

VAT IN THE PUBLIC SECTOR AND EXEMPTIONS IN THE PUBLIC INTEREST

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INFORMED DECISIONS



| COLOPHON

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TABLE OF CONTENTS

Preface.....	4
Executive summary.....	6
Chapter 1 Main findings.....	9
1.1. Legal challenges	12
1.2. Outsourcing support services.....	13
1.3. Outsourcing core services	16
1.4. Compliance cost.....	18
1.5. Solution models for creating a level playing field	21
1.6. Recommendations	35
Chapter 2 Current VAT treatment of public sector activities.....	36
2.1. Provisions of the Common VAT System Directive.....	37
2.2. Adoption in the Member States.....	53
2.3. Comparison with OECD countries with a GST system	94
2.4. Problems with the current treatment of public sector activities	108
Chapter 3 The Economic Consequences	114
3.1. Challenges arising from differential VAT treatment.....	114
3.2. Method for quantifying the economic effects from removal of distortions	131
Chapter 4 Possible Solutions.....	151
4.1. Full taxation.....	151
4.2. Refund system.....	167
4.3. Public bodies treated as taxable persons, with certain exemptions.....	176
4.4. Option to tax for tax-exempt persons	188
References.....	191

PREFACE

The European Commission has asked Copenhagen Economics and KPMG AG in collaboration to study the VAT rules applied to the public sector in EU member states, and make a comparison with the VAT/GST rules applied in key OECD countries outside the EU.

The study collects and analyses relevant studies already carried out at international, EU or national level. The study describes the problems that arise from current VAT rules applied in the public sector. We analyse what the drivers and underlying causes of such problems are. We investigate the impact from differential VAT treatment between public and private entities on the input side in public entities and on the output side where competition between private sector entities and public sector entities are distorted. We have not looked at the postal sector in this study, however, because of the existing Commission proposal.

Having identified problems and causes, we present main policy options, which has been defined in co-operation with the Commission services. These options are analysed and quantified using among others, a computable general equilibrium (CGE) model of the EU-economy. Discussions of costs of compliance are included in the analysis. In our economic model, we specifically model the so-called ‘core’ services waste disposal, cultural services, education, hospital services and broadcasting in agreement with the EU Commission. Hence, the modelling scenarios produce changes in output in these public activities which make up the results regarding the changes in public sector output.

In order to model the quantitative effects from the policy options we needed to assess the baseline scenario as precisely as possible. To do this, we constructed a legal and an economic questionnaire and submitted them to our network in the majority of Member States.

The legal questionnaires we designed to give detailed insight into current VAT systems and rates applied to our modelled sectors. We got information for most Member States. See appendix.

The economic questionnaire we designed to give us detailed insight into the structure of the public sector use of support services (how much is own production and how much is procured from private services) and core services (how much is produced by public entities and how much by private entities). However the economic questionnaire did not return the information we hoped for. It would have provided novel information on a very detailed level, and it would have made the economic analysis and modelling more precise. Instead we have, in addition to economic theory and literature studies, used data from the GTAP database, Eurostat and the Amadeus database. Moreover, we have had to apply a number of assumptions. More information and explanations are given in chapters 3 and 4 and the model appendix.

The report includes a number of case studies complementing the macroeconomic analysis.

EXECUTIVE SUMMARY

The essential piece of European legislation establishing the common system of VAT is the Common VAT System Directive (CVSD). It is designed in a manner, that VAT should only be a burden on final consumption. When incurred during the process of production and distribution of goods and services, VAT should be deducted.

Public and private activities may be taxed differently in Member States. Often public activities will be tax exempt or non-taxable whereas private activities will be taxable. However, there are many exceptions to this 'rule'. For example, private hospital services are not taxed, whereas public waste management activities are sometimes taxed and sometime not depending on industry specific circumstances. In many of the cases where differential VAT treatment exists between public activities and private activities, there is a risk of distortion of competition between the public and private activities. The distortion will reduce economic efficiency and welfare.

Distorted competition may primarily show itself in two ways:

First, the distortion may affect the input side as a reduced incentive of public entities to outsource support services/back office-services, such as cleaning services, IT-service, accountancy and facility management. The reason is that if the public entity carries out the support service in-house with own staff, no VAT is added to the value of this in-house produced service. This is not the case if the public entity decides to outsource the same support service to a private provider, as the private provider will add VAT to its invoice; VAT that the public entity cannot recover.

Second, the distortion may affect the output side through reduced competitiveness of private entities vis-à-vis public entities. The reason is that if a public and a private provider of a service compete in the same market, the public provider will have the advantage of not charging its clients VAT. However, the private provider will have to add VAT to its clients. Hence, the public provider may have a competitive advantage over the private provider of the same service. This is of course only the case when public and private providers actually compete.

We find that these distortions do indeed exist as a result of differential VAT treatment. So how best to eliminate them?

A number of EU Member States, eight in total, already have refund schemes in place that allow public entities to recover input VAT when outsourcing support services. This eliminates the first distortion. Inspired by these existing schemes, we have estimated the potential economic gains if the remaining EU Member States adopted similar schemes. We find an EU wide potential economic gain of 0.01 percent of Gross Domestic Product (GDP) corresponding to a little more than 1 billion euro. The gain comes from increased efficiency in production of sup-

port services as public entities begin to outsource a larger share of in-house produced input service to private providers who are able to produce the services more efficiently due to e.g. economies of scale and competitive pressure. The gain may be larger, if public entities also start to consider outsourcing support services beyond the ‘traditional’ ones such as cleaning and IT-services. We estimate public sector cost savings of around 0.3 percent of consumption cost, equivalent to around 5 billion euro. Implementing refund schemes across the EU would imply a redistribution of funds from the state to the VAT paying public entities of approximately 100 billion euro.

However, refund schemes do not eliminate the second distortion on the output side. Furthermore, we find evidence that refund schemes may imply higher compliance costs arising from additional public administrative resources required to administer such schemes and additional costs for public entities from complying with them. We do not know the exact size of compliance costs from refund schemes, but they do ultimately reduce the initial economic gain, and possibly they may be so large as to neutralise the initial economic gain.

Given these drawbacks of a refund type scheme we recommend to look towards a full taxation solution. In this solution, VAT is applied to public entities’ output, and at the same time the solution allows for public entities to fully deduct its incoming VAT. In this way, public and private entities are treated equally regarding VAT. This eliminates the input and output distortions.

We find potential economic gains in our economic model of 0.04 percent of GDP *up to* 0.19 percent of GDP, the latter corresponding to almost euro 21 billion from a full taxation solution for all Member States in the covered sectors. The lower estimate corresponds to a situation with little current competition between public and private providers of the core services covered. For instance, there is no actual alternative to the public providers. In this situation, it matters less that the distortion caused by differential VAT is removed. The upper estimate assumes significant distortion of competition in the current situation, which is then removed when public and private produced are taxed equally: By removing a significant distortion in the economy, we end up utilising resources better, thus spurring growth.

These are large numbers compared to the 0.01 percent from eliminating the first distortion alone. On the one hand, it should be interpreted as a maximum for potential gains, because effective competition between private and public suppliers may be hindered by other barriers than VAT. On the other hand our modelling does not cover the entire public sector. The full taxation solution is in many ways similar to the current system in place in New Zealand, which is often mentioned as a best practice case in literature.

The EU27-wide impact on VAT revenue of the full taxation model for the covered sectors could be an increase of up to 195 billion euro, which could then be offset by a proportional decrease of 19 percent for *all* (standard and reduced) VAT rates; e.g. the Germany standard rate would drop from 19 percent to 15.4 percent. This revenue increase assumes that the entire values of the five covered public core services (broadcasting, waste management, hospital, education and cultural services) are taxed with output VAT. If that is not the case, the increased VAT revenue will be correspondingly smaller.

On a final note, a full taxation solution where the public and private services are taxed identically is 'future proof', in the sense that whatever developments may occur in how public and private entities compete, this solution automatically ensures a level playing field between them. This, however, presupposes that public entities cannot fully escape the VAT.

Chapter 1 MAIN FINDINGS

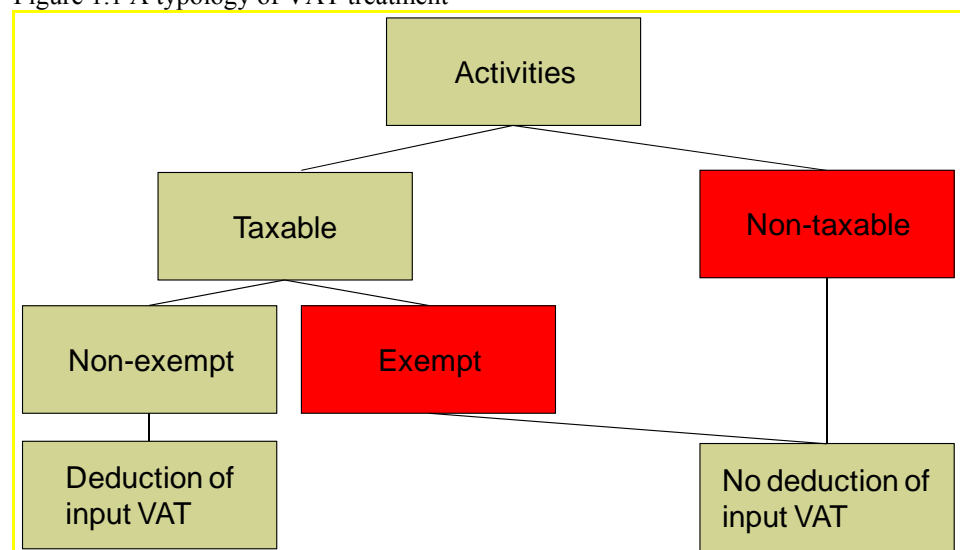
In order to ensure the establishment and the functioning of the internal European market, Article 113 Treaty on the Functioning of the European Union allows the harmonisation of VAT Law.

The essential piece of European legislation establishing the common system of VAT is the Common VAT System Directive (CVSD). Designed as a general tax on consumption exactly proportional to the price of goods and services, the European VAT System allows the deduction of the amount of VAT borne directly by the various cost components of the production and distribution process before final consumption (deduction of input VAT). This mechanism exists in order to ensure the fiscal neutrality of VAT system despite the length of the production chain. In other words, VAT should only be a burden on final consumption. When incurred during the process of production and distribution of goods and services, VAT should be deducted.

However, public and private activities may be taxed differently in Member States. As public activities are often non-taxable and private activities are taxable, there is a risk that the VAT system may distort the competition between private and public activities.

The distortion of competition may either come from a public sector activity being taxable but exempt, or it may come from a public sector activity being non-taxable, cf. the marked boxes in Figure 1.1.

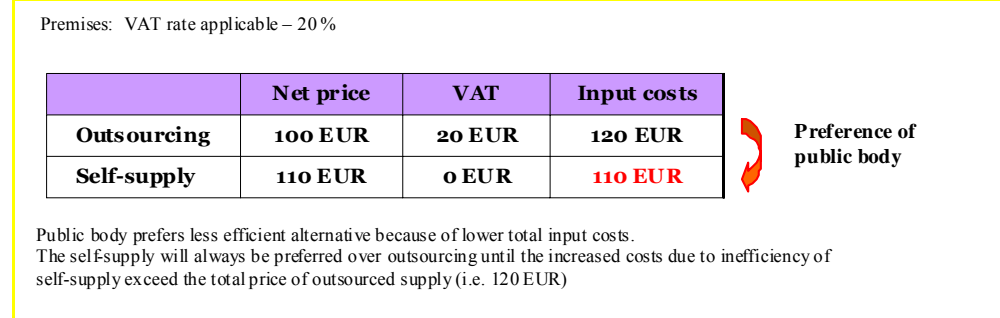
Figure 1.1 A typology of VAT treatment



Source: KPMG AG.

The distortion may affect the input side as a reduced incentive of public sector bodies to outsource support activities, such as cleaning services, IT-service, accountancy and facility management. The reason is that if the public body carries out the support service in-house with own staff, no VAT, which the public body cannot recover, is added to the value of this in-house produced service. This is not the case if the public body decides to outsource the same support service to a private provider, as this provider will add VAT to its invoice; VAT that the public body cannot recover, cf. Figure 1.2

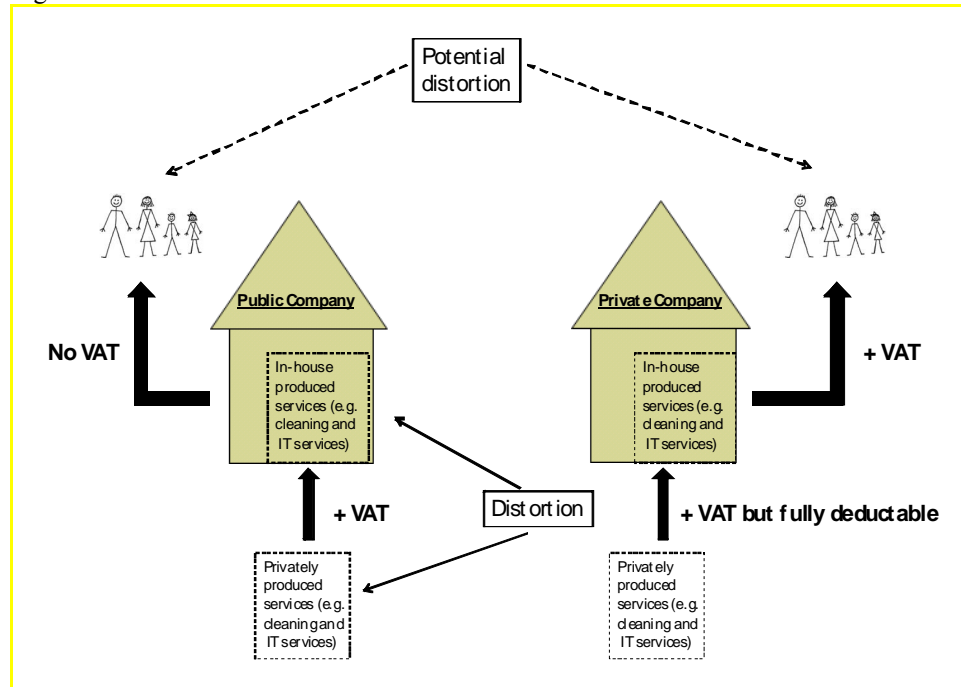
Figure 1.2 Choice between outsourcing and self supply



Source: KPMG AG

The input side distortion is illustrated in the bottom part of Figure 1.3 showing that for the public sector a distortion exists between in-house public produced support services and outsourced private produced support services. For the private sector (right half of the figure depicting the flows in a private company), we assume that this distortion is not present, as the private company is able to deduct the incoming VAT.

Figure 1.3: Illustration of current distortions



Note: The figure illustrates where distortions may arise in a given Member State without compensation schemes in place which serve to eliminate the distortions. The figure does not, however, depict an actual Member State or industry.

Source: Copenhagen Economics

The distortion may also affect the output side through reduced competitiveness of private sector entities vis-à-vis public competitors. This is illustrated in the top half of the figure. The reason is that if e.g. a public and a private provider of waste management services compete in the same market, the public provider will have the advantage of not adding VAT to its clients. The private provider of waste management service will, on the other hand, have to add VAT to its clients. Hence, the public provider of waste management service may have a competitiveness advantage over the private provider of the same service. This is of course only the case when public and private providers compete on the same market.

To what extent does this differential treatment reduce economic efficiency? And what are the available solutions and their potential impact on economic efficiency?

These are questions that we try to answer in this report. We start out with identifying the legal issues arising from the current treatment of public entities in regarding VAT (1.1). We then proceed with discussing how differential VAT treatment may create a loss of efficiency from lack of public outsourcing of input services such as cleaning services to private providers (1.2),

and from lack of outsourcing of output services such as waste collection (1.3). In subchapter 1.4, we discuss the importance of compliance costs. Finally, in subchapter 1.5, we present concrete solutions that may allow Member States to reap economic gains from less distortion between public and private entities, and we quantify these potential economic gains.

1.1. LEGAL CHALLENGES

The comparison of the adoption of the CVSD regarding the public sector among the Member States has shown a large variety in the adoption of EU provisions as well as the application of the national law. In this respect a major problem proved to be the different understanding of the terms ‘public body’ and ‘public law’ among the Member States. As a result the same activity may for example be considered to be non-taxable in one Member State whereas it would be treated as taxable in another Member State. In addition to these interpretative differences, a lack of harmonisation is caused by the various stand still clauses applicable only to some Member States and provisions of the CVSD which leave the adoption at the discretion of the respective Member State such as Article 133 CVSD. Consequently, the detailed analysis of the VAT treatment of waste disposal, cultural services, education, hospital services, homes for the elderly, sports and broadcasting has identified differences among the Member States¹.

According to our assessment based on the legal and economic analysis the major problems of the current VAT treatment are its high complexity and legal uncertainty as well as its distortive effects in relation to economic decisions of the public sector bodies and the competition with the private sector.

As regards the legal uncertainty of the system, it must be noted that it aggravates many of the aforementioned problems. A lack of certainty about the tax consequences of specific transactions will make economic operators reluctant to undertake new investments or extending and adapting existing activities². Furthermore, it creates additional entry costs for private actors when trying to challenge established public incumbents, creates compliance costs as well as administration costs and encourages the use of complex structures or tax schemes³.

In order to counter the distortions caused by the current VAT treatment, some Member States have introduced a system designed to compensate public bodies for their non-deductable input VAT. However, the legal analysis has shown that the compensation systems in practice vary

¹ In chapter 2 we present overview tables of the results of the legal analysis for each sector and Member State.

² C. Amand (2006), ‘VAT for Public Entities and Charities – Should the Sixth Directive be Renegotiated?’, *International VAT Monitor*: 433-443, at 435.

³ C. Amand (2006), ‘VAT for Public Entities and Charities – Should the Sixth Directive be Renegotiated?’, *International VAT Monitor*: 433-443, at 435.

considerably from Member States to Member State and sometimes even cause additional distortions.

The legal comparison of the EU VAT treatment of the public sector with selected OECD countries has shown different approaches in order to deal with public sector bodies. The Canadian rebate system basically follows the same approach as the Member States with a compensation system by granting rebates to public bodies which cannot deduct input VAT. The most radical approach to taxation of the public sector is present in New Zealand and Australia, which virtually treat all activities of the public sector as taxable with the right to deduct input VAT. Unlike Australia, the New Zealand system grants extremely few exemptions for public sector bodies and consequently comes very close to a full taxation of the public sector. Therefore it has frequently been advocated as remarkably neutral and favourable system of VAT taxation of the public sector. However, the legal analysis showed that the full taxation approach also involves conceptual difficulties, particularly the identification of explicit consideration for public supplies.

1.2. OUTSOURCING SUPPORT SERVICES

Public entities that are either taxable but exempt or non-taxable may have economic incentives to keep production of back office or support services in-house solely due to their status as either exempt or non-taxable. This could for example be cleaning services, IT-services and HR-management. The reason is that if a public entity produces support services in-house, it is not paying any VAT on the value of the support function. But if the same public entity chooses to outsource the same support services to a private entity, the private entity will add VAT, which the public entity must pay but cannot deduct.

Hence, for a public entity to outsource support functions, expected monetary gains must be so large as to offset the added cost from VAT. As this is not always the case, differential VAT treatment works to reduce economic efficiency through ‘too little’ outsourcing.

The same logic applies to labour saving investment decisions: A public entity will choose *not* to invest in new technology that could substitute in-house labour even if the expected gains from e.g. lower labour costs are larger than the investment. The reason is that the public entity must pay VAT on the investment which it cannot deduct, whereas VAT is not added to in-house labour. The consequence is too little investment leading to lower growth in public productivity than without the differential VAT treatment.

Moreover, public entities may choose suboptimal organisational structures. For example, the forming of shared services centres between public entities may allow these entities to reap efficiency gains due to e.g. economies of scale. But they may nevertheless choose not to form a

shared services centre if the services of the shared centre are taxable. Examples of these mechanisms are given in Box 1.1.

Box 1.1 Case of less outsourcing due to tax exemption

In Germany, hospitals are tax-exempt, meaning that if a hospital takes part in the public funding system and, as a consequence, accepts to treat all patients which approach it, they will not have to pay VAT of 19 percent, but cannot deduct input VAT either.

We have looked into a concrete case of a German non-profit hospital group with a church background. The group consists of several hospitals and several homes for the elderly. It has more than 4,000 employees and sales of more than EUR 250 million. The group is organised in a management holding company, several hospital-operating companies (running one hospital each) and several shared service centre companies with supportive functions like catering or central purchasing for the group.

VAT is influencing the hospital group on different levels. For example, VAT currently plays a major role for choosing the legal form of the group structure. For most of the supportive services rendered by the shared service centre companies (e.g. catering) as well as for the management service rendered by the management holding company (e.g. management of group, accounting, human resources) 19% VAT would become due as the VAT exemption in Art. 132(1)(b) CVSD is not applicable concerning the shared service companies. The hospital-operating companies would not be able to deduct input VAT insofar they are using the services rendered to them for tax-exempt hospital services. As a consequence it is – from an economic point of view – usually not possible to form shared service centres in a hospital group as a separate legal entity. Further it is not possible to divide a hospital group into different legal entities if supportive functions shall be concentrated in one company. Finally it is not possible to concentrate management activities in a separate holding company. In our case study the formation of a shared service company is only possible because of the German rule about tax grouping.

Once an outsourcing decision seems to be advantageous the costs have to be so low that the non-deductable VAT can be compensated as a self-supply is not taxed with VAT but the supply by a third party is taxed. This leads to the consequence that often there is only an outsourcing within the VAT group (shared service centres). The only chance for third party suppliers to have a competitive offer is to cut the personnel costs by paying lower wages or by saving material costs, e.g. through economies of scale.

VAT also has an influence on investment decisions, e.g. often goods are leased because the VAT (non-deductable input VAT) becomes due on a pro-rate basis and not at once in the beginning of the useful life of the good. Also the non-deductable input VAT has to be amortised. However, it was not considered that the VAT has a material effect for investment decisions.

Another case is that of one of the major Danish private hospitals with a turnover of more than Euro 15 million. In Denmark hospital services are tax-exempt (except for certain cosmetic procedures provided by private hospitals, which will be liable to VAT from 1 January 2011). A compensation scheme exists, which means that input VAT might be recovered. However, not for private hospitals. They cannot recover their input VAT. The hospital estimates that it has costs of input services such as cleaning services, call centres or catering services at around 5-8 percent of its turnover. It produces by far the majority of these services in-house, as the VAT of 25 percent most often exceeds the expected monetary gains from outsourcing. However, the hospital regularly makes business cases for outsourcing the input services. It reckons that it would outsource the majority of its input services if the input VAT was compensated for.

Source: KPMG for the Germany case. Copenhagen Economics for the Danish case.

It should be noted, that the currently existing Art. 132 (1) f CVSD offers a partial solution for the VAT induced disadvantages to outsourcing, since under certain conditions it allows an exempt supply of services within a so-called cost sharing group of persons, who are carrying on exempt activities or are not regarded as taxable. However, Art. 132 (1) f CVSD is only applicable under specific circumstances; the basic problem remains where Art. 132 (1) f CVSD is not applicable. Furthermore, the initial costs incurred by the cost sharing group would nevertheless

still include non deductible VAT. Even if Art. 132 (1) f CVSD is applicable, a disadvantage for outsourcing of services would remain. As a consequence, Art. 132 (1) f CVSD cannot be regarded as a sufficient solution. A significant improvement of the VAT treatment of the public sector requires a reform of the VAT treatment of the public sector.

Studies indicate that in-house produced support services share of total public sector expenditure may be in the area of 8-20 percent, cf. Table 1.1.

Table 1.1 Support services share of public sector expenditure

	UK	Denmark	France
Support services share (pct)	8	20	19
Share definition	Pct. of total public sector running cost	Pct. of municipality running cost.	Pct. of total state running cost

Source: HM Treasury (2009), Statistics Denmark (2010), Direction du Budget (2010).

In our economic modelling later, we apply an estimate of 10 percent, cf. Table 1.2. Private business services' input to public production, which is the relevant substitute for most in-house produced support services, account for around 3 percent.

Table 1.2 Public and private support services share of public production costs

	Share of public production costs
Public support services input to public production (own production)	10%
Private business services input to public production	3%
Total input of business services (own public + private) to public production	13%

Source: Copenhagen Economics

In our economic modelling, these 13 percent support services are provided as input to the five modelled public core services and public administration, making up 28.4 percent of EU27 GDP, cf. Table 1.3.

Table 1.3 The public services and administration modelled for distortion on the input side

Services	Share of EU27 GDP, percent
Broadcasting, public	0.2
Education, public	2.9
Hospitals, public	2.2
Cultural services, public	1.8
Waste disposal, public	0.5
Public administration	20.9
Total	28.4

Source: Copenhagen Economics, based on GTAP database.

Note: The sectoral shares of the economy do not exactly correspond to those one would obtain using data with a NACE classification as this classification does not exactly correspond to the GTAP classification.

1.3. OUTSOURCING CORE SERVICES

If one considers outsourcing actual public core services to the private sector, the potential gains could be even larger. By core services we mean the entire public entity. For example, a municipality could choose to outsource its entire waste management responsibility to a private entity instead of having the municipality owned waste management entity to perform the service.

Waste management and broadcasting services may be obvious candidates for eliminating any possible differential VAT treatment and allowing for competition as differential VAT treatment occurs in many Member States. The reason is that these sectors, from a legal point of view, are characterised by differential VAT treatment. In the economic analysis we investigate the impact of differential VAT treatment for output in the 5 sectors in Table 1.4. Together they represent 13.6 percent of the EU27 GDP.

Table 1.4 The five core services modelled for distortion on the output side

Services	Share of EU27 GDP, percent
Broadcasting, public and private	0.3
Education, public and private	3.6
Hospitals, public and private	2.7
Cultural services, public and private	6.0
Waste disposal, public and private	1.0
Total	13.6

Source: Copenhagen Economics, based on GTAP database.

Note: The sectoral shares of the economy do not exactly correspond to those one would obtain using data with a NACE classification as this classification does not exactly correspond to the GTAP classification.

There may also be gains from outsourcing more ‘advanced’ support services. The simpler support services such as cleaning services, IT-services and HR-management that we looked at in the previous subchapter, will often produce gains of a static nature: Since competitive private markets for e.g. cleaning services and IT-services already exist, more outsourcing from public entities are not likely to spur dynamic effects through increased competition and innovation within these services. The gains emerge, as the private producers are able to produce more efficiently than public producers.

Dynamic effects through new markets, business models and innovation could come from outsourcing more ‘advanced’ support services closer to core functions. For example monitoring of patients in hospitals, which could take place from a distance using communications technology, cf. Box 1.2.

Box 1.2 Outsourcing other support services

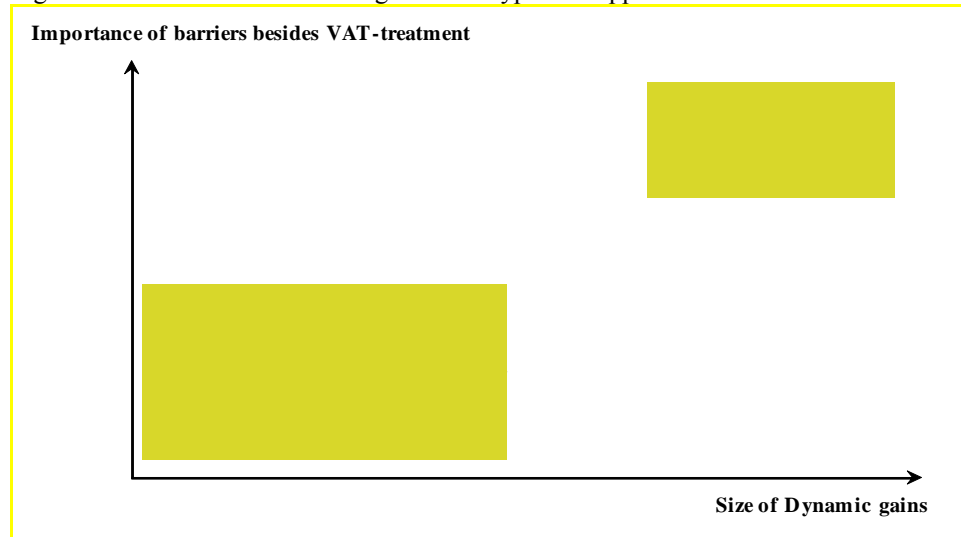
The hospital from Box 1.1 said that it believed that with input VAT compensated for, it would start to look into outsourcing or making investments in new technology not even considered today. For example, monitoring of patients and in general the types of services where trained nurses are not necessary.

Source: Copenhagen Economics.

The gains from outsourcing such other support services could therefore be even bigger than outsourcing the more traditional support services. However, outsourcing other services could also to a larger extent be hampered by barriers other than differential VAT treatment; for example immature technology or licensing requirements. Hence, these services may be less affected right now by lack of a level playing field with respect to VAT, and it may require a larger set of public reforms to reap them.

Figure 1.4 illustrates this idea that outsourcing other services may bring about more dynamic gains than outsourcing the more traditional support services, but that more barriers are likely to be present as well.

Figure 1.4: Gains from outsourcing different types of support services



Source: Copenhagen Economics.

1.4. COMPLIANCE COST

We have now discussed some rough potential gains from eliminating the VAT bias between public and private providers of support services and core services. However, these gains depend very much on two factors.

- That differential VAT treatment is actually the decisive barrier
- That compliance costs from a system designed to eliminate the VAT bias does not erode the initial economic gains

First, that biased VAT treatment is actually the decisive barrier. If that is not the case, eliminating this bias alone is not going to have any major impact on public entity's outsourcing decisions.

On the one hand, we believe that there are costs to be saved from outsourcing a number of support services such as cleaning services, catering services and IT-services, where few other legal and attitudinal barriers exist. We base this on the clear economic incentive for saving costs as well as the literature and case studies we have collected.

On the other hand, a number of core services may be more difficult to outsource due to quality and safety standards, regulatory barriers or attitudinal barriers. This is supported by a recent

Danish study⁴, which finds that these concerns are important for a decision maker about to decide whether or not to outsource a public service, c.f. Table 1.5.

