simple but crucial insight, using more recent data, [in a later section of the paper, not reproduced here] and show that it has lost no force over the years.[78]

The authors concluded that abolishing zero and reduced rates of VAT would "cut compliance and administration costs for business and government, interfere less with people's spending decisions, and raise enough revenue both to improve the living standards of poorer families and to cut other taxes by £11 billion." The then director of the IFS, Robert Chote, noted that "the authors make a powerful case on efficiency, fairness and practical grounds for moving to a uniform rate of VAT, rather than the complex mix of full, zero and reduced rates and exemptions we have at the moment", going on to observe that "the main obstacle to such a reform appears to be a lack of political leadership, which is perhaps understandable when the public focus on individual elements of the tax system rather than on the whole."[79]

In July 2008 the Commission published proposals for a relatively limited change in the rules on reduced VAT rates, noting the "the lack of political guidance from the Council" and the need for "a clearer view … of the use and effectiveness of reduced VAT rates in promoting certain other policies."[80] Details were given in a press notice issued at this time:

> The **housing sector** will no longer be limited to services linked to a social policy, as it is currently, but will be broadened to include the supply and construction of all housing, as well as all services related to the housing sector (including renovation, maintenance, cleaning, ...).
>
> Supply of **restaurants and catering services**, excluding alcoholic beverages, are also included.

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77 Hemming, Richard, and John A. Kay, 1981, "The United Kingdom," pp75-89 in Henry J. Aaron (ed) *The Value-Added Tax: Lessons from Europe* (Washington DC: Brookings Institution).

78 Ian Crawford, Michael Keen & Stephen Smith, *Value-Added Tax and Excises*, IFS July 2008 pp 9-10.

79 IFS press notice, *Simplify VAT to cut costs, raise revenue and help the poor, says study prepared for the Mirrlees Review*, 31 July 2008. The final report of the review also made the case for removing nearly all zero & reduced rates: see, "Chapter 9: Broadening the VAT base" in *Tax by design*, September 2011.

80 COM(2008) 428/3, 7 July 2008. See also, EC Memo/08/481, *Communication on VAT reduced rates – FAQs*, 7 July 2008

> It is proposed that **labour-intensive services** , should be permanently included in the list of services eligible for reduced rates. Moreover, the category is broadened to other locally supplied services of a similar nature. That is:
>
> - Minor repair of tangible movable goods, including bikes but excluding other means of transport. Examples include shoes, clothes, computers, watches,
> - Cleaning and maintenance services of all these goods and, in this case, other means of transports are included;
> - Domestic care services (e.g. home help and care of the young, elderly, sick or disabled);
> - All personal care services (including hairdressing, beauty services, ...)
> - Gardening services
> - Renovation and maintenance services provided to places of worship, cultural heritage and historical monuments, as recognised by Member States.
>
> In addition a number of small clarifications are proposed. The category of **pharmaceutical products** is widened to cover all absorbent hygiene products, notably including children's nappies. Concerning **medical equipment** for the disabled the Commission proposes widening this category to cover all specially designed or adapted material or equipment for the exclusive personal use of the disabled (including specially adapted cars, Braille keyboards...).
>
> Printed **books**, under current legislation, may be subject to reduced rates. The Commission proposes widening the definition of books to include audio-books. These are defined as 'CDs, CD-ROMs or any physical support that predominantly reproduce the same information content as printed books' and which do not include other material such as games.[81]

In a memorandum to the draft text, the Commission addressed the fact that it was not proposing any extension in reduced rates to energy saving products:

> Indeed, the current proposal does not include provisions on the use of VAT reduced rates for environmental purposes. However, it does give Member States the possibility of applying reduced VAT rates to renovation and repair works, with a view to increased energy-saving and efficiency. The feasibility of a more far reaching proposal from an environmental point of view is currently being examined by the Commission services, in accordance with the request from the European Council in March 2008 to examine areas where economic instruments, including VAT rates, can have a role to play to increase the use of energy-efficient goods and energy-saving materials.
>
> The results of these analyses will allow the Commission to assess the most cost effective way to promote the production and use of energy-saving materials and energy-efficient appliances and equipment. Those results are expected in the autumn. The

81 European Commission press notice IP/08/1109, 7 July 2008

> Commission will then present the results of these analyses, accompanied by relevant proposals and recommendations.[82]

In evidence to the European Scrutiny Committee, the Government stated that it was "generally supportive of the draft Directive, consistent with its position of supporting the flexibility of Member States to apply their own choice of VAT rates in support of their domestic priorities and social objectives, provided that this does not materially affect the functioning of the single market." In addition, it "particularly welcomes the proposal for a reduced rate for the repair and maintenance of places of worship and monuments … for which it has strongly advocated." The Committee concluded that "the increased flexibility for Member States in the application of VAT rates that is the principal purpose of this draft Directive is to be welcomed."[83]

However, a significant number of Member States strongly opposed the Commission's proposals. In a second memorandum updating the Committee in November 2008, the Government noted that, "whilst many Member States would prefer more flexibility in the system, a group of Member States, for philosophical reasons or in response to domestic pressures, are opposed to new reduced rates and wish to limit the existing arrangements. These Member States continue to show strong opposition to the proposal."[84]

European Finance Ministers discussed the proposals twice before finally reaching a political agreement on 10 March 2009, making only two changes to these provisions.[85] First, the scheme to apply reduced rates to labour-intensive services would be made permanent, though the categories would not be extended at all. Second, two supplies from the list of suggestions from the Commission would be added to the reduced rate list: restaurant services and books on all physical means of support.[86] Legislation to make these minor changes was agreed on 5 May, and took effect on 1 June 2009.[87]

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82 European Commission Memo/08/481, 7 July 2008
83 *Thirty fourth report*, 23 October 2008 HC 16-xxxiv 2007-08 p44
84 *Fortieth report*, 4 December 2008 HC 16-xl 2007-08 p113
85 HC Deb 9 December 2008 c43-4WS; HC Deb 23 February 2009 cc1-2WS; HC Deb 17 March 2009 cc42-3WS
86 ECOFIN press notice 7048/09, *2931st meeting of the Council*, 10 March 2009 pp10-11
87 Directive 2009/47/EC of 5 May 2009. These seven services are now included in the list of items set out in Annex III of Directive 2006/112/EC.

