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# The French VAT System and Revenue Efficiency

By Athena Kalyva, Hans Naudts and Savina Princen

## Summary

France faces important consolidation and indebtedness challenges. At the same time, the overall tax burden is one of the highest in the EU. Against this background France has adopted an expenditure-based consolidation strategy while at the same time reducing the tax burden on labour to boost competitiveness. As a complement to this strategy to reignite growth and rein in the deficit, the design of the tax system could be further improved. In this context, the fairly widespread application of reduced rates and exemptions in Value added taxation (VAT) is adding to the complexity of the tax system and weighing on its efficiency.

VAT receipts in France were below the EU average in 2014 as a percentage of total tax revenue (14.5 %; EU average of 17.5%). Since VAT is easier to administer and relatively less harmful to growth compared with other forms of taxation, increasing revenues from VAT could be important in alleviating the tax burden on labour, which remains relatively high in France despite the recent policy initiatives to reduce it.

This brief focusses mainly on the VAT rate structure in France and identifies channels for potential efficiency and revenue gains. In comparison with other Member States, the extensive application of reduced rates and the use of exemptions diminish the revenue efficiency of the VAT system. The revenue foregone from reduced VAT rates and exemptions considered as tax expenditures by the French authorities carry a substantial budgetary cost of around 1% of GDP. We also take a close look at the rationale used to justify the various reduced rates for specific categories of goods and services and question whether reduced VAT rates are the best tool to achieve the policy goals. In our opinion, there are strong economic arguments for having a simple VAT system, with a limited use of reduced rates. Finally, we suggest a number of ways to improve the efficiency of the VAT rate structure in France.

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## Context and stylized facts

**With its government deficit above 3% of GDP since 2008 and public debt at 96% of GDP in 2015, France faces important fiscal consolidation and public indebtedness challenges.** These challenges need to be seen in the overall context of weak economic growth, high unemployment and a continued need to improve competitiveness.

**France has adopted an expenditure based consolidation strategy, while at the same time reducing the tax burden on labour.** At 57.3% of GDP in 2014, the expenditure ratio is one of the highest in the EU. To finance these expenditures, France runs a deficit, at 4% of GDP in 2014, and resorts to high revenues, with the tax burden, at 47.8% of GDP, being one of the highest in the EU. To reduce the deficit, France is implementing an expenditure-based consolidation strategy curbing spending growth compared to its trend with EUR 50 billion in the period 2015-2017. At the same time, France is reducing the tax burden on labour with EUR 30 billion as part of the Responsibility and Solidarity Pact. The expenditure based consolidation strategy will need to be continued and even reinforced to further rein in the deficit and reduce the tax burden.

**The tax system relies relatively heavily on distortionary taxes.** A large part of tax revenues in 2014 come from the more distortionary forms of taxation. Labour taxes represent 53.1% of total tax revenues (50.5% for the EU average) and capital taxes account for 22.8% (EU average of 21.2%). Therefore, more growth-friendly taxes on consumption and environment only represent 24.1% of total tax revenue, which compares to 28.3% in the EU on average. This suggests there is scope to change the composition of taxes to make them less distortionary as a complement to the expenditure based consolidation strategy.

**Further increasing revenue from consumption taxes, in particular from VAT, could allow for additional labour tax reductions.** Since VAT is easier to administer and relatively less distortionary for growth than other forms of taxation, increasing VAT is considered as an efficient way to finance further reductions of the tax burden on labour. This seems to be particularly true in the case of France, given that VAT revenue in France were substantially below the EU average in 2014 as a percentage of total tax revenue (14.5%; EU average of 17.5%). In addition, in terms of GDP, VAT receipts have been steadily declining since the 1970s, from 8% of GDP

to 6.9% in 2014, while the share of private consumption in GDP has remained constant at 55% between 1970 and 2014. As a matter of fact, France has regularly been recommended to review its tax system and to broaden the tax base on consumption. For instance, under the 2015 European Semester, France was recommended among others to *'simplify and improve the efficiency of the tax system, in particular by removing inefficient tax expenditure. To promote investment, take action to reduce the taxes on production and the corporate income statutory rate, while broadening the tax base on consumption...'*. (Council of the EU, 2015).

This economic brief analyses the VAT rate structure in France and identifies channels for potential efficiency and revenue gains. It is the second of its kind with a similar analysis being produced on Belgium by Kalyva et al (2014). We compare the French VAT rate structure with that of other Member States. We discuss recent reforms of the VAT rate structure in France and analyse the implications of the VAT rate structure on revenue efficiency. Finally, we discuss the pros and cons of reduced VAT rates and conclude with some issues to be considered in a VAT reform. The focus of this paper is on reduced VAT rates and exemptions. While compliance issues are discussed in this economic brief, an in depth discussion of compliance would merit a separate economic brief.