Table 1.5 Perceived barriers to outsourcing in Danish municipalities

Barrier	Assessment of the effect on outsourcing
Attitudinal	Significant
Economical	Significant
Regulatory	Medium
Organisational	Medium

Note: "Attitudinal" describes barriers, where the decision maker chooses not to outsource a service, as they have a negative attitude toward outsourcing that particular service. The analysis emphasise that this is in general more based on personal bad experiences than ideology.

Source: Udbudsrådet (2010a).

Second, that the compliance costs implied by a system designed to eliminate the VAT bias does not erode the initial economic gains.

On the one hand, estimates could suggest significant compliance costs associated with a *refund system*. We are not aware of the existence of studies aiming specifically at quantifying the compliance costs associated with having a refund system in place. But a recent OECD review on the size of public and private compliance costs associated with complying with the *general* VAT systems in Europe, reports losses in the area of 0.0-0.5 percent of GDP, cf. Table 1.6⁵.

Table 1.6: Estimates of administrative costs from systems of consumption taxation

Country	Year	Pct of GDP
Austria	2007	0.1%
Denmark	2004	0.1%
Germany	2007	0.5%
Netherlands	2002	0.3%
Norway	2007	0.0%
UK	2007	0.1%

Source: OECD (2008). Eurostat GDP figures have been used to convert OECD monetary estimates into comparable shares of GDP.

These are potentially large costs. But the numbers of course only relate to compliance with the general VAT system, not a refund system. Our interviews with public authorities in the eight

⁴ Udbudsrådet (2010a).

⁵ We are not aware of the existence of studies that have attempted to quantify the compliance costs associated with having a system in place designed to eliminate the VAT bias.

Member States that actually do have refund systems in place seem to indicate that administrative costs are small to medium cf. Table 1.7. So they do exist, but are probably not huge.

Table 1.7 Size of administrative costs from refund systems in 8 EU Member States

Size of administrative costs	Number of EU Member States
High	0
Medium	2
Low	5
No answer	1

Source: Legal questionnaire, filled out by KPMG experts.

Based on these considerations, we conclude that barriers to outsourcing exist in addition to differential VAT treatment. This reduces the immediate economic gains from eliminating the differential VAT treatment. Furthermore, we conclude that compliance costs from a refund system exist but are not huge.

The conclusion that other barriers may exist and that refund systems may imply compliance costs fits well with the observation that only 8 out of 27 EU Member States currently have refund schemes in place, cf. Table 1.8. One could expect more Member States to have refund systems in place, if they perceived economic gains to far outweigh e.g. higher compliance costs.

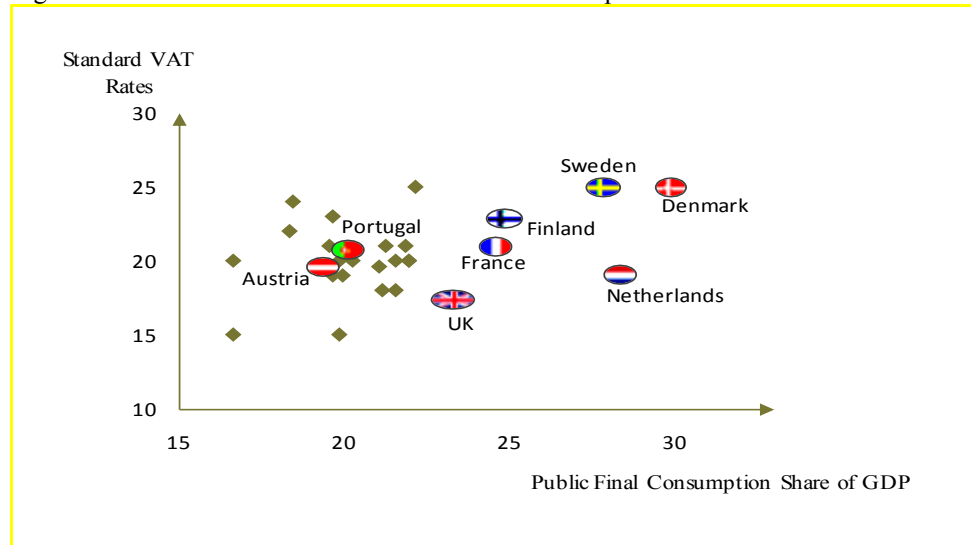
Table 1.8: Countries with and without compensation mechanisms

Countries with refund schemes	Countries without refund schemes		
Austria	Belgium	Greece	Malta
Denmark	Bulgaria	Hungary	Poland
Finland	Cyprus	Ireland	Romania
France	Czech Republic	Italy	Slovakia
Netherlands	Estonia	Latvia	Slovenia
Portugal	Lithuania	Spain	Germany
Sweden	Luxembourg		
United Kingdom			

Source: KPMG survey

The Member States with schemes in place also tend to be the ones with relatively large public consumption shares (relative to GDP), cf. Figure 1.5. The flags in the figure represent the presence of a refund scheme in that particular Member State. The rationale for this is that the larger the public sector is, the larger will be the potential inefficiencies caused by differential VAT treatment simply because a larger part of the economy is potentially experiencing inefficiencies on this account. In contrast, it does not seem that Member States with a high standard VAT rate are more likely to have a refund scheme in place.

Figure 1.5: EU27 Member States with and without compensation schemes



Note: A flag indicates that the particular Member State has a compensation scheme in place.
Source: Eurostat.

1.5. SOLUTION MODELS FOR CREATING A LEVEL PLAYING FIELD

There are several sources of inspiration to reform the VAT treatment of public entities. In Australia and New Zealand all activities – public or private – are basically taxed at the same rate, removing distortions of input decisions and distortions in the output market of private and public sector activities. In Canada and several EU Member States, public bodies are compensated for their VAT expenditure when they buy inputs for non-taxable or exempt activities.

We present four solution models for reducing the distortions caused by the current differential treatment of VAT.

- Full taxation
- Refund system
- Treated as taxable persons (public bodies treated as taxable persons as a rule, with certain exemptions)
- Treated as taxable persons with an option to tax (public bodies treated as taxable persons as a rule, with certain exemptions and an option to tax for exempt taxable persons)

Full taxation

The main change introduced with a full taxation system would be a fundamental alteration of the taxation of output supplies. In the public sector, all supplies, which are currently treated as non-taxable (Art. 13 CVSD) or tax-exempt (Art. 132 CVSD) would be treated as taxable and non-exempt. Special rules leaving discretionary power to the Member States (e.g. Art. 133, 371 ff. CVSD) would be deleted if they were concerning the public sector. The taxation of the output supplies leads to the possibility to deduct input VAT pursuant to Article 168 CVSD.

Generally, the full taxation model can be introduced in two basic modifications. In the first one, all supplies of public entities are taxed regardless whether a consideration is provided or not (e.g. also on supplies of police, fire brigades or charities which are only receiving donations). In the second one, output VAT is applied to supplies only if an explicit fee is charged. Supplies funded e.g. from taxation or other comparable sources thus remain outside the scope of the VAT.

We choose to focus on the second one because a shift towards taxation of supplies with no consideration would be a fundamental change in the entire EU VAT system, which would lead to types of costs to the private and public sectors which we are not able to quantify within the scope of this analysis (costs of legal uncertainty and other costs of adjustment). However, it should be noted, that taxing public output only when a fee is charged for it (for consideration), may provide incentive to finance public entities through subsidies instead in order to escape VAT.

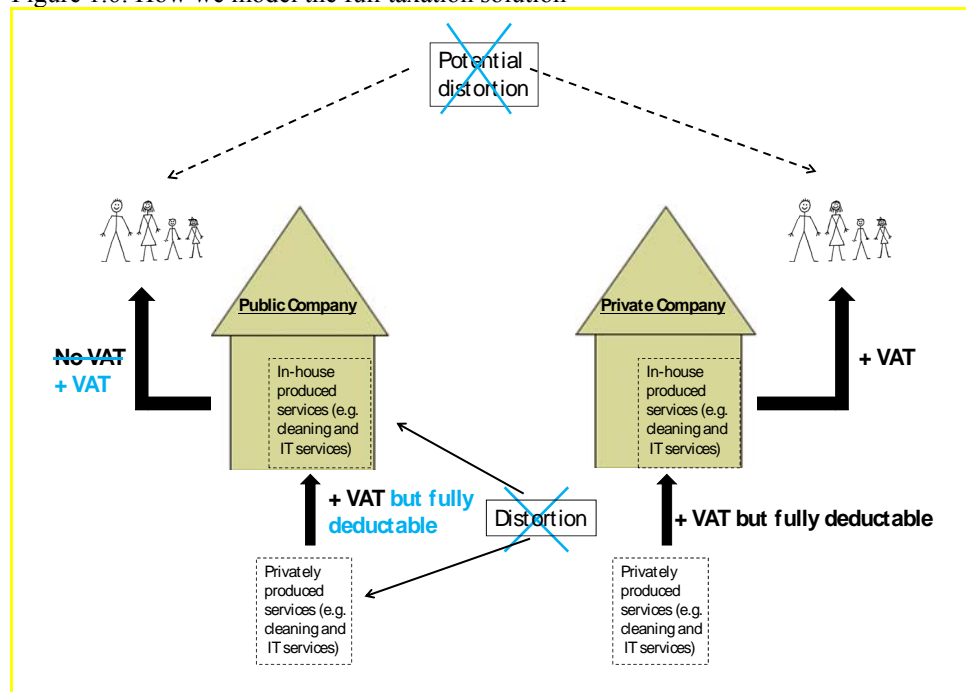
We do not have precise information about the share of output from our five modelled core services that are provided for consideration and not for consideration. We therefore need to make assumptions about this split. For the five private produced services covered in this study, we assume that they are predominantly provided at a consideration. The basic intuition is that if a fee cannot be charged, they would not be provided by a private supplier. For the equivalent public produced services, we assume that hospital and waste management services are provided for a consideration, whereas broadcasting, education and cultural services are provided with only a small charge and the rest is financed through subsidies. This is an important assumption: if even a minor fee is charged, taxing this fee with the VAT rate applicable to the similar private output removes a distortion and economic efficiency is increased. If on the other hand, no fee is charged at all, there is nothing to tax and hence no distortion to eliminate, and hence no increased economic efficiency.

In our economic modelling, we model the economic impact of allowing taxation of output supplies (for the five modelled sectors) and deductibility of input supplies (for the five modelled sectors and public administration). In the economic modelling we do not consider the

postal sector, because of the existing Commission proposal. Hence, in our modelling, this solution effectively removes the distortions on the input side and the output side in all Member States, cf.

Figure 1.6.

Figure 1.6: How we model the full taxation solution



Source: Copenhagen Economics

The current VAT system does not impact services and Member States in the same way. For example, private hospital services are not taxed, whereas public waste management activities are sometimes taxed depending on whether a potential distortion is deemed to actually exist. Some Member States by definition do not allow competition between public and private waste management providers. In other Member States, that is not the case, and a distortion may or may not de facto exist.

In our modelling of the full taxation solution, we therefore model two scenarios. In the one scenario called ‘without competition’, we assume that competition does actually *not* exist between public and private providers in the five modelled activities, or that the current differential VAT treatment does not give rise to a distortion. In the other scenario, called ‘with competition’, we assume that competition does in fact exist between the public and private providers in

the five modelled activities, or that the current differential VAT treatment does give rise to a distortion.

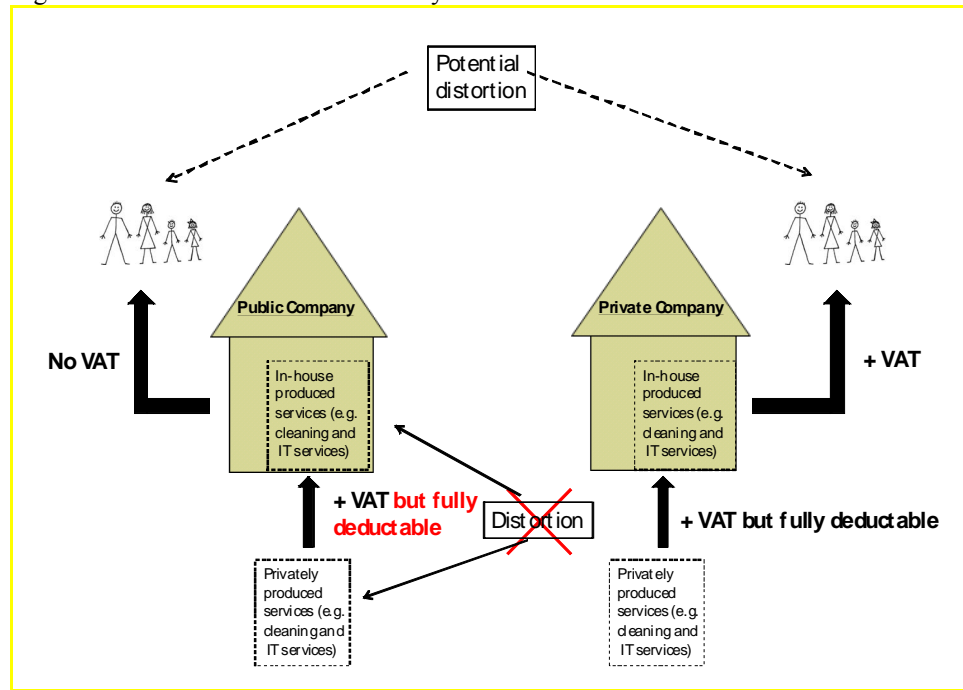
We do not model compliance costs when introducing a full taxation solution compared to the current system of differentiated VAT. There might, in fact, be significant compliance *gains* compared to the current system of differentiated VAT, but we do not model these explicitly in the economic model.

Refund system

This solution extends the type of refund systems currently in place in eight Member States.

In our economic model, we assume full compensation of public sector input VAT (for the five modelled sectors and public administration). This equalises VAT treatment between public and private sector on the input side but leaves behind the current potential distortion on the output side, cf. Figure 1.7. As this the type of solution currently applied in eight EU Member States, we do not model any change in these eight Member States. We therefore implicitly assume that any EU wide refund system will have no impact compared to their current refund schemes.

Figure 1.7: How we model the refund system solution



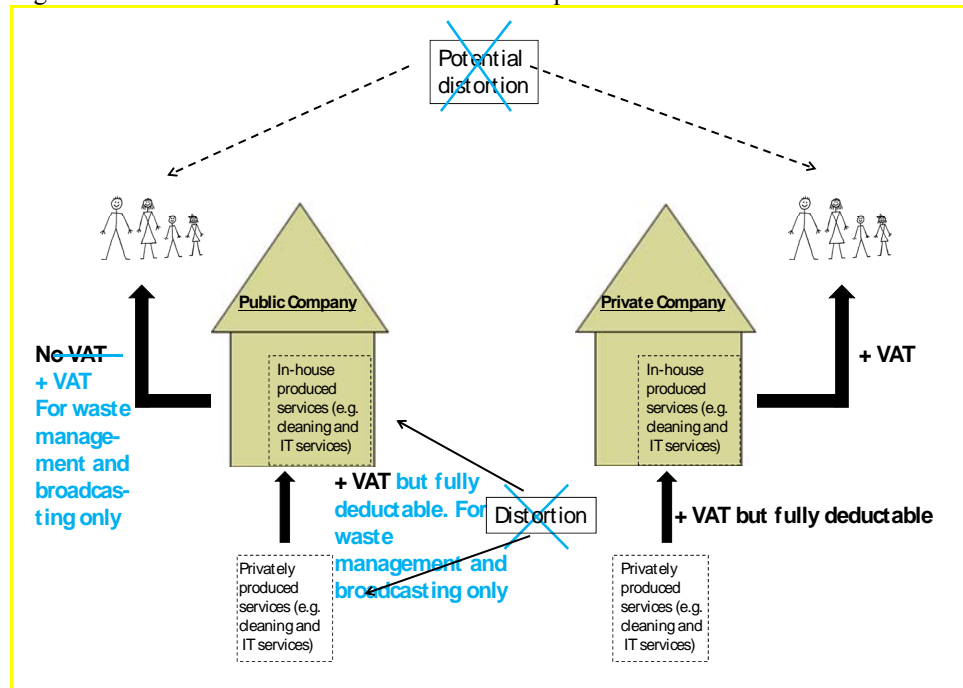
Source: Copenhagen Economics

In our model, we also discuss the impact of compliance costs in the refund system solution, as this new way of recovering VAT for public entities is expected to add administrative burdens compared to the current situation where most Member States do not have a refund system in place. One could discuss whether or not the current system with differential VAT produces high compliance costs similar to those of a refund system. However, our discussion above suggests that a refund system adds further compliance costs.

Treated as taxable persons

This solution adds VAT to public entities' output which is currently non-taxable and allows public entities to deduct VAT for services such as waste management, broadcasting, sewage, air traffic control, parking and road tolls and crematoriums. In our economic modelling we introduce this 'full taxation' however, only for waste management and broadcasting services as these services are the only one we can model, cf. Figure 1.8. Distortions on both input and output side will be eliminated in the two sectors, but only in these two sectors.

Figure 1.8: How we model the 'Treated as taxable persons' solution



Note: Distortions on input and output side will be eliminated only for waste management and broadcasting services as explained in the text.

Source: Copenhagen Economics

Treated as taxable persons with an option to tax

This is similar to the ‘treated as taxable persons’ solution model, but it adds an option to tax additional public entities. Hence, this solution model will only have a larger economy wide impact if this option to tax is applied to more public entities than in solution three. We do not explicitly simulate this option in the economic model as its characteristics are not possible to interpret into the model.

Economic modelling results

Our modelling for the first two solutions (full taxation and refund system) show GDP effects of 0.01 percent to 0.19 percent of EU Gross Domestic Product (GDP), cf. Table 1.9.

Table 1.9: Model results, percentage change from baseline of differentiated VAT treatment of public and private sector

	Solution 1: Full taxation		Solution 2: Refund system**	
	without competition	with competition	with compliance costs	without compliance costs
Change in GDP	0.04% (€ 4.8 billion)	0.19% (€ 20.9 billion)	Potentially zero	0.013% (€ 1.4 billion)
Change in public core services share of total output, pct.-points	-0.02	-0.09	-	0.01
Change in private core services share of total output, pct.-points	-0.06	0.03	-	-0.01
Change in private business services input share to public sector, pct.-points	1.50	1.42	-	1.43
Change in public business services input share to public sectors, pct.-points	-1.81	-1.74	-	-1.74
Change in public sector employment	-0.40 % (164,400 persons)	-1.10 % (452,100 persons)	-	-0.14 % (57,540 persons)
Change in total employment	0	0	-	0
Change in wages	0.02%	0.10 %	-	0.00%
Potential cost savings for public sector, pct.of public consumption/absolute	At least 0.3 percent of government consumption / € 5.2 billion from more efficient use of support services. More costs savings when taking into account shift in core services. We do not estimate this due to impact of other mechanism in the model, making it difficult to isolate a relevant measure for cost saving		-	0.3 percent of government consumption / € 5.2 billion

Initial cost from re-funding incoming VAT	€ 100 billion**	€ 100 billion**
Initial change in VAT revenue due to output VAT alone /proportional VAT percent change in entire economy to offset change	195 billion euro / -19 percent If entire value of public output is taxed	_* *_

*Note: * - No correction in VAT rates, as revenue remains constant due to no change in output VAT rates.*

***Government costs from refunding incoming VAT to public entities can be considered an internal government transfer from one public entity (the state) to another (e.g. a public hospital now being allowed to recover VAT). Without competition means that no competition exists between the private and public core services covered. With competition means that competition does exist. With compliance means that taking compliance costs into account reduces the GDP effect. We do not have information about the size of compliance costs caused by a refund system, hence, we cannot specifically estimate the net effect of the positive efficiency gains and negative compliance costs from the refund system. Without compliance means that estimate does not include assumptions on compliance costs. In general see more on these numbers in chapter 4. The results do not cover the postal sector.*

Source: Copenhagen Economics

The driving mechanisms

In general, the increase in GDP is driven by more efficient use of resources through less distortions. This is brought about by removing the distortion due to differential VAT treatment. Furthermore, we have assumed that private production of the five covered core services is 15% more efficient than the similar public production. The same goes for private production of support services compared with public own produced support services. This is due to e.g. economies of scale and more incentive to innovate due to competition.

To provide an initial overview of the driving mechanisms behind the solutions, we start by looking at the GDP increase of 0.01 percent of GDP for solution 2: Refund system. This increase is driven by a substitution of support services in the five modelled public services and public administration, from own produced support services to private produced support services.

Next we turn to solution 1: full taxation without competition, with a GDP increase of around 0.04 percent. Without competition, means that we assume that the five modelled public and private core services do not compete with each other. So the relative demand between the public and private core services does not change even when we equalise their output VAT and thereby create new relative prices facing the consumer. This implies that the difference between the 0.04 percent of GDP in this solution and the 0.01 percent in the refund solution is driven by less distortion between the five core services and rest of the economy. Hence, this effect is driven by the consumers choosing to shift consumption away from public and private core services, to other goods and services.

The full taxation model with competition indicates a GDP increase of 0.19 percent. ‘With competition’ means that we assume that the five public and private core services compete with each other. And when the distortion caused by differential VAT is removed demand changes from public to private services. As we assume a high degree of substitution between public and private core services in this scenario (the equivalent to our concept of with competition), the consumers reduce their demand for the public core services significantly substituting towards private core services and also towards other goods and services.

Solution 2: Refund system

The spread in the refund system solution is caused by the existence of compliance costs, or non-existence of compliance costs. Notice, that we have not actually modelled the scenario with compliance cost. The reason is that we have no credible estimate for its size. However, we have previously concluded that we believe that a refund system entails compliance costs. This is the reason for writing ‘potentially zero’ for the GDP effect in the column with compliance: If in fact compliance costs amount to the GDP effect of 0.013 percent in the scenario without compliance costs it will cancel out this gain. We therefore believe that care should be taken, should one favour a refund system solution, to create a solution as transparent and easy to administer as possible. Otherwise there is a risk that the economic gains from elimination of the distortions could be neutralised (or even be negative).

The GDP increase of estimated 0.013 percent of GDP is caused by elimination of the distortion on the input side. We find an increase of 1.43 percent of the share of public sector use of private produced support services, and a drop of 1.74 percent in share of public in-house produced support services. This is the shift from in-house produced support services to private produced – outsourced – support services that we expect from eliminating the distortion on the input: private produced support services become relatively cheaper than public in-house produced support services. Because we assume that private support services are produced more efficiently than public in-house produced services, we get the positive impact on overall GDP.

This more efficient use of resources also may approximately be interpreted as a public cost saving of 0.3 percent or around 5 billion euro.

We estimate that a refund system solution would ‘cost’ 100 billion euro from allowing public entities to recover incoming VAT. However, in the model we interpret this cost merely as a transfer from one public entity to another. E.g. from the state to a public hospital, who can now get its incoming VAT refunded from the state. Hence, this ‘cost’ does not influence on our GDP results or our public cost savings estimate. The only exception is for charities, which may also recover VAT in this solution model. Naturally, this does not constitute a transfer between government entities. We do not model the charities.

Solution 1: Full taxation – without competition

The first assumption ‘without competition’ generates an increase in GDP of around 0.04 percent, cf. the first results row. The assumption is that public and private services that are currently not equally taxed do *not* compete with each other. This is in line with the general idea in the CVSD (the ‘VAT directive’) that differentiated VAT should in general not cause distortions between public and private entities. This is reflected in the rows ‘Change in public core services share of total output’ and the corresponding ‘Change in private core services share of the economy’, which both drop as a consequence of higher taxes, but they do not shift between themselves.

Consequently, the GDP effect is driven by the fact that we lower distortions in the rest of the economy. Introducing a full taxation system would lead to a VAT revenue gain. This revenue gain comes from taxing public sector output. To re-balance the public budget in the model, we have reduced the VAT rate proportionally on all goods and services in the economy. The results table show that taxing the entire output in the five modelled sectors could increase VAT revenue up to 184 billion euro, and that this is directed back to consumers through an 18 percent proportional reduction in all VAT rates, seen across the entire EU (there would be differences between the Member States). For example, if Denmark were to reduce its standard VAT rate by 18 percent, it would go down from currently 25 percent to 20.5 percent.

The revenue gain assumes that the entire value of public core services output is taxed. This may not be the case since only the value of e.g. public output corresponding to the consideration is taxed, and if the consideration does not reflect the entire output value. However, we do not know how large a share of the output value that may be financed through a consideration in a future full taxation solution. So we are only able to provide this upper bound for revenue increase.

The fourth and fifth results rows show the effect of elimination of the distortion on the input side. We find an increase of 1.50 percent of the share of public sector use of private produced support services, and a drop of 1.81 percent in share of public in-house produced support services. This is the shift from in-house produced support services to private produced – out-sourced – support services that we expect from eliminating the distortion on the input: private produced support services become relatively cheaper than public in-house produced support services. Because we assume that private support services are produced more efficiently than public in-house produced services, we get the positive impact on overall GDP.

Public sector employment falls in this solution-scenario by -0.40 percent. Private sector job creation rises, by definition, by the same absolute amount: In a new long run equilibrium with unchanged overall labour supply, we always find a drop in public jobs is compensated for by an

increase of private sector jobs. Notice, that the model does not take into account short run labour market rigidities.

Finally, we see that effects on overall wages are small as calculated in the model. The model does not, however, take into account potential higher wages in certain public activities. In general, public employees that, under the current regime of differential VAT treatment, are experiencing higher wages compared to similar jobs in the private sector, may experience a drop in wages, as the full taxation model makes it easier to substitute expensive own production of public support services with cheaper private production. This will tend to add pressure on any ‘mark-up’ on public wages.

Solution 1: Full taxation – with competition

Here the assumption is that all public and private services that are currently not equally taxed do in fact compete with each other, and that the differential VAT therefore in general creates a distortion in favour of the public services. Eliminating the distortion on the output side (and of course also on the input side) under this assumption, results in economics gains of 0.19 percent of GDP. This is a significantly larger gain compared to the 0.04 percent in the ‘without competition’ scenario. The difference of 0.15 percent of GDP may thus be attributed to elimination of the distortion on the output side.

Hence, in Member States where competition on the output side exists between public and private service providers, but differential VAT treatment is a key factor in distorting competition, there may be significant economic gains from a full taxation solution. The reason is that we reduce overall distortions in the economy by equalising taxation between services that are close substitutes. It must be kept in mind, however, that barriers to distortion of competition may still exist, so that elimination of differential VAT treatment may not bring about economic gains.

We find a shift towards private produced core services share of total output (up 0.03 percentage points) from public produced core services share of total output (down 0.09 percentage points).

The solutions are qualitatively compared in the table below.

Table 1.10: Comparing the solution models

Category	Full taxation	Refund system	Treated as taxable persons	Treated as taxable persons, with an option to tax
Distortion of competition	No distortion	Distortions on output side	No distortion in waste and broadcasting	No distortion depending on execution of option

Barriers to market entry	No	Possible barriers	No barriers in those sectors	No barriers depending on execution of option
Level and structure of investment	Investments and outsourcing are encouraged	Investments and outsourcing on support services are encouraged	Investments and outsourcing are encouraged	Investments and outsourcing are encouraged. Incentive for public entities to opt in and out of tax. This could distort investment decisions.
Level and structure of employment	Shift from public to private sector	Shift from public to private sector	Shift from public to private sector in these sectors	Shift from public to private sector
Efficiency of public services	More efficiency	More efficiency	More efficiency	More efficiency, but risk that own choice of whether or not to be taxable may imply distortions
Consumer prices (level not inflation)	Go up as a first round effect because taxes are added to public output.*	May go down as public production is carried out more efficient and thereby cheaper.	No detectable impact on the overall price level.	No detectable impact on the overall price level.
Wages	Go up as efficiency increases in the overall economy. This is primarily because of more production taking place in the more efficient private sector. Could be a negative wage pressure in public entities if a wage premium exists for certain public entity jobs	Go up as efficiency increases in the overall economy. This is primarily because of more production taking place in the more efficient private sector. Could be a negative wage pressure in public entities if a wage premium exists for certain public entity jobs	No detectable impact on the overall wage level. Could be a negative wage pressure on public production in covered sectors.	No detectable impact on the overall wage level. Could be a negative wage pressure on public production in covered sectors.
Impact on tax revenues	Increased revenues initially as taxes are levied on public output, but neutralised in our modelling scenarios.	Neutral to small loss. The latter due to loss to charities.	Increased revenues initially as taxes are levied on waste and broadcasting output, but neutralised in our modelling scenarios.	Increased revenues initially as taxes are levied on waste and broadcasting output and maybe more sectors depending on execution of option to tax
Welfare gains	Positive	Positive	Overall small- but could	Overall small - but could

			be significant in covered services	be significant in covered services
Tax compliance costs	Low	Medium	Low	Low to medium, depending on discussions and compliance costs caused by option to tax

Note: * The full taxation will also have implications for the financing flows between the government, those paying social security contributions, and the social security institutions owing to higher final prices for medicines and health care.

Source: KPMG AG and Copenhagen Economics.

Impact on employment

The shift away from public production naturally, reduces demand for labour. The model results indicate a change in public employment from -0.14 percent to -1.10 percent. This roughly corresponds to from -450,000 jobs to -55,000 jobs in the public sector, cf. Table 1.11.

Table 1.11: Shift of jobs away from public sector

Coverage	Public sector employment, millions	Change in public sector employment, percent	Change in public sector employment
EU27	41.1	-1.10	-450,000
		-0.14	-55,000

Note: Public sector employment is for 2008 except for six countries-Belgium(2000) France(2006) Lithuania (2007) Malta (2006) Poland(2007) and Sweden (2007). Public sector employment consists of general government sector, which is the sum of three sectors (government units, social security funds and other non-profit institution) and publicly owned enterprises. See <http://laborsta.ilo.org/applv8/data/sectore.html>. The employment effects in absolute numbers do not exactly correspond to the modeling results above. The reason is that our modeling does not cover the entire public sector but only the five modeled sectors and public administration, which makes up around 70 percent of total public sector.

Source: OECD based on ILO-Labour statistics database for public sector employment. Change in public sector employment is from the economic modeling results presented above.