8. The Commission's VAT strategy (2010-13)

In December 2010 the Commission published a Green Paper on the future of VAT, asking for views on how the tax could be simplified and strengthened.[88] The Commission argued that there were "numerous shortcomings in the current VAT system which create obstacles to the Internal Market, cause burdens for businesses and prevent Member States from benefitting from the true potential of this tax":

> While fundamental idea behind VAT is to have a broad-based, globally applied consumption tax, the wide and divergent use of reduced rates and exemptions by Member States means that only part of final consumption is being taxed at the standard rate. Moreover, inconsistencies in the application of reduced VAT rates also lead to distortions of competition within the Internal Market. Finally, the current VAT system is relatively vulnerable to fraud and a significant part of the VAT is lost this way.[89]

On this last point the Commission estimated that VAT fraud across the Community was considerable – and that the 'VAT gap', the difference between actual VAT receipts and what national governments should have expected, was on average 12% of Member States' net theoretical liability.[90] In its memo on the Green Paper the Commission explained why the current system was relatively susceptible to fraud:

> The current European VAT arrangements are designed so that intra-EU supplies of goods between businesses are exempt in the Member State of origin, with taxation taking place in the Member State of destination. This exemption mechanism exposes the VAT system to fraud, in particular carousel or 'Missing Trader' fraud. This is when a fraudster purchases goods VAT-free in one Member State and resells them with VAT in another Member State. The fraudster then pockets the VAT and goes missing, without declaring anything to the tax authorities in the Member State of destination.
>
> One way of tackling carousel fraud is to implement a "reverse charge" system i.e. making the customer responsible for paying the VAT, rather than the seller. The Green Paper seeks feedback from stakeholders on various options that could help to prevent fraud, such as cross-border reverse-charge or taxing intra-EU supplies. It also opens a discussion on new means for collecting VAT, which would guarantee that Member States get the VAT that they are due, prevent fraud and provide more legal certainty to businesses.[91]

On the particular question of VAT rates, the Green Paper noted that there was no evidence that the current variety of rates undermined the single market, but went on to suggest that further harmonisation might be desirable:

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88 *Green Paper: On the Future of VAT*, COM(2010) 695 final, 1 December 2010. Responses to the Green Paper were invited by 31 May 2011.

89 European Commission, *Questions and Answers: Value Added Tax (VAT) : Memo/10/633*, 1 December 2010

90 The VAT gap includes legal avoidance and insolvencies as well as fraud.

91 *Memo/10/633*, 1 December 2010

> The ‘definitive’ VAT system based on taxation at origin would require a higher degree of harmonisation of VAT rates compared to the current system based on taxation at destination, which provides Member States with more flexibility still within the limits set by the single market requirements.
>
> It has been argued that the application of a single VAT rate to all goods or services would be an ideal solution from the point of view of maximising economic efficiency.[92] At the same time, the use of reduced rates as a policy instrument is often advocated notably for health, cultural and environmental reasons to provide easier and more equal access to educational and cultural content and incentives for eco-innovation and knowledge-based resource efficient growth.[93]
>
> The current variation in the standard rate in the EU and the reduced rates applied by some Member States do not seem to disrupt the single market. This is mainly because there are correction mechanisms (special schemes for distance sales of goods or services and new vehicles …) in the current VAT system, but these add substantially to its complexity. Cross-border transactions involving goods and services at a reduced rate do, however, create compliance costs and legal uncertainty for business. This is particularly a problem when a business becomes liable for VAT in a Member State in which it is not established. More transparency, with a binding online database of goods and services under a reduced rate could be envisaged.
>
> Moreover, there are still inconsistencies in the VAT rates applied to comparable products or services. For instance, Member States may apply a reduced VAT rate to certain cultural products but have to apply the standard rate to competing on-line services such as e-books and newspapers. The ‘Digital Agenda for Europe’[94] stipulates that the challenges of convergence between the online and the physical environment should be addressed in all reviews of public policy, including tax matters. To cope with these discriminations, two possible options exist: either to maintain the standard VAT rate, or to transpose into the digital environment the reduced rates existing for goods in traditional supports.[95]

In an explanatory memorandum Treasury Minister David Gauke set out the Coalition Government’s position:

> The Government welcomes the production by the Commission of the Green Paper and accompanying Staff Working Document and the opportunity to begin the high level debate on key issues and principles in order to inform the future direction of the EU VAT system. The Government is also supportive of the broad aims of reducing administrative burdens; combating fraud; and modernisation and simplification. However, the Government will counter unhelpful ideas, including for example those that might lead to an erosion of UK national sovereignty or result in tax matters being dealt with otherwise than in Council under a unanimity basis.[96]

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92 Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, Final Report, 21.6.2007.
93 The summary report of the outcome of the public consultation ‘Review of existing legislation on VAT reduced rates’ carried out in 2008 is available online.
94 COM(2010) 245, 19.5.2010, p9
95 COM(2010) 695 final pp14-15
96 HM Treasury, *Explanatory memorandum 17491/10*, 20 December 2010 para 16