## VAT system in France

**France has a complex VAT rate structure, applying four different rates.** EU Member States are obliged to apply the common European VAT system, which was set up in 1967<sup>1</sup>. The VAT Directive sets out general rules framing Member States freedom to set VAT rates. These rules were intended to guarantee, above all, the neutrality, simplicity and workability of the VAT system. As a default rule – a standard VAT rate – not less than 15% – is applied to all taxable supplies of goods and services. It permits also two reduced rates, set at 5% or more, which are confined to certain goods and services listed in the VAT Directive. In addition a number of reduced rates, including lower than 5%, are allowed in certain Member States according to 'standstill derogations'. This system has experienced several major reforms, resulting in different VAT rate structures across Member States<sup>2</sup>. Eight Member States, including Germany have a two-rate structure and eleven apply at most three rates (European Commission, 2015a). France, together with other seven Member States, including Belgium and Luxembourg, applies a four-rate structure.

France applies a standard VAT rate of 20%, two reduced rates (5.5% and 10%), as well as a super reduced rate (2.1%).

**The standard rate in France (20%) is below the average standard rate in the EU (21.6% in 2015).** Approximately 55% of the products in the price index are subject to the standard rate in France (Gautier and Lalliard, 2013). Currently, the standard rate applied in the EU ranges from 17% in Luxembourg to 27% in Hungary. A standard rate of 19-21 % is applied in all neighbouring countries. However, only four countries (Luxembourg, Malta, Cyprus and Germany) have a lower standard rate than France.

**France applies lower tax rates than the EU Member States on average for most categories of goods and services subject to reduced VAT rates (2.1%, 5.5% and 10%).** In order to avoid that policy recommendations encourage cross-border shopping, it is important to consider also the VAT structure in other peer Member States, especially in neighbouring countries; France applies on average lower VAT rates for all categories of goods in comparison to neighbouring peer countries (see Table 1). The 10% rate is applied to approximately 15% of the products and services in the price index, with almost 20% of product being taxed at the reduced rate of 5% and a more limited amount of products at the super reduced rate of 2.1%. A reduced rate of 5.5% is particularly low, given that countries with a two-rate structure, applying a standard rate and one reduced rate, often apply a reduced rate varying between 10 and 12%. Moreover, only five Member States (Spain, France, Ireland, Italy and Luxembourg) apply a super reduced rate. At the time of the introduction of the Single Market in 1992, there was a political commitment to phase out these super-reduced rates

at a four years times horizon but this has not materialised.

**For certain products and services France is an exception in applying reduced rates.** Certain products or services such as food, hotels and transport are taxed at reduced rates in France and practically everywhere in Europe. For example, Denmark, Bulgaria, Slovakia, Lithuania and Estonia are the only Member States to tax all food at the standard rate. However, France is one of the only countries to tax non-alcoholic beverages, TV licences and pay TV at reduced VAT rates. Also, in other countries domestic care is often taxed at the standard rate, but not so in France.

**France makes use of optional exemptions provided for in the VAT Directive and applies certain mandatory exemptions in the public interest without restrictions** (e.g. certain paramedical services). The VAT Directive (2006/112/EC) requires EU Member States to exempt certain goods and services from VAT ('compulsory exemptions') (e.g., postal services, medical and certain paramedical services). For the purposes of ensuring a correct and straightforward application of those exemptions and preventing any possible evasion, Member States may lay down conditions under which compulsory exemptions are applied. The exemption for certain other goods and services is optional ('optional exemptions') under the VAT Directive. France applies those special derogations by exempting certain services such as the supply of services by authors, artists, lawyers (up to EUR 42.000 of annual turnover) and other liberal professions. The high level of public expenditure and the application of the mandatory exemptions in the public interest without restrictions imply that the exemption for public good results in a much stronger loss in revenue than on average in the EU (see below)