The reduction of public sector jobs is due to two forces working in opposite direction. The first force reduces public sector jobs as in-house public produced support services and core services are outsourced to private sector. The other force increases public sector jobs as the outsourcing makes public production more efficient thereby increasing public production and therefore demand for employees.

However, it is important to note that this drop in public sector employment is offset by a similar increase in private sector job creation. As the solution models do not impact structural labour supply, we would not expect a net gain nor a net loss of jobs in the economy in the longer run. In the longer run, all experience tells us that additional unemployment is absorbed into new jobs elsewhere in the economy.

In the short run this may not be the case for everyone, especially in a situation of economic slowdown. And it is not automatically so that the people losing public jobs are the ones that gain jobs in the private sector.

The literature suggests that in the short run there will be a negative effect on employment from outsourcing and in general opening up monopoly type institutions on employment. But in the medium to long run (5+ years) the employment in the opened sectors as a total will have increased. This may be due to strong private job creation, not necessarily public jobs, cf. Table 1.12.

Certain groups may have more difficulty finding a new job once they have lost their current one. Literature suggests that this applies to older people and people with shorter experience in the labour market.

Table 1.12: Select literature analysing the impact on employment

Study	Research question	Findings
Jacob R.M. (2010)- "Whose Job goes Abroad?- International outsourcing and individual job separation", <i>Scandinavian. J. of Economics</i> 112(2), 339–360, 2010	The study attempts to test the fact that outsourcing at most gives rise to short-run adjustment costs in the form of spells of unemployment following job displacement, however; in the long run the level of unemployment is unaffected, although some workers may suffer lower wages. The study uses the data for Danish manufacturing sector from 1990-2003	The paper concludes that outsourcing may induce long-run productivity gains from cost savings and reallocation of workers to new firms and industries, but in the short run there may be individual losses in terms of unemployment and lower reemployment earnings.
Bachmann R. and Braun S.(2010),"The impact of international outsourcing on labour market Dynamics in Germany", <i>Scottish Journal of Political Economy</i> , Vol. 58, No. 1, February 2011	Using an administrative data set containing daily information on individual workers' employment histories, they investigate how workers' labour market transitions are affected by international outsourcing	Outsourcing has a positive but small impact on overall job stability in the manufacturing sector, and considerably increases job stability in the service sector. However, the effect of outsourcing varies strongly across skill levels and age groups, with negative effects for some workers.
Egger, H. and Egger, P. (2006), "International outsourcing and the productivity of low-skilled in the EU", <i>JEL</i> Vol. 44, No. 1, January 2006, 98–108	The article presents insights into the role of outsourcing on the productivity of low-skilled workers in EU manufacturing.	The study confirms that the short run international outsourcing exhibits a negative marginal effect on real value added per low-skilled worker, however; the long-run parameter estimates reveal a positive impact.
EC, DG for Economic and Financial Affairs (1999), "Liberalisation of networking industries: Economic implications and main policy issues".	The publication studies the economic implications of the liberalisation of the networking industries and the main policy issues. Relevant analyses are carried out with a focus on the telecommunications industry.	The study finds that employment in the short run (1-2 years) will decrease due to the liberalisation, but in the long run the number of jobs in the industry will increase above the initial level.
Ugur (2007), "Liberalisation in network industries in the European Union: Evidence on market integration and performance".	The paper examines the extent of liberalisation and the nature of market performance in a group of European network industries. The paper is based on data from, among others, Copenhagen Economics.	The paper find that in the short run (1-5 years) the employment in the liberalised industries has fallen gradually. At the same time, the overall industrial employment has been gradually increasing indicating relatively fast re-employment.
Sewin C. and Stevens.A.F (2008), "Job Loss and Employment Patterns of Older Workers" <i>Journal of Labor Economics</i> , Vol.19, No. 2.(Apr., 2001), pp. 484-521.	The study explores the employment patterns of workers aged 50 and above who have experienced involuntary job loss.	The study stresses the large and lasting effects of job loss on future employment probability of older workers once they involuntary lose their job due to plant closing or layoff. The study also indicates that this result is in line with the literatures in related studies.
Joanna N. Lahey (2005), "Do older workers face discrimination" Centre for retirement research at Boston college, No.33	The paper focus on assessing the existence of age discrimination against older people in labour market.	The study concludes that even if older people would like to work more in their later age, they face discrimination from the employer. Hence, those who have lost jobs and those with little work experience who unexpectedly need to enter the labour market, such as widows, divorcees, will have less probability of joining the labour market.

Source: Stated sources in the table.

Summary of case studies

Throughout the analysis, we have carried out a number of interviews with representatives from private and public and charity entities, in order to gain hands on insight into their perception of the consequences of differential VAT.

Below we summarise select case studies on hospitals.

Table 1.13 Select Case studies on hospitals

Case studies	Impact of VAT on legal form	Administration Cost of VAT	Impact of VAT on outsourcing decision	Impact of VAT on Investment decision
Full taxation (Australia)	The choice of legal form doesn't depend on VAT treatment	Relatively low administration cost of VAT	Outsourcing is made purely on the basis of non-VAT criteria	VAT has no influence on investment decision
Countries with compensation scheme (UK)	VAT does not influence the choice of legal form	Involves admin. cost of VAT as there is a need for advisors in VAT compliance	VAT does not have impact on outsourcing decision as most input VAT is recoverable	VAT has influence on investment decision
Countries without Compensation Scheme (Germany)	VAT plays a major role on the choice of legal form, see e.g. case in Box 1.1	Involves admin. cost of VAT but it varies across private and public sectors	VAT is considered as an important factor for outsourcing decision	VAT has influence on investment decision

Source: Based on interviews. See all case studies in appendix

1.6. RECOMMENDATIONS

Based on the above results, we believe that the most attractive solution to eliminating the distortions caused by differential VAT treatment of public and private entities is a full taxation model. It promises greater potential economic gain than the kind of refund systems currently in place around the EU. Furthermore, it is likely to reduce compliance costs compared to the current differential VAT treatment, where refund systems will add compliance costs. Finally, a full taxation solution is 'future proof', in the sense that whatever developments may occur in how public and private entities compete, the full taxation model automatically ensures a level playing field.

However, taxing only the consideration part of public output may provide incentive to finance public entities through e.g. global subsidies instead in order to escape VAT. That could reduce the positive economic impact of the full taxation solution. Hence, one could consider a full taxation solution which taxes the entire value of the public produced services regardless of how they are financed, i.e. also taxing e.g. global subsidies.

Chapter 2 CURRENT VAT TREATMENT OF PUBLIC SECTOR ACTIVITIES

The VAT treatment of public sector activities in the EU has been discussed for several years. The main problems so far identified by the Commission and literature are as follows:

- Lack of neutrality (particularly: unfair competition, self supply bias, disincentive to investment, cascade effects)
- Lack of harmonisation
- Complexity

The aim of this chapter is to analyse the current VAT treatment of the public sector activities from a primarily legal point of view. First it will be examined how the provisions of the EU VAT law for public sector activities work (2.1). Afterwards it will be analysed how the EU VAT law is adopted in the Member States (2.2). This subchapter also describes the refund and compensation mechanisms already in place in some Member States. Finally the situation within the EU will be compared with the current situation in several OECD countries with a VAT/GST system (2.3).

However, it should be noted that – for assessing the economic effects of the VAT rules regarding the public sector – it is also necessary to take into account factors outside the VAT law:

- Of considerable importance is the distinction between public and private activities as regards regulatory issues. In some sectors private competition with public activities is legally forbidden though theoretically possible due to regulatory national Member State legislation. A different understanding of public tasks within the Member States leads to a variety of sectors where private competition is allowed in one Member State and forbidden in another. However, most Member States have a tendency to liberalise former exclusively public sectors allowing more private competition. It should also be noted that the Member State regulations have to comply with the Market Freedoms laid down in Articles 45 to 66 of the Treaty on the Functioning of the European Union.
- Public bodies are in general welfare-orientated opposed to profit-orientated private companies. As a consequence, certain sectors are considered better to be reserved for public bodies and non-profit organisations, because the exposure to a free market seems inappropriate. In the case of merit goods such as basic health care for example, it is deemed socially desirable not to charge a price that reflects the full value of the supply. Low income members of the society should not be unfairly deprived of merit goods⁶. Regarding this, the absence of a competitive free market for certain goods also serves distributional purposes. In order to cover the difference between market value and user contribution the state steps in or grant subsidies.
- Activities in the public interest – or merit goods – are not only done by public bodies but also by the third sector (charity organisations). Very often public bodies and third sector are cooperating, but from time to time they are also competing on the social market.

⁶ P. Gendron (2005) 'Value-Added Tax Treatment of Public Sector Bodies and Non-Profit Organisations: A Developing Country Perspective', ITP Paper 0514, URL:<http://www.rotman.utoronto.ca/riib/> (last checked: 11 January 2011).

- It is important to note that in many Member States the public sector is still subject to accounting standards or methods different from those applying to the private sector. This makes it more complicated to keep records for VAT purposes.

2.1. PROVISIONS OF THE COMMON VAT SYSTEM DIRECTIVE

2.1.1 Basic provisions

In order to ensure the establishment and the functioning of the internal European market, Article 113 Treaty on the Functioning of the European Union allows the harmonisation of VAT Law. The essential piece of European legislation establishing the common system of VAT is the Common VAT System Directive (CVSD)⁷. Designed as a general tax on consumption exactly proportional to the price of goods and services, the European VAT System allows the deduction of the amount of VAT borne directly by the various cost components of the production and distribution process before final consumption (deduction of input VAT). This mechanism exists in order to ensure the fiscal neutrality of the VAT system despite the length of the production chain. In other words, VAT should only be a burden on final consumption. When incurred during the process of production and distribution of goods and services, VAT should be deducted.

In its Article 2 the CVSD defines as subject to VAT the supply of goods and services for consideration by a taxable person within the territory of a Member State. These transactions generally fall within the scope of VAT and are called “taxable” (or “within the scope of VAT”). However, being taxable a transaction may still fall within the scope of an exemption, freeing the taxable person from the VAT payment. Consequently the VAT treatment of any transaction is dependent on two fundamental questions: Is the transaction “taxable” or “non-taxable”, and, if it is taxable, is it “tax-exempt” or “non-exempt”?⁸

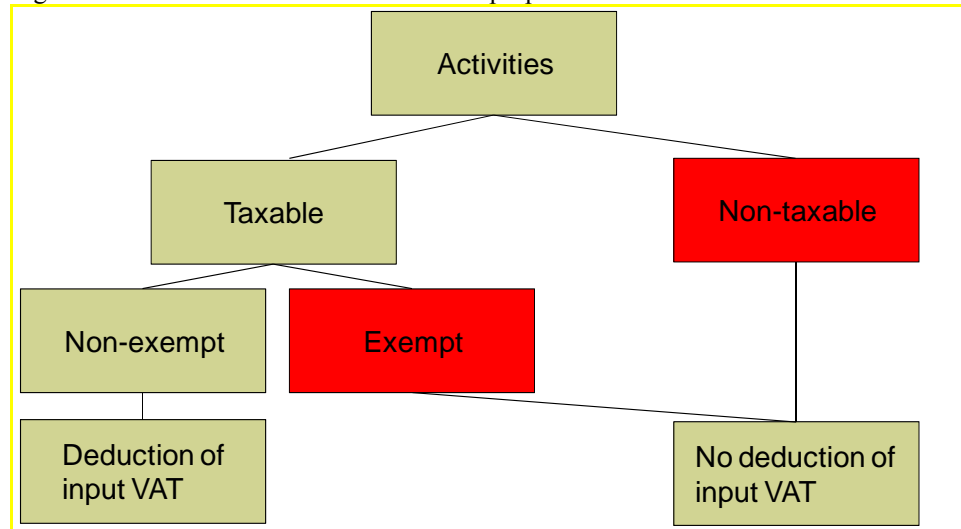
The deduction of input VAT is not possible as regards costs incurred by a non-taxable activity. Also for certain kinds of tax-exempt activities (e.g. public sector activities like health care, education) it is not possible to deduct input VAT, whereas for other tax-exempt activities (e.g. intra-community and export supplies) the deduction of input VAT is possible. Article 9 defines a taxable person as any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity. These provisions appear to be easily applied to public bodies as they may also engage in economic activities. However, like most VAT Sys-

⁷ Council Directive 2006/112/EC of 28 Nov. 2006 on the common system of VAT, (2006) OJ L347/1 recasting Sixth Council Directive 77/388/EEC of 12 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of VAT: uniform basis of assessment, (1977) OJ L145/01.

⁸ See R. De la Feria (2009) ‘The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction’, *Intertax* 37, on page 149.

tems in the world, the CVSD has special additional rules where activities of the public sector and activities in the public interest are involved.

Figure 2.1 Classification of activities for the purpose of VAT



Source:KPMG AG

The CVSD is not directly applicable in the Member States. It needs to be adopted by the national legislation of the Member States who are the addressees of the CVSD (Article 288 third paragraph Treaty on the Functioning of the European Union)⁹.

2.1.2 The VAT treatment of the public sector

The CVSD contains several stipulations especially designed for the public sector. According to Article 13 public bodies are not treated as taxable persons as regards certain activities. There are no special provisions for the third sector. Charity organisations might not qualify as taxable persons pursuant to the general rule laid down in Article 9 CVSD if they do not receive remuneration for their activities.

Insofar as public bodies and charity organisations are acting as taxable persons their activities might be tax-exempt according to Article 13² or one of the so-called stand still clauses in the 13th Title of the CVSD¹⁰. Furthermore taxable and non-exempt activities might be subject to reduced VAT rates (Articles 98 ff.) if a Member State elects to apply reduced VAT rates.

⁹ Although the CVSD might be directly applicable in cases where a Member States fails to adopt the CVSD timely or properly.

¹⁰ The CVSD provides more than these tax-exemptions, e.g. Article 135 CVSD. As these tax-exemption are not specially related to the public sector they are not discussed in detail.

2.1.3 Treatment of public bodies as taxable persons (Article 13)

Article 13(1) first paragraph states that states, regional and local government authorities and other bodies governed by public law shall not be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities. In other words, their activities are non-taxable, thus outside the scope of VAT.

However, Article 13(1) second paragraph states two exceptions from this basic rule.

- First, bodies governed by public law shall nevertheless be regarded as taxable persons in respect of those activities or transactions where their treatment as non-taxable persons would lead to significant distortions of competition (distortion clause).
- Second, they shall in any event be regarded as taxable persons in respect of the activities listed in Annex I¹¹, provided that those activities are not carried out on such a small scale as to be negligible (non-negligible clause).

Furthermore, according to Article 13(2) Member States may choose to treat certain tax-exempt activities engaged in by bodies governed by public law as activities in which those bodies engage as public authorities (exempt activities clause). As a consequence, the VAT status of the particular activity within its scope may change from “taxable but tax-exempt” to “non-taxable”.

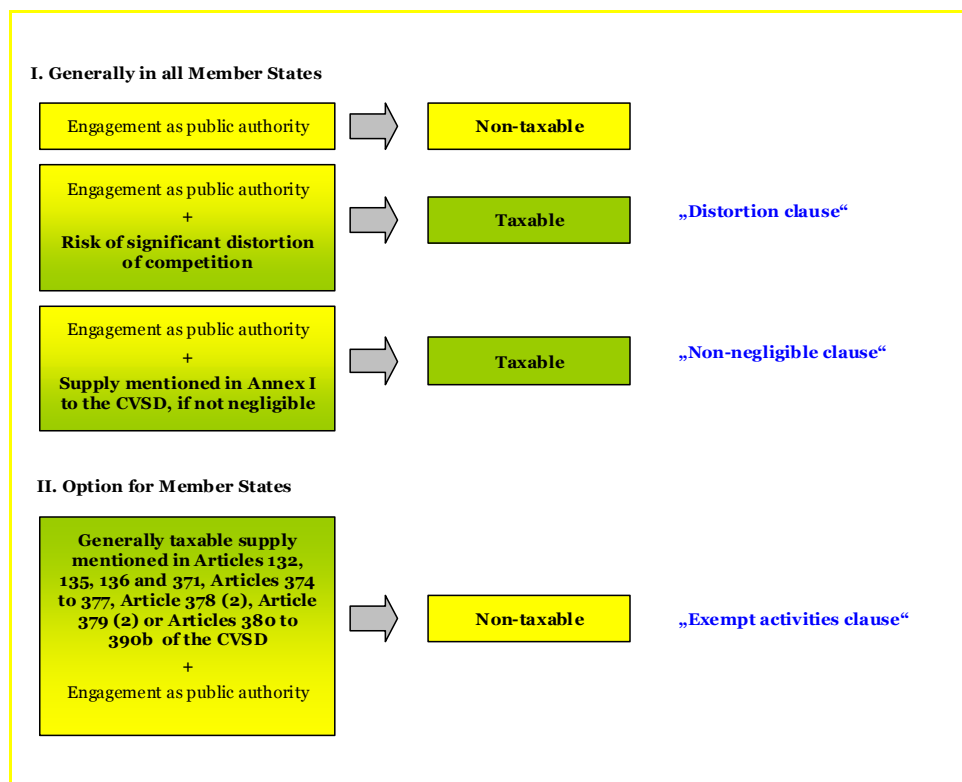
As a result of these provisions an economic activity will be non-taxable if the following criteria are met:

- Activity of a body governed by public law
- Public body is engaged in as public authority
- The distortion clause does not apply (i.e. treatment as non-taxable would not lead to significant distortions of competition)
- The non-negligible clause does not apply (i.e. either no activity listed in Annex I or only on a negligible scale)

Only if the treatment as non-taxable does not apply the exempt activity clause (Article 13 (2) CVSD) may become relevant changing the VAT status from exempt to non-taxable.

Figure 2.2 Possible treatment of supplies of public bodies

¹¹ Telecommunications services; supply of water, gas, electricity and thermal energy; transport of goods; port and airport services; passenger transport; supply of new goods manufactured for sale; transaction in respect of agricultural goods; organisation of trade fairs and exhibitions; warehousing; activities of commercial publicity bodies; activities of travel agents; running of staff shops, cooperatives and industrial canteens and similar institutions; activities carried out by radio and television bodies insofar as these are not exempt pursuant to Art. 132(1)(q).



Source: KPMG AG

The following paragraphs will discuss the provisions of the CVSD concerning the taxability of public bodies in more detail in order to provide a better understanding of the system.

Economic Activity

Economic activities are defined in Article 9 as comprising all activities of producers, traders and persons supplying services.

An analysis of those definitions, according to the ECJ, shows that the scope of the term 'economic activities' is very wide, and that the term is objective in character, in the sense that the activity is considered per se and without regard to its purpose or results¹². However, receipt of payment for an activity alone is not sufficient to qualify an activity as economic in nature¹³. A supply of services for consideration presupposes a direct link between the service provided and the consideration received¹⁴ without which the activity at issue is not considered an economic

¹² Case C-235/85, *Commission v. Netherlands*, (1987) ECR, 1471, at paragraph 8.

¹³ Cases C-408/06, *Götz*, (2007) ECR I-11295, at paragraph 21; C-284/04, *T-Mobile and Others*, (2007) ECR I-5189, at paragraph 45.

¹⁴ Case 102/86 *Apple and Pear* (1988) ECR 1443, paragraphs 11 and 12.

one. Recently, the ECJ, as regards public legal advice services, has clarified that the link must be primarily focused on the value of the services as well. If a consideration depends only in part on the actual value of the service provided and for the most part for example on the income situation of the recipient, it is not an economic activity¹⁵.

Bodies Governed by Public Law

It is not defined in the CVSD what, besides States, regional and local government authorities, shall be considered as a body governed by public law. However, according to the ECJ, a body governed by public law must be itself part of the public administration¹⁶. Therefore a private person, even if exercising the powers of a public authority, can never be a body governed by public law¹⁷. Furthermore, a private company does never fall within the scope of Article 13(1) even if its shares are being held 100 percent by a body governed by public law. It follows that the main purpose is to exclude all private law entities from the scope of Article 13.

The definition of the public administration is more or less left to the discretion of national legislation. This causes a different VAT treatment in Member States where public tasks are assigned to private entities to a large extent and Member States where this is not the case.

Acting under Public Authority

In *Carpareto Piacentino and Rivergaro*¹⁸ the ECJ ruled that acting under public authority requires the public body¹⁹ to act under the special legal regime applicable to it, whereas acting under the same legal conditions as those that apply to private traders excludes the public body from the scope of Article 13. The court has consistently reiterated that the main criterion for ‘acting as a public authority’ is the legal regime applicable to a public body under national law²⁰ leaving it to the national court’s discretion to determine the nature of the legal regime applicable to the activity at issue. Based on the traditional distinction between private and public law this criterion is particularly difficult to handle in common law Member States where a clear distinction between private and public law does not, at least with the same emphasis, exist²¹.

No Significant Distortion of Competition

The distortion clause is designed to avoid VAT induced unfair competition between public and private entities. Although acting under the special legal regime applicable, bodies governed

¹⁵ Case C-246/08 *Commission v. Finland*, (2009), Official Journal C 312 , 19/12/2009 Page 7, at paragraph 51.

¹⁶ Case C-260/98 *Commission v. Greece*, (2000) ECR, I-6537, at paragraph 40.

¹⁷ Case 235/85 *Commission v. Netherlands*, (1987) ECR, 1471, at paragraph 8.

¹⁸ Joint cases 231/87 and 129/88, *Carpareto Piacentino and Rivergaro*, (1989) ECR 3233, at paragraph 16.

¹⁹ As far as we use the term ‘public body’ it refers to a body governed by public law.

²⁰ See for example: Case C-4/89, *Commune di Carpaneto Piacentino and Others*, (1990) ECR I-1869, at paragraph 8; Case C-202/90, *Ayuntamiento de Sevilla*, (1991) ECR I-4247, at paragraph 18.

²¹ R. De la Feria (2009), ‘The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction’, *Intertax* 37 No 3, on page 149.

by public law may, under national law, engage in activities of an essentially economic nature that can also be carried on in parallel by private operators. As a consequence, competition between public bodies and private operators is possible. Given a competition with private operators, the rule of Article 13(1) first paragraph may lead to a distortion of this competition by treating the public body's services as non taxable whereas the private competitor would be obliged to charge VAT for his services. The distortion clause seeks to avoid this effect by treating both competitors in the same way for VAT purposes if otherwise significant distortions of competition are to be suspected. As the ECJ pointed out, the aim of the distortion clause is to ensure fiscal neutrality²².

However, the provisions of Article 13(1) second paragraph are particularly unclear leaving room for interpretation. The CVSD does not mention under which exact circumstances a competition between private and public entities is considered to exist and when a distortion is considered to be significant. Furthermore, it is up for interpretation whether a competition has to be actually already in existence or if the possibility of a future competition does suffice. The ECJ essentially clarified the scope of the distortion clause in its judgement *Isle of Wight and others*²³. The court held that the distortion of competition has to be evaluated by reference to the activity in question as such, without such evaluation relating to any local market in particular²⁴. The scope of the distortion clause includes not only actual competition, but also potential competition, provided that the possibility of a private operator entering the relevant market is real, and not purely hypothetical²⁵. The ECJ sees Article 13(1) first paragraph as an exemption to the basic rule of Article 9, concluding that Article 13(1) has to be interpreted narrowly. According to the ECJ, it follows that the distortion clause, restoring the general rule that any activity of an economic nature be subject to VAT, must not be interpreted narrowly. Therefore, a distortion of competition is considered to be significant if it is more than negligible²⁶.

No Annex I Activity unless carried out on negligible scale

The non negligible clause in Article 13(1) paragraph 3 pursues the same objective as the distortion clause. However, it uses a different approach consisting of two elements. First, the activity at issue must be one listed in Annex I. Furthermore, it must not be carried out on such a small scale as to be negligible. The idea behind it is that the listed activities (which were traditionally carried on by public bodies in many Member States in the 1970'es when the VAT law was harmonised) are presumed to lead to distortions of competition. If carried out only on a negligible scale, it can be assumed that the distortion of competition would also only be negligible²⁷.

²² Case C-430/04, *Halle*, (2006) ECR I-4999, at paragraph 24.

²³ Case C-288/07, *Isle of Wight and Others*, (2008) ECR I-7203.

²⁴ Case C-288/07, *Isle of Wight and Others*, (2008) ECR I-7203, at paragraph 53.

²⁵ Case C-288/07, *Isle of Wight and Others*, (2008) ECR I-7203, at paragraph 65.

²⁶ Case C-288/07, *Isle of Wight and Others*, (2008) ECR I-7203, at paragraph 79.

²⁷ Case C-288/07, *Isle of Wight and Others*, (2008) ECR I-7203, at paragraph 75.

Transposition of this second non-negligible-scale element however is optional²⁸. Thus, Member States are free to treat bodies governed by public law acting under the special legal regime applicable to them as a taxable person in respect of the activities listed in Annex I even if they are carried out only on a negligible scale. Unfortunately, the ECJ never ruled on the meaning of ‘such a small scale as to be negligible’ causing the criterion to be particularly difficult to handle. However, the ECJ used the term to construe the distortion clause in the Isle of Wight case.

Exempt Activities Clause

As highlighted above, under Article 13(1) a public body must engage in the activity as public authority, that is, under the certain legal regime applicable to it. Otherwise it does not fall within the scope of Article 13(1), resulting in taxable transactions. However, Article 13(2) allows Member States to still regard a public body as falling within the scope of Article 13(1) provided that the activity at issue is covered by one of the listed exemptions. Thus, Article 13(2) broadens the scope of Article 13(1) first paragraph, offering the possibility to change the VAT status of a transaction from taxable but tax-exempt to non-taxable. The ECJ ruled that the application of the exempt clause generally requires the Member State to make an express legal provision to that effect, rather than applying a mere administrative practice²⁹.

In practice, the qualification of an activity as non-taxable or taxable but tax-exempt may be important for a supplier’s right to opt for tax enabling him to deduct input VAT himself. In the case of *Salix*, for instance, a private company engaged in letting immovable property to a public body. Generally, the letting of immovable property shall be tax-exempt according to Article 135(1)(l). Member States are allowed to grant taxable persons a right of option for taxation as stated by Article 137(1)(d).

Another relevance of the distinction between non-taxable and taxable but tax-exempt supplies concerns the obligation to be registered for VAT purposes and to file VAT returns which generally only applies to taxable persons³⁰.

Examples

Example 1:

²⁸ Joint cases 231/87 and 129/88, *Carpareto Piacentino and Rivergaro*, (1989) ECR 3233, at paragraph 27; Case C-4/89, *Commune di Carpaneto Piacentino and Others*, at paragraph 14.

²⁹ Case C-102/08, *Salix*, (2009) ECR I 4629, at paragraph 58.

³⁰ However, public bodies might be obliged to file VAT returns as regards intra-community acquisitions and reverse-charge services.

A municipality is rendering waste disposal services to citizens. The legal relations are subject to public law. The citizens are bound to use this public offering. Private entities are not allowed to offer waste disposal services to citizens.

The activities of the municipality are non-taxable. The municipality is a public body which is acting as such. A distortion of competition is not possible as a private service offering is not allowed. Finally, waste disposal is not listed in Annex I.

Example 2:

A municipality is rendering public off-street parking. A private service offering would be legally possible but actually there is no private competitor in the local market. The activities of the municipality are taxable as there is a potential competition at hand.

Example 3:

A municipality with more than 1,000,000 inhabitants supplies gas to all citizens and companies within its area. A private competition is not allowed in the area of the municipality (state monopoly). The legal relations are subject to public law.

The activities of the municipality are taxable. The municipality is a public body acting as such and there is no distortion of competition at hand. However, the supply of gas is listed in Annex I and cannot be seen as non-negligible because of the size of the municipality.

Example 4:

A public body is letting immovable property to a taxable person based on a civil law agreement. The Member State in question has elected to treat taxable but tax-exempt activities as non-taxable in its national VAT Act.

The activities of the public body are non-taxable. The conditions of Article 13 are not met because the public body is acting on a civil law basis and there is a distortion of competition possible as other persons might as well offer immovable property to let. However, the letting of immovable property is subject to a tax-exemption (Article 135(1)(l) CVSD). Thus it can be treated as non-taxable pursuant to Article 13(2) CVSD.

Effects

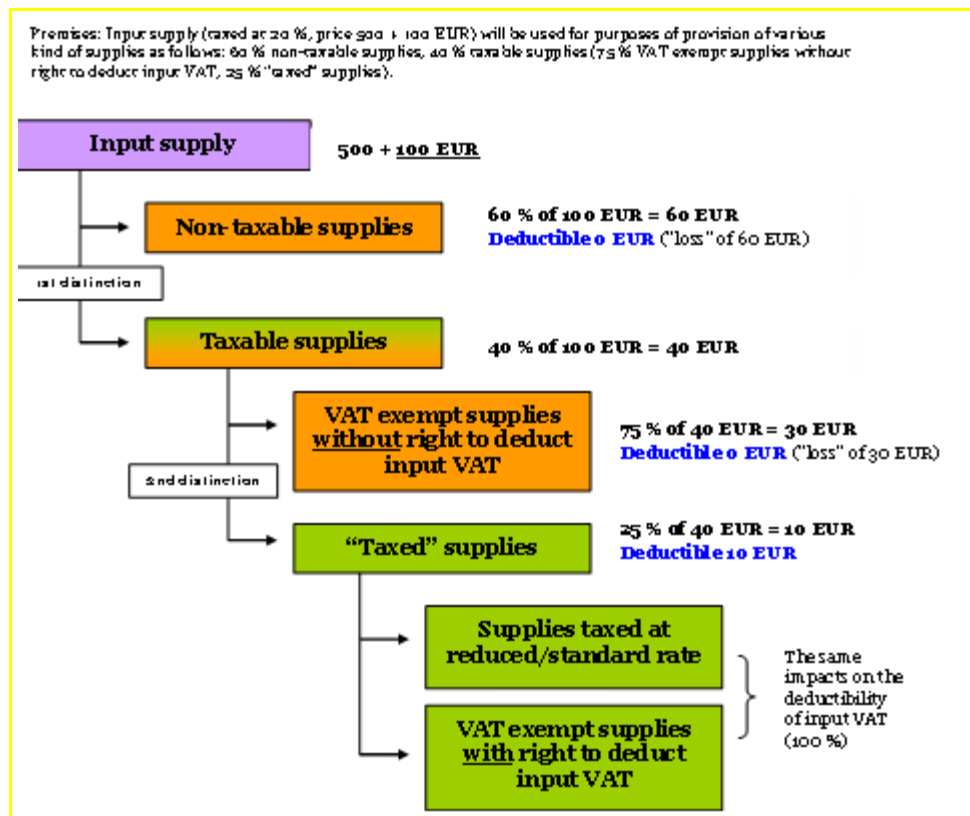
Where Article 13 leads to non-taxability, the public body will not be entitled to deduct the input VAT according to Article 168. In other words the public body is as regards the VAT system de facto treated as a final consumer who has to bear the VAT burden on his inputs.