The European Scrutiny Committee considered the Green Paper in February 2011, noting that the new VAT strategy would clearly be "important", and that "before considering the Green Paper further we should like to see in due course the response to it, which we presume the Government will be making."[97] In June the Coalition Government gave the Committee a draft of its response to the Green Paper, which supported the broad aims of the consultation, but underlined its opposition to any change in the VAT rules which could result in the abolition of the UK's zero rates:

> The Government supports … flexibility for Member States to apply their own choice of VAT rates in support of their domestic priorities and social objectives, provided that this does not materially affect the functioning of the single market … in any future work on possible changes to the legal process of the EU VAT system, in addition to the principles of subsidiarity and national sovereignty, the Government will continue to wholly support the principle of unanimity in taxation and will not endorse any moves away from this principle.[98]

In response the Committee cleared the document, commending the Government's emphasis "on national tax sovereignty, subsidiarity, unanimity for votes on indirect taxation legislation and simplification and modernisation of the VAT system."[99]

In December 2011 the European Commission published its new VAT strategy;[100] a summary was given in a press notice:

> Three overriding objectives shape the vision for the new VAT system:
>
> First, VAT must be made more workable for businesses. A simpler, more transparent VAT system would relieve businesses of considerable administrative burdens and encourage greater cross-border trade. This, in turn, will be good for growth. Among the measures envisaged for a more business-friendly VAT are expanding the one-stop-shop approach for cross border transactions; standardizing VAT declarations; and providing clear and easy access to the details of all national VAT regimes through a central web-portal.
>
> Second, VAT must be made more efficient in supporting Member States' fiscal consolidation efforts and sustainable economic growth. Broadening tax bases and limiting the use of reduced rates could generate new revenue for Member States without the need for rate increases. The standard VAT rate could even be reduced in some Member States, without any impact on revenue, if exemptions and reductions were removed. The Communication sets out the principles that should guide the review of exemptions and reduced rates. The Commission will also be analysing Member States' use of reduced rates and exemptions when reviewing their fiscal policies in the context of the European Semester (see MEMO/11/11).
>
> Third, the huge revenue losses that occur today due to uncollected VAT and fraud need to be stopped. It is estimated that around 12% of the total VAT which should be collected, is

97 *14th report*, 7 February 2011 HC 428-xiii 2010-12 para 7.9
98 *33rd report*, 20 June 2011 HC 428-xxix 2010-12 para 12.10
99 HC 428-xxix 2010-12 para 12.11
100 *Communication: On the Future of VAT*, COM(2011) 851 final, 6 December 2011

> not (so-called VAT Gap). In 2012 the Commission will propose a quick reaction mechanism to ensure Member States can respond better to suspected fraud schemes. Furthermore, the Commission will see whether current anti-fraud mechanisms, such as Eurofisc, need to be strengthened and will explore the possibility of a cross-border audit team to facilitate multilateral controls.[101]

As part of this the Commission announced it would review the structure of VAT rates during 2012, so as to bring forward proposals for changes by the end of 2013. The review would have a number of 'guiding principles':

> Abolition of those reduced rates which constitute an obstacle to the proper functioning of the internal market;
>
> Abolition of reduced rates on goods and services for which the consumption is discouraged by other EU policies;
>
> Similar goods and services should be subject to the same VAT rate and progress in technology should be taken into account in this respect.[102]

One important aspect of the Commission's strategy was its decision to abandon its plans to move to VAT being based on 'taxation of origin' – a reform that in the mid-1980s the Commission had anticipated as being part and parcel of the completion of the Single European Market. Indeed the agreement by Member States in 1991 harmonising EU VAT rates set December 1996 as a potential deadline for this reform being agreed. However, the Commission found that the responses to its Green Paper suggested that this was still politically unachievable.[103] In a commentary on the Commission's proposals, the IFS welcomed this decision – although it felt that the Commission should have made the case for a fundamental broadening of VAT:

> Another promising proposal is to abandon the long-standing objective of moving towards a VAT based upon taxing cross-border trade at the rate of VAT applicable in the exporting country (the origin principle). Doing this will allow the Commission to focus on improving the operation of the existing EU VAT system largely based on the destination principle: taxation in the importing country at the importing country's VAT rate. Such a system has real benefits. For instance, cross-country differences in rates of VAT should not distort where firms choose to source their inputs from: they pay the domestic rate of VAT whether they buy things from a domestic supplier or a supplier based in another EU country …
>
> As stated by the Commission "the Member States are primarily responsible for limiting as far as possible the scope of such [reduced] rates", and they also have some discretion about when to apply exemptions. Implementing a reduction in the use of exemptions and reduced rates is likely to be political difficult: those sectors benefiting from them will lobby against their

101 EC press notice IP/11/1508, 6 December 2011

102 EC MEMO/11/874, *Questions and Answers: VAT*, 6 December 2011

103 For more details see COM(2011) 851 final para 4.1. The Commission note that the principle of an origin system underpinned the very first moves to harmonise VAT across Member States in the late 1960s.