**Table 1. Reduced VAT rates in France**

| Category                               | Average EU rate <sup>(1)</sup> | MS with reduced rates for the category | Neighbouring MS with reduced rates for the category <sup>(2)</sup> | Average neighbouring rate <sup>(3)</sup> |
|--|--------------------------------|--|--|--|
| Reduced rate of 2.1% applied in France |                                |  |  |  |
| Periodicals                            | 8.6%                           |  | 24 DE(7%), LU(3%), BE (0%) ES (4%)                                 |  |
| Pharmaceutical products                | 13.4%                          |  | 24 LU(3%), BE (6 %) ES(4%) IT (10%)                                |  |
| Tv licence                             | 17.3%                          |  | 5 IT (4%)  |  |
| Newspapers, periodicals                | 8.8%                           |  | 24 LU(3%) ES(4%) IT(4%) BE (0%, 6%)                                |  |
| Reduced rate of 5.5% applied in France |                                |  |  |  |
| Restaurants                            | 14.3%                          |  | 15 LU(3%), BE (12%)  |  |
| Foodstuffs                             | 11.3%                          |  | 24 DE(7%), LU(3%) BE (6%, 12%) ES(4%, 10%) IT(4%, 10%).            |  |
| Books                                  | 8.8%                           |  | 26 DE(7%), LU(3%), BE (6%) ES (4%) IT(4%)                          |  |
| Soft drinks                            | 15.7%                          |  | 13 LU(3%), BE(12%)   |  |
| Renovation of private dwellings,       | 13.6%                          |  | 14 LU(3%), BE (6%) ES (4%) IT (4%, 10%)                            |  |
| Electricity                            | 15.5%                          |  | 15 LU(8%), BE (6%)   |  |
| Admission to cultural services         | 10.3%                          |  | 21 DE(7%), LU(3%), BE (6%) IT(10%)                                 |  |
| District heating                       | 18.7%                          |  | 6 LU(8%)   |  |
| Electricity                            | 18.1%                          |  | 8 BE(6%), LU(8%)   |  |
| Natural gas                            | 19.1%                          |  | 6 IT(10%), LU(8%)  |  |
| Domestic care                          | 18.7%                          |  | 6 n.a.   |  |
| Social housing                         | 12.7%                          |  | 15 LU(3%) BE (6%, 12%) ES (4%, 10%) IT (4%, 10%) LU (3%)           |  |
| Reduced rate 10% applied in France     |                                |  |  |  |
| Foodstuffs                             | 11.3%                          |  | 24 DE(7%), LU(3%)  |  |
| Pharmaceutical products                | 13.4%                          |  | 24 LU(3%), BE (6 %)  |  |
| Admission to amusement parks           | 17.4%                          |  | 14 LU(3%), BE (12%)  |  |
| Renovation of private dwellings.       | 13.6%                          |  | 14 LU(3%), BE (6%) ES (4%) IT (10%)                                |  |
| Hotel accommodation                    | 10.9%                          |  | 24 BE(6%), DE(7%), LU(3%), ES(10%) IT (10%)                        |  |
| Pay tv/ cable TV                       | 19.5%                          |  | 5 LU(3%)   |  |
| Use of Sporting facilities             | 16.8%                          |  | 10 BE(6%), LU(3%)  |  |
| Firewood                               | 13.8%                          |  | 15 DE(7%), LU(8%), BE(6%) IT (10%)                                 |  |

Source: European Commission (2015a) and own calculations.

Note: (1) the average EU rate refers to the weighted average and includes the simple arithmetic average at country level when more than one rate applies to one category of goods or services; (2) countries not mentioned apply the standard VAT rate to the specific category; (3) different goods/services of the same category are subject to different reduced rates thus mentioned twice ; (4) as regards electricity, France applies a reduced VAT rate to the subscription, while natural gas and electricity consumption is taxed at the standard VAT rate.

\*District heating (tele heating) is a system for supplying heat generated in a centralized location for residential and commercial heating requirements such as space heating and water heating.

**In addition, a special VAT framework with reduced rates applies in Corsica as well as in French overseas territories** (see Table 2). It is worth noting that geographical discrepancies are rare in the EU VAT system. However, certain countries have put in place lower VAT rates for remote islands (e.g. Greece applies lower VAT rates in the Aegean

islands, Portugal applies special reduced rates in the Azores and Madeira). On the contrary, Spain applies its usual VAT rates in the Balears and Italy in Sardinia and Sicily. However, the budgetary cost of these reduced rates is small in France (in total EUR 15 million French Ministry of Finance, 2014).

**Table 2. Reduced VAT rates applied in different regions of France**

| Region               | Standard rate (%) | Reduced rates (%)   | Super reduced rates (%)   | Excluded from VAT                              |
|----------------------|-------------------|---|---|--|
| France*              | 20.0%             | 5.5% and 10%  | 2.10%   |  |
| Corsica              | 20.0%             | 13%: petroleum products, 10%: certain transactions in immovable property, agricultural inputs, low voltage electric energy. | 0.9%: Certain theatrical shows and circuses, sale of live meat animals, 2.1%: goods provided in Corsica at which reduced tax rates are applied at the mainland of France. |  |
| Overseas Territories | 8.5%              | 2.1%  | 1.05%   | Guadelupe, French Guiana, Martinique, Reunion. |

Note: Overseas territories include Martinique, Guadeloupe and Reunion. Guyane and Mayotte are excluded from VAT  
\*For a detailed overview of the different categories and rates applied to the rest of France please see Table 1.

**Table 3. Changes in VAT rates since 1995 in France**

|                |  |
|----------------|--|
| August 1995    | Increase of standard rate from 18.6% to 20.6%  |
| September 1999 | Transition to reduced rate for works to improve dwellings (20.6% to 5.5%)                |
| April 2000     | Reduction of standard rate from 20.6% to 19.6%   |
| July 2009      | Transition to reduced rate for restauration services (19.6% to 5.5%)                     |
| January 2012   | Creation of an intermediary rate of 7% (certain goods and services went from 5.5% to 7%) |
| January 2014   | Increase of standard rate from 19.6% to 20% and intermediary rate from 7% to 10%         |

Source: Gautier and Lalliard (2013)

## Recent reforms in France

**In the last 20 years, the standard rate has evolved in the range from 18.6% to 20.6% and is currently at 20%.** Table 3 above presents the reforms the VAT system has undergone the last 20 years. The standard rate was increased from 18.6% to 20.6% in 1995 to be reduced to 19.6% in 2000. In the beginning of 2012 the Parliament had voted to increase the standard rate with 1.6 ppt to 21.2% and to use the revenues to reduce the employer's social security contributions with EUR 13.2 billion. This tax shift, which was called '*TVA sociale*' in the French debate, was intended to improve competitiveness. However, this reform was not carried through, essentially because of concerns on the distributional impact of a VAT increase. Instead, at the end of December 2012 the Parliament voted the *Crédit d'impôt pour la compétitivité et l'emploi (CICE)*, which is a tax credit for wages between 1 and 2.5 times the minimum wage (SMIC), implying a reduction of the labour cost with EUR 20 billion. This tax cut was financed for 50% by additional revenues and for 50% by additional expenditure cuts. Concerning revenues, 2/3<sup>rd</sup> of the revenue came from an increase of the standard VAT rate from 19.6% to 20% and of the reduced rate from 7 to 10%. The impact of the CICE is the subject of a forthcoming economic brief (see Burgert et al, forthcoming).