It is obvious that Article 13 is a very complex provision which leaves room for interpretations concerning the question whether a distortion is “significant” or an Annex I activity is “non-negligible”. Another complexity arises from the fact that Article 13 highly depends on specific national law even though the ECJ tries to avoid this by a formal interpretation of “public body” and “acting under public authority”. Furthermore the combination of the distortion clause and the non-negligible clause does not lead to consistent results. The possibility to treat taxable but tax-exempt supplies as non-taxable is also not consistent. Finally, it is worth pointing out that the complexity leads to compliance costs for public bodies. On the other hand, private competitors are highly dependent on clear and consistent provisions to check whether they can claim an equal taxation of competing public bodies (i.e. like in the Halle case).

It is noteworthy that public bodies will often engage in taxable activities as well as in non-taxable activities. In practice, public bodies being completely outside the scope of VAT are actually uncommon. Consequently, they will only be able to deduct a part of their input VAT. The calculation of the deductible VAT is often problematic and has been subject of considerable case law³¹. Additionally it may be very complicated for public bodies to calculate the partial input VAT if they are subject to simplified accounting standards or methods which are not comparable with the EU Accounting Directives or the IFRS.

Figure 2.3 Assessment of the deductible and non-deductible part of input VAT

³¹ See for example cases C 98/98, *Midland Bank*, (2000) ECR I-4177; C-515/07, *VNLTO* (2009); C-437/06 *Securita* (2008) ECR I-1597.



Source: KPMG AG

The mechanism of Article 13(1) paragraph 2 and 3 is – theoretically – capable to avoid unfair competition caused by treating public transactions in the same way as those of private competitors, as long as otherwise a distortion of competition is to be feared. However, the success of this approach highly depends on the proper transposition and application by the Member States.

It is interesting to note that, although the distortion clause at first glance appears to be foremost concerned with the protection of the private sector, the ECJ has recently ruled in *Salix*³², that a distortion not to a private person's but to a public body's detriment may as well fall within the scope of the open clause.

A weakness of the distortion clause becomes evident as regards national market regulations. Since Member States may pass national market regulations stating that certain transactions may exclusively be provided by public bodies, this broadens the scope of the distortion clause:

³² Case C-102/08, *Salix*, (2009) ECR I 4629.

Where legally forbidden, there is no potential private competition. As a side effect Member States may influence VAT treatment of their public bodies according to Article 13 through adjustments of their national market regulations. As a result the same transaction by a public body in one Member State might be taxable because of the distortion clause, yet at the same time in another Member State be non-taxable because private competition is legally impossible. National market regulations, however, have to comply with the market freedoms laid down in Articles 45 to 66 of the Treaty on the Functioning of the European Union. It has to be noted that this effect is only possible if – at the same time – a Member State stipulates that only a public service offering is allowed and the citizens are forced to use this public service offering (full state monopoly)³³. In cases where there is only a public service offering allowed but the citizens can also use service offerings from other Member States, a competition situation may arise.

Furthermore, it must be pointed out that Article 13(1) paragraph 2 and paragraph 3 are primarily focused on possible distortions of competition caused by the VAT treatment of the output of a public body. As a consequence they do not have any effect on the problems related to the VAT treatment of a public body's *input*. This concerns the inability of a public body to deduct VAT on its input, as long as its output is considered to be non-taxable. The main input related distortions identified by the Commission and literature are:

- Self supply bias and disincentive to investment
- Cascade effect

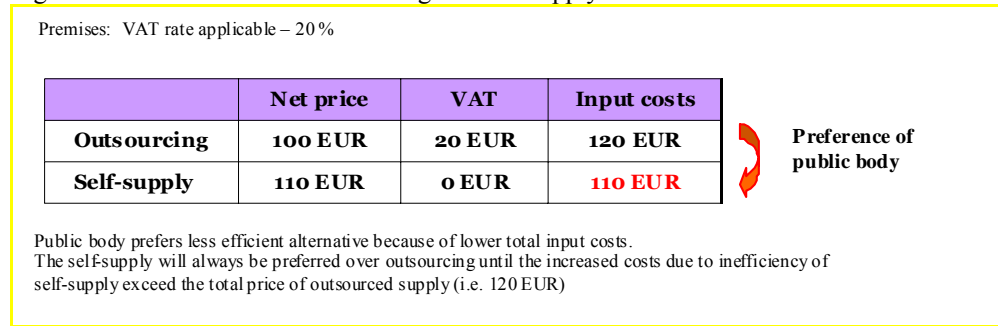
Self supply bias and disincentive to investment

The inability to deduct input VAT causes extra costs when a non-taxable public body considers investments or a contracting out of services to the private sector. They may however avoid this extra cost by choosing to self supply. It follows that the current VAT situation encourages self supplies even if alternatives such as contracting out or public private partnerships would be more efficient³⁴; the higher the Member State's VAT rate, the stronger the effect. This is illustrated in the figure below.

³³ Case C-408/06, *Götz*, (2007) ECR I-11295, at paragraph 21.

³⁴ See Dijkgraaf & R.H.J.M. Gradus (2003), 'Cost Savings of Contracting Out Refuse Collection', *Empirica*: 149-161; K. Mause (2009), 'Contracting Out the State in the OECD World: What Do We (Not) Know?', Paper prepared for FoJus-Panel, DVPW-Kongress 2009 Kiel, URL: <https://www.dvpw.de/fileadmin/docs/Kongress2009/Paperroom/2009FoJus-pMause.pdf> (last checked: 11 January 2011) at chapter 4.2, who points out that, based on the existing empirical data, the question whether contracting out or public private partnerships are more efficient than self supply and public production, cannot be answered in general, making it necessary to decide on a case-by-case basis; also see G. Bel & X. Fageda (2009), 'Factors explaining local privatization: a meta-regression analysis', *Public Choice*: 139: 105-119; M. C. Wassenaar & R. H. J. M. Gradus (2004), 'Contracting out: The Importance of a Solution for the VAT Distortion', *CESifo Economic Studies* 2: 377-396, on page 380.

Figure 2.4 Choice between outsourcing and self supply



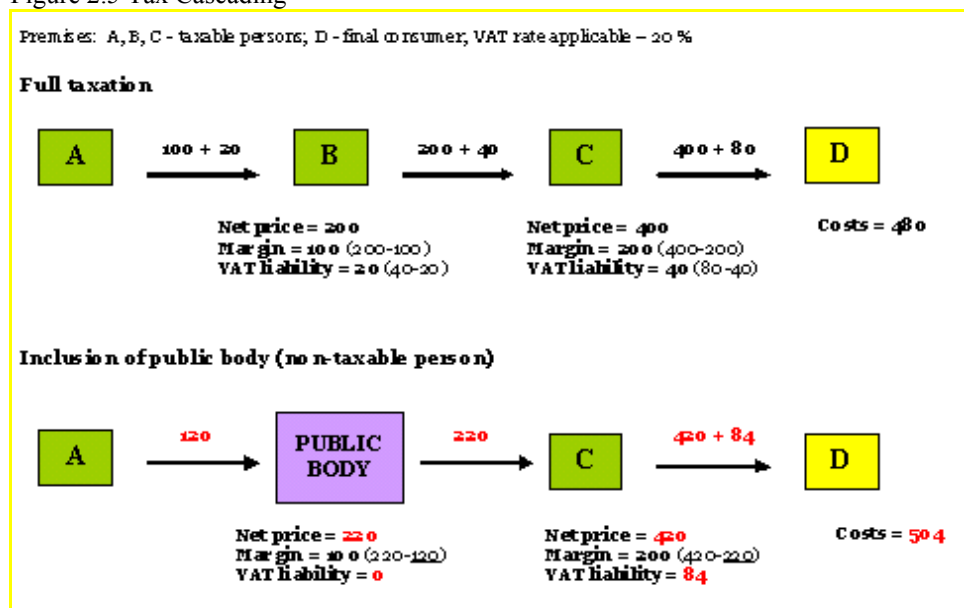
Source: KPMG AG

Cascade effect

This effect describes the situation that the service of a non-taxable public body is an intermediate step in the production. The public body may pass on the extra cost of non-deductable input VAT to a private operator who, because of the hidden character of the forwarded VAT, will also be unable to deduct and pass on his extra costs himself to his customer. It is important to note that these effects are not specifically related to the treatment of public bodies as non-taxable (Article 13), but apply equally in relation to public and private bodies benefiting from tax-exemptions such as Article 132 and Article 135³⁵. This is illustrated in the figure below.

³⁵ As regards parts of Article 135, Member States are free to introduce regulations according to which taxable persons could waive the tax-exemption (Article 137).

Figure 2.5 Tax Cascading



Source: KPMG AG

2.1.4 Treatment of public sector activities as tax-exempt (i.e. Article 132)

Even if a public body is considered as taxable person, it may not in fact be obliged to pay VAT if its activities fall under one of the tax-exemptions provided for in the CVSD.

Article 132 rather unsystematically lists exemptions for certain activities in the public interest covering a wide area. Some of these exemptions are related to the identity of the supplier, others relate to the qualification of the activity at issue. Concerning the identity of the supplier, some of the exemptions require explicitly a public body³⁶, whereas others refer to organisations with a formal recognition by the Member State. Hospital care, for example, falls within the scope of the Exemption in Article 132(1)(b) when it is either provided by a public body or under comparable social conditions by duly recognised establishments.

Additionally, the 13th title of the CVSD provides for several stand still clauses which are mainly the result of negotiations between old and new Member States. These exemptions are not matching with the general VAT system as laid down in the CVSD. Parts of these exemptions

³⁶ In particular, the supply by the public postal services (Art. 132(1)(a)); hospital and medical care and closely related activities (Art. 132(1)(b)); the supply of services and of goods closely linked to welfare and social security work, (Art. 132(1)(g)); the supply of services and goods closely linked to the protection of children and young persons (Art. 132(1)(h)); children's or young people's education, school or university education, vocational training or retraining, (Art. 132(1)(i)); certain cultural services and goods closely linked thereto (Art. 132(1)(n)); the activities of public radio and television bodies other than those of commercial nature (Art. 132(1)(q)).

are relevant for public bodies. As the exemptions are very individual they will be discussed in the section about the adoption of the CVSD in the Member States.

In its case-law the ECJ developed in particular three principles, which it applies for the interpretation of exemptions in the public interest. First, since exemptions constitute an exception to the general principle of taxation of all services supplied for consideration by a taxable person, they are to be strictly interpreted³⁷. Regarding this principle, it is important to realize that it may conflict with other principles such as the neutrality and uniformity of the VAT system, which may require an exemption to be interpreted widely in order to avoid unequal treatment of similar goods³⁸. Second, according to the ECJ, exemptions constitute independent concepts of Community law which must be placed in the general context of the common system of VAT introduced by the Sixth Directive³⁹. Therefore the interpretation of exemptions must, despite the context and the purpose of the rules of which they form part, also take into consideration the intention of the legislator at the time when the rules were introduced⁴⁰.

Article 133 allows Member States to impose one or more additional conditions for a group of exemptions. This discretionary power however results in considerable differences among the Member States, as regards the application of these exemptions.

Furthermore, Article 134 includes another compulsory restriction to certain exempt activities such as hospital and medical care, and social welfare services stating that a supply shall not be exempt if it is not essential to the exempted transactions or basically serves the purpose of obtaining additional income through transactions in direct competition with those of commercial enterprises subject to VAT.

As regards the deduction of input VAT, the same effect as for non-taxable activities is also true for exempt activities. A taxable person engaging only in tax-exempt activities according to Article 132 may not deduct any input VAT and is thus de facto treated as final consumer (Article 168). Given tax-exempt and non-exempt activities at the same time, the proportion of deductible input VAT will have to be calculated according to Articles 173 to 175.

³⁷ Case C-453/93, *W. Bulthuis-Grillioen*, (1995) ECR I-2341, at paragraph 19.

³⁸ See, for example Case C-106/05, *L.u.P.* (2006) ECR I-5123, regarding the interpretation of the exemption applicable to medical services (Art. 132(1)(b) CVSD).

³⁹ C-141/00, *Kügler*, (2002) ECR I-6833, on the interpretation of the exemptions applicable to medical services and that applicable to welfare and social work (Art. 132(1)(b) and (g) CVSD).

⁴⁰ Case C-372/88 *Cricket St. Thomas* (1990) ECR I-1345, paragraph 19, Case C-2/95 *SDC* (1997) ECR I-3017, at paragraph 22, and Case C-384/98 D (2000) ECR I-6795, at paragraph 16; Case C-169/04 *Abbey National*, Opinion of general advocate, delivered on 8 September 2005, paragraph 58; see also European Commission (2006) 'Consultation Paper on Modernising Value Added Tax Obligations for Financial Services and Insurances', on page 10.

Like Article 13 the provisions leave much room for interpretations. Article 132 also highly depends on specific national law as the Member States have the freedom to recognise private entities as tax-exempt and to elect additional criteria for the tax-exemption like in Article 133. Things are complicated further because the Member States have different concepts for the recognition of charity organisations (which often depend on not harmonised national income tax law). Thus, it could happen that a charity organisation which operates in different Member States cannot be sure that its activities are treated as tax-exempt in all of the Member States. The same uncertainties happen concerning private entities that are profit-oriented.

As regards the tax-exemptions in the public interest, the self supply bias and disincentive to invest (cf. above) appear again. These effects are combined with a disincentive for the third sector to organise charitable activities.

Art. 132 (1) f CVSD

It should be noted that the currently existing Art. 132 (1) f CVSD⁴⁴ offers a partial solution for VAT induced disadvantages to outsourcing. However, the effect is limited.

Art. 132 (1) f CVSD stipulates an exempt supply of services within a so-called cost sharing group of persons. The provision exempts the supply of services by independent groups of persons, who are carrying on an activity which is exempt from VAT or in relation to which they are not taxable persons, for the purpose of rendering their members the services directly necessary for the exercise of that activity, where those groups merely claim from their members exact reimbursement of their share of the joint expenses, provided that such exemption is not likely to cause distortion of competition. As a consequence, the supply of services from the cost sharing group to its members does not involve non-deductable input VAT.

However, the scope of Art. 132 (1) f CVSD is quite limited since only the supply of services by the cost sharing group to its members is exempt. For example, a private company which offers support services for a public body does not benefit from the exemption. An additional problem of Art. 132 (1) f CVSD is the fact that, alike Art. 13 CVSD, it uses a terminology which makes a difficult interpretation necessary. The various possible interpretations as regards the likelihood of a distortion of competition for example lead to considerable legal uncertainties.

Furthermore, the initial costs incurred by the cost sharing group would nevertheless still include non-deductable VAT leaving the problem of hidden VAT unsolved. Therefore, even if Art. 132 (1) f CVSD is applicable, a disadvantage for outsourcing of services would remain. As a consequence, Art. 132 (1) f CVSD cannot be regarded as a sufficient solution to the problems of the VAT treatment of the public sector.

⁴⁴ This exemption has been discussed in the recent ECJ case C-407/07 *Stichting* (2008) ECR I-9615.

If for example a cost sharing group consisting of several VAT exempt medical practices acquires an MRI machine for 1 million Euros net price plus 200.000 Euros VAT the supply of services from the cost sharing group to its members as regards using the MRI machine would be exempt according to Art. 132 (1) f CVSD. The exemption would include consideration for the personnel necessary to operate the machine. However, the initial VAT on the acquisition of the machine by the cost sharing group would be non-deductable since the group only engages in exempt supplies. As a consequence, this VAT burden would be forwarded as a hidden cost element of the price charged by the cost sharing group to its members.

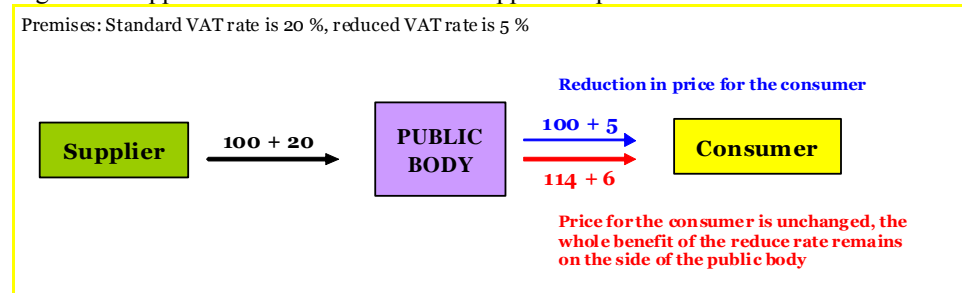
It becomes evident that only insofar as the supply of services of the cost sharing group does not involve incurred input VAT the self supply bias, disincentive to outsourcing and the cascade effect are effectively neutralised.

2.1.5 Reduced tax rates

Article 98 of the CVSD allows Member States to introduce one or two reduced tax rates which should generally only be applied to the services listed in Annex III. As stated by Article 99(2), the minimum rate is generally 5%.

However, as an exception to this rule, Member States which, at 1 January 1991, were applying reduced rates lower than this may according to Article 110(1) continue to grant those exemptions as long as they have been adopted for clearly defined social reasons and for the benefit of the final consumer. As a result, some Member States have so called “zero rates”. As opposed to ordinary exemptions which involve the loss of input deduction, zero rates have the effect of relieving the taxable person from the obligation to pay and charge VAT while at the same time allowing the deduction of input VAT.

Figure 2.6 Application of reduced rates on supplies of public bodies



Source: KPMG AG

For both non-taxable, tax-exempt activities and for the application of reduced tax rates, the situation is further complicated by the rule that ancillary supplies generally share the same regime applicable to the principal supply, for it is particularly hard to determine which supplies are actually ancillary⁴².

2.1.6 Subsidies

Public bodies (as well as charity organisations) often rely on subsidies for their supplies. Article 73 states that the taxable amount shall generally include those subsidies that are directly linked to a supply. As regards subsidies paid to private entities held by public bodies or to charity organisations it is often unclear whether these subsidies are to be understood as remuneration and therefore are liable to VAT. This would be the case if the receiving entity is rendering a service and the subsidy is a direct-linked remuneration.

On the other hand, a subsidy not directly linked to a supply does not necessarily decrease the amount of deductible input VAT. Only for apportionment of input tax situations Article 174 (1) second paragraph allows the Member States to include in the denominator the amount of subsidies, other than those directly linked to the price of supplies.

In practice, the question whether a subsidy is directly linked to a supply is particularly difficult to answer often causing disputes with the tax authorities about the actual nature of the payment⁴³.

2.2. ADOPTION IN THE MEMBER STATES

2.2.1 General problems concerning the adoption

As highlighted above, the provisions of the CVSD concerning the treatment of public sector bodies and exemptions in the public interest leave room for interpretation. It is therefore not surprising that Member States have a different understanding for instance of terms like ‘bodies governed by public law’ and ‘acting as public authority’, resulting in different transpositions among the Member States which in many cases prove to be contrary to the notion that the ECJ has developed in its judgements. The general consequence of a conflict between national regulations and the provisions of the CVSD is that administrative authorities, including municipal authorities, are under the same obligation as a national court to directly apply the provisions of the CVSD and to refrain from applying provisions of national law which are inconsistent⁴⁴. Pro-

⁴² The ECJ case C-434/05 *Horizon College* (2004), ECR I-11237 is a good example for the complexity of the regulatory concept of Article 132.

⁴³ C. Amand (2006), ‘VAT for Public Entities and Charities – Should the Sixth Directive be Renegotiated?’, *International VAT Monitor*: 433-443, at 436.

⁴⁴ Case C-103/88, *Fratelli Costanzo*, (1989), ECR 1839, at paragraph 33.

vided that the CVSD's provisions are unconditional and sufficiently precise, they may be relied upon by an individual against the Member State⁴⁵. However, there the individual may as well choose not to rely upon European Law, which will be advisable when he benefits from the inconsistency.

As Amand pointed out, the uncertain aspects concerning possible inconsistencies with European Law encourage arrangements with the local tax authorities for the individual cases that are normally confidential⁴⁶. On the one hand, these individual solutions require considerable resources as regards necessary legal advice. On the other hand, usually neither part of such an arrangement will actually challenge the national regulation, with the result that the inconsistencies remain.

Furthermore, the discretionary powers, as regards the transposition of certain provisions such as the optional exempt activities clause in Article 13 (2), counteract the aim of harmonising the Member State's VAT regimes. This effect is reinforced by the various exceptions from the provisions applicable only to some of the Member States, such as the possibility to introduce reduced VAT rates lower than 5 percent.

As it has been noted above, regulations outside the scope of VAT which are not subject of the harmonisation process may also affect the application of VAT law such as national market regulations. Another example are VAT compensation schemes outside the VAT law, which have been introduced by some Member States in order to compensate non-taxable or tax-exempt parts of the public sector for their inability to deduct input tax. These compensation mechanisms will be discussed in more detail below.

2.2.2 Member State VAT treatment

In order to gather reliable information about the VAT treatment of the public sector in the different Member States KPMG has contacted its specialists in the Member States within its Global Indirect Tax network. For this process KPMG has used a questionnaire specially designed for this purpose which has been answered by each KPMG member firm in the Member States. In coordination with the Commission, sector related questions have been limited to the seven sectors of waste disposal, hospital services, cultural services, education, sport, broadcasting and homes for the elderly. In order to provide a clear structure, the information on the Member State VAT treatment is presented at three different levels of detail. The following written remarks aim to point out noticeable highlights as regards common grounds and differences among the Member States. For this purpose the level of detail is limited in favour of clar-

⁴⁵ Case C-8/81, *Becker*, (1982), ECR 53, at paragraph 25.

⁴⁶ C. Amand (2006), 'VAT for Public Entities and Charities - Should the Sixth Directive be Renegotiated?', *International VAT Monitor*: 433-443, 440.

ity. A considerably higher level of detail is included in overview tables attached to our comments. These tables are designed to help compare the situation of the different Member States, as regards the general regulations concerning the VAT treatment of public bodies and the treatment of the different sectors. The highest level of information can be found in the answered questionnaires which are attached to this report.

General VAT treatment of the public sector

The information gathering process has confirmed that the national VAT legislations in the EU show a large variety regarding the public sector. It can be pointed out that there are, in principle, two tendencies present among the Member States. First, some Member States have adopted their national statute law very closely to the provisions of the CVSD. This concerns in particular Member States which had to make considerable adjustments of their VAT taxation system when joining the EU. However, a close legal adoption is not in every case accompanied by a correct application of the law in line with the jurisdiction of the ECJ. In Estonia for example many activities by public bodies are regarded as non-taxable by the tax authorities despite possible private competition. Second, many Member States have the tendency to hold on to their traditional regulation technique, which is often quite different from the approach of the CVSD (e.g. the adoption of Art. 13 CVSD in Austria and Germany). These Member States, however, in many cases come to the same legal result as the CVSD by interpretation of the national law in accordance with the European provisions. This concerns particularly older Member States and those who did not have to considerably adjust their VAT taxation system in order to join the EU.

In general it could be confirmed that the VAT treatment of the public sector is highly dependent on the understanding of the terms “public body” and “public law” in each Member State. In this respect naturally the different legal systems in the EU are accompanied by different perspectives of the public sector and its objectives. This fact can be regarded as a limiting factor for the harmonisation of the VAT treatment of the public sector. The terms “public body” and “public law” depend on the context of the respective Member State’s legal system and can hardly be defined in an isolated and different way for VAT purposes. In this regard, a perfect harmonisation of the VAT treatment of the public sector will hardly ever be possible because of the diversity of the Member State’s legal systems.

The following remarks follow the same order as the attached questionnaires, to which the reader may refer for detailed information on each Member State.

Adoption of Article 13 (1) CVSD

The Member States have adopted the first section of Article 13 CVSD in a variety of different approaches. Some countries, such as Slovenia and Greece, introduced a regulation with almost

the same wording as the CVSD, whereas the United Kingdom and Sweden, for example, have not at all explicitly adopted the provisions of Art. 13 CVSD in the form of statute law but nevertheless apply basic principles of the provisions by interpretation of the existing law. Following a completely different approach, in Austria and Germany the VAT treatment of public bodies depends on a reference to the national Corporate Income Tax Act. Although this structure can hardly be regarded as a proper adoption, the German and Austrian jurisdictions, in practice, in most cases interpret the law in accordance with the provisions of the CVSD, leading to the same result. Yet another unique approach is present in the Hungarian VAT law, according to which a public body's activity can only be regarded as non-taxable if the damages caused by the public body during its public activity fall under the special damage compensation rules of the Hungarian Civil Code. Some Member States such as Poland have a regulation which leads to non-taxability for the activities of certain public bodies but did not adopt the distortion of competitions clause. In the case of Poland there is also a special exemption covering the activities of certain public bodies which are not already treated as non-taxable.

Definitions of public bodies

Only few Member States (e.g. Malta) have in fact a specific definition of the term "public bodies" in their national VAT law. Many countries use the definition provided by regulations outside the national VAT Act. In Estonia and Lithuania, for example, a definition of the term "public body" is provided by the national Civil Law Code, whereas Latvia defines public bodies in reference to a regulation in the Law on Budget and Financial Management. However, in many cases there is a national regulation expressly listing certain entities which are considered to be public bodies as regards the adoption of Article 13 CVSD (e.g. Poland, Finland and the Czech Republic). In Member States where the law does not provide a definition of public bodies the understanding of the term is usually forged by administrative guidelines and jurisdiction (e.g. the UK). However, some entities including municipalities and the State are considered to be public bodies in all Member States. Most Member States understand the term "public body" as limited to special public legal entities. However, in some Member States (e.g. Poland, Lithuania) private legal entities can be regarded as public bodies as well under certain conditions, for example if they are controlled and owned by the State.

Existence of a special public law

Most Member States distinguish between public and private law as for instance Austria, France, Greece and Slovenia. Many countries such as the Netherlands, Romania and Lithuania, do not have a general public law applicable to all public bodies but many several Acts for different public bodies which regulate the relationships between the public body and the citizens. Some Member States, however, do not have a comparable concept of public law and civil law, this concerns particularly the common law based legal systems of the UK and Ireland.

Adoption of Article 13 (2) CVSD

The information gathering process has shown, that except for Spain and Italy there is no Member State which elected to introduce the provisions of Article 13 (2) CVSD into national VAT law. However, in Estonia for example, despite the absence of an adoption, tax authorities in many cases regard a public body as non-taxable if it only renders exempt services.

Adoption of Article 132 CVSD

It can be pointed out that the provisions of Article 132 CVSD have rarely been completely adopted among the Member States. However, Cyprus and Romania for example have introduced the complete wording of Article 132 (1) CVSD into their national VAT legislation. Sometimes the adoption of a certain exemption is regarded as superfluous, since other exemptions are interpreted widely. In Hungary for example, the transport of sick people is regarded to be included in the exemption for medical services.

Although in many cases countries have not adopted some of the exemptions, in some cases Member States even introduced wider exemptions than allowed. Finland and Sweden for instance have a general exemption for services of certain non-profit organisations which is considerably larger in scope than the provisions of the CVSD.

Additional conditions according to Art. 133 CVSD

The additional conditions allowed in Article 133 CVSD are often adopted in connection with exemptions for non-profit organisations. In Austria, for example, several exemptions refer to acknowledged charity organisations. In order to be acknowledged as charity organisation their activities must not be to obtain profits and the exemption must not lead to a distortion of competition. However, many Member States have not adopted any of the additional conditions of Article 133 CVSD (e.g. Bulgaria, Cyprus, Estonia, Finland and Sweden).

Relevant use of Articles 371, 374 and other stand still clauses

As mentioned above, the various exemptions allowing a derogation from the CVSD for specific Member States counteract an effective harmonisation. However, it can be pointed out that only few of these special exemptions are relevant to the public sector, since they concern exemptions which equally apply to public bodies and private entities. Sometimes even Member States outside the scope of the stand still clauses exempt the mentioned services. In Austria, for instance, even though Article 371 CVSD is not applicable there are exemptions for services by blind persons and services related to aircraft vessels used by public bodies. Although the number of allowed derogations from the CVSD for specific Member States is high, not all stand still clauses are actually used and cannot be reintroduced. Finland for example could according to Article 379(2) CVSD and Annex X, Part B, section 10 exempt the transport of passengers including the transport of goods accompanying them. However, Finland has not yet applied this

option. Worth mentioning is also the treatment of water supplies in France. As long as a municipality has fewer than 3,000 inhabitants the supply of water in France is treated as non-taxable. Although the stand still clause of Article 371 CVSD in connection with Annex X Part B section 8 only allows an exemption for the supply of water by a body governed by public law, in France citation of this provision is considered to justify the treatment as non-taxable.

Reduced rates in the public sector

Most countries do not have any reduced rates which are specifically relevant for the public bodies since the reduced rates only relate to the activity and apply to both public and private entities. However, Austria for example has a reduced rate of 10% for services rendered by charities. As an example for a reduced rate relevant for the public sector may be regarded the French super-reduced rate of 2.1% for the audiovisual fees collected in favour of the public service television and radio broadcasting system, which is applicable since France has not adopted the exemption for public broadcasting services according to Article 132(1) q CVSD.

Treatment of subsidies

Most countries treat price subsidies as taxable base in accordance with the Article 73 CVSD. Only few Member States have in accordance with Article 174(1) CVSD elected to take subsidies other than those directly linked to the price into consideration when calculating the pro rata proportion (e.g. Portugal, Slovenia and Hungary).