> abolition, and it is unlikely to be popular with national electorates either. But doing so would bring real economic gains.[104]

(As noted above, the case for removing zero & reduced VAT rates as well as VAT exemptions was made in the Mirrlees Review, published by the IFS. It was also examined in a major 2011 study of the VAT system commissioned by the Commission from several economic institutes, including the IFS, – to underpin its work on its VAT strategy.[105])

At this time the Treasury Minister David Gauke set out the Coalition Government's position to the European Scrutiny Committee:

> The Minister says that:
>
> • many of the priority areas [in the Communication] are unsurprising — several actions correspond to the ones the Government pushed for in its response to the Green Paper (including a high priority for implementation of 2015 changes and better information and guidance to business);
>
> • overall, the list contains lots of ideas — some of which can be easily and quickly achieved without legislation whilst others are much longer term; and
>
> • ideas for reform are predominantly focused on making the current system work better, which would minimise disruption, but still enable key problems and irritants to be addressed — all of which is likely to be welcomed by most UK businesses.
>
> However, the Minister also comments, less positively, that:
>
> • there are also actions the Government will need to watch (including standardised VAT return and VAT rates);
>
> • proposals and initiatives will need to be evaluated as they emerge, testing ideas according to their effectiveness and negotiability and whether the impact on businesses can be justified; and
>
> • the Government will also continue to counter unhelpful proposals and initiatives, including for example those that might lead to an erosion of UK national sovereignty or result in tax matters being dealt with otherwise than in Council under a unanimity basis.[106]

(Further to this, the Minister provided a helpful précis of the different actions proposed in the Communication in a letter to the Committee.[107])

The Committee recommended that the House should debate this, and that on this occasion "Members might pay particular attention to the proposed fundamental change from an origin principle based VAT Directive to a destination principle based one."[108] European Standing Committee B debated the issue in April 2012; on this occasion Treasury Minister David Gauke set out the Government's position on this package, as well as the vexed question of VAT rates:

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[104] David Phillips, *IFS Observations: Reforming VAT: a promising proposal, but much more still to be done*, 19 December 2011

[105] European Commission, *A retrospective evaluation of elements of the EU VAT system*, December 2011

[106] *Fifth-third report*, 6 February 2012 HC 428-xlviii 2010-12 p15

[107] *Letter from Exchequer Secretary to Commons European Union Scrutiny Committee*, 6 January 2012

[108] HC 428-xlviii 2010-12 p16

> The UK response to the Green Paper consultation supported the effective basis for the current EU VAT system—largely based on taxation at the place of destination. It meets the objective of tax accruing to the member state of consumption. That remains our view. UK businesses also largely support the existing system and consider taxation at the place of destination to be pragmatic and achievable. A system based on destination is also the basis for all other VAT systems across the world, so it is important in terms of consistency for businesses involved in international trade …
>
> The Commission [also] proposes an assessment of the current VAT rates structure, in particular focused on restricting the use of reduced rates. Change in this area is not a priority for the Government, nor is it for most of our European partners. The Government's view is that tax issues should continue to lie within the competence of member states and, where there is no cross-border impact, VAT rates policy within the EU framework must remain a matter for national Governments.[109]

In general the debate was not contentious, though the Minister was asked to say a little more about the reasons for supporting the destination principle; in response Mr Gauke said the following:

> As a pragmatic matter, the destination approach works better. VAT is a consumption tax; taxing at the point of consumption. Taxing at the rates that apply where the good or service is consumed makes sense … if we were not to have the destination system the pressures for much greater harmonisation as far as rates were concerned, and for some kind of clearing system whereby funds would be moved from one member state to another, would become much stronger.
>
> UK Governments have consistently argued and I think other member states have also argued that the destination system is a more pragmatic and sensible approach, and we are pleased that in this strategy paper the Commission shares that view.[110]

On 8 October 2012 the Commission launched its consultation on VAT rates, asking respondents if, in their view, any existing reduced rates distorted competition – even though earlier work by the Commission and others had not revealed any major anomalies.[111] The paper asked if some reduced rates should be reconsidered, given that the wider costs to their consumption is recognised in other EU policies (specifically, the reduced rates for water, energy, waste management and housing). The paper also sought views on the best way to apply VAT to similar goods and services, which had been affected by recent technological developments – such as digital and non-digital books & newspapers, as well as radio & television broadcasting done 'offline' and online.[112]

The Commission underlined that the review would be "holistic and very inclusive" and that it did not "pre-suppose the elimination of any particular reduced rate." It also underlined the fact that even if the Commission proposed abolishing any reduced rate, this would not

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[109] European Committee B, *VAT (Single Market)*, 23 April 2012 cc5-6
[110] *op.cit.* cc8-9
[111] European Commission, *Review of existing legislation on VAT reduced rates (TAXUD/C1)*, October 2012 p7. The consultation closed in January 2013.
[112] *op.cit.* p10

affect the fact that any change in these rules would have to be unanimously agreed by Member States.[113]

In a paper on the developments to EU VAT law published at this time, Professor Rita de la Fiera argued that the scope of the Commission's consultation had shaped the nature of the responses that had been made:

> As opposed to previous initiatives which were broad in their scope, this was a very targeted public consultation: only nine questions, strictly framed by the guiding principles, eight of which concerned specific sectors of activity, namely the application of reduced rates of VAT to water, energy, waste and e-books. Despite the limited scope of the questions asked, the Commission also asked more generally for any "concrete examples of distortions of competition within the internal market or of specific problems encountered due to the current VAT rules".
>
> Despite this effective broadening of the scope of the consultation, the targeted nature of the questions resulted in a low number of submissions from academics, tax advisors and tax practitioners; and on the contrary, a very high number – more than half of all submissions – from national or European associations, the large majority of them representing sectors currently benefiting from a reduced VAT rate.
>
> Unsurprisingly, the nature of the respondents reflected heavily on the contents of the responses: most were opposed to the abolition of the reduced rates and/or advocating for their extension; and many challenged the general trend of shifting taxation away from labour towards consumption. Some submissions also defended that no further harmonisation should take place, and that the decision on whether or not to apply reduced VAT rates should be left to the Member States.[114]

Professor de la Fiera went on to argue that there were wider forces at work encouraging the harmonisation of VAT systems across the EU – namely, the pressing needs to increase domestic tax revenues:

> In the context of the outcome of this public consultation, it is pertinent to question whether this latest initiative can be successful. Reviewing the rate structure has been part of every Commission's attempt to reform the EU VAT system—and with good reason. A recent study commissioned by the EU Commission indicates that a 50% reduction in the dissimilarity in VAT rates structures between Member States could result in a rise of 9.8% in intra-EU trade and an increase in real GDP of 1.1%.[115]
>
> Moreover, this is merely the last of several studies indicating the negative consequences of rate differentiation and its unproven positive effects. Yet, these studies in themselves have traditionally been insufficient to convince Member States to act. On the contrary, what has now made many Member States act at a domestic level has been the pressing need for extra revenue...
>
> Since 2009 twenty-five of the thirty-three OECD countries have increased their VAT rates, resulting in a broad convergence of VAT

[113] European Commission (MEMO 12/750), *Questions and Answers on reduced VAT rates*, 8 October 2012; see also, EC press notice (IP/12/1079), 8 October 2012.

[114] Rita de la Fiera, *EU VAT rate structure: towards unilateral convergence?*, Oxford Centre for Business Taxation Working Paper WP13/05, 2013 pp17-18

[115] see, European Commission, *A Retrospective Evaluation of Elements of the EU VAT System*, December 2011

> standard rates across the EU around the 20% mark. Furthermore, there has also been a decrease in levels of differentiation with a reduction in number of VAT rates applicable in many Member States, as well as various base broadening measures. The latest developments raise the possibility that Europe might be finally entering a process of convergence of VAT rate structures, not by EU initiative but by domestic necessity; an unforeseeable, unplanned unilateral convergence, to contrast to the long-sought, but so far unattainable, EU harmonisation.[116]

In the months following this consultation the Commission did not publish any detailed proposals to amend the rules on VAT rates. In answer to a PQ in July 2013, the Treasury Minister David Gauke said, "the last discussions on reduced rates of VAT concluded after six years of highly politically charged negotiation and there is limited appetite among the member states at EU level to revisit them."[117]

[116] *EU VAT rate structure: towards unilateral convergence?*, 2013 p18, p1
[117] HC Deb 15 July 2013 c529W

9. The Commission's Action Plan on VAT (2016-18)

For the next two years there appears to have been little formal discussion at an EU level on this issue. On a domestic level, in 2015 the IFS published an overview of the Coalition Government's record, and as part of this noted the absence of any reforms to the VAT base: "The trivial (and unsuccessful) 'pasty tax' and 'caravan tax' proposals in Budget 2012 merely serve to highlight the lack of more substantive reform."[118] The controversy over the Coalition Government's decision to make some marginal changes to the scope of existing zero rates for hot takeaway food, holiday caravans, and other miscellaneous items, also highlighted the considerable political difficulties to governments increasing the VAT liability of any selected goods or services.[119] It is notable that the anticipated annual tax yield from these highly publicised changes was about £205m.[120] By comparison, the increase in the standard rate of VAT to 20%, announced in the Coalition Government's first Budget, was estimated to raise *£14bn* in 2015/16.[121]

Public interest in the UK's discretion to set VAT rates was rekindled during 2015, with a campaign for the zero rate on sanitary protection, a change that would be contrary to the EU rules. At the Report stage of the Finance Bill on 26 October 2015, the House debated a new clause supported by a cross-party selection of Members, to require the Government to seek the necessary change in EU VAT law. On this occasion Treasury Minister David Gauke gave a commitment to raise the issue with the European Commission and other Member States.[122]

That month the European Commission confirmed that, as part of its work programme for 2016, it would present an initiative on VAT rates.[123] The *Tax Journal* argued that the review "represents a reversal of the position of the EC on reduced VAT rates. Since as recently as 2013, the EC had been calling for a full withdrawal of the use of reduced VAT rates based on them being a distortion of the single market for goods and services."[124] The *Financial Times* reported that the review "will consider whether states could have greater powers over the VAT rates of specific products. Member States wold have the 'leverage' to raise specific concerns, for example over women's sanitary products."[125]

118 *The Coalition Government's Record on Tax : BN167*, March 2015 p19
119 For more detail see, *VAT: Budget 2012 changes to loopholes and anomalies*, Commons Briefing paper CBP6298, 3 September 2013.
120 Amendments made by the Coalition Government following responses to the 2012 Budget cut the expected annual yield from around £270m to £205m (*Budget 2012*, HC 1853, March 2012 p50; *Autumn Statement*, Cm 8480, December 2012 p57).
121 Adam & Roantree, *The Coalition Government's record on tax: IFS Briefing Note BN167*, March 2015 p7 (Table 2.1).
122 HC Deb 26 October 2015 cc84-128. For more details see, *VAT on sanitary protection*, Commons Briefing paper CBP1128, 14 January 2019.
123 European Commission, *Commission Work Programme 2016*, COM(2015) 610 final, 27 October 2015 p8
124 "EU reduced VAT rates review", *Tax Journal*, 31 October 2015
125 "Britain could drop VAT on sanitary products, says EU", *Financial Times*, 28 October 2015

Writing in the *Financial Times* after the Commons debate, Giles Wilkes suggested that the controversy illustrated "that VAT exemptions occupy a middle ground between politics and economics":

> The EU origin of the VAT restrictions led to last week's Commons debate being portrayed as national sovereignty versus Brussels' over-reach, with the campaign to exempt female sanitary products attracting support from eurosceptic Conservatives as well as politicians from the Green party, Scottish National party and Labour. Analysts, however, say such rules are essential to maintain the integrity of the EU's single market. Varying rates of VAT could otherwise become trade tariffs by another name ...
>
> Such rows are a reminder that VAT exemptions occupy a middle ground between politics and economics. Politicians like to deploy them as a tool for pleasing a particular constituency but tax experts complain that by altering prices, differential rates make compliance more costly to enforce. They also distort consumers' decisions towards buying one item over another, muffling the price signal provided by the underlying cost of the product.[126]