**The increase of the reduced rate to 10% has been a way to indirectly broaden the VAT base.** However, over the last 20 years, a number of goods and services, such as restauration services and works to improve dwellings, have moved from the standard rate to the reduced rates.

## Implications on revenue efficiency

**The overall efficiency of the French VAT system as measured by the VAT revenue ratio is average yet there is significant scope for revenue gains if efficiency is improved towards the level observed in the best performers in the EU.** A first step to assess the revenue efficiency of a VAT system is to compare actual revenues with theoretical revenues that could be raised if VAT was applied at the

standard rate to all final consumption. This first assessment is done by using the VAT revenue ratio<sup>3</sup>. The indicator is subject to significant caveats due to the fact that final consumption of the household, non-profit and government sector may differ significantly from the tax base - for example as net final consumption takes into account imputed rents for people that live in their own homes - and that the indicator is affected by tax evasion, bankruptcies and by the economic cycle. Nonetheless, the VRR gives a first indication of the revenue foregone due to the use of exemptions and reduced rates and/or due to poor tax compliance. For France, CASE (2013, 2015) estimated the VAT revenue ratio at 47.8 % in 2014, slightly below the EU average of 48.1% (Graph 1). The suggested improvement potential of moving towards the average efficiency in the EU is below 0.1% of GDP. However, improving the efficiency to the best performers in the EU would yield significant benefits. For example, in Germany efficiency is much higher at 54.4%. If France would reach the same efficiency level as Germany, VAT revenue could increase by about 1% of GDP.

**The analysis of the VAT revenue ratio needs to be complemented by an analysis of policy issues and compliance issues that could hamper the overall efficiency of the VAT system.** As there are a number of caveats to the VRR and to further refine the analysis, a second step is to determine whether the efficiency of the VAT system is hampered by policy choices or compliance issues. The two indicators used for this assessment are: (i) the VAT policy gap indicator, which is the ratio of the theoretical VAT revenues (based on the VAT law) to the ideal VAT revenues which would have been accrued without applying reduced rates or exemptions<sup>4</sup> and (ii) the VAT compliance gap, which measures non-compliance with the tax rules and the failure of the tax administration to collect revenue<sup>5</sup>.

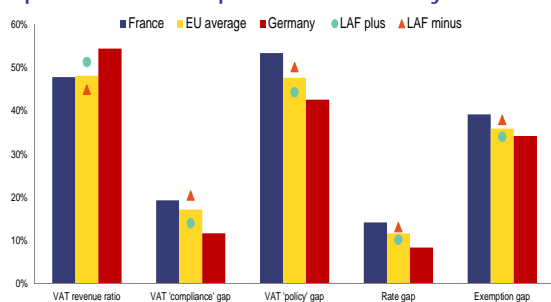
**The compliance gap illustrates that there is some scope to increase efficiency, and thus revenue, by improving compliance.** The 'compliance gap',



estimated at 19.3% is above the EU average of 17.2% and the German gap of 11.2%, indicating that France faces a VAT compliance issue. The suggested improvement potential compared to the EU average is up to 0.2% of GDP additional revenue if the French compliance gap would be improved towards the EU average. The potential of improving the compliance up to the best performers in the EU is more substantial. For example, if France were to reach the German compliance gap it could increase its revenues by up to 0.7% of GDP<sup>6</sup>.

**The policy gap indicates that there is significant scope to increase revenue if reduced rates and exemptions are used more selectively.** The French VAT 'policy' gap is well above the EU average and the German gap (53.4 % for FR vs 47.2 % for the EU and 42.6% for DE)<sup>7</sup>. Moving towards the EU average policy gap would yield 1% of GDP additional revenue. Improving towards the policy gap of the best performers, e.g. Germany would yield 1.7% of GDP additional revenues. However, taking into account the exemptions for imputed rents, public goods and the financial services sector – for which no VAT is levied throughout the EU-, the improvement potential compared to the EU and Germany reduces to respectively 0.5% and 0.6% of GDP. This is due to the fact that exemptions for imputed rents and public goods are more important in France than in the EU or Germany.<sup>8</sup>

Graph 1. Overall and specific VAT efficiency indicators



Source: CASE (2013, 2015)

Note: 'LAF plus' and 'LAF minus' are two performance thresholds indicating a good and a poor performance respectively. 'LAF plus' captures the top one-third performers. The values below (above) 'LAF minus' capture the worst one third (see Wöhlbier et al. 2014).