2.2.3 VAT-Treatment of the different sectors

For a comparison of the Member State VAT treatment as regards the different sectors please refer to the attached tables (pages). We comment on the results in the following. These comments include a description of the sector, the VAT treatment according to the CVSD and certain derogations in the Member States. We do not comment on all derogations. Derogation does not necessarily mean a breach of EU law because often special situations occur.

Waste disposal

Waste disposal is assigned to public bodies in nearly all Member States, which means that the Member States have to provide a public service offering (except Estonia where a public offer is possible). In fifteen Member States it is mandatory to use this public offer, i.e. regarding household waste. Generally, the service offer is subject to public law. It has to be noted that Bulgaria, Malta and Romania have very special public law stipulations about waste disposal.

From a CVSD perspective waste disposal may qualify for Art. 13 CVSD, i.e. it is not mentioned in Annex I. However, the Member States seem to have different interpretations whether waste disposal is a service which is rendered “under public authority”. There is neither a tax-

exemption according to Art. 132 CVSD nor an exemption according to a stand still clause. It is possible for the Member States to apply a reduced tax rate (Annex III no. 18).

It is interesting to note that Austria, Slovenia and Sweden are treating their public service offerings as taxable although they might have qualified as non-taxable. Obviously these countries assume that the public bodies are not acting under public authority. Austria and Slovenia apply a reduced tax rate instead. In Portugal the taxable public service offering seems to be tax-exempt. Besides this there are no reportable findings.

In the Member States where public and private providers are taxed equally there are no special VAT problems. As all activities are taxed and input VAT is granted, there are no distortions or other negative effects at hand. Where the public sector is treated as non-taxable, this is justified by a lack of competition due to state monopolies. However, in these countries the missing input VAT deduction causes problems (self supply bias, disincentive to invest, tax cascading).

Table 2.1 Waste disposal

Sector	Waste disposal											
Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Austria	Assigned		Yes	Sub-contractor	Public law	Taxable	Taxable	Non-Exempt(*)	Non-Exempt(*)		No	Lawful - not aware of challenges
Belgium	Assigned		Partially	Sub-contractor and Authorised person	Public law and Civil law(*)	Taxable and Non-Taxable(*)	Taxable	Non-Exempt	Non-Exempt	No	No	Lawful - not aware of challenges
Bulgaria	Assigned(*)		No(*)		Public law	Non-Taxable	Taxable		Non-Exempt(*)	No	No	Lawful - not aware of challenges
Cyprus	Assigned(*)		Yes and Partially(*)	Sub-contractor	Public law	Non-Taxable	Taxable		Non-Exempt(*)	No	No	Lawful - not aware of challenges
Czech Republic	Assigned		No		Public law	Non-Taxable	Taxable		Non-Exempt	No	No	Lawful - not aware of challenges
Denmark	Assigned(*)		Partially	Sub-contractor(*)	Public law	Taxable	Taxable(*)	Non-Exempt	Non-Exempt(*)		No	Lawful - not aware of challenges
Estonia	Not Assigned	Open for public bodies	No		Public law	Non-Taxable	Taxable		Non-Exempt	No	No	Lawful - not aware of challenges
Finland	Assigned		Partially(*)	Sub-contractor	Public law	Taxable(*)	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
France	Assigned		No		Public law and Civil law(*)	Taxable and Non-Taxable(*)	Taxable	Non-Exempt(*)	Non-Exempt	No	No	Possible derogation from CVSD
Germany	Assigned		Partially(*)	Sub-contractor(*)	Public law(*)	Non-Taxable(*)	Taxable	Non-Exempt	Non-Exempt	No	No	Challenge by private subcontractors
Greece	Assigned		Yes	Sub-contractor	Public law	Non-Taxable				No	No	Lawful - not aware of challenges
Hungary	Assigned		No		Public law	Taxable	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Ireland	Assigned		Partially(*)	Sub-contractor and Authorised Person	N/A(*)	Taxable(*)	Taxable	Non-Exempt	Non-Exempt	No	No	Lawful - not aware of challenges

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Italy	Assigned		Yes(*)	Sub-contractor and Authorised person	Public law	Non-Taxable(*)	Taxable		Non-Exempt	No	No	Lawful - not aware of challenges
Latvia	Assigned		No		Public law	Taxable	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Lithuania	Assigned		Yes(*)	Sub-contractor	Public law	Taxable and Non-Taxable(*)	Taxable		Non-Exempt(*)	No	No	Lawful - not aware of challenges
Malta	Not Assigned(*)	Open for public bodies	Yes(*)		Public law	Taxable and Non-Taxable(*)	Taxable	Non-Exempt(*)	Non-Exempt	No(*)	No	Lawful - not aware of challenges
Netherlands	Assigned(*)	Open for public bodies(*)	Partially(*)	Sub-contractor	Public law(*)	Non-Taxable(*)	Taxable	Non-Exempt(*)	Non-Exempt	Yes(*)	No	Lawful - not aware of challenges
Poland	Assigned		No		Civil law(*)	Taxable and Non-Taxable(*)	Taxable	Non-Exempt	Non-Exempt	No	No	Lawful - not aware of challenges
Portugal	Assigned		No		Public law(*)	Taxable(*)	Taxable	Tax-Exempt	Non-Exempt	No	No	Lawful - not aware of challenges
Romania	Not Assigned(*)	Open for public bodies(*)	No(*)		Public law		Taxable		Non-Exempt		No	Lawful - not aware of challenges
Slovak Republic	Assigned		No		Civil law	Taxable(*)	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Slovenia	Assigned		Yes	Sub-contractor	Public law	Taxable	Taxable	Non-Exempt(*)	Non-Exempt(*)		N/A	Lawful - not aware of challenges
Spain	Assigned		Partially(*)	Sub-contractor and Authorised person	Public law	Non-Taxable	N/A		N/A	No	No	Lawful - not aware of challenges
Sweden	Assigned		Yes	Sub-contractor	Public law	Taxable	Taxable(*)	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
UK	Assigned		Partially(*)	Sub-contractor	N/A(*)	Taxable and Non-Taxable(*)	Taxable	Non-Exempt	Non-Exempt	Yes(*)	No	Lawful - not aware of challenges

* for additional comments please see the questionnaire of the respective country

Cultural services

Cultural services are assigned to public bodies in nearly all Member States – except France, Hungary and the Netherlands where public bodies may have a service offering. Generally this sector is open for private service offerings. Only Greece seems to know some limitations. There is no uniform picture concerning the application of public or private law to public service offerings.

According to the CVSD cultural services may qualify for Art. 13 CVSD, i.e. they are not mentioned in Annex I. Under the conditions set in Art. 132(1)(n) CVSD the services may be tax-exempt. There are quite a lot stand still clauses which allow further exemptions (Art. 371, 375, 376, 377, 379(2), 384, 389 CVSD). It is also possible to apply a reduced rate according to Annex III no. 7.

In general, public service offerings are treated as taxable. Exemptions from that are Cyprus, Greece and Estonia (theatres only), who in many cases seem to treat public bodies as non-taxable. The same applies to Poland, which is treating public bodies as non-taxable if services are offered on a public law base regardless of a possible distortion of competition. In Denmark and Finland there are legal uncertainties whether a public service offering is non-taxable or tax-exempt. Furthermore, in Finland it seems possible for private organisations to be treated as non-taxable.

Usually taxable service offerings are treated as tax-exempt if the conditions set in Art. 132(1)(n) CVSD or the respective national law are met – regardless whether a public or a private offer is concerned. The tax-exemption seems to be interpreted very strictly in Estonia, Finland, Hungary, Malta and Portugal.

Basically the CVSD provision should lead to an equal taxation (exemption) of public and private supplies. In these cases the missing opportunity to deduct input VAT causes self supply biases, disincentive to invest and tax cascading. However, as Article 132 CVSD and its adoption in many Member States differentiate between different legal forms (public body, charity, private), there are quite a lot of distortions of competition at hand.

Table 2.2 Cultural services

Sector		Cultural services										
Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Austria	Not Assigned	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt	Non-Exempt(*)	No	No	Lawful - not aware of challenges
Belgium	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	Yes(*)	Lawful - not aware of challenges
Bulgaria	Assigned(*)		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Cyprus	Assigned(*)		No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Czech Republic	Assigned		No		Public law and Civil law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Denmark	Assigned(*)	Open for public bodies(*)	No		Public law	Taxable and Non-Taxable(*)	Taxable	Non-Exempt and Tax-Exempt(*)	Non-Exempt and Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Estonia	Not Assigned	Open for public bodies	No		Public law	Taxable and Non-Taxable(*)	Taxable	Non-Exempt	Non-Exempt	No	No	Lawful - not aware of challenges
Finland	Assigned		No		Public law	Non-Taxable(*)	Taxable and Non-Taxable(*)		Non-Exempt	Yes(*)	No	Lawful - possible challenges(*)
France	Not Assigned	Open for public bodies	No		Civil law(*)	Non-Taxable(*)	Taxable	Non-Exempt(*)	Non-Exempt(*)	No	No	Lawful - not aware of challenges
Germany	Not Assigned(*)	Open for public bodies	No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Greece	Assigned		Partially(*)	Sub-contractor	Public law	Non-Taxable	Taxable		Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Hungary	Not Assigned	Open for public bodies	No		Public law	Taxable	Taxable	Non-Exempt and Tax-Exempt(*)	Non-Exempt and Tax-Exempt	No	No	Lawful - not aware of challenges
Ireland	Assigned		No		N/A(*)	Taxable(*)	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxability of public services	3.2.2 Taxability of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Italy	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Latvia	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Lithuania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Malta	Assigned		No		Public law	Taxable	Taxable	Non-Exempt and Tax-Exempt(*)	Tax-Exempt	No	No	Lawful - not aware of challenges
Netherlands	Not Assigned	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	Yes(*)	No	Lawful - not aware of challenges
Poland	Assigned		No		Public law and Civil law(*)	Taxable and Non-Taxable(*)	Taxable	Non-Exempt and Tax-Exempt(*)	Non-Exempt and Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Portugal	Assigned		No		Public law(*)	Taxable(*)	Taxable	Non-Exempt and Tax-Exempt(*)	Non-Exempt	No(*)	No	Lawful - not aware of challenges
Romania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Slovak Republic	Assigned		No		Public law and Civil law (*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Slovenia	Not Assigned(*)	Open for public bodies	No		Public law and Civil law	Taxable	Taxable	Tax-Exempt	Tax-Exempt(*)	No	N/A	Lawful - not aware of challenges
Spain	Not Assigned(*)	Open for public bodies	No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Sweden	Assigned and Not Assigned(*)	Open for public bodies	No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt	Non-Exempt	No	No	Lawful - not aware of challenges
UK	Not Assigned(*)	Open for public bodies	No		N/A(*)	Taxable	Taxable	Tax-Exempt(*)	Non-Exempt and Tax-Exempt(*)	Yes(*)	No	Lawful - not aware of challenges

* for additional comments please see the questionnaire of the respective country

Education

Education is assigned to public bodies in nearly all Member States (except Estonia). In no Member State is it mandatory to use the public service offering. In nearly all countries public law is applicable.

From a CVSD perspective education may qualify for Art. 13 CVSD, i.e. it is not mentioned in Annex I. However, it has to be noted that a private offer is allowed in (nearly) all Member States. The services may be exempt according to Art. 132(1)(i) CVSD. No stand still clauses or reduced rate apply.

Generally the Member States treat public service offerings as taxable but tax-exempt. However, some countries treat public bodies as non-taxable (Cyprus, Greece, Estonia and Poland as well as Denmark and Finland - as mentioned above, c.f. cultural services; also Austria, Germany, Italy, the Netherlands). This could be justified where the services are rendered for no consideration.

Please refer to our comments about cultural services for an evaluation.

Table 2.3 Education

Sector Education

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxibility or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Austria	Assigned		No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Belgium	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	Yes(*)	Lawful - not aware of challenges
Bulgaria	Assigned(*)		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Cyprus	Assigned(*)		No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Czech Republic	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Denmark	Assigned(*)		No		Public law	Non-Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Estonia	Not Assigned	Open for public bodies	No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Finland	Assigned		No		Public law	Non-Taxable(*)	Taxable		Tax-Exempt	Yes(*)	No	Lawful - not aware of challenges
France	Assigned		No		Public law(*)	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Germany	Assigned(*)		No		Public law	Non-Taxable(*)	Taxable		Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Greece	Assigned		No		Public law	Non-Taxable	Taxable		Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Hungary	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Ireland	Assigned		No		N/A(*)	Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Italy	Assigned		No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Latvia	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Lithuania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Malta	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Netherlands	Assigned(*)	Open for public bodies(*)	No		Public law and Civil law(*)	Non-Taxable(*)	Taxable		Tax-Exempt(*)	No	Yes(*)	Lawful - not aware of challenges
Poland	Assigned(*)		Yes(*)		Public law and Civil law(*)	Taxable and Non-Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Portugal	Assigned		No		Public law(*)	Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Romania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Slovak Republic	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Slovenia	Assigned and Not Assigned(*)		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	N/A	Lawful - not aware of challenges
Spain	Not Assigned(*)	Open for public bodies	No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Sweden	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
UK	Assigned		No		N/A*	Taxable	Taxable	Tax-Exempt	Non-Exempt and Tax-Exempt(*)	Yes(*)	No	Lawful - not aware of challenges

* for additional comments please see the questionnaire of the respective country

Hospital services

Hospital services are assigned to public bodies in nearly all Member States. Health care services could be offered by private institutions in all Member States. Public service offerings are subject to public and private law.

Hospital services may qualify for Art. 13 CVSD, i.e. it is not mentioned in Annex I. However, it has to be noted that a private offer is allowed in all Member States. The services may be exempt according to Art. 132(1)(b) CVSD. No stand still clauses apply. A reduced rate could apply according to Annex III no. 17.

Generally the Member States treat public service offerings as taxable but tax-exempt. However, some countries treat public bodies as non-taxable (Cyprus, Greece, Estonia and Poland as well as Denmark - as mentioned above, c.f. cultural services; also Italy). In Greece it seems possible for private organisations to be treated as non-taxable in special cases.

In general all Member States treat the health care services as tax-exempt. Only in Austria all private offerings are non-exempt but a reduced rate is applicable.

Please refer to our comments about cultural services for an evaluation.

Table 2.4 Hospital Services

Sector		Hospital services										
Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Austria	Assigned		No		Civil law	Taxable	Taxable	Tax-Exempt	Non-Exempt(*)	Yes(*)	No	Lawful - not aware of challenges
Belgium	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	Yes(*)	Lawful - not aware of challenges
Bulgaria	Assigned(*)		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Cyprus	Assigned		No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Czech Republic	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Denmark	Assigned(*)		No		Public law	Non-Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Estonia	Not Assigned	Open for public bodies	No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Finland	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	Yes(*)	No	Lawful - possible challenges(*)
France	Assigned		No		Public law(*)	Non-Taxable(*)	Taxable	Tax-Exempt(*)	Tax-Exempt	No	No	Lawful - not aware of challenges
Germany	Not Assigned(*)	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Challenged by private hospitals
Greece	Assigned		Partially	Sub-contractor	Public law	Non-Taxable	Taxable		Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Hungary	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Ireland	Assigned		No		N/A(*)	Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt(*)	No	No(*)	Lawful - not aware of challenges(*)

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Italy	Assigned		No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Latvia	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Lithuania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Malta	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Netherlands	Not Assigned	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Poland	Assigned(*)		Yes(*)	Sub-contractor and Authorised person	Public law and Civil law(*)	Taxable and Non-Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Portugal	Assigned		No		Public law(*)	Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Romania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Slovak Republic	Assigned		No(*)		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Slovenia	Not Assigned(*)	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	N/A	Lawful - not aware of challenges
Spain	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Sweden	Assigned		No		Public law and Civil law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
UK	Assigned		No		N/A(*)	Taxable	Taxable	Tax-Exempt	Tax-Exempt	Yes(*)	No	Lawful - not aware of challenges

* for additional comments please see the questionnaire of the respective country

Homes for the elderly

Care services and accommodation in homes for the elderly are assigned to public bodies in only half of the Member States. Health care services could be offered by private institutions in all Member States. Public service offerings are mainly subject to private and sometimes to public law.

Services in homes for the elderly may qualify for Art. 13 CVSD, i.e. it is not mentioned in Annex I. However, it has to be noted that a private offer is allowed in all Member States. The services may be exempt according to Art. 132(1)(g) CVSD. No stand still clauses apply. Member States can introduce a reduced rate according to Annex III no. 18.

Generally the Member States treat public service offerings as taxable but tax-exempt (if conditions are met). However, some countries treat public bodies as non-taxable (Cyprus, Greece, Estonia and Poland as well as Denmark – as mentioned above, c.f. cultural services; also Italy).

All Member States apply a tax-exemption except Hungary (for public and private service offerings) and Cyprus (private offerings only).

Please refer to our comments about cultural services for an evaluation.

Table 2.5 Homes for elderly

Sector Homes for elderly

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Austria	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Non-Exempt(*)	Yes(*)	No	Lawful - not aware of challenges
Belgium	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	Yes(*)	Lawful - not aware of challenges
Bulgaria	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Cyprus	Not Assigned(*)	Open for public bodies(*)	No		Public law	Non-Taxable	Taxable		Non-Exempt	No	No	Lawful - not aware of challenges
Czech Republic	Assigned		No		Public law and Civil law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Denmark	Assigned		No		Public law	Non-Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Estonia	Not Assigned	Open for public bodies	No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Finland	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	Yes(*)	No	Lawful - possible challenges(*)
France	Not Assigned	Open for public bodies	No		Civil law(*)	Non-Taxable(*)	Taxable	Non-Exempt	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Germany	Not Assigned(*)	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Greece	Not Assigned(*)	Open for public bodies	No		Public law	Non-Taxable	Taxable		Non-Exempt	No	No	Lawful - not aware of challenges
Hungary	Not Assigned	Open for public bodies	No		Public law	Taxable	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Ireland	Assigned		No		N/A(*)	Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/pending cases	3.2.7 Accordance of VAT law with CVSD
Italy	Assigned		No		Public law	Non-Taxable	Taxable		Tax-Exempt	No	No	Lawful - not aware of challenges
Latvia	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Lithuania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Malta	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Netherlands	Not Assigned	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Poland	Assigned(*)		No		Public law and Civil law(*)	Taxable and Non-Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Portugal	Not Assigned	Open for public bodies	No		Public law(*)	Taxable(*)	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Romania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Slovak Republic	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Slovenia	Not Assigned	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	N/A	Lawful - not aware of challenges
Spain	Not Assigned(*)	Open for public bodies	No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Sweden	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
UK	Not Assigned(*)	Open for public bodies	No		N/A(*)	Taxable	Taxable	Tax-Exempt	Tax-Exempt	Yes(*)	No	Lawful - not aware of challenges

* for additional comments please see the questionnaire of the respective country

Services in connection with sports

In several Member States services in connection with sport (e.g. facility services, admissions) are assigned to public bodies. However, the sector is open for a private offering in all countries. Public services are subject to private or public law.

Art. 13 CVSD would allow treating such services as non-taxable if the conditions are met. In this context it is noteworthy that in all Member States a private offer is allowed. Art. 132(1)(m) CVSD exempts services in connection with sport which are carried out by non-profit organisations. However, Art. 371 (Annex X(B)(1) CVSD for old Member States) and Art. 380 CVSD (Sweden) allow to exempt admission fees.

Generally the Member States treat public service offerings as taxable. Like with other services some Member States are treating public bodies as tax-exempt (Greece, Estonia and Poland as well as Denmark – as mentioned above, cf. cultural services). In Germany some private offerings are treated as non-taxable because the *Kennemer Golf & Country Club* judgement of ECJ⁴⁷ has not been transposed so far. As a consequence Germany has no rules about a tax-exemption in this sector.

Besides this Portugal and the United Kingdom do not exempt public sport services. Sport services cannot be treated as tax-exempt in Austria, Cyprus, Estonia, Finland (maybe non-taxable), Greece, the Netherlands and Sweden, either.

Please refer to our comments about cultural services for an evaluation.

⁴⁷ Case C 174/00, *Kennemer Golf*, (2002) ECR I-3293.

Table 2.6 Services in connection with sports

	Sector	Sport										
Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxibility or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Austria	Not Assigned	Open for public bodies	No		Civil law	Taxable	Taxable	Non-Exempt	Non-Exempt		No	N/A
Belgium	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	Yes(*)	Lawful - not aware of challenges
Bulgaria	Assigned(*)		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Cyprus	Assigned(*)		No		Public law	Taxable	Taxable	Tax-Exempt	Non-Exempt	No	No	Lawful - possible challenges(*)
Czech Republic	Assigned		No		Public law and Civil law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Denmark	Assigned(*)	Open for public bodies(*)	No		Public law	Taxable and Non-Taxable(*)	Taxable	Tax-Exempt(*)	Non-Exempt and Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Estonia	Not Assigned	Open for public bodies	No		Public law	Non-Taxable	Taxable		Non-Exempt	No	No	Lawful - not aware of challenges
Finland	Assigned(*)		No		Public law	Taxable(*)	Taxable	Non-Exempt	Non-Exempt	Yes(*) / No(*)	No	Lawful - not aware of challenges
France	Not Assigned	Open for public bodies	No		Civil law(*)	Non-Taxable(*)	Taxable	Non-Exempt(*)	Non-Exempt(*)	No	No	Lawful - not aware of challenges
Germany	Not Assigned(*)	Open for public bodies(*)	No		Public law	Taxable	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Greece	Not Assigned(*)	Open for public bodies	No		Public law	Non-Taxable	Taxable		Non-Exempt	No	No	Lawful - not aware of challenges
Hungary	Not Assigned	Open for public bodies	No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Ireland	Assigned		No		N/A(*)	Taxable(*)	Taxable	Non-Exempt and Tax-Exempt(*)	Non-Exempt and Tax-Exempt(*)	No	No	Lawful - not aware of challenges

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxability of public services	3.2.2 Taxability of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Italy	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt	No	No	Lawful - not aware of challenges
Latvia	Assigned		No		Public law	Taxable	Taxable	Non-Exempt and Tax-Exempt	Non-Exempt and Tax-Exempt	No	No	Lawful - not aware of challenges
Lithuania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Malta	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Netherlands	Not Assigned	Open for public bodies	No		Civil law	Taxable	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Poland	Assigned(*)		No		Public law and Civil law(*)	Taxable and Non-Taxable(*)	Taxable	Non-Exempt and Tax-Exempt(*)	Non-Exempt and Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Portugal	Not Assigned	Open for public bodies	No		Civil law(*)	Taxable(*)	Taxable	Non-Exempt	Non-Exempt and Tax-Exempt(*)	No(*)	No	Lawful - not aware of challenges
Romania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Slovak Republic	Assigned		No(*)		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Slovenia	Not Assigned(*)	Open for public bodies	No		Public law and Civil law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	N/A	Lawful - not aware of challenges
Spain	Not Assigned(*)	Open for public bodies	No		Public law	Taxable	Taxable	Tax-Exempt(*)	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Sweden	Not Assigned(*)	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt	Non-Exempt	No	No	Lawful - not aware of challenges
UK	Not Assigned(*)	Open for public bodies	No		N/A(*)	Taxable	Taxable	Non-Exempt	Non-Exempt and Tax-Exempt(*)	Yes(*) / No(*)	No	Lawful - not aware of challenges

* for additional comments please see the questionnaire of the respective country

Broadcasting services

In several Member States basic broadcasting services are assigned to the public authorities. In all countries the market is open for private offerings. Some Member States apply public law, others not.

The services can be treated as non-taxable according to Art. 13 CVSD (Annex I limits this to the activities referred to in Art. 132). Art. 132(1)(q) CVSD stipulates that non-commercial activities of public broadcasting services are tax-exempt. However, Art. 370 CVSD (old Member States), 378 CVSD (Austria) and 379(1) CVSD (Finland) allow some Member States to treat even these services as non-exempt. Annex III no. 8 opens the possibility to apply a reduced rate to certain services in connection with broadcasting.

Nearly all Member States treat the basic services as taxable but tax-exempt. Estonia, Greece and Poland treat them as non-taxable (cf. above cultural services). Germany and Italy treat the services as non-taxable (thus, there is no tax-exemption available). Also Spain and the United Kingdom treat the services as non-taxable. Noteworthy is that in the United Kingdom the broadcasting services are rendered by a public-held private company, the BBC. It seems that some other countries also treat private companies as tax-exempt (Czech Republic, Republic of Ireland, the Netherlands, Poland, Romania and Slovenia).

The tax-exemption for public broadcasting is not granted in Austria, Belgium, France and Finland (stand still clauses), nor in Latvia and Portugal.

As public broadcasting has special aims, the differential VAT treatment in certain Member States could be justified. Whereas private broadcasting services are usually financed 100% through advertisements (non-exempt), public services are usually partially financed through public funding (exempt) and advertisements (non-exempt). Where the public service is treated as tax-exempt, the same problems occur as with education, culture etc. (self supply bias, disincentive to invest, tax cascading). The private provider is not suffering these problems.

Table 2.7 Broadcasting

Sector Broadcasting

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxibility of public services	3.2.2 Taxibility of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxibility or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Austria	Assigned		No		Public law	Taxable	Taxable	Non-Exempt(*)	Non-Exempt(*)		No	Lawful - not aware of challenges
Belgium	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Bulgaria	Assigned(*)		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Non-Exempt	No	No	Lawful - not aware of challenges
Cyprus	Assigned(*)		No		Public law	Taxable	Taxable	Tax-Exempt	Non-Exempt	No	No	Lawful - possible challenges(*)
Czech Republic	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt(*)	Non-Exempt	No	No	Lawful - not aware of challenges
Denmark	Assigned(*)		No		Public law	Taxable	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Estonia	Not Assigned	Open for public bodies	No		Public law	Non-Taxable	Taxable		Non-Exempt	No	No	Lawful - not aware of challenges
Finland	Assigned(*)		No		Public law	Taxable	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
France	Not Assigned	Open for public bodies	No		Civil law(*)	Taxable	Taxable	Non-Exempt	Non-Exempt(*)	No	No	Lawful - not aware of challenges
Germany	Assigned(*)		No		Public law	Taxable and Non-Taxable(*)	Taxable	Non-Exempt(*)	Non-Exempt	No(*)	No	Lawful - not aware of challenges
Greece	Assigned		No		Public law	Non-Taxable	Taxable		Non-Exempt	No	No	Lawful - not aware of challenges
Hungary	Not Assigned	Open for public bodies	No		Public law	Taxable	Taxable	Tax-Exempt(*)	Non-Exempt	No	No	Lawful - not aware of challenges
Ireland	Assigned		No		N/A(*)	Taxable(*)	Taxable	Non-Exempt and Tax-Exempt(*)	Non-Exempt and Tax-Exempt(*)	No	No	Lawful - not aware of challenges

Question	3.1.1 Service assigned to public bodies	3.1.2 Services may be provided by public bodies?	3.1.3 Mandatory use of public service offerings	3.1.4 Possible involvement of private entities in public offerings with mandatory use	3.1.5 Applicable law for public service offering	3.2.1 Taxability of public services	3.2.2 Taxability of private services	3.2.3 Exemptions for taxable public services	3.2.4 Exemptions for taxable private Services	3.2.5 Input deduction despite non-taxability or tax-exemption	3.2.6 Planned amendments of VAT law/ pending cases	3.2.7 Accordance of VAT law with CVSD
Italy	Assigned		No		Public law	Taxable and Non-Taxable(*)	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Latvia	Assigned		No		Public law	Taxable	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Lithuania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Malta	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Non-Exempt	No	No	Lawful - not aware of challenges
Netherlands	Not Assigned	Open for public bodies	No		Civil law	Taxable	Taxable	Tax-Exempt(*)	Non-Exempt(*)	Yes(*)	No	Lawful - not aware of challenges
Poland	Assigned(*)		No		Public law and Civil law(*)	Taxable and Non-Taxable(*)	Taxable	Non-Exempt and Tax-Exempt(*)	Non-Exempt and Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Portugal	Assigned		No		Civil law(*)	Taxable(*)	Taxable	Non-Exempt	Non-Exempt		No	Lawful - not aware of challenges
Romania	Assigned		No		Public law	Taxable	Taxable	Tax-Exempt	Tax-Exempt	No	No	Lawful - not aware of challenges
Slovak Republic	Assigned		No		Public law and Civil law(*)	Taxable	Taxable	Tax-Exempt(*)	Non-Exempt	No	No	Lawful - not aware of challenges
Slovenia	Assigned and Not Assigned(*)		No		Public law and Civil law	Taxable	Taxable	Tax-Exempt	Non-Exempt and Tax-Exempt(*)	No	N/A	Lawful - not aware of challenges
Spain	Not Assigned(*)	Open for public bodies	No		Public law	Non-Taxable	Taxable		Tax-Exempt(*)	No	No	Lawful - not aware of challenges
Sweden	Assigned(*)		No		Public law	Taxable	Taxable	Tax-Exempt	Non-Exempt	No	No	Lawful - not aware of challenges
UK	Assigned		No		N/A(*)	Non-Taxable	Taxable		Non-Exempt	Yes(*)	No	Lawful - not aware of challenges

* for additional comments please see the questionnaire of the respective country

General remark for all sectors concerning input VAT

As regards the deduction of input VAT it has to be noted that, in general, such a deduction is not granted in the Member States where a service is treated as non-taxable or tax-exempt. The only derogations from this principle are the Member States with a special compensation or refund system.