The European Council met on 17/18 March 2016, and although most of its deliberations concerned migration and the impact of the war in Syria, in its formal conclusions it noted: "the Commission intends to publish shortly a communication on an action plan on VAT. It welcomes the intention of the Commission to include proposals for increased flexibility for Member States with respect to reduced rates of VAT, which would provide the option to Member States of VAT zero rating for sanitary products."[127] This part of the statement was mentioned by the Prime Minister when he gave a statement to the House on the outcome of the Council meeting a few days later:

> [At the Council] I took the opportunity to deal with a long-standing issue we have had about the VAT rate on sanitary products. We have had some EU-wide VAT rules in order to make the single market work, but the system has been far too inflexible, and this causes understandable frustration. We said we would get this changed and that is exactly what we have done.
>
> The Council conclusions confirm that the European Commission will produce a proposal in the next few days to allow countries to extend the number of zero rates for VAT, including on sanitary products. This is an important breakthrough. Britain will be able to have a zero rate for sanitary products, meaning the end of the tampon tax.[128]

Subsequently the Commission's 'Action Plan on VAT' was published on 7 April 2016.[129] The Commission announced it would publish a series of proposals over the next two years to modernise the current EU VAT rules, including:

- key principles for a future single European VAT system;
- short term measures to tackle VAT fraud;

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[126] "Tax row throws spotlight on EU VAT anomalies", *Financial Times*, 1 November 2015

[127] European Council press release 143/16, *European Council conclusions 17-18 March 2016*, 18 March 2016

[128] HC Deb 21 March 2016 cc1245-6

[129] Details are on the Commission's site; see also, "Brussels to hand back VAT powers in 'tampon tax' move", *Financial Times*, 7 April 2016.

- update the framework for VAT rates and set out options to grant Member States greater flexibility in setting them;
- plans to simplify VAT rules for e-commerce in the context of the Digital Single Market (DSM) Strategy and for a comprehensive VAT package to make life easier for SMEs.

Further details were set out in a press notice issued at the time:

> **A future definitive EU VAT system for cross-border trade to reduce opportunities for fraud**
>
> The current VAT system needs to be modernised to keep pace with the challenges of today's global, digital and mobile economy. The current VAT system for cross-border trade which came into force in 1993 was intended to be a transitional system and leaves the door open to fraud. The Commission therefore intends to come forward in 2017 with a proposal to put in place definitive rules for a single European VAT area. Under the new rules, cross-border transactions would continue to be taxed at the rates of the Member State of destination ('destination principle') as today, but the way taxes are collected would be gradually changed towards a more fraud-proof system. At the same time, an EU-wide web portal would be implemented to ensure a simple VAT collection system for businesses and a more robust system for Member States to gather revenue.
>
> **Immediate measures to tackle VAT fraud under the current rules**
>
> Cross-border VAT fraud deprives Member States of vast sums of revenue. Estimates show that the future VAT system could reduce cross-border fraud by around EUR 40 billion (or by 80%) a year. Later this year, the Commission will propose measures to reinforce current tools used by Member States to exchange information related to VAT fraud, fraud schemes and good practices. We will continue to closely monitor the performance of tax administrations in collecting and controlling VAT.
>
> **More autonomy for Member States to choose their own rates policy**
>
> Under the current rules, Member States need to stick to a pre-defined list of goods and services when it comes to applying zero or reduced VAT rates. The Commission plans to modernise the framework for rates and to give Member States more flexibility in future. It proposes two options: one option would be to maintain the minimum standard rate of 15% and to review regularly the list of goods and services which can benefit from reduced rates, based on Member States' input. The second option would abolish the list of goods and services that can benefit from reduced rates. This would, however, require safeguards to prevent fraud, avoid unfair tax competition within the Single Market and it could also increase compliance costs for businesses. Under both options, the currently applicable zero and reduced rates would be maintained.
>
> **Support for e-commerce and SMEs**
>
> The current VAT system for cross-border e-commerce is complex and costly for Member States and businesses alike. EU businesses are at a competitive disadvantage because certain non-EU traders can import VAT-free goods to the EU. The complexity of the system also makes it difficult for Member States to ensure compliance. The Commission will come forward by the end of 2016 with a legislative proposal to modernise and simplify VAT for

> cross-border e-commerce as part of the Digital Single Market strategy. This will include a proposal to ensure that e-publications can benefit from the same reduced rates as physical publications. As a second step, we will present in 2017 a VAT simplification package designed to support the growth of SMEs and to make it easier for them to trade across borders.[130]

The Commission published proposals regarding the definitive VAT system in October 2017[131] and for new rules regarding VAT rates in January 2018.[132] In the latter case it is envisaged that Member States would be free to apply reduced or even zero-rates of VAT to any good or service, except for those specifically listed:

> **How will Member States set their VAT rates in future, according to your proposal?**
>
> While a minimum standard VAT rate of at least 15% will continue to apply, the harmonised and less restrictive rules will enable all Member States to apply a range of rates to products:
>
> - two separate reduced rates of between 5% and the standard rate chosen by the Member State;
> - one exemption from VAT (or 'zero rate');
> - one reduced rate set at between 0% and the reduced rates.
>
> At the same time, the Commission proposes to abolish the list of goods and services to which reduced rates can currently be applied. Instead, there is now a list of products to which reduced rates cannot be applied, ensuring that products such as alcohol, weapons, tobacco and gambling will always be taxed at the standard rate or above. That will give Member States more freedom in setting VAT rates, as per their request.
>
> Safeguards will be introduced to avoid potential risks like revenue erosion, distortion of competition, unnecessary complexity and legal uncertainty. Member States will be required to ensure that reduced rates benefit the final consumer and, in order to protect revenues, that the average VAT rate applied to those transactions for which VAT cannot be deducted always exceeds 12%.[133]