**The policy gap can in turn be decomposed into two separate effects, namely the rate gap and the exemption gap.** The 'rate gap' represents the potential revenue loss due to the existence of reduced rates whereas the 'exemption gap' represents the potential loss due to the existence of exemptions. In 2013, both indicators for France (14.2 % and 39.2%) were well above the EU weighted average (of 11.7% and 35.9 % respectively) and the German gaps (of 8.4% and 34.2% respectively) reflecting the

widespread application of reduced VAT rates and VAT exemptions (CPB/CASE, 2013, 2015).

**The scope for revenue gains implied by the policy gap analysis is confirmed by the quantification of VAT tax expenditure in France.** The VAT base subject to the standard rate represents 65% of the tax base against 81% in Germany (Conseil Supérieur des Finances, 2014). Overall, the revenue forgone from VAT tax expenditures is far from negligible<sup>9</sup>. VAT reduced rates and exemptions considered as tax expenditures by the French authorities total EUR 17.8 billion (0.8% of GDP) in 2015. For restaurants the revenue foregone is estimated to amount to EUR 2.5 billion, for renovation works to EUR 1.4 billion, for hotels to EUR 0.7 billion, and for newspapers to EUR 0.2 billion for 2015 (French Ministry of Finance, 2014).

**Improving the overall efficiency of VAT is a better revenue generating strategy than increasing the standard rate.** According to the IMF improving the VAT revenue ratio by 5 ppt. would increase revenues by 0.79% of GDP, which yields twice as much as a 1 point increase in the standard rate (with a yield of only 0.36% of GDP) (IMF, 2010). Increasing the efficiency of the VAT system by limiting the use of reduced rates could, therefore, generate more revenue than increasing the standard rate.

## Pros and cons of reduced rates

**The use of reduced VAT rates is sometimes justified in the literature to serve employment-related objectives or to favour demand for certain goods.** Table 4 provides an overview of the reasons that are cited in Copenhagen Economics (2007) and Mirrlees et al. (2011) to justify reduced VAT rates. A first series of justifications is related to employment related objectives. In particular, reduced VAT rates are sometimes put in place for services that employ low-skilled labour, substitute do-it yourself work or are complementary to such work and have a high risk of tax evasion. Sectors for which these arguments are used typically include restauration services and the repair and maintenance of dwellings. A second series of justifications is related to the nature of the product or service. Reduced VAT rates are sometimes put in place to make the consumption of certain goods and services more affordable, either based on their intrinsic merit (this is e.g. the justification for a reduced VAT rate on cultural goods) or because they are seen as essential goods that should not be highly taxed (e.g. medicines or food) in view of achieving distributional or other social policy goals. Note that for certain categories of goods or services more than one economic justification are put forward as a possible justification for reduced rates.

**Table 4. Economic reasons to apply reduced rates to specific categories of goods and services - based on economic literature**