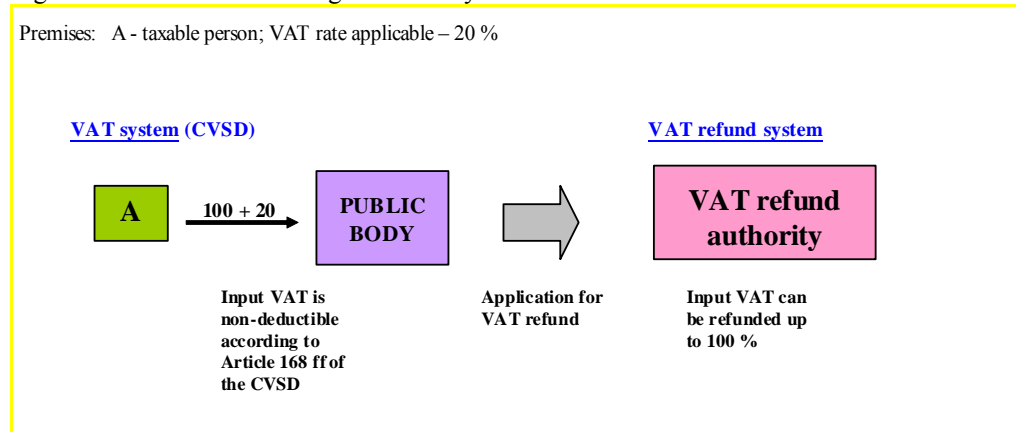
2.3.4 Compensation outside the scope of CVSD

With the intention to counteract the bias towards self supply Austria, Denmark, Finland, France, the Netherlands, Portugal, Sweden and the United Kingdom have introduced systems designed to compensate public bodies for the inability to deduct input VAT⁴⁸. These compensation systems appear in different forms, for the most part being outside the national VAT regime⁴⁹. In the following we understand ‘compensation system’ as a general term covering systems which grant a refund for non-deductable input tax as well as other systems designed to address VAT issues as regards the public sector, such as a compensation for expected hidden VAT included in the price of an exempt transaction provided by a private entity to a public body.

⁴⁸ It has to be noted that some Member States might use individual compensation methods for certain sectors. These are discussed in the section about the adoption in the Member States (2.3.2).

⁴⁹ See X. Yang (2005) ‘VAT Treatment of Government Procurement: A Comparative Analysis’, *International VAT Monitor* 5: 342-348, pointing out that Finland has actually formally incorporated the refund mechanism in the Finnish VAT Act of 1993.

Figure 2.7 General functioning of refund systems



Source:KPMG AG

Categories of Refund Schemes

The schemes may be globally categorized in terms of four characteristics, namely the funding of the system, the person entitled to a refund, the covered transactions and whether the refund is general or sector related.

First, refund systems may be divided into open systems funded by the extra VAT receipts from additional contracting out and closed systems funded by the public bodies themselves⁵⁰. Second, the system may only entitle public bodies to a refund but it is also imaginable to entitle non-governmental persons such as charities, too. Third, the system, such as the Swedish model, may include non-taxable activities as well as exempt activities or it may be restricted to non-taxable activities such as the French system. Fourth, the system may grant a general refund or be restricted to certain sectors or to certain kinds of privatisation such as public private partnership projects. Finally the refund systems could be limited to inland input VAT or open for foreign VAT (the Netherlands only).

⁵⁰ M. C. Wassenaar & R. H. J. M. Gradus (2001), 'Contracting out: the importance of a level playing field', Research memorandum 0108, Erasmus University Rotterdam, on page 11.

Box: Changing financing of the Danish VAT compensation fund

In 2007, financing of the Danish VAT compensation fund, momsudligningsordningen, was changed. Prior to 2007, municipalities and county authorities operated the VAT compensation fund, both drawing from the fund according to their eligible VAT expenditure as well as paying to the fund in accordance with their individual tax bases to cover the claims made on the fund. General block grants from the state to municipalities and county authorities took the burden of financing the compensation fund into account.

The new way of financing the VAT compensation means that the fund is now managed by the state directly rather than by the users themselves. At the same time general block grants from the state to the municipalities and county authorities are reduced in accordance with the size of reimbursements, cf. Indenrigs- og Sundhedsministeriet, notes to 'forslag til Lov om konkurrencemæssig ligestilling...', article 2.1.

"The bill changes the VAT compensation scheme so that municipalities and counties will no longer be charged a separate contribution to VAT. The cost of the scheme is hereafter paid by the state. The general block grants to municipalities are reduced and an estimate of the anticipated reimbursement expenditures will be included in the determination of the first general block grants to the regions. Cost changes in the reimbursement system will be included as a factor in determining future block grants."

Two of the reasons motivating the change in finance were the following. *First*, municipalities and county authorities reported that it was difficult to understand the payment flows occurring under the old system, since there were no direct connection between the size of block grants from the state and a municipality's payment to the VAT compensation fund. The new system more closely ties payments from the state to municipalities' VAT compensation. *Second*, municipalities found that direct self-contribution to the compensation fund limited their incentive to contract out. In particular, large municipalities and county authorities with high tax bases found, that they financed a significant share of their own compensation. Involving the state directly in financing the VAT compensation fund should avoid the disincentive to contract out.

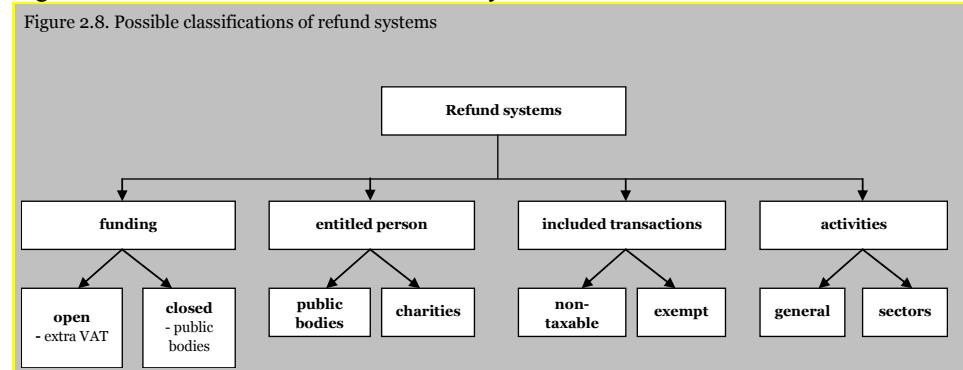
The change in finance in Denmark was inspired by similar changes made to compensation schemes in both Sweden and Finland.

According to Head of Section Eva Lisby, the Ministry of the Interior and Social Affairs has not received any complaints in the new system since its inception.

Note: All sources are in Danish. Text translated to English by Copenhagen Economics.

Sources: Indenrigs- og Sundhedsministeriet, 'Forslag til Lov om konkurrencemæssig ligestilling mellem kommuner og regioners egenproduktion og køb af ydelser hos eksterne leverandører i relation til udgifter til merværdiafgift m.v. samt om momsfondet', 29. marts 2006. (Available in Danish at <https://www.retsinformation.dk/Forms/R0710.aspx?id=89127>). Indenrigs- og Sundhedsministeriets Finansieringsudvalg, 'Et nyt udligningssystem', betænkning nummer 1437, bind 1 + 2, januar 2004.

Figure 2.8 Possible classification of refund systems



Source:KPMG AG

Table 2.8 Definitions

Definitions		
Funding	<i>Open</i>	Refund is funded by extra VAT deriving from outsourcing
	<i>Closed</i>	Refund is funded by public bodies (public subsidies are reduced correspondingly)
Entitled Persons	<i>Public Bodies</i>	Refund is only available for all or certain public bodies
	<i>Charities, Others</i>	Refund is available for all or certain entities (often combined with activities in a certain sector)
Included Transactions	<i>Non-taxable</i>	Refund is (only) available for non-taxable transactions
	<i>Tax-exempt</i>	Refund is (also) available for tax-exempt activities
Activities	<i>General</i>	Refund system is available for all sectors
	<i>Certain Sectors or Activities</i>	Refund system is only available in certain sectors (e.g. health care) or for certain activities (e.g. public private partnerships)

Source: KPMG AG

Compensation systems currently in operation

The KPMG information gathering process has confirmed that the Member States' compensation systems reflect a large variety in scope reaching from sector related, relatively small recoverable proportions to a complete refund of non-deductable input VAT. Some systems such as the Austrian refund system only compensate for input VAT linked to exempt activities, whereas other Member States only compensate for input VAT linked to non-taxable activities (e.g. the Netherlands, Denmark) or both (e.g. Sweden, Finland). Some Member States even operate two different compensation mechanisms such as Finland, Sweden and the United Kingdom.

Austria

The Austrian compensation system can be described as sector related since only physicians, dentists, nursing homes, retirement homes, hospitals, convalescent homes and social security entities are entitled to a refund for non-deductable VAT. The legal basis of the Austrian refund system lies outside the VAT law within the Austrian Health and Social Security Code⁵¹.

In 2008 social security entities received a total refund of 560 million Euros. Unlike the other refund systems within the EU, the Austrian refund scheme is limited to input VAT that is linked to exempt services. Input VAT linked to activities outside the scope of VAT is not refundable. Another remarkable point about the Austrian compensation system is that it is not limited to public bodies but in some cases also applicable to private entities (e.g. physicians). However, private hospitals are not entitled to a refund because they can recover any input VAT. The amount of refundable input VAT depends on the entity claiming the refund. While hospitals and convalescent homes are entitled to a refund of the exact amount of non-deductable input VAT connected with the exempt services, the other entities may only claim a certain percentage of their turnover. This percentage currently amounts from 3 to almost 7% and depends on which entity claims the refund. Health insurances for example currently receive a refund of 4.3%. The funds are distributed by the Austrian Central Government. Administration costs for the application of the compensation system are relatively low. Only hospitals and convalescent homes must keep record of refundable input VAT, which requires an adaption of their accounting system. However, after this adaption continuing compliance costs are relatively low.

In practice, the Austrian compensation system is considered to succeed in preventing public bodies' incentive to self supply. This result, however, is only fully achieved as far as public hospitals and convalescent homes are concerned since only these entities may recover the total amount of input VAT incurred. The refund for the other entities is usually smaller than the actual amount of non-deductable input VAT. As a consequence, the incentive to self supply is

⁵¹ Gesundheits- und Sozialbereich-Beihilfengesetz.

only partially eliminated. Regarding other entities the incentive to self supply is only partially eliminated as the compensation does not depend on the amount of input VAT actually incurred. Austrian private hospitals are complaining about the compensation system causing a disadvantage since they have to charge (reduced) VAT on their services in order to obtain an input VAT refund.

Denmark

Denmark has introduced a compensation system for public bodies. The Danish compensation system may be regarded as a general refund since it applies to all sectors. Although for the most sectors compensation is only granted in connection with specific activities, municipalities and regions, however, are entitled to a refund of almost all costs subject to very few exemptions. The Danish refund system applies to input VAT linked to non-taxable as well as to exempt activities. Since 2007 the system is financed through a compensation fund which is managed by the State directly. However, the general grants from the State to the municipalities and county authorities are reduced in accordance with the size of reimbursements. As a consequence, the Danish compensation system can be characterised as closed system, since it is in fact financed by the beneficiaries themselves. In principle, the Danish system is considered to eliminate the public bodies' incentive to self supply. However, unlike Sweden and Finland Denmark has no compensation mechanism which is designed to compensate for hidden VAT included in the price of exempt supplies by private entities.

There is also a refund available for certain charity organisations which are approved by the Danish tax authorities. These organisations can apply for a refund each year. The refund amount is calculated as follows:

$$\text{VAT expenses in current year} - \text{VAT expenses held in 2004}$$

Each year is compared with 2004 as "the basis year".

The "independent financing" is calculated as the size of revenue the organisation gets from gifts from private persons, from sale of goods, from events etc. compared to the total revenue including contributions from public bodies, e.g. the state. In other words: the better an organisation is to fundraise money itself the bigger VAT refunds it gets.

Furthermore, only expenses which are deductible according to the Danish VAT legislation can be refunded, e.g. there is only $\frac{1}{4}$ VAT refund for expenses regarding hotel expenses.

Finland

The Finnish VAT law contains two different compensation mechanisms.

First the Finnish VAT Act comprises a refund system which allows certain public bodies to receive a refund for input VAT included in acquisitions linked to exempt or non-taxable activities. It is not limited to a special sector and can be consequently described as a general refund system. However there are certain exemptions, i.e. exempt activities for which no refund may be claimed (e.g. received transactions for the purpose of leasing of exempt immovable property).

The second system aims to compensate public bodies for hidden VAT which is expected to be included in the price of received transactions. In addition to the first refund system it entitles municipalities to a refund of a calculated 5% of the purchase price on goods and services related to health and medical care and social welfare if these services are acquired exempt from tax. The scheme covers services which are acquired from private firms, the State, non-profit organisations or other entities. Transactions made by one municipality to another municipality, however, are outside the scope of the scheme. The amount of 5% is considered to correspond to the approximate amount of hidden VAT caused by the inability of the private provider to deduct input tax because of the exemption. Also covered are subsidies granted by municipalities to persons carrying out health and medical care or social welfare when the subsidies are granted for the purpose of these activities. It does not cover subsidies or aids given from one municipality to another.

Both refund schemes are applicable to municipalities, municipal public utilities and federations of municipalities. However, purchases made by the State, State owned public utilities or private firms are outside the scope of the refund schemes.

In the year 2008 more than 1.5 billion Euros were paid to the municipalities as compensation. The schemes are financed by the central government (i.e. the State of Finland). However, since 2002, when the prevailing system was introduced, the amount of compensation received by municipalities has had influence on the amount of corporate tax revenues granted from the budget of the State to municipalities. Insofar, the compensation mechanism could be deemed to be partially financed by the municipalities themselves. The Finnish compensation schemes are considered to eliminate the public bodies' incentive to self supply where they apply. Since public bodies have to keep separate accounts for VAT which is deductible according to the standard provisions and for the refundable VAT, the compensation schemes involve extra administration costs. These additional costs, however, are considered to be relatively minor.

France

France operates a VAT compensation fund⁵². The French approach is different from most of the other Member States. Local government authorities receive a fixed rate of 15.482% compensation for the VAT that they pay on their investment expenses. In principle, legal entities

⁵² Fonds de Compensation pour la TVA.

governed by public law are entitled to this compensation. However, private entities as well as central government bodies are excluded from the scope of the system. The refund is limited to input VAT that is linked to non-taxable activities, input VAT linked to exempt activities is not refunded. Only input VAT in connection with investment expenses for fixed assets of the public body qualify for a refund. The refunds are principally financed by the central government. However, specific State subsidies have to be deducted from the attribution base of the refund system leading to partial financing by the beneficiaries of the scheme, where they have been computed VAT included. Unlike the refund mechanisms in other Member States the French refund is not granted immediately on a monthly basis but generally two years after the actual investment costs. It has to be pointed out that since the compensation of 15.482% is higher than the reduced French VAT rate of 5.5%, the refund system can even cause a financial gain for a public body receiving mostly services subject to the reduced rate.

In the year 2009 the amount of refund paid was assessed at approximately 5.8 billion Euros. In principle, the French refund mechanism, like the Dutch Refund system, does not legally exclude VAT paid in other Member States.

Netherlands

In the year 2003 the Netherlands introduced their compensation scheme for municipalities, provincial authorities and designated regional governments. It does only apply to these public bodies and can be characterized as a general refund since it is not limited to certain sectors. Private entities and other public bodies are, however, excluded from compensation.

The scope of the Dutch compensation scheme covers only non-deductible input VAT connected to activities of the public body which are outside the scope of VAT. Input VAT connected to exempt services is not refunded. This includes activities of a public body which are non-taxable but would be tax-exempt if they were provided by a VAT entrepreneur (e.g. hospital services). This exception serves to prevent an unfair advantage of public bodies compared to private entities which render the same services. Non-deductible VAT connected to activities from which specific individuals or groups of individuals benefit is also excluded from compensation.

In 2008 and 2009 the annual compensation payments amounted to approximately 2.4 respectively 2.5 billion Euros. This amount is in principle financed by the municipalities and provincial authorities themselves via a reduction of the general grants given to these users. The reduction is calculated for each individual user on the basis of a formula with a number of variables. However, the reduction is not linked to the size of compensation payments for the individual user. Reductions per user have been fixed since a few years. As a result, the Dutch central government will finance an “over claim” of VAT compensation by the group of users as a whole

via its VAT revenues. Therefore, besides these “over claims” the Dutch refund system may be regarded as a closed system.

The introduction of the compensation scheme in 2003 caused a temporal increase in compliance and administration costs. However, after the process was significantly simplified in 2007 the compliance costs decreased. The public body must keep record of refundable input VAT and file an annual request for compensation. For certain costs an advance payment is possible.

The Netherlands system is unique in the respect that it also compensates for VAT paid in other EU Member States as well as Norway, Iceland and Liechtenstein. It is generally considered to succeed in eliminating the public bodies’ incentive to self supply. However, an incentive to self supply remains where input VAT cannot be recovered because it is linked to tax-exempt services.

Portugal

Portugal operates a refund mechanism on the legal basis of various individual Decree-Laws. The Portuguese compensation system compensates certain entities in special sectors for incurred input VAT. The entities benefitting from this compensation scheme are for example the army, political parties, the church, social solidarity bodies and fire departments. In some cases the compensation covers input VAT linked to non-taxable activities such as the activities of fire departments and sometimes also covers exempt activities (e.g. social solidarity bodies). The Portuguese compensation system can be characterized as open, since it is exclusively financed by the State. In order to receive a refund the respective invoice has to be delivered. The process is not complicated and does not cause high administration costs for the beneficiaries. Like in most other refund systems only VAT paid in Portugal can be refunded.

Sweden

As Finland, Sweden operates two different compensation schemes, one more general refund system and another system aiming to compensate public bodies for hidden VAT.

The more general refund system covers input VAT incurred for exempt activities as well as input VAT incurred for non-taxable activities. Municipalities, regional governments, county councils, associations of local governments and central government bodies are entitled to a refund for transactions received from the private sector. Private companies are outside the scope of the refund system. Where the system applies, benefitting public bodies may claim a refund on a monthly basis⁵³. The system is, in principle, financed by the central government.

⁵³ This applies only to authorities, for municipalities the application can cover 1-3 calendar months.

The second system allows municipalities to receive compensation of 6%⁵⁴ when they purchase exempt services from private firms in the sector of health care, dental care, social care or education. The central government is not entitled to this compensation. As the second refund scheme in Finland, the Swedish system is also designed to compensate for hidden VAT included in the price of these supplies because of the inability of the private supplier to deduct input VAT linked to these exempt transactions.

Both Swedish refund schemes are financed by the central government on a monthly basis. In practice, the schemes are considered to succeed in eliminating the public body's incentive to self supply where they apply. However, in certain cases the possibility of a refund might lead to unfair competition if the same activity is exempt if provided by a private entity. In these cases the private provider will be in a disadvantage since, unlike the public body, no refund of non-deductable input VAT is possible.

In 2009 approximately a total of 5 billion Euros was refunded. A refund of input VAT paid in another country is not granted.

United Kingdom

In the United Kingdom two different compensation schemes can be distinguished.

First the English VAT law to a certain extent generally allows the deduction of input VAT although it is attributable to exempt transactions if the proportion of this input VAT incurred is insignificant in relation to input VAT attributable to taxable non-exempt transactions. This "partial exemption de minimis limit" allows the taxable person to treat exempt input tax as if it were taxable input tax and recover it in full if the total value (directly attributable plus the exempt proportion of any residual input tax) is less than a prescribed amount⁵⁵. The general limit applicable to private traders in this respect is that input VAT relating to exempt transactions must not exceed GBP 625 per month and half of the total input tax in the relevant period. In other words, input VAT attributable to exempt services will still be deductible as long as the amount of this input VAT does not exceed GBP 625 in the respective month. However, the limit for certain public bodies is far more generous allowing them to fully deduct their input VAT incurred if it does not exceed 5% of the total VAT recoverable during the financial year. If, however, the public body exceeds this limit it cannot deduct any input VAT attributable to exempt transactions at all. In practice, the 5% limit allows the respective public bodies to deduct much higher amounts of input VAT attributable to exempt transactions than the usual limit of GBP 625 per month. The different treatment of civil and public entities in this respect characterizes this first compensation mechanism. However, this special de minimis limit does

⁵⁴ In certain cases the compensation is 18 percent.

⁵⁵ HMRC public notice 706 (9).

not apply to all public bodies but only applies to some public bodies which are specifically mentioned in Art. 33(3) VAT Act.

The second refund scheme applies specifically to governmental departments which cannot apply the special partial exemption de minimis limit for public bodies. Government departments may claim a refund for certain contracted out services according to Section 41(3) VATA. This compensation scheme is designed to remove a possible VAT disincentive to the use of outside contractors to perform activities which could also be self supplied by the Government department. In order to be entitled to a refund, the service to which the input VAT is attributable must not be rendered for business purposes as specified in the taxing directions by the Treasury. Input VAT for the purchase of goods linked to non-taxable activities of the government department do, in principle, not entitle to a refund. VAT may be reclaimed only on goods where they are clearly essential to the supply of the service. The Treasury “Contracting-out Direction” is published regularly in the form of two lists, one of which lists eligible Government departments whereas the other one lists non-business related services on which Treasury agree that VAT may be recovered. Both compensation systems in the UK do not compensate for VAT that is paid in another country.

Table 2.9 Overview of compensation systems

	Funding	Entitled person	Included transaction	Activities
<i>Austria</i>	Open	public bodies and private entities	exempt output	health sector
<i>Denmark</i>	Closed	public bodies and approved charity organisations	exempt and non-taxable output	General
<i>Finland 1</i>	Open	public bodies	exempt and non-taxable output	General
<i>Finland 2</i>	Open	public bodies	exempt input (hidden VAT)	health/ social welfare
<i>France</i>	Open	public bodies	non-taxable output	fixed assets investments
<i>Netherlands</i>	Closed	public bodies	non-taxable output	General
<i>Portugal</i>	Open	public bodies	exempt and non-taxable output	certain listed activities
<i>Sweden 1</i>	open	public bodies	exempt and non-taxable output	General
<i>Sweden 2</i>	open	certain local and regional public bodies	exempt input (hidden VAT)	health sector/ social care/ education

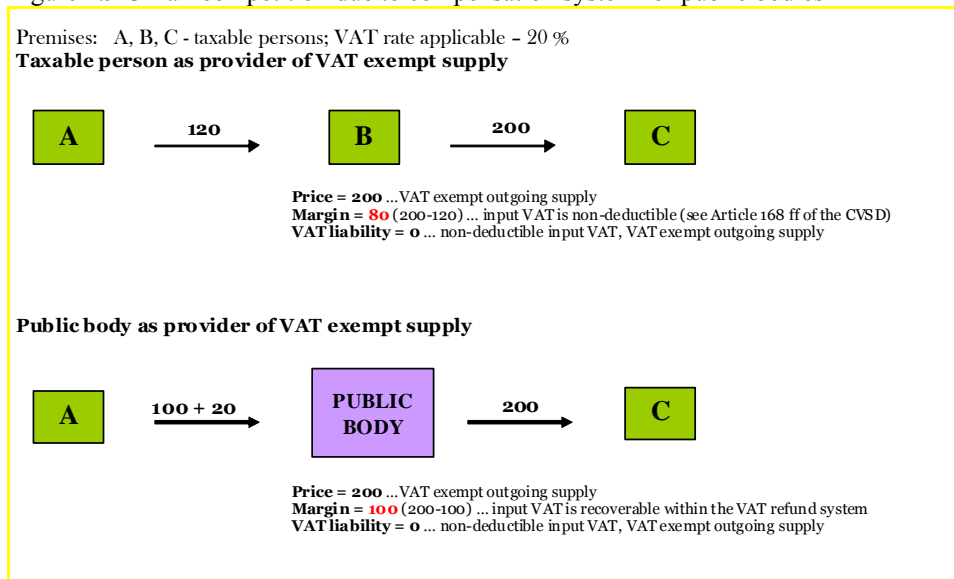
UK 1	open	public bodies	non-taxable output	General
UK 2	open	government departments	non-taxable output	contracted out services

Source: KPMG AG

Problems with compensation systems

One problem of refunding non-deductible input VAT is connected with unfair competition caused by the VAT treatment of public bodies. Since the provisions of Article 13(1) second and third paragraph have in many cases not been properly adopted into the national Member State VAT regimes⁵⁶ unfair competition is still present. For these activities the distortion of competition will be even increased by additionally granting public bodies a compensation for non-deductible input VAT.

Figure 2.9 Unfair competition due to compensation system for public bodies



Source: KPMG AG

Another problem concerns the necessity to track the amount of non-deductible input VAT for compensation purposes. Non-taxable public bodies are usually not registered for VAT purposes and do not need to account for input VAT. Often they are applying simplified account-

⁵⁶ Reference to 2.3.2.

ing standards or methods. A refund mechanism would require these public bodies to introduce the tracking of input VAT into their accounting system, creating considerable administrative efforts and costs. Furthermore, the introduction of a refund system involves administrative costs for the local authorities managing the refund.

It must be noted that there is no guarantee for the introduction of a VAT refund to actually increase the percentage of contracting out. This will be the case, if other barriers to contracting out exist in addition to the barrier of differential VAT.

The differences of the refund systems currently in operation create inequalities amongst the Member States, particularly affecting private companies who offer their services to public bodies of different Member States³⁷. Furthermore, the introduction of a refund scheme is especially difficult in Member States with a federal system raising fundamental questions concerning fiscal allocation as opposed to Member States with a central government³⁸. This will also apply to all Member States where the VAT revenues have to be shared and where public funding is split up between different governmental bodies. In these cases a compensation system for public bodies could have the effect of an additional fiscal allocation to the benefitting public bodies not provided for in the regulations governing the Member State's financial allocations. As a consequence, the introduction of a compensation system would require an adjustment of these regulations which in some Member States such as Germany form part of the constitution.

Another problem concerns the fact that most of the existing refund systems do not compensate foreign VAT³⁹. Although this measure is understandable in respect of a refund system's funding, it creates further inequalities contradicting the principle of VAT neutrality.

Zero Rates

As highlighted above, zero taxation has the effect of a tax-exemption without losing the ability to deduct input VAT. In this respect, applied instead of an ordinary exemption, it counteracts the bias towards self supply, the disincentive to investment and tax cascading within the VAT System. However, as has been noted, it is only reserved for some Member States which are using stand still clauses. Furthermore, zero taxation is only an option where public bodies are taxable, thus ineffective as regards non-taxable activities of public bodies. Finally, zero rates lead to under-taxation of private (final) consumption.

³⁷ See R. De la Feria (2009), 'The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction', *Intertax* 37 No 3, on page 162.

³⁸ See, KPMG (2005) 'Summary Final Report on the Expert Opinion "PPP in Public Construction Projects - VAT Refund System"' for the Federal Ministry of Transportation, Construction, and Housing, URL: <http://www.bmvbs.de> (last checked: 11 January 2011), on page 14.

³⁹ An exception is the Dutch system where also non-national costs are refunded.

2.3. COMPARISON WITH OECD COUNTRIES WITH A GST SYSTEM

In literature the EU VAT system is often compared with the “modern” GST systems in Australia and New Zealand. From a public sector perspective also a comparison with the Canadian and its special rebate rule may be of interest. The New Zealand system could be characterised as the most radical one. The Australian system is very close to the New Zealand system, whereas the Canadian system is similar to the EU VAT system practised in Member States with a refund or compensation mechanism.

2.3.1 Canada

General rules

The GST is levied on all supplies and importation of goods and services by taxable persons. The GST rate is currently 5%. Also, various provinces are imposing a provincial sales tax with different tax rates. In several provinces the provincial sales tax and the GST have been legally harmonized (so-called HST which consists of a federal and a provincial part). In some other provinces there are still more or less independent sales taxes (i.e. in Quebec the QST). The GST is calculated on the consideration without the GST or provincial retail or land transfer taxes included.

The GST paid for acquiring goods and services which are used for a taxable supply is credited. In certain cases the right to claim an input tax credit is restricted:

- Supply of a membership in a club where the main purpose is to provide dining, recreational or sporting facilities
- Supply of a passenger vehicle to the extent the consideration exceeds CAD 30,000
- Meal and entertainment expenses (50% input credit)

The legal concept of a taxable person is broad although there is also a registration threshold for small businesses. It is possible to form a GST group with several taxable persons.

A taxable supply is a supply of goods or services that is made by a taxable person within the course of business for a consideration and has a connection with Canada.

A supply is not taxable if it is zero-rated or exempt:

- Zero-rated means that no GST is levied on the supply whereas the taxable person is still entitled to claim an input GST credit
- Exempt means that no GST is levied on a supply and there is no input GST credit (this is comparable with the VAT exemptions under European VAT law).

Zero-rated are for instance the following supplies:

- Exported goods

- Exported financial services
- Most international transportation services
- Basic groceries
- Certain agricultural or fishing products
- Certain prescription drugs and medical services
- Supplies to provincial governments or their agencies

It is obvious that some of these zero-rate supplies are similar to the VAT exemptions stipulated in EU VAT law. The difference is that the deduction of input GST is always possible.

Exempt are for instance the following supplies:

- Domestic financial services
- Residential rent
- Sales of residential premises
- Most health and dental services
- Child care
- Most educational services
- Most supplies by registered charities, municipalities, governments and other public sector bodies, except for supplies in competition with the private sector
- Legal aid (provided under financial assistance programmes)
- Bridge, road and ferry tolls

These exemptions are very similar to the exemptions in the EU VAT system, i.e. they do not allow the deduction of input GST - if no rebate is possible (cf. below).

Public bodies

The registration threshold for public service bodies is CAD 50,000 (approx. EUR 37,500). A voluntarily registration is possible. Non-registrants do not charge GST nor are they entitled to claim input GST.

Purchases of the federal government are subject to GST. The provinces are relieved from paying GST on their input supplies except for several provinces and territories that have agreed to pay GST on their supplies. The suppliers to the relieved provinces do not charge GST but are entitled to claim input tax credit.

One of the main concepts of GST in the public sector is the concept of municipal services and municipalities. The Canadian GST system has a broad understanding of the term municipality which consists of the cities, counties, villages as well as of their para-municipal organisations like health boards. The tax status of a municipality is also available for private organisations that are related to the territory of a municipality, i.e. volunteer fire organisations, private-run (unbottled) water suppliers, water distribution, sewerage or drainage systems or Indian bands and

councils. The stipulations are quite complex. The status as a municipality has to be acknowledged by Canada Revenue Agency.

Many activities of municipalities are exempt, e.g.

- Library services
- Registrations/licences
- Law enforcement
- Fire protection
- Residential services like sewerage services, if provided on a non-optional basis
- Waste disposal, if supplied by a municipality
- Water distribution, sewerage, or drainage systems, if supplied by a municipality
- Municipal transit services
- Other municipal services (like maintaining of streets, removing snow, ice and vegetation)
- Certain intra-municipal services
- Certain recreational programs, amateur performances and events as well as admission to places of amusement (e.g. theatres)
- Supplies of food, beverages or short-term accommodation to people in need
- Homemaker services (cleaning, meal preparation, care) of municipalities to individuals that require assistance due to age or infirmity or disability
- Charitable events by a public institution

As far as public bodies render taxable supplies they are entitled to receive an input tax credit. Insofar as they are rendering exempt services the input tax credit is not possible. However, in these cases it is possible to claim a rebate of input GST according to the rebate scheme for public service bodies (cf. below).