In February 2018 the Government published a memorandum on the draft text expressing support for this plan, adding that it had started a 'mapping exercise' to ensure that the UK's existing range of zero and reduced rates could be retained under the proposal:

> Currently, Annex III of the VAT Directive provides an exhaustive list of goods and services eligible for reduced rates. This would be replaced with a new Annex IIIa which would provide a list of goods and services to which the standard rate of VAT must be applied.
>
> In contrast with the current rules, Member States would be permitted to apply reduced rates to all goods and services not included in the proposed Annex IIIa. The Commission's Explanatory Memorandum indicates that the new Annex IIIa list would include supplies of excisable goods, and supplies of

[130] European Commission press notice IP16-1022, *VAT Action Plan*, 7 April 2016
[131] European Commission press notice IP17-3443, 4 October 2017
[132] European Commission press notice IP18-185, 18 January 2018
[133] European Commission, *Q&As on the VAT package (MEMO18-186)*, 18 January 2018

> services, which if subject to reduced or zero-rates could lead to distortions of competition …
>
> The Government has therefore begun a mapping exercise in order to identify how the categories included in the proposed Annex IIIa and the intended classification of products by activity codes, align with the UK's existing zero and reduced VAT rates. As a proposal intended to grant Member States greater flexibility in the setting of their domestic VAT rates, it is important that full consideration is given to aspects of the proposed changes which may result in the inadvertent loss of Member State autonomy in this respect. It is unlikely that Member States will be willing to agree to any changes that force them to remove or amend their existing reduced and zero rates.[134]

The Government did not give any date for the proposal being agreed, although it observed that "previous discussions on VAT rates have shown that Member States hold a wide range of views and therefore, swift progress … is unlikely."[135]

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[134] HM Treasury, *Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of VAT – explanatory memorandum*, 8 February 2018 para 3, 23

[135] *op.cit.* para 32

10. Recent developments

In April 2018 the European Scrutiny Committee published a report on the Commission's proposals to implement the VAT Action Plan, underlining the fact that it was very difficult to ascertain what impact, if any, the new rules on VAT rates might have in the context of Brexit:

> For the UK, the implications of the [draft rates directive] … are inextricably linked to its post-Brexit relationship with the EU's common VAT area after Brexit. If the UK, as a 'third country' like Norway, is completely outside of that area when the 'definitive' VAT system takes effect, the Government would in any event have full flexibility to vary value added tax rates beyond the constraints imposed by EU law present or future.
>
> We note in this respect that it is the European Commission's intention that the new VAT system—including the updated rules in rate-setting—will not take effect before 2022, well after the "two year period" of transition during which the UK would remain in the common VAT area after Brexit …
>
> We have repeatedly asked the Government to provide details of its proposals on the UK's post-Brexit relationship with the EU on Value Added Tax, in the context of:
>
> - either the trade barriers that arise as a result of leaving the common VAT area for UK businesses which import or export goods and services to or from the EU; or
> - minimising UK-EU trade friction by remaining in, or aligned with, the single EU VAT area, and the potential constraints continued alignment with the EU's VAT Directive could place on the UK's domestic tax sovereignty—including the ability to vary rates—after Brexit.
>
> To date, we have not received a satisfactory response to these questions.
>
> As recently as 19 February, the Financial Secretary told us that he could provide no details about the VAT implications of Brexit for UK businesses because the "arrangements in this regard" will "depend on the outcome of the negotiations", without specifying what the Government's objectives are other than a vague ambition to the most "free and frictionless trade as possible". However, he has not ruled out continued UK alignment with EU VAT law (which the European Parliament also supports).[136]

In July 2018 the Government published its White Paper on leaving the EU, and on VAT, simply stated "to ensure that new declarations and border checks between the UK and the EU do not need to be introduced for VAT and Excise purposes, the UK proposes the application of common cross-border processes and procedures for VAT and Excise, as well as some administrative cooperation and information exchange to underpin risk-based enforcement."[137]

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136 *Value Added Tax: EU proposals for reform and the implications of Brexit*, HC 301 of 2017-19, 3 April 2018 paras 2.11, 2.14-5

137 HM Government, *The future relationship between the UK and the EU*, Cm 9593, July 2018 p18. On the wider issue of the potential impact of Brexit for the UK's VAT system see, Jeremy Cape & Max Schofield, "*VAT and Brexit: The Past, Present and Future*," *EC Tax Review* (vol 27, issue 6), November 2018.