| <b>Economic reasons and alternatives<br/>(based mainly on Copenhagen Economics, 2007 and Mirrlees et al., 2011)</b>  | <b>Categories for which reduced rates<br/>are applied in France</b>  |
|--|--|
| <p><b>Services substitutable with own work or complementary to work</b><br/>Reduced VAT rates could be used to encourage the consumption of services which are easily substituted by do-it-yourself work (e.g. repair services, cleaning) or which are complementary to work (e.g. childcare services). Those services tend to be under-consumed, as taxation drives a wedge between the costs of supplying them yourself and buying them on the market. In particular, high-skilled people should be induced to perform more productive labour. However, reducing the tax burden on specific labour market groups may be a more efficient way than VAT reductions to make work more attractive than self-supplying the services concerned. Equivalently, complements to leisure (entertainment, holiday accommodation, theatre tickets) should not be subject to reduced VAT rates (although sometimes reduced rates are used for competitive reasons).</p> | <ul style="list-style-type: none"> <li>• Restaurant services (10%)</li> <li>• Renovation and repair of private dwellings (10%)</li> <li>• Admission to cultural events, amusement parks, (5.5%)</li> <li>• Hotel and camping accommodation (10%).</li> </ul> |
| <p><b>Services employing low-skilled labour</b><br/>Reduced VAT rates could potentially boost demand for services employing low-skilled workers, (e.g. hotels and restaurants). Analysis (e.g. for tourism sector, see OECD, 2013), however, shows that their economic effects tend to be temporary and hold only in countries with rigid and non-flexible labour markets for low-skilled workers where wages do not easily adjust. Reducing the tax wedge for low income groups and adjusting the labour market would be more targeted and effective than applying reduced VAT rates.</p>   | <ul style="list-style-type: none"> <li>• Hotel accommodation (10%)</li> <li>• Restaurant services (10%)</li> <li>• Renovation and repair of private dwellings (10%), window cleaning and cleaning in private households (10%)</li> </ul>                     |
| <p><b>Services with a high risk of tax evasion</b><br/>Reduced VAT rates are sometimes applied to services which tend to be provided by undeclared workers in order to lower the potential gain from tax evasion. As services performed by small businesses or self-employed tend to be less controlled, the risk of evasion is typically higher. However, an alternative solution could be to directly address the challenge and take measures to strengthen compliance in these sectors.</p>   | <ul style="list-style-type: none"> <li>• Renovation and repair of private dwellings (10%) window cleaning and cleaning in private households (10%)</li> <li>• Restaurant services (10%).</li> </ul>  |
| <p><b>Goods weighing more on budgets of low-income households</b><br/>The use of reduced VAT rates is sometimes driven by distributional concerns and the strong regressive impact of energy tax increases. Empirical evidence, however, shows that abolishing reduced rates often does not have equity consequences (Boeters et al., 2006 and Jacobs, 2013). A reduced VAT rate for food however does not only benefit low income households but high income households as well, implying a considerable revenue loss. The benefit system and a progressive income tax should be able to deal with redistribution objectives far more efficiently than relief through the VAT system. The same argument holds for reduced VAT rates on energy products, which in addition constitute environmentally harmful subsidies and go against environmental goals.</p>  | <ul style="list-style-type: none"> <li>• Foodstuff (5.5%) Pharmaceuticals (2.1%)</li> <li>• Energy products (5.5%)</li> </ul>  |
| <p><b>Merit goods and services</b><br/>Lower VAT rates are also used to encourage the supply and demand of merit goods and services, as consumers often do not recognise the full (long-term) benefit of consuming merit goods and services (e.g. transfer of knowledge). Since high income earners may consume merit goods independently from the VAT rates applied, using reduced VAT rates tends to be very costly.</p>   | <ul style="list-style-type: none"> <li>• Admission to cultural events (5.5%)</li> <li>• Periodicals and books (2.1%, 5.5%)</li> <li>• Newspaper (printed) (2.1%)</li> <li>• Supply of social services (5.5, 10%)</li> </ul>                                  |
| <p><b>Limit distortions of competition related to publicly provided services</b><br/>Reduced VAT rates are occasionally applied to reduce the tax burden on specific public services provided by private suppliers (e.g. medical services, telecommunication services etc.). Since under the EU VAT system, these services are often VAT exempted when carried out by a public body, reduced VAT rates are applied to private agents in order to limit the distortions of competition. Such reduced rates, however, increase the complexity of the system and create additional distortions (e.g. definition of the status of services, higher risk of distorted competition).</p>   | <ul style="list-style-type: none"> <li>• Admission to cultural events (5.5%)</li> </ul>  |
| <p><b>Limit distortions of savings and investment choices</b><br/>Reduced VAT rates on new buildings could support owner-occupied housing as a basic need. However, owner-occupied housing is, in many Member States also a rather favourably taxed investment good (low recurrent property taxes and no taxation of imputed rents), leading to distortions to savings and investment choices and hampering growth. Applying the standard VAT rate to new buildings is a way to capture the consumption value of housing services and counterbalance the low tax burden on owner-occupied housing as an investment good. However, this might create distortions between the sale of old and new dwellings.</p>   | <ul style="list-style-type: none"> <li>• Social housing (5.5%)</li> </ul>  |

**The efficiency of applying a reduced VAT rate depends on the extent to which prices react.** As was also observed for the restauration sector in France (see Box 1), prices only react partially to the reduced VAT rate. Factors that influence the price reaction are the price elasticity of demand for the

good or service in question, the elasticity of supply (which in the long run is linked to the degree of competition in the sector) and possible price developments of other goods. If prices do not react fully, demand will not increase and thus employment effects will be limited, whereas the cost

in terms of foregone revenue will be comparatively high. Any selective cut in VAT may therefore end up largely increasing rents or the deadweight of the tax system as a whole.

**Furthermore, the use of reduced VAT rates may not be the best instrument for achieving social equity or for encouraging the consumption of certain goods and services.** As recently illustrated by the OECD (OECD, 2015) using reduced VAT rates comes at a cost, because reduced rates do not allow for specific targeting of low-income households. Since reduced rates are granted on all purchases of a given good or service, both low- and high-income households benefit from them. This leads to a considerable revenue loss from wealthier

households since, in absolute terms, they spend considerable amounts on for instance food, medicines and cultural goods (Copenhagen Economics, 2007). For these reasons, other policy tools that can be targeted at specific groups, like means-tested benefit schemes, may better achieve social equity, while incurring a lower budgetary cost (see also Institute for Fiscal Studies, 2011). The initial results of simulations carried out by the OECD show that a targeted cash transfer can generally compensate the vast majority of low-income households for the loss in purchasing power they would suffer as a result of reduced VAT rates being abolished. A small number of low-income households may, however, lose out.

### Box 1. Evidence from the reduced VAT rates on the restauration sector in France

France has made use of the possibility offered by the Council in 2009 to reduce VAT for the traditional restauration sector. On 1 July 2009, the VAT rate for traditional restauration was decreased from the standard rate of 19.6% to the reduced rate of 5.5%. However, on 1 January 2012 the rates for restauration have been reallocated to the reduced rate of 7%, with the reduced rate being increased to 10% for all goods at this rate on 1 January 2014.