Charities and Non-profit organisations

Charities have to register for GST purposes when they are rendering taxable services and are exceeding the thresholds for small businesses. If registered Charities have to pay GST on their taxable supplies and are entitled for claiming input tax credits. A charity is a registered charity or registered Canadian amateur athletic association for income tax purposes.

The input tax credit is limited according to the so-called net tax calculation which is a special calculation method for charities. Under this scheme only 60% of the GST due has to be paid. On the other hand input tax credit is only possible for certain items. Charities can elect not to use the net tax calculation under certain provisions. Under the net tax calculation it is possible to get an additional rebate according to the rebate system. The rebate system is also accessible for all charities that are not registered.

The following exemptions are available for charities:

- Most services
- Supplies of donated or used goods
- Short term residential rental accommodation
- Meal on wheel programs
- Parking space and facility rentals
- Catering services for private functions
- Property and services sold in fundraising activities (under certain provisions)
- Fundraising events
- Direct cost exemption (supply of goods and services for an amount that is not more than the direct cost)
- Certain gambling events (lottery, bingo)
- Recreational programs for children of 14 or under
- Free supplies (if 90% of supplies are for free, no supply is taxed)
- Memberships (except for certain exceptions)
- Admissions to places of amusement (e.g. theatres)
- Supplies for the relief of poverty, suffering, or distress

The GST does not apply to donations or gifts (voluntarily transfer of money or property). The same applies to grants and subsidies. Even certain sponsoring activities are not liable to GST.

There are special regulations for real property and the purchase of printed books.

Similar rules apply to non-profit organisations (NPO). NPO or prescribed government organisations need to have a 40% government funding to qualify as a NPO for GST purposes. The percentage is calculated without any remuneration for supplies to the government.

‘Rebate system for public service bodies’

Through the rebate system it is possible to claim input GST that would be irrecoverable under the general GST rules. The rebate system is available for public service bodies (charities, NPO, certain government bodies) regardless whether they are registered for GST purposes or not. Insofar it is similar to the compensation mechanism in certain EU Member States.

It has to be noted that a rebate is also available for the provincial part of the HST or some provincial sales taxes.

Certain purchases and expenses are not eligible for the rebate (e.g. memberships in dining, recreational or sporting clubs, tobacco products, and some real estate-related costs).

The rebate is limited to a percentage of the input GST incurred:

Table 2.10 Rebates

Public Service Body Type	Rebate factor for GST / federal part of GST
Municipality	100%
University	67%
School Authority	68%
Public College	67%
Hospital Authority	83%
Facility Operator	83%
External Supplier	83%
Charity	50%
Qualifying NPO	50%

Source:KPMG

The rebates are funded out of general government revenues.

Further, the percentage concerning the provincial part of HST or provincial sales taxes varies between 0% and 93%.

Evaluation

The Canadian GST system for public bodies and charities has many similarities with the EU VAT law and recently has been considered to be worthy for consideration in the EU as a practical compromise between the current system and a full taxation of the public sector⁶⁰.

In the Canadian GST the public bodies' activities are not subject to GST in many cases. As a consequence they cannot claim input tax credits. However, like in those EU countries which have introduced a refund system an input tax credit is in practice possible through a compensation system which derives from the basic rule that an input tax credit is only possible for costs incurred by taxable supplies.

The Canadian system with its zero-rate supplies fails to tax the private consumption of the outputs of the public sector. It is still necessary to have complex rules to define exempt (or zero-rated) supplies and suppliers. Public and private sector are treated differently⁶¹.

⁶⁰ P. Gendron (2010), 'VAT Treatment of Public Sector Bodies: The Canadian Model', URL: <http://www.sbs.ox.ac.uk> (last checked: 11 January 2011).

⁶¹ P. Gendron (2009), 'How should the U.S. treat government entities, non-profit organisations and other tax-exempt bodies under a VAT?', URL: www.americantaxpolicyinstitute.org/research.html (last checked: 11. January 2011).

The rebate is a measure to minimize the self supply bias, reluctance to invest and tax cascading. However, the rebate rates vary by the type of supplier, the place where the supplies are made and by the type of services. This results in a non-neutral treatment of similar supplies⁶². As a result there is no neutrality concerning entities or activities that are not eligible for a rebate.

It has to be noted that the net calculation scheme for charities is a concept which seems to be an efficient simplification. It allows charities to limit their compliance costs concerning the refund of input taxes⁶³.

2.3.2 Australia

General rules

Australia introduced the Goods and Services Tax (GST) in 2000. The GST is levied on all supplies and importation of goods and services by taxable persons. The GST rate is currently 10%. The GST is included in the price (1/11 of sale price).

A taxable supply is a supply that is made by a registered person within the course of an enterprise for a consideration and has a connection with Australia. The GST paid for acquiring goods and services which are used for a taxable supply is credited.

Taxable persons are registered for GST purposes or which are obliged to register. The registration threshold is annual taxable supplies (past or projected) of AUD 75,000 (approx. EUR 52,500).

A supply is not taxable if it is GST-free or input taxed:

- The expression GST-free means that no GST is levied on the supply whereas the taxable person is still entitled to get an input GST credit (this mechanism could also be called zero rated)
- The expression “input taxed” means that no GST is levied on a supply and there is no input GST credit (this is comparable with the VAT exemptions under European VAT law).

GST-free (zero-rated) are for instance the following supplies:

- Transfer of going-concern/businesses
- Exports and other supplies for consumption outside of Australia
- International mail

⁶² P. Gendron (2009), ‘How should the U.S. treat government entities, non-profit organisations and other tax-exempt bodies under a VAT?’, URL: www.americantaxpolicyinstitute.org/research.html (last checked: 11. January 2011).

⁶³ P. Gendron (2009), ‘How should the U.S. treat government entities, non-profit organisations and other tax-exempt bodies under a VAT?’, URL: www.americantaxpolicyinstitute.org/research.html (last checked: 11. January 2011).

- Food
- Water and sewage
- Medical and health services (incl. medical aids, appliances and medicines)
- Goods that have a proven health benefit
- First aid and life saving course
- Complementary medical services, i.e. acupuncture, herbalism, naturopathy (for a 3 year period)
- Cars for use by disabled people
- Child care
- Education
- Adult education and training which is likely to develop employment-related skills
- Religious services
- Non-commercial activities of charitable institutions

It is obvious that some these exemptions are similar to those stipulated in EU VAT law. The difference is that the deduction of GST is possible.

Input taxed (tax-exempt) are for instance the following supplies:

- Financial services
- Residential rent
- Sales of residential premises

These exemptions are very similar to the exemptions in the EU VAT system, i.e. they do not allow the deduction of input GST.

Public bodies

According to Section 149 Australian VAT Act public bodies are eligible to register for GST purposes even if they are not an entity or an enterprise (the stipulations about registering of public bodies or parts thereof are quite complex). Thus, the Australian government imposes a tax to itself - at least on a notional base (Section 177 Australian VAT Act). Public bodies may choose not to register even if they exceed the threshold of AUD 75,000 (approx. EUR 52,500). If registered, basically the same rules apply like for other taxable persons.

Where the government makes a supply of services and the receiving party has no obligation to do anything in return or provides any monetary consideration, in this case that supply does not attract any GST. Thus, if the government makes any supplies for no consideration, for example, provision of social welfare benefits or subsidies, such supplies would have no GST consequences. From the government perspective, such “supplies” or transactions would not be reported in the government’s GST return.

The parliamentary budget is relevant to determine whether a grant from one government department to the other is an appropriation for GST purposes. An appropriation generally is not subject to GST. If the grant for some reasons does not satisfy the requirements for being an appropriation, potentially the receiving government (the grantee) may need to remit GST on the grant and the other government department (the grantor) may be entitled to claim a GST credit.

However, if the government renders services for “consideration”, the tax base is the value of that consideration (if a monetary consideration) or the market value of that consideration (if the consideration is in a non-monetary form). If the market value of the non-monetary consideration cannot be ascertained, the GST is taxed based on the market value of the services rendered by the government (i.e. market value means what a party, on the arm’s length basis, would be willing to pay for the same services provided by a third party).

Non-profit organisations

Generally non-profit organisations (NPO) are treated like taxable persons but several special rules are applicable. This concerns the registration threshold and treatment of certain supplies as “GST-free” (or zero-rated) and “input-taxed” (or tax-exempt).

The NPO must only register if their turnovers exceed AUD 150,000 (EUR 105,000). The threshold is higher than for other entities (AUD 75,000). The NPO may choose to register if their turnovers are below that sum. Such a decision is binding for 12 months. If a NPO is not registered, GST is not included in the sale price. On the other hand the GST paid for services to render a service is not deductible. If a NPO is registered, 10% GST is due on (almost) all sales. The NPO can claim a credit for GST paid to buy services and goods in carrying on activities. The possibility to register voluntarily allows the NPO to decide whether the administration costs of GST are higher than a benefit from input GST.

Grants (from the government or foundations) attract GST if a supply is carried on in return for the funding. The same is applicable to sponsorships received for advertising, naming rights or other benefits. A gift is not a consideration – no GST applies. Gifts are not calculated in the annual turnover for the registration threshold. A gift has to be made voluntarily, i.e. the payer does not receive a material benefit (no contractual obligation to pay is allowed). A material benefit could be tickets, dinners, items for use. No material benefit are insubstantial values (like ribbons, pins etc.).

If a NPO is GST-registered, it has access to general concessions:

- School tuck shops are shops operated on grounds of a primary or secondary schools. They can elect for input taxed supplies (no taxation of sales and no deduction of input GST).

- For a NPO it is easier to form GST groups.

Special concessions are available for certain kinds of NPO like “charities”, “gift deductible entities” and “government schools” (these kinds of institutions are defined in Australian tax law):

- Raffles and bingo events are GST-free (deduction of input GST possible).
- Sales in connection with fundraising events can be treated as input taxed (no deduction of input GST).
- If consideration for sales is below a certain value, sales are GST-free (non-commercial activities). The amount charged has to be less than 50% of the GST-inclusive market value or less than 75% than the amount paid to acquire the goods sold (if accommodation services: less than 75% of the GST-inclusive market value or less than 75% of costs).
- Reimbursement of volunteer expenses (input GST is granted on expenses paid to volunteers). The deduction input GST requires a tax invoice to the volunteer.
- Sales of donated second hand goods are GST-free - if there is no change in the original character of the goods.
- Transactions between members of a religious group are GST-free.
- Services of retirement villages are GST-free, but not as far as services to visitors or employees concerned (unless these services are non-commercial).
- Sub-entities. Identifiable branches of NPO which are registered separately. This special scheme requires a separate organisation and accounting of the sub-entity (used for fundraising dinner, fetes etc.). A sub-entity is not possible when the activities are relating to the main purpose of the NPO (e.g. membership activities).
- Accounting on cash basis is possible regardless of the annual turnover (instead of the non-cash - or accruals - method which is the general rule).
- No adjustment of GST credits if an item is donated (usually GST credit has to be paid back by taxable persons if an item is not used for business activities).

Evaluation

The Australian system has different approaches to the taxation of public bodies, non-profit organisations (NPO) and certain services in the public interest.

Public bodies

The basic concept of a full taxation of supplies by public bodies is considered as superior to the EU VAT system in the tax literature⁶⁴. The full taxation removes all distortions of competition which occur with the EU VAT system because public bodies and private entities are taxed

⁶⁴M. Aujean/P. Jenkins/S. Poddar (1999), ‘A new approach to public sector bodies’, VAT Monitor 1999: 144-149; R. De la Feria (2009), ‘The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction’, *Inter-tax* 37 No 3, on page 148; P. Gendron (2009) ‘Treatment of Public Service Bodies under Canada’s VATs: The Rebate Model’, presentation at Fiscalis Seminar on The VAT Treatment of Bodies Governed by Public Law and of Subsidies: Issues and Prospects, November 2009 in Florence.

equally. There is no self supply bias or reluctance to invest, either, as public bodies are entitled to deduct input GST. Finally, consumers of public services do not have to bear cascaded GST⁶⁵. There is also a real simplification of GST administration and compliance (no definition of public bodies, their public activities or definitions of tax exemptions). A full taxation levies the GST at the level of final consumers, and not at the level of governments which are not final consumers of services from a scientific point of view.

However, it has to be noted that even in Australia government activities without remuneration (e.g. fire protection, law enforcement) are outside of scope of GST. As a consequence input GST is not credited. This means that the known problems of EU VAT law, like the self supply bias, reluctance to invest, cascading, are only partially solved.

From a financial point of view revenues would rise through a taxation of cases where a consideration is paid. They would drop due to input GST refunds. The more public bodies outsource their activities the more input GST deduction is possible. If, on the other hand, outsourcing could be used for lowering the prices of public services, this also means that there will be less GST revenues for output supplies.

Public bodies would have the advantage to get a refund of GST. Disadvantages would occur for the recipients of public services (i.e. merit goods) who are not entitled to deduct any GST. The public services will not be more expensive as long as the advantages deriving from the input GST deduction could be used for achieving lower costs and, thus, lower prices for public services. The refund of input GST is not a real expenditure as long as the same governmental level is considered. Economic effects may result concerning other government levels. This will work easier in systems with only a few government levels and will be more complicated in systems with lots of government levels. From a mere scientific point of view it could be remarked that distributional goals could be fulfilled by using expenditure policies and income tax systems⁶⁶.

Another difficulty derives from the complex legal concept of imposing a tax to the state itself. It has to be defined what activities are qualifying as a taxable supply and which are not. Especially

⁶⁵ M. Aujean/P. Jenkins/S. Poddar (1999), 'A new approach to public sector bodies', VAT Monitor 1999: 144-149; P. Gendron (2009) 'Treatment of Public Service Bodies under Canada's VATs: The Rebate Model', presentation at Fiscalis Seminar on The VAT Treatment of Bodies Governed by Public Law and of Subsidies: Issues and Prospects, November 2009 in Florence.

⁶⁶ Aujean/ M. Aujean/P. Jenkins/S. Poddar (1999), 'A new approach to public sector bodies', VAT Monitor 1999: 144-149; P. Gendron (2009) 'Treatment of Public Service Bodies under Canada's VATs: The Rebate Model', presentation at Fiscalis Seminar on The VAT Treatment of Bodies Governed by Public Law and of Subsidies: Issues and Prospects, November 2009 in Florence.

intra-state financial transactions are not necessarily remuneration for a service. This is for instance discussed in connection with appropriations of funds⁶⁷.

Non-profit organisations (NPO)

Generally NPO are taxed like other private entities but they have access to some special concessions.

It has to be noted that the use of exemptions (“input-taxed” and “GST-free” supplies) is basically not sector-related but activity-related.

Some of the NPO services are treated (like in the EU) as tax-exempt (“input taxed). This causes the same problems as in the EU (self supply bias, reluctance to invest and cascading). However, it has to be considered that only very few turnovers are affected (school tuck shops and fundraising events) and thus the economic effects could be considered as minor.

There are several supplies that are treated as zero-rated (GST-free), like non-commercial activities, raffles and bingo, sales of donated second hand goods and services between religious groups. As the deduction of input GST is possible, there will be no disadvantages like self supply bias, reluctance to invest or tax cascading. However, distortions of competition could still be possible as taxable persons and NPO are not treated the same way. Considering the list of GST-free services of NPO the distortions will not be enormous.

The system for NPO seems to be more complex than the system for public bodies. However, there seems to be a simplification because the concessions are dependent on an acknowledgment of certain categories of NPO (endorsement by tax office). The EU VAT law foresees lots of different requirements for the different exemptions in Art. 132 CVSD.

Services in the public interest

There are several services in the public interest that are GST-free, i.e. in the health care and educational sector or water and sewage. As the deduction of input GST is possible, there will be no disadvantages like self supply bias, reluctance to invest or tax cascading. A distortion of competition is not at hand because the exemption is for all suppliers (public bodies, NPO or private sector).

⁶⁷ Pyanic/Fife (2009), ‘GST treatment of appropriations’, Australian GST Journal, page 105.

2.3.3 New Zealand

General rules

The GST was introduced in New Zealand in 1985. The GST is levied on all supplies and importation of goods and services by taxable persons. The GST rate used to be 12.5% and changed to 15% from 1 October 2010. The GST is calculated on the value of a supply (the GST exclusive price).

The GST paid for acquiring goods and services which are used for a taxable supply is credited.

Taxable persons are registered for GST purposes or which are obliged to register. The registration threshold is annual taxable supplies (past or projected) of NZD 60,000 (approx. EUR 33,000).

A taxable supply is a supply that is subject to GST that is made by a registered person in the course of carrying on an activity that involves or is intended to involve the supply of goods and services for a consideration (Sec. 5(2) GST Act).

A supply is not subject to GST at 12.5% if it is zero-rated or exempt:

- Zero-rated means that 0% GST is levied on the supply whereas the supplier is still entitled to get an input GST credit
- Exempt means that no GST is levied on a supply and there is no input GST credit (this is comparable with the VAT exemptions under European VAT law).

Compared with other VAT/GST systems the New Zealand GST comes closest to a full taxation as there are only a few exemptions or zero-rated supplies.

Zero-rated are for instance the following supplies:

- Transfer of going-concern/businesses
- Exports and other supplies for consumption outside of New Zealand
- Financial services supplied to non-residents or to New Zealand residents who are GST registered and make at least 75% taxable supplies

It is obvious that some of these zero-rated supplies are similar to the VAT exemptions stipulated in EU VAT law. The difference is that the deduction of GST is possible.

Exempt are for instance the following supplies:

- Financial services that cannot be zero-rated
- Residential rent
- Sales of residential premises

- Supplies by a non-profit body of donated goods and services

These exemptions are very similar to the exemptions in the EU VAT system, i.e. they do not allow the deduction of input GST.

Public bodies

In general public bodies are obliged to register for GST purposes. Their supplies are taxable if they are not exempt. The assessment base for the sales is typically calculated on the basis of revenue received from the Crown (in the form of Government funding) or from the public (in the form of rates, levies, fees and other charges). Thus the government renders deemed supplies (Sec. 5(6) and (7) GST Act). Like in Australia the state imposes a tax to itself. The GST Act contains a number of definitions for the assessment base of the deemed supplies.

Non-profit organisations

For GST purposes a non-profit body (NPO) is any society, association or organisation that is not carried on for the profit or gain of any member, and whose rule prevent the distribution of money or property to any of its members, proprietors or shareholders.

NPO must register if their turnover exceeds NZD 60,000 (approx. EUR 33,000). NPO may choose to register if their turnovers are below that sum.

Registered NPO charge GST on goods and services they supply but are able to claim credits for the GST incurred in relation to goods and services acquired in making the supplies. Non-registered NPO do not charge GST and are not entitled to credits for the related GST they incur. To register a NPO must be able to identify some good or service that is provided for a consideration (e.g., if they are wholly funded by donations, then they are unlikely to be able to register for GST purposes).

In New Zealand a gift or donation to a non-profit body will not be subject to GST in the hands of the non-profit body. The exception to this is where the donation or gift is in respect of a supply of goods and services to the donor or someone associated with the donor. Like in other jurisdictions the differentiation depends on the question whether there is a link between the payment and any advantage received. This leads to the consequence that NPO that are registered and that are financed through donations only can effectively reach a 100% zero-rate tax position.

The only exemption for NPO is that the supply of donated goods and services is exempt (Sec. 14 New Zealand VAT Act).

Evaluation

The New Zealand system comes closest to a full taxation. Only very few exemptions exist.

Public bodies

Like the Australian GST system the New Zealand GST system is considered as superior to the EU VAT system in the tax literature⁶⁸. Distortions of competition like self supply bias or reluctance to invest are removed as public bodies are entitled to deduct input GST. Also, business consumers of public services do not have to bear cascaded GST⁶⁹. There is also a real simplification of GST administration and compliance (no definition of public bodies, their public activities or definitions of tax-exemptions). A full taxation levies the GST at the level of final consumers, and not at the level of governments.

Unlike the Australian system the New Zealand system comes very close to a full taxation because of the deemed supplies of public bodies.

The financial consequences are very similar to those in Australia so that we refer to our comment regarding Australia.

The greatest conceptual difficulty is the insistence on identifying explicit consideration before a supply is seen to be made (there is no explicit fee, no direct link between fee and benefit provided)⁷⁰. There are especially problems with public goods (fire protection, defence etc.) and some authors recommend a service for a consideration of nil with zero tax⁷¹.

Non-profit bodies (NPO)

The non-profit bodies (NPO) are treated as taxable persons - if they have less than NZD 60,000 turnover this is left to their discretion. Thus, a NPO financed only by donations can deduct input GST. As a consequence there is no government share (through GST) concerning

⁶⁸ M. Aujean/P. Jenkins/S. Poddar (1999), 'A new approach to public sector bodies', VAT Monitor 1999: 144-149; R. De la Feria (2009), 'The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction', *Inter-tax 37 No 3*, on page 148; P. Gendron (2009) 'Treatment of Public Service Bodies under Canada's VATs: The Rebate Model', presentation at Fiscalis Seminar on The VAT Treatment of Bodies Governed by Public Law and of Subsidies: Issues and Prospects, November 2009 in Florence.

⁶⁹ M. Aujean/P. Jenkins/S. Poddar (1999), 'A new approach to public sector bodies', VAT Monitor 1999: 144-149; P. Gendron (2009) 'Treatment of Public Service Bodies under Canada's VATs: The Rebate Model', presentation at Fiscalis Seminar on The VAT Treatment of Bodies Governed by Public Law and of Subsidies: Issues and Prospects, November 2009 in Florence.

⁷⁰ M. Aujean/P. Jenkins/S. Poddar (1999), 'A new approach to public sector bodies', VAT Monitor 1999: 144-149; R. De la Feria (2009), 'The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction', *Inter-tax 37 No 3*, on page 148.

⁷¹ P. Gendron (2009), 'How should the U.S. treat government entities, non-profit organisations and other tax-exempt bodies under a VAT?', URL: www.americantaxpolicyinstitute.org/research.html (11 January 2011).

the donations and how they are used. The charities are relieved from the VAT burden they face within the EU.

There is only one exemption for NPO: The sale of donated goods. This effectively causes a distortion of competition because the sale of similar goods by other taxable persons is taxed. This should have minor economic effects as there is limitation of the extent of goods that are donated.

2.4. PROBLEMS WITH THE CURRENT TREATMENT OF PUBLIC SECTOR ACTIVITIES

As highlighted above, the legal provisions of the CVSD concerning the public sector and exemptions in the public interest are often unclear and leave considerable room for interpretation. Together with the considerable discretionary powers and multiple choices granted to Member States, as regards the adoption, this results in a high level of complexity and legal uncertainty. As a consequence, distortions of competition are possible. Furthermore, the current VAT system creates barriers for private competitors to enter into markets which are dominated by the public sector and has a negative effect on the efficiency in delivering public services. Finally, the VAT system affects the level and structure of investments and employment.

Distortions of competition

Although the provisions of the CVSD are designed to avoid significant distortions of competition resulting from a public body's treatment as non-taxable⁷² due to a lack of proper transposition or a lack of proper application of the national law, distortions of competition may in some Member States still occur. Where a Member State for example fails to properly transpose the provisions of the distortion clause of Article 13(1) paragraph 2 CVSD the VAT treatment of public entities may still result in unfair competition mostly to the disadvantage of private competitors. This distortion of competition can even be increased where Member States operate refund schemes in order to compensate public bodies for non-deductible input VAT. Where the provisions of Article 13(1) paragraph 2 and 3 are however properly transposed, unfair competition as regards the VAT treatment of output is minimized. Nevertheless, Member States may use national market regulations to prohibit private competition.

However, not only in the case of non-taxable public activities distortions of competition are possible. They may also arise as regards special exemptions for the public sector according to Article 132 CVSD which depend on the status of the supplier as a body governed by public law. If for example a private hospital does not provide for social conditions comparable with

⁷² R. De la Feria (2009), 'The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction', *Intertax* 37 No 3, on page 151.

those applicable to bodies governed by public law, it will not benefit from the exemption of Article 132(1)(b) CVSD even if it offers the same services as a public hospital. In this respect, the exemption creates a distortion of competition to the disadvantage of the private hospital which must charge VAT as opposed to the public hospital, which is exempt because of its status as a body governed by public law. Similar distortions may arise where Member States chose to impose additional conditions for exemptions according to Article 133 CVSD.

Another distortion of competition results from the fact that the current VAT treatment of the public sector causes a bias towards self supply. In this respect, the VAT system creates a disadvantage for private businesses specialised in contracting out of public services. The irrecoverable input VAT burden in the case of non-taxable or exempt public activities consequently leads to a distortion of competition in favour of in-house production.

Barriers to entry into existing markets

Given the possibility of VAT induced distortions of competitions, the current VAT system can also have the effect of creating a barrier for a private company to enter into existing markets which are dominated by public bodies. Since, unlike non-taxable public bodies, a private competitor would be within the scope of VAT, it would have to charge VAT on the price of its services and supplies. Where supplies are made to end-consumers who do not have the right to deduct input VAT, this would result in the private supply being more expensive as opposed to the public supply. As a consequence, a private competitor would in many cases not be able to compete with public competitors. However, it must be pointed out that a proper transposition and application of the distortion clause of Article 13(1) paragraph 2 CVSD should minimize this effect. Furthermore the complexity of the VAT treatment along with the differences in the Member States and the legal uncertainties deters in particular small and medium sized private competitors from attempting to enter into new markets, especially if confronted with the VAT treatment of the public sector in another Member State.

Level and structure of investment

As described above, the current VAT treatment of the public sector causes a bias towards self supply and a disincentive to invest. This affects the level of investments wherever a public sector body intends to make an investment for its non-taxable or exempt activities and if the received service or supply is taxable, so that the public sector body would be charged irrecoverable VAT. Because of the public sector body's inability to deduct input VAT, the VAT burden creates an additional cost for the investment and becomes an obstacle to investment⁷³. Given the budgetary restrictions of public bodies such as municipalities, the VAT burden may in some cases actually make the investments impossible.

⁷³ M. Aujean (2009), 'The treatment of Government entities, non-profit organisations and other exempt bodies under a VAT: a discussion paper', URL: <http://www.americantaxpolicyinstitute.org> (last checked: 11 January 2011), on page 3.

Level and structure of employment

Since the current VAT treatment encourages public bodies engaged in non-taxable or exempt activities to self supply, these public bodies have an increased need for personnel for the actual self supply instead of outsourcing. As a consequence, the current VAT treatment of the public sector has the effect to encourage a relatively high level of public employment.

Efficiency in delivering public services

The above-mentioned bias towards self supply and away from outsourcing in addition has a negative impact on the efficiency of public services and supplies, since cooperation with the private sector such as the contracting out of services is in many cases regarded to result in lower costs⁷⁴. Even when contracting out of a public service would be more cost efficient than self supply, the inability to deduct input VAT may lead to the public body choosing self supply over the more cost efficient cooperation with the private sector. As a result, the public sector is unable to achieve the maximal efficiency gains⁷⁵. In this regard, the current VAT treatment of the public sector also creates a disadvantage for Public Private Partnerships, which are generally regarded as a way of improving the efficiency of public service delivery⁷⁶.

Impact on public revenues

The impact of the current VAT treatment of the public sector on public revenues depends on the kind of activity. On the one hand, the inability of public sector bodies to deduct input VAT incurred for their non-taxable or exempt activities creates revenue (although at overall public level the net impact is close to zero). On the other hand, the current system in this regard fails to tax the value added as regards the consuming of public non-taxable and exempt public supplies and services. As a result, actual revenue is only achieved where the taxable input of a public body is higher than the non-taxable or exempt output. If, however, the amount of the output is higher, the current system in fact favours the public sector as regards supplies and services to final consumers without the right to deduct input VAT.

Welfare costs

Assuming that in the welfare sector the amount of taxable input is usually higher than the consideration received, the current VAT treatment results in a disadvantage of public welfare bodies, since they carry the burden of irrecoverable input VAT. In this respect the inability to deduct input VAT may for example prevent a charitable organisation from making necessary in-

⁷⁴ Dijkgraaf & R.H.J.M. Gradus (2003), 'Cost Savings of Contracting Out Refuse Collection', *Empirica*, on page 161; M. C. Wassenaar & R. H. J. M. Gradus (2004), 'Contracting out: The Importance of a Solution for the VAT Distortion', *CESifo Economic Studies* 2: 377-396, on page 380.

⁷⁵ M. C. Wassenaar & R. H. J. M. Gradus (2004), 'Contracting out: The Importance of a Solution for the VAT Distortion', *CESifo Economic Studies* 2: 377-396, on page 377.

⁷⁶ R. W. McQuaid and Walter Scherrer (2008), 'Public Private Partnership in the European Union: Experiences in the UK, Germany and Austria', URL: <http://www.fu.uni-lj.si/uprava/> (last checked: 11 January 2011), on page 27.

vestments for their activities such as for example buying buildings for social housing⁷⁷. However, this is only true if the public body which provides the welfare services is not also the recipient of the tax revenue.

As highlighted above, the current VAT treatment prevents possible cost efficiency gains in the public sector through contracting out or other kinds of cooperation between the public and the private sector.

Prices to be paid by consumers

The effect of the current VAT treatment on the prices paid by consumers of public supplies and services also depends on the situation. Where the consumer pays for a non-taxable or exempt public service, he does not have to carry the VAT burden. On the other hand, the price includes an amount of hidden VAT on the taxable input of the public body which could not be recovered. As a consequence, the current VAT system tends to increase the prices for public offerings where the amount of irrecoverable input VAT exceeds the amount of VAT which is not charged because of the non-taxability of the supply. However, if the consideration for public supplies or services paid by the consumers exceeds the amount of the respective public body's non-taxable input, the non-taxability or exemption allows a lower price.