On 14 November 2018 the UK concluded the draft Withdrawal Agreement with the EU. This provides for a transition period, also described as the 'implementation period', to bridge the period between the date of the UK's exit from the EU, set for 29 March 2019, and the entry into force of the new, yet to be negotiated, UK-EU partnership arrangements. The transition would run until the end of December 2020, with the possibility of extension for up to two years. During this period the UK would continue to apply EU law, with a few exceptions, as if it were a Member State, though the UK would have no institutional representation and no role in decision-making.[138]

Later the same month agreement was reached on the Political Declaration, which aimed to set the scope and terms for the UK's future relationship with the EU. This was not a legislation as such, and it is unlikely that it would bind the parties to anything beyond a commitment to negotiate for a future relationship in good faith.[139] The Declaration said nothing specific about VAT, though it included a commitment to open and fair competition between the UK and the EU, that would include relevant tax matters; as the Government underlined, this type of agreement would ***not*** "fetter sovereign discretion on tax, including in relation to setting direct or indirect tax rates."[140]

In a letter to the European Scrutiny Committee on 5 December 2018 Treasury Minister Mel Stride confirmed "the Withdrawal Agreement sets out that during the Implementation Period, the UK will no longer be a Member State of the EU, but market access will continue on current terms. Accordingly, common rules will remain in place until the end of the Implementation Period, meaning businesses will be able to trade on the same terms for the duration of this period." The Minister went on to note that the Political Declaration "reiterates the competition between the UK and the EU must be open and fair, and that there should be provisions covering tax matters", though "the precise nature of these provisions will be a matter for future negotiation."[141]

The prospect of Brexit has encouraged many stakeholders to make representation for new VAT reliefs on the UK's departure from the EU.[142] However, it would be difficult to make any confident predictions as to the future range of VAT rates, given the fundamental uncertainties governing the UK's future relationship with the EU.

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138 For details see, *The UK's EU Withdrawal Agreement*, Commons Briefing paper CBP8453, 7 December 2018.

139 For details see, *The Political Declaration on the Framework for Future EU-UK Relations*, Commons Briefing paper CBP8454, 30 November 2018.

140 HMG, *Explainer for the Political Declaration setting out the framework for the future relationship between the UK and the EU*, November 2018 para 85.

141 Letter from Financial Secretary to EU Scrutiny Committee, "EU legislative proposals on VAT", 5 December 2018. Of course the Minister's letter pre-dated the Government's defeat on the draft Withdrawal Agreement on 15 January 2019.

142 Paul Johnson, director of the IFS noted recently, "I am told that the Treasury has been inundated already with special pleading to abolish VAT on a range of specific goods and services, something that is not possible inside the EU but may be possible outside" ("Taking back control does not mean giving in to political temptation", *Times*, 10 December 2018).

11. Annex: Supplies that may be charged a reduced rate

Legislation to harmonise VAT rates across Member States was reached in June 1991, and encompassed by directive 92/77/EEC of 19 October 1992. As part of this agreement, Member States have the option of applying one or two reduced rates, no lower than 5% to certain specified goods, as listed in Annex H of the directive. These provisions are now incorporated in Article 98 and Annex III of the principal EC VAT directive (2006/112/EC).[143]

Article 98

1. Member States may apply either one or two reduced rates.

2. The reduced rates shall apply only to supplies of goods or services in the categories set out in Annex III. The reduced rates shall not apply to electronically supplied services with the exception of those falling under point (6) of Annex III.

3. When applying the reduced rates provided for in paragraph 1 to categories of goods, Member States may use the Combined Nomenclature to establish the precise coverage of the category concerned.

ANNEX III

LIST OF SUPPLIES OF GOODS AND SERVICES TO WHICH THE REDUCED RATES REFERRED TO IN ARTICLE 98 MAY BE APPLIED

(1) Foodstuffs (including beverages but excluding alcoholic beverages) for human and animal consumption; live animals, seeds, plants and ingredients normally intended for use in the preparation of foodstuffs; products normally used to supplement foodstuffs or as a substitute for foodstuffs;
(2) supply of water;
(3) pharmaceutical products of a kind normally used for health care, prevention of illnesses and as treatment for medical and veterinary purposes, including products used for contraception and sanitary protection;
(4) medical equipment, aids and other appliances normally intended to alleviate or treat disability, for the exclusive personal use of the disabled, including the repair of such goods, and supply of children's car seats;
(5) transport of passengers and their accompanying luggage;
(6) supply, including on loan by libraries, of books on all physical means of support (including brochures, leaflets and similar printed matter, children’s picture, drawing or colouring books, music printed or in manuscript form, maps and hydrographic or similar charts), newspapers and periodicals, other than material wholly or predominantly devoted to advertising;
(7) admission to shows, theatres, circuses, fairs, amusement parks, concerts, museums, zoos, cinemas, exhibitions and similar cultural events and facilities;
(8) reception of radio and television broadcasting services;
(9) supply of services by writers, composers and performing artists, or of the royalties due to them;

143 The consolidated version of the Directive is on the Commission’s EUR-lex site here (retrieved, January 2019).

(10) provision, construction, renovation and alteration of housing, as part of a social policy;
(10a) renovation and repairing of private dwellings, excluding materials which account for a significant part of the value of the service supplied;
(10b) window-cleaning and cleaning in private households;
(11) supply of goods and services of a kind normally intended for use in agricultural production but excluding capital goods such as machinery or buildings;
(12) accommodation provided in hotels and similar establishments, including the provision of holiday accommodation and the letting of places on camping or caravan sites;
(12a) restaurant and catering services, it being possible to exclude the supply of (alcoholic and/or non-alcoholic) beverages;
(13) admission to sporting events;
(14) use of sporting facilities;
(15) supply of goods and services by organisations recognised as being devoted to social wellbeing by Member States and engaged in welfare or social security work, in so far as those transactions are not exempt pursuant to Articles 132, 135 and 136;
(16) supply of services by undertakers and cremation services, and the supply of goods related thereto;
(17) provision of medical and dental care and thermal treatment in so far as those services are not exempt pursuant to points (b) to (e) of Article 132(1);
(18) supply of services provided in connection with street cleaning, refuse collection and waste treatment, other than the supply of such services by bodies referred to in Article 13.
(19) minor repairing of bicycles, shoes and leather goods, clothing and household linen (including mending and alteration);
(20) domestic care services such as home help and care of young, elderly, sick or disabled;
(21) hairdressing.

BRIEFING PAPER
Number 2683, 17 January 2019