The initial budgetary cost of the reduction in the rate was estimated at EUR 3.1 billion (ca 0.15% of GDP) by the authorities. The passage from 5.5% to 7% was expected to yield only EUR 300 million whereas the passage from 7% to 10% would yield EUR 640 million, with the remaining budgetary cost of the reduced rate being estimated at EUR 2.5 billion.

The initial introduction of the reduced rate was accompanied by commitments of the restauration sector to pass through the full price decrease to consumers, to create 40000 additional jobs and to improve the situation of employees in the sector by increasing salaries and collaborating with authorities against undeclared work in the sector (Ministry of Economy, Industry and Employment, 2009).

In an assessment of the commitments in 2012 the results were found to be mixed (Ministry of Craftsmanship, Trade and Tourism, 2012). On the one hand, 50000 additional jobs had been created and the level of compensation in the sector had improved. On the other hand, the pass through of the reduced VAT rate to the final price had only been partial, while the increase to 7% in 2012 had fully passed through. Moreover, the sector did not fully collaborate on the fight against undeclared work and the number of observed infringements in this area actually increased since 2009. Other research tends to confirm these findings. For example, a study of the INSEE concluded that only 20% of the initial VAT reduction was passed through into lower prices (Lafféter and Sillard, 2014).

From an economic perspective, it is not clear that reduced VAT rates on restauration is a good use of scarce budgetary resources given the economic challenges faced by France described within the 2015 Country report (European Commission, 2015b) identifying competitiveness and indebtedness as macro-economic imbalances. Moreover, reducing labour taxes, complemented by labour market reforms, is more efficient to create employment and reduce undeclared work. If such labour cost reductions are focused on low wage earners they also favour the labour intensive sectors, like the restauration sector, without introducing differences in taxation among sectors, as is inherent in using reduced VAT rates as a tool. In this context, it should be noted that the *hébergement and restauration* sector is the one that benefits most from the labour cost reductions provided by the CICE with 87% of the wage mass being eligible for this tax credit (versus 63% for the total wage mass) (Comité de suivi du CICE, 2015). Finally, the existence of a VAT rate of 5.5% for take-away and of 10% for traditional restauration and the different VAT rates for non-alcoholic drinks depending on the container used can lead to compliance issues and does not seem justified on economic grounds. In this context, increasing the 5.5% VAT rate for take-away and certain drinks to 10% could be considered.

**Also from an efficiency point of view, there are strong arguments in favour of a simple and uniform VAT system.** First, a uniform and broad-based VAT structure fosters economic efficiency by reducing distortions of consumer choices. In addition, differences in VAT rates between similar products give rise to administrative and legal conflicts about the definition and the proper classification of specific goods. Moreover, a simple VAT structure, in most cases, reduces the

opportunities for political lobbying for the application (or re-introduction) of reduced rates for specific goods and services. This can result in extra costs for businesses and the tax administration, which have to classify the goods according to different VAT rates. Finally, collection and compliance costs are minimised under a simple and uniform VAT system, as costs rise sharply when the number of VAT rates increases (European Commission, 2010).

**Finally, reducing labour taxes is a more efficient way to create employment than applying reduced VAT rates.** A reduction of VAT works indirectly on employment via the mechanism of a decline in the price of the good or service which enhances the demand for the good or service which then may enhance the employment in that sector. Directly targeted support schemes for workers, e.g. reducing the labour tax for low-skilled workers, are superior in terms of employment creation and are less distortive. In this context, sectors that employ a lot of low-skilled labour in France, such as the restauration sector, would be better off and would be able to create more employment with lower labour taxes than with a reduced VAT rate.

### Issues to be considered in VAT reform

**There is scope to further improve the tax structure in France by shifting the tax burden from labour to consumption.** A reform of the VAT rate structure could contribute to consolidation efforts, in complement to the existing expenditure based consolidation strategy, through the improvement in the efficiency of the tax system and to increased VAT revenues. This would create room to shift the tax burden further away from labour. Reshaping the tax structure to less growth-distortive taxes - in particular away from labour towards consumption – could also improve incentives to work, save and invest. However, redistributive effects of removing reduced VAT rates should be taken into account. These beneficial elements need to be weighed off against the consequences of increasing the rates for the affected products and services and compared with the cost and benefits of alternative revenue increasing measures. In this context, it should be kept in mind that changes in VAT rates will also have an impact on inflation, especially taking into account the prevailing indexation mechanisms in France for the minimum wage and social benefits. This impact on inflation can reduce the potential employment creation of such a tax shift if fully passed to wages, although this factor would be less relevant in the current low inflation environment. In order to offset the negative impact on competitiveness, accompanying wage cost measures might be needed, such as reforms in the wage-setting system or a reduction of the tax burden on labour.

**In designing a VAT reform the following elements could be considered:**

- **Increasing the reduced rate rather than the standard rate to generate extra revenue.** For revenue-raising purposes, countries with a two-

rate structure often apply a reduced rate varying between 10 and 12% (8 Member States). France has increased one of its reduced rates from 7 to 10% in 2014 and therefore further quantitative analysis of the revenue and other effects would be needed to determine the possible scope of increasing its reduced rates further. .

- **Reducing the number of rates.** This re-assessment would per reduced rate weigh the possible economic and social cost of abolishing the reduced rates against the benefit of revenue gains, simplifying the VAT rate structure, strengthening the efficiency of the VAT system and going in the direction of having a neutral VAT system, which does not favour one sector, activity or technology over others.
- **Re-assess whether there is a clear rationale for applying the reduced rate for certain goods and services.** This re-assessment could point to certain goods or services for which applying a reduced rate would no longer be justified or for which a higher reduced rate would be more appropriate. Obvious candidates for applying a higher rate or the standard rate would be energy products and soft drinks as consumption thereof is harmful for the environment and/or health. Given the rather inelastic demand, increases in revenue could be expected when moving this category to the standard rate. In addition, even if some arguments can be found to justify reduced rates for some specific categories, there is a need to evaluate whether the policy objectives of using reduced rates are met. If the reduced rate for a particular good or service is not effective, it could be considered to increase the rate and to design alternative policies to reach the same policy objective.
- **Part of the revenue of raising reduced rates could be used to account for redistributive effects of removing reduced VAT rates.** While VAT is considered as a regressive tax, increasing raising reduced rates as argued for above would imply higher costs for low income households. Therefore part of the revenue of raising reduced rates can be used to reinforce or create well-designed and means tested schemes to provide income support for low-income households, while preventing some disincentives to work. Such schemes, if well designed, would create less economic distortions and are the most cost-efficient means of achieving economic and social policy goals.
- **A reform of the VAT system should be accompanied by sufficient control of compliance.** It is important to bear in mind that VAT compliance tends to fall as rates are

increased, at least in Member States with weaker tax enforcement (CASE, 2015). This is particularly important for France taking into account the high compliance gap (well above the EU average). The suggested improvement potential towards the EU average could yield additional revenue as well.

**Furthermore, France could broaden its VAT base by limiting the extent of mandatory exemptions and the use of VAT optional exemptions.** Options could include:

- Introducing certain conditions foreseen by the VAT Directive to limit mandatory exemptions

for hospital and medical care undertaken by profit-making private suppliers in order to ensure that these exemptions are provided under conditions comparable with those applicable to public bodies (i.e. abolish exemptions covering certain paramedical services).

- Limiting the use of certain optional exemptions. Obvious candidates are the supply of services by lawyers (up to a certain threshold) and other liberal professions. In Belgium, abolishing the exemption for notaries, bailiffs and lawyers yielded about 0.05% of GDP.

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<sup>1</sup> Council Directive 77/388/EEC and 2006/112/EC

<sup>2</sup> The issue of reduced VAT rates is going to be addressed in the context of VAT Action Plan initiative (COM (2016) 148 final 7.4.2016). The scope is to move towards a modernised VAT rates Policy in EU and to adapt to economic and digital developments.

<sup>3</sup> The VAT revenue ratio (VRR) consists of actual VAT revenue divided by the product of the standard VAT rate and the net final consumption expenditure, i.e. final consumption expenditure of household, non-profit and government sector minus VAT revenue. It is important to note that there is no one-to-one mathematical relationship between on the one hand the compliance gap and the policy gap and on the other hand the VRR with the definitions we have used. This is due to some of the caveats we highlight in the main body of the text. .

<sup>4</sup> The VAT policy gap indicator is the ratio of the VAT total theoretical liability (the so-called VTTL), according to the VAT law, to an ideal tax liability without applying reduced rates or exemptions.

<sup>5</sup> The compliance gap measures the difference between the potential VAT and actual VAT revenues that might be attributed to non-compliance rather than to policy issues.

<sup>6</sup> In the case of France the results are sensitive to the assumptions on the size of the black economy with the WIOD database in CASE (2013) estimating a relatively big size of the black economy compared to the indications given by the INSEE. As the focus of this note is not on compliance issues, we do not further explore this issue but acknowledge that the suggested improvement potential related to the compliance gap is potentially overstated.

<sup>7</sup> The policy gap has been calculated with the classical methodology. The CASE (2015) study calculates an 'actionable policy gap' of 18.1% in France compared to the EU average of 12.4% and 11.6% in Germany. This new indicator is obtained by calculating separate detailed exemption gaps for different economic sectors, and subtracting them from the overall exemption gap. The 'actionable policy gap' is then obtained by adding to the rate gap the 'actionable exemption gap'.

<sup>8</sup> For public goods the gap is 24.1% in France versus 22.3% and 20.3% in the EU and Germany. For imputed rents the gap is 9.9% in France versus 8.2% and 6.7% in the EU and Germany.

<sup>9</sup> French authorities in estimating tax expenditures apply the revenue forgone method. Behavioural responses or the interaction with other than VAT tax bases is disregarded. The tax expenditure is typically the product of the tax provision (e.g. the reduced rate) and the volume it applies to (e.g. consumption of particular good or service). However, this method has, therefore, important drawbacks for estimating the budgetary costs and can only give a very first illustration of the possible revenue effects of a tax provision (e.g. reduced rate). In addition a number of reduced rates applied is considered as tax expenditure. However, there is no clear definition of what constitute a tax expenditure.





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