Complexity and tax compliance cost

The current VAT treatment of the public sector under the CVSD is complex⁷⁸ and requires a relatively high level of compliance and administration costs. As pointed out by Gale and Holtzblatt, complexity may even be defined as the sum of compliance costs - which are incurred directly by individuals and businesses—and administrative costs - which are incurred by the government⁷⁹. The already high level of complexity provided by Articles 13 and 132 CVSD is additionally increased by the various exception rules for some Member States and provisions which may voluntarily be adopted. The possibility of multiple tax rates, for example, increases the complexity by raising question of classification if different rates apply to purchases and supplies⁸⁰.

⁷⁷ C. Amand (2006), 'VAT for Public Entities and Charities - Should the Sixth Directive be Renegotiated?', *International VAT Monitor*: 433-443, on page 434.

⁷⁸ See R. De la Feria (2009), 'The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction', *Intertax* 37 No 3, on page 148; M. Aujean/P. Jenkins/S. Poddar (1999), 'A new approach to public sector bodies', *VAT Monitor* 1999: 144-149, on page 145.

⁷⁹ See W.G. Gale & J. Holtzblatt (2002), 'The Role of Administrative Factors in Tax Reform: Simplicity, Compliance, and Administration', in *US Tax Reform in the 21st Century*, eds R. Zodrow & P. Mieszkowski (Cambridge: Cambridge University Press, 2002), 179-214, at chapter I. A.

⁸⁰ P. Gendron (2009), 'How should the U.S. treat government entities, non-profit organisations and other tax-exempt bodies under a VAT?', URL: www.americantaxpolicyinstitute.org/research.html (last checked: 11 January 2011), on page 9.

Even further, complexity is caused by the legal uncertainty. Because of the unclear provisions and common occurring violations of CVSD provisions in the national law regime, public bodies effectively cannot trust the national regulations but must always account for the possibility of different taxation according to the European provisions. It is evident that coping with this uncertainty usually requires considerable legal advice causing high compliance costs. Additional costs and risks arise along with public body's attempts to construct fiscal schemes in order to avoid negative VAT effects⁸¹.

It can be noted that the impacts on the efficiency in delivering public services and on the level and structure of investments and employment are consequences of the current VAT treatment of the public sector's inputs and lie within the VAT system of the CVSD itself. As a result, these problems cannot be solved by enforcing harmonisation but require a change of the European VAT legislation. The approach of some Member States to introduce compensation mechanisms appears to be problematic. Alternative solutions and their effects will be discussed in chapter 4.

Conclusion

According to our assessment the major problems of the current VAT treatment are its complexity and legal uncertainty as well as its distortive effects in relation to economic decisions of the public sector bodies and the competition with the private sector.

As regards the legal uncertainty of the system, it must be noted that it aggravates many of the aforementioned problems. A lack of certainty about the tax consequences of specific transactions for example causes inactivity as regards the undertaking of new investments or extending and adapting existing activities⁸². Furthermore, it additionally complicates entering into new markets for private competitors, creates compliance costs as well as administration costs and encourages the use of complex structures or tax schemes which take advantage of the situation⁸³.

The distortions of the current system also have the effect of enforcing many of the highlighted negative impacts. The distortion of competition to the disadvantage of private competitors has the additional effect of depriving the consumers of public goods of the benefits of increased competition between public and private sector providers⁸⁴. The distortion as regards input

⁸¹ H. van Dijk & G. Lubbers (2000), 'The VAT Compensation Fun(d)?', VAT Monitor, on page 7.

⁸² C. Amand (2006), 'VAT for Public Entities and Charities - Should the Sixth Directive be Renegotiated?', International VAT Monitor: 433-443, at 435.

⁸³ C. Amand (2006), 'VAT for Public Entities and Charities - Should the Sixth Directive be Renegotiated?', International VAT Monitor: 433-443, at 435.

⁸⁴ P. Gendron (2009), 'How should the U.S. treat government entities, non-profit organisations and other tax-exempt bodies under a VAT?', URL: www.americantaxpolicyinstitute.org/research.html (last checked: 11 January 2011), on page 7.

choices by public bodies hinders public investments and efficiency gains of cooperation with the private sector. These effects cannot effectively be neutralised by the existing Art. 132 (1) f CVSD. Furthermore, it is difficult to assess the impact of public sector body's inability to deduct input VAT, since it depends on the relation between the amount of taxable input and non-taxable or exempt output of the respective body. As in the case of non-taxable or exempt welfare activities the VAT system can even lead to an effective tax burden for the consumption of public goods that directly contradicts social and distributional aims⁸⁵.

Therefore the EU should seriously consider the possible policy options as described in chapter 4.

⁸⁵ R. De la Feria (2009), 'The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction', *Intertax* 37 No 3, on page 148.

Chapter 3 THE ECONOMIC CONSEQUENCES

In the previous chapter we learned that the major problems with the current VAT treatment have to do with complexity and legal uncertainty as well as with distortive effects in relation to economic decisions of the public sector bodies and the competition with the private sector.

In this chapter we add the economic perspective on the problems of the current VAT treatment. First we address the economic importance of the problems caused by distortions in relation to economic decisions of the public sector (section 3.1). Then we address the economic importance of distortions of competition with the private sector (section 3.2). Finally we present a method to assess the economy wide effects of the problems of the current VAT treatment (section 3.3).

In general in this chapter we work at a different level of detail than in chapter 2. First of all we do not link the economic problems directly with particular pieces of EU or national legislation. Second, when we present case studies, we do not collect information for all the sectors contained in the legal questionnaire in chapter 2. Third, when we collect information on productivity differences between public and private sectors, the economic data available does not allow us to take a very detailed approach to assessing the economic importance of the problems with the VAT system. We have used the knowledge we could find, and supplemented this with new case studies in selected areas. We also refer to the discussion about data availability in the preface.

3.1. CHALLENGES ARISING FROM DIFFERENTIAL VAT TREATMENT

Some background from the literature

There is a small body of research on the question of how differential VAT treatment of private and public bodies affects their sourcing decisions.

Ernst & Young (1998) analyse how the current VAT system in the EU15 works by applying legal and economic principles to the EU VAT legislation. On this basis they find that the VAT system in the EU at the time Ernst & Young's analysis was made generates the following biases: self supply, impediment to privatisation, hindrance of the voluntary sector, barrier to intra-community trade and tax cascading. They identify a range of options for policy reform, including a move to a full taxation system, zero or reduced rating, a pure exemption system or adoption of the Canadian system. The key features of the EU VAT system, which gave rise to Ernst & Young's assessment, have not been changed since then.

Wassenaar and Gradus (2004) review the literature on sourcing of public sector activities around the World in a range of areas, among others cleaning services. They find that the current VAT treatment of public entities does have a significant effect on the size of contracting

out by public entities; that the current VAT system facilitates own supply. They also conclude that VAT refund schemes facilitate outsourcing of public sector activities.

Wassenaar et al. (2007) conducted an interview of a representative sample of Dutch municipalities, where they asked whether the VAT hindered the decision to outsource activities, and whether the introduction of a VAT-compensation fund caused an increase in outsourcing of activities. The interview responses were matched with data on a range of characteristics of the municipalities, and the responses were analysed while controlling for municipality specific characteristics. The results were that 8 percent of the municipalities believed that VAT had hindered outsourcing, and 4 percent of the municipalities believed that the introduction of the VAT compensation fund had already led to outsourcing. 12 percent of the municipalities believed that the VAT compensation fund would lead to outsourcing in the future.

A more recent study by Cnossen (2008) compares the EU VAT system with the principles of economic theory of optimal taxation. Cnossen considers a range of economic sectors, of which some of them are public. He argues for more public activities to be taxed thereby creating a level playing field with private providers. Cnossen even extends the conclusion to services such as cultural services, health care services and education services. The reason is that as private provision of competing services emerges with the continuous development of the EU economies, distortions created by a lack of a level playing field, will grow in real economic importance.

A taxonomy of services

The distinction between “core” and “support” services is often used to distinguish between an entity’s activities. Core services are, “what the customers are demanding from the public sector”. This could be health care services, police services and education services. Support functions or services (we use the interchangeably throughout the report) are inputs that are in principle similar across the core services. E.g. cleaning services, accountancy services, receptionist services and IT support services, cf. Table 3.1. Many support services can in principle be outsourced.

Table 3.1 Selected core services and their common support services

Sector name	Health care	Social services	Fire protection	Police
Core services (examples)	Surgery	Counseling services	Emergency response	Emergency response
	Disease treatment	Job intermediation	Fire prevention	Prevention of crime
	General practitioners Emergency rooms	Day-care centres	Control of buildings	Issuance of allowances
	Disease prevention			
	Book keeping /accounting services	Preparation of food		Receptionist services
Support services – common for all sectors (examples)	Cleaning services	Facilities management / Janitor services		Human re-
	source management services			
				IT-support services

Source: *Copenhagen Economics*.

Differential VAT treatment increases the incentive to self-supply

A differential VAT treatment of external and self-supplied inputs to production (support services) distorts sourcing and investment decisions, leading to a bias towards self-supply even in cases where private suppliers are more efficient. This bias occurs for both private, non-profit and public sector bodies which are tax exempt or non-taxable.

The basic intuition is that the public and private bodies alike seek to minimise the cost of producing goods and services. If a public body cannot deduct input VAT, then it becomes more costly for the public body to hire a firm (which has to charge VAT on its sales) than to let its own employees perform a range of activities.

Although it is true that any VAT payment is in principle just a transfer back to the State itself, the VAT payment is still an expense for the public body, which cannot deduct VAT or get a VAT-refund, and it reduces the amount of resources the entity has to pursue its objectives. Box 3.1 contains two examples of these effects.

Box 3.1 Example of self-supply bias and investment distortions

Example of self-supply bias:

Municipality A outsources its IT department (costs 85). Municipality B keeps it in-house (costs 100).

Municipality A:
Costs $85 + 20\% \text{ VAT} = 102,50$

Municipality B:
Costs $100 + \text{no VAT}$

In this example, municipality A is economically worse off than municipality B, even though municipality A chooses a private supplier with lower net-of-VAT costs (85) than the costs of the in-house solution (100).

Example of disincentive to invest:

University U is non-taxable. It wants to build a new building. The net costs of such a building are 100. The funds of the university are limited to 100. The building cannot be erected as VAT becomes due so that the costs are 120 (100 costs + 20% VAT). The university will have to wait until the funds are 120. With every rise of the VAT rate they need more funding.

Source: KPMG AG.

The box illustrates that even though the net of VAT costs of having an external supplier are less than the net of VAT costs of self-supply, the VAT expense may be so large that the total costs of having an external supplier are larger than the total costs of self-supply.

There are several examples where the differential VAT treatment has led to, or leads to, a waste of resources. In Box 3.2 below we describe an example where German charity owned hospitals choose not to exploit economies of scale by sharing inputs, because if they establish a separate legal unit which supplies e.g. catering, this unit will be taxable, increasing costs to a point where it is not economically viable.

The case also describes how the VAT discourages the hospitals from investing in equipment and buildings, but instead encourages them to enter into specific forms of lease arrangements in order to save VAT expenditure.

Box 3.2 Case study of German non-profit hospitals

This case study is from a German non-profit hospital group with a church background. The group is consisting of several hospitals and several homes for the elderly. It has more than 4,000 employees and sales of more than EUR 250 million. The group is organised in a management holding company, several hospital-operating companies (running one hospital each) and several shared service centre companies with support functions like catering or central purchasing for the group.

The VAT currently plays a major role for choosing the legal form of the group structure. For most of the support services rendered by the shared service centre companies (e.g. catering) as well as for the management service rendered by the management holding company (e.g. management of the group, accounting, human resources) 19% VAT would be due as the VAT exemption in Art. 132(1)(b) CVSD is not applicable concerning the shared service companies. The hospital-operating companies would not be able to deduct input VAT insofar they are using the services rendered to them for tax-exempt hospital services. As a consequence it is – from an economic point of view – usually not possible to form shared service centres in a hospital group as a separate legal entity.

There are certain costs of administration of the VAT. The hospitals sales have to be split-up into tax-exempt services (e.g. curative medical treatment) and their non-exempt services (e.g. convenience services like TV and telephone, other services). Often there is a legal uncertainty concerning the split-up of activities. In these cases the hospital group has to ask a tax advisor for support. Also the input VAT has to be split-up. This usually causes more work than the split-up of output services. Several employees of the accounting department are working on this for several days each year. However, all in all the VAT-related administration costs are considered as relatively low and non-material.

The VAT is not considered as the most important factor for outsourcing decisions but as a very important one once outsourcing is considered as advantageous from an economic perspective. When this is the case, the costs have to be so low that the non-deductable VAT can be compensated as a self-supply is not taxed with VAT but the supply by a third party is taxed. This leads to the consequence that often there is only outsourcing within the VAT group (shared service centres). The only chance for third party suppliers to have a competitive offer is to cut the personnel costs by paying lower wages or by saving material costs, e.g. through economies of scale.

The VAT has also an influence on investment decisions, e.g. often goods are leased because the VAT (non-deductable input VAT) becomes due on a pro-rata basis and not at once in the beginning of the useful life of the good. Moreover, the non-deductable input VAT has to be amortised. However, it was not considered that the VAT has a material effect for investments decisions.

Source: KPMG AG.

Another case, where the VAT affects economic decisions is given in Box 3.3 below. In the UK there is a compensation mechanism which allows public health organisations to recover their VAT on many inputs. Therefore, the outsourcing decisions concerning e.g. ICT and facilities management are not affected by VAT. However, the hospital cannot recover VAT on capital construction work and medical equipment. Therefore investment decisions are affected by VAT considerations.

Box 3.3 A case study from a UK public health organisation

The following summary of case study is taken from a public health organisation in the UK. At present, public health bodies in the UK have in practice no choice over their legal form. However, some exceptions exist for bodies in England. Firstly, they can apply to become “foundation trusts” which have greater autonomy and control. Due to this fact, it is also expected that all English National Health Service trusts will become foundation trusts within a short timescale. Secondly, English Primary Care Trusts have to divest themselves of their “provider arms”. Some are considering alternative models including social enterprises. From this reason, VAT is not able to influence the public health organisation by choice of its legal form.

Most of the activities of the public health organisation are considered as non-business activity; and hence are out of the

scope of VAT administration. However, some incomes e.g. from catering for staff and visitors are taxable (taxed) and have to be announced in VAT returns. In relation to this the organisation incurs the costs of app. £15.000-20.000 per annum for advisers to support VAT compliance.

Outsourcing, in this health organisation, is used especially in areas such as estates, IT, medical directorates and facilities. The choice between self-supply and outsourcing is made on basis of non- VAT criteria, as input VAT can be mostly recovered. Due to this fact, public bodies are generally discouraged from using tax planning (e.g. cost-sharing scheme, VAT grouping etc.).

Turning to the effects of VAT on investments, the public health organisation assesses that VAT has impacts on how capital goods such as medical equipment are acquired. The organisation estimates that use of managed service contracts rather than standard leases (or purchases) saves approximately £500.000 per annum. As regards costs incurred in connection with solving VAT issues (e.g. advisory fees and administrative costs), they are assessed at 5 % of recoverable VAT.

Source: KPMG AG.

A final example is that of a Swedish private hospital, for which no VAT compensation scheme applies, cf. Box 3.4.

Box 3.4 A case study from a Swedish public health organisation

We undertake a case study on a private health care provider in Sweden. The health care provider is a leading health-care provider in Europe and supplies services within several medical specialities. The provider has about 100 operating units with some 15,000 employees in the EU. Annual sales amount to approximately SEK15,500 million (1.6 billion Euro). Customers include county councils, municipalities, companies as well as public and private insurance companies that purchase healthcare services.

The core health services provided by the company are exempted from VAT, but not other services. Hence the uneven treatment of inputs and outputs for VAT purposes can create an administrative burden on handling VAT deduction from purchases. However, the overall administrative burden in this case is not excessive since they, as a rule of thumb, consider certain percentage of total purchase of goods and services as VAT deductible.

The major effect of the current VAT system through competition distortion lies in the outsourcing support function to specialized firms.

Example 1

Real estate is one example. In most cases, VAT is levied on housing rents. Real estate owners can register their property and make it exempt from VAT, but they are in general unwilling to do so, probably because this reduces their possibilities to deduct VAT from their own purchases.

This reduces the number of localization alternatives for our case study hospital when, for example, planning a new hospital. It constitutes a real cost disadvantage. One can clearly see that this has had an influence on where health service provider premises are placed. In theory, one can of course contemplate owning the buildings and internalise the problem, but real estate management is not what our case study hospital wants to focus on: as it is a health service provider, that is what it wants to concentrate on.

Example 2

Our case study hospital runs their own IT to almost 100%. In public hospitals, the picture is reverse, they have outsourced most or all. The VAT-issue is the principal explanation according to our case study interviewee.

Source: Copenhagen Economics.

On the other hand, our cases from New Zealand and Australia do not point to VAT (or GST in the case of Australia) causing any self-supply bias or disincentive to invest. This is because in

these countries, both public and private sector bodies put VAT on their outputs and can deduct VAT on their inputs.

Differential VAT treatment distorts competition

Differential VAT treatment of public and private bodies with respect to whether they have to charge VAT on their supplies generates a distortion of competition. The distortion may affect the output side through reduced competitiveness of public sector entities vis-à-vis private competitors. The reason is that if e.g. a public and a private provider of waste management services compete in the same market, the public provider will have the advantage of not charging VAT on its clients. The private provider of waste management service will, on the other hand, have to add VAT to its clients. Hence, the public provider of waste management service may have a competitive advantage over the private provider of the same service. This is of course only the case when public and private providers actually are competing.

Our assessment is that this is most prevalent in the waste disposal and broadcasting sectors, where the legal questionnaire conducted as part of this study indicates that there are many EU countries where the output VAT rates are different for private and public bodies.

Differential VAT treatment of public and private sector bodies can also give public suppliers an advantage over their private or non-profit competitors in the form of being able to offer the services at lower price, because they have lower production costs.

The first case is that of a Swedish private hospital – the same one we described earlier. When the hospital invests in medical equipment, it has to pay VAT, which makes it more expensive for the hospital to supply its services – this is not the case for public hospitals, cf. Box 3.5. This effect arises only in the particular case where there is a VAT refund scheme for public bodies, but not for private firms. If there were no refund scheme, public and private hospitals would be on an equal footing, but then both public and private hospitals would have a disincentive to outsource.

Box 3.5 A case study from a Swedish private hospital

Consider again the Swedish private hospital described in Box 3.4 above. When the hospital buys for example an x-ray unit for 10 million SEK (approx. 1,068 million Euro), the company would have to pay an extra 2.5 million SEK (approx. 267,000 Euro) in VAT. Clearly, this affects their investment decisions. The company invests less to the detriment for patients and the service they can provide, including waiting time for treatment. This problem impacts the private company, not the public hospitals.

Source: *Copenhagen Economics (2010)*.

Another interesting case study is regarding a Danish non-profit organisation. In Denmark there is currently a special VAT compensation scheme for some selected non-profit organisations.⁸⁶ The compensation scheme thus creates a level playing field for a selection of non-profit organisations and public bodies. However, our case illustrates the importance of the distortion of competition by describing the development of the scale of the non-profit organisations' activities before and after the introduction of the compensation scheme for non-profit organisations.

It turns out that the introduction of the compensation scheme for non-profit organisations in Denmark led to a remarkable increase in the scale of activities of the non-profit organisations which we consider. This indicates that it may cause significant distortions to competition if only public bodies within tax exempt sectors can recover input VAT.

Costs of administration, compliance costs and other VAT system effects

There are some interesting cases where VAT treatment causes public and private bodies to do things that appear to be irrational from the view of society or even that of "good business".

One variant of distortions caused by differential VAT treatment between public and private firms is the case of public-private partnerships in Germany. In Germany, the differential VAT treatment of public and private bodies affects the extent and the form of public private partnerships. The VAT treatment of the outputs and inputs of a public private partnership can have an effect on whether the partnership is economically viable. Box 3.6 describes the German example.

⁸⁶ We provide a description of the Danish compensation scheme for non-profit organisations in chapter 4.

Box 3.6 VAT and public-private partnerships – a case from Germany

In Germany, differential VAT treatment of the public and private sectors has become a problem for public-private partnerships, because public-private partnerships have to pay VAT, which often makes participation in public-private partnerships more expensive to the public parts than the “normal” in-house production.

The problem has been acknowledged by German politicians as evidenced by the SPD publication “Öffentlich Private Partnerschaften – Eine Zwischenbilanz im Jahre 2009”. The publication points to differential VAT treatment as one of the major barriers to more and better partnerships.

It is noteworthy that while other European economies can demonstrate a share of around 15 percent investments through public-private partnerships, the corresponding figure for Germany is only 4 percent. Since labour-intensive projects contain larger value added, especially if the projects contain constant flows of services provision, the projects will face larger VAT burdens and are therefore less likely to be implemented.

The publication also points to several ‘grey-zone’ attempts to avoid VAT. A standard solution found for instance in German military or prison projects is to set up an organisation within the relevant public entity, which is then practically driven by the private firm. In this way, e.g., labour costs can be paid directly by the public authority without incurring VAT payments.

Apart from creating a distortion between private provision and public self-supply, there are also distributional effects involved. Municipalities who choose public private partnerships despite the VAT differential not only minimises the use of resources (given inferior public productivity), but also transfer money to other municipalities through VAT payments. In a calculation of a concrete school project, we see that the municipality paying a total of 753,350 Euro in VAT only receive a few Euro-cents, while the remaining revenue goes to other municipalities and the general government.

Source: SPD (2009) and Copenhagen Economics.

Finally, it is costly to handle VAT in systems with multiple different VAT treatments, as it is illustrated in the case in Box 3.7.

Box 3.7 Case on administration costs in a Danish university college

Danish university colleges are subject to the Ministry of Education’s VAT refund scheme, the rules of VAT and wage taxes in the VAT law, and a range of other VAT rules and schemes applicable for special projects, where the funding parties have different rules for VAT compensation.

A medium size university college receives and processes more than 20,000 invoices each year. For each invoice it has to be decided how to apply the VAT treatment and, depending on the number of VAT rules and schemes which the invoice refers to, it will take between one and 10 minutes to assess the correct VAT treatment. An estimate of the time spent on handling VAT in a medium sized university college is that it takes at least one man-year to ensure the proper VAT treatment of invoices.

Source: Copenhagen Economics.

The importance of differential VAT treatment for support functions

It is reasonable to believe that a significant share of the public sector’s support services (e.g. IT-services, accounting services and cleaning services) could in principle be outsourced to the private sector. An illustration of this point is that the private sector actually outsources these services to a large extent. For example, a recent study by ZEW (2009) found that more than 30 percent of German firms outsource IT infrastructure management.

There is not much data on how big the share of support functions in the public sector is relative to the total amount of public sector activity. However, the data we have found indicates that support functions make up a substantial share of public spending. For example, in the UK, the Operational Efficiency Survey estimated that the public sector back office (i.e. support) functions account for around 8 percent of public sector costs, cf. Table 3.2. Drawing on more general data sources, as done for Denmark and France, we find that support functions amount to approximately 20 percent of public budgets. We interpret these larger figures as upper limits on how much activity that in principle can be outsourced; a non-trivial part of these functions will most likely be kept in-house to meet certain production, quality and risk criteria.

Table 3.2 Differential VAT treatment affects a large share of public expenditure

	UK	Denmark	France
Support function share (%)	8	20	19
Explanation	Focus on selected support functions. Not all outsourcable functions.	Only municipalities. Large budget categories with possibly too wide coverage.	Large budget categories with possibly too wide coverage.
Source	HM Treasury (2009)	Statistics Denmark (2010)	Direction du Budget (2010)
Share definition	Percent of total public sector running cost	Percent of municipality running cost.	Percent of total state running cost

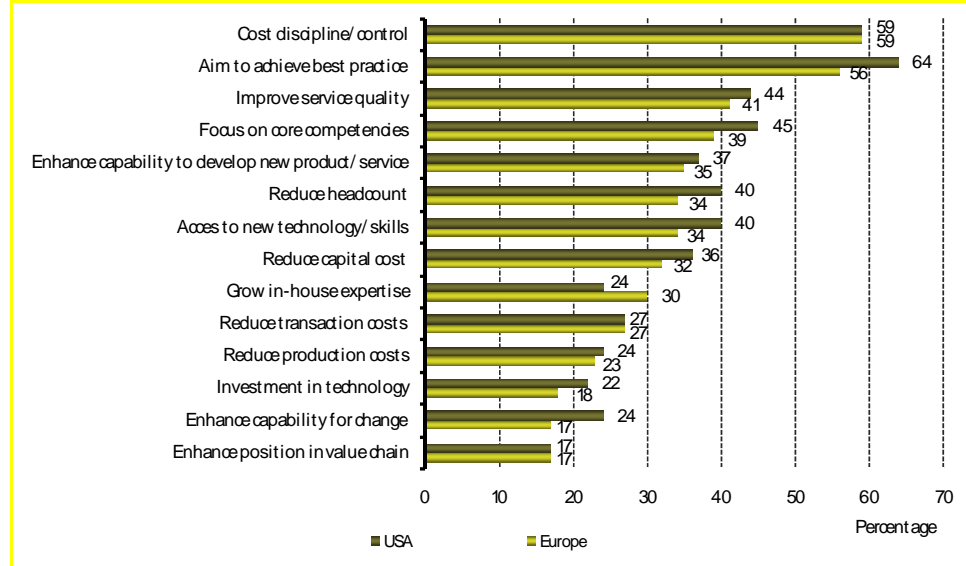
Source: Copenhagen Economics based on stated sources.

A first key reason why the private sector outsources services is that it expects real efficiency gains from outsourcing. It follows more or less from the definition of core and support services that firms rarely specialise in their own support services. For example, a car manufacturer will probably not be the best firm in the market to set up IT-systems. Therefore, it is likely that it will be cheaper for the car manufacturer to have an external supplier carry out this support service.

A second reason is that firms outsource in order to improve quality. The logic behind this is the same as for the cost motive: Firms rarely specialise in their own support services, and it is therefore likely that an external supplier is able to deliver better quality than what the firm could do on its own.

A third reason is of more strategic nature: Firms want to limit their activities to the set of activities which are their core competencies, and where they hold a competitive advantage. Figure 3.1 shows a list of important reasons for why firms choose to outsource, and how large a share of firms in the USA and in Europe that state the different reasons as important. For example 59 percent of respondents in both the USA and Europe state that cost discipline is an important reason for outsourcing, whereas only 22 percent of respondents in USA state that investment in technology is an important reason for outsourcing, and 18 percent of European respondents mention investment in technology as an important reason for outsourcing.

Figure 3.1 Drivers for outsourcing in the private sector



Source: Kakabadse et al. (2005).

The outsourcing of support services is part of a broad tendency to ‘slice up the value chain’, so that firms break up their activities and outsource them to the suppliers who can best carry out the activities – in order to increase profits. As it is stated in a report from Centre for European Economic Research (ZEW) “We live in an age of outsourcing”.⁸⁷

Because economic considerations and the desire to focus on core business areas play such an important role for private firms’ outsourcing decisions, we assess that the VAT will also make a big difference for public bodies’ decisions whether to outsource support services. This assessment is backed by the results of Wassenaar et al. (2007). In a survey of Dutch municipalities they found that introducing a VAT compensation scheme in the Netherlands would have the effect that 12 percent more municipalities would outsource support services in the longer run.

So if outsourcing support services is desirable for public bodies, and the VAT treatment matters, what is the economic consequence of this? How much does it matter that production of support services moves from the public sector to the private sector?

In general, for private firms, it seems to be the case that business service outsourcing leads to improved productivity. In ZEW (2009) an analysis on empirical firm-level data is performed,

⁸⁷ ZEW (2009).

concluding that outsourcing of business services has a positive and significant effect on productivity.

In the available literature the empirical estimates of efficiency gains from outsourcing in the public service differ. The literature suggests that outsourcing of support functions does lead to increased efficiency, in the range of 5 to 30 percent.

In Udbudsrådet (2010b) – a Danish authority responsible for promoting outsourcing in the public sector – it is estimated that the EU average cost reduction from tendering is 8 percent, which rises substantially when the amount of bidders increase, cf. Table 3.3.

Table 3.3 Cost reductions from public tendering

Number of bidders	EU Average cost reduction from tendering
Average	8%
5 to 10 bidders	Up to 20 %

Source: Udbudsrådet (2010b).

The above is an average of all types of public tenders. Support functions however are standard services with a well functioning market with many possible bidders, indicating that the cost reduction potential is greater for support functions.

Even higher estimates are found in other studies. Paldam (2001) finds a 30 percent cost reduction from outsourcing cleaning services in Danish public schools. Paldam (2001) notes that this estimate is in the higher end of what is typically found in the literature on public outsourcing of support functions. This literature typically finds cost reductions in the area of 25–30 percent.

These empirical results match well with select cases from Denmark. The Danish municipalities have to an increasing extent been outsourcing support services to private suppliers in recent years. There are both cases where the outsourcing has been an immediate success and where the initial experiences have been poor. In Box 3.8 we present two examples of experiences of outsourcing support function in Danish municipalities where outsourcing has been a success. One where wage administration was being outsourced and one where human resource management was being outsourced. In both cases there were significant cost reductions of 12.5 and 22 percent respectively.

Box 3.8 Case studies on the outsourcing of administration in Danish municipalities

Administration of wage office in Frederiksberg Kommune

The Danish municipality of Frederiksberg made a call for tender on the administration of the wage office. The call for tender was handled by a centralised unit, which handles all tenders in Frederiksberg. The tender called for a 3 years contract and had a contracted value of DKK 18 million (approx. Euro 2.5 million). The tender was based on “lowest price” and came with a detailed formulation of tasks and quality of the service. This was chosen to minimize problems with flow of information and interfaces between the intern administration and a new external administration partner. The municipality gave a “control bid” itself, but the task ended with being outsourced, as a private company gave the lowest bid. It is estimated that the cost savings were DKK 1.7 million (approx. Euro 0.2 million) per year, summing to DKK 5.1 million (approx. Euro 0.6 million), over the three year period of the contract. This is a cost reduction of 22 percent. The outsourcing has also led to more efficient work procedures.

Administration of wage office and human resources (HR) in Greve Kommune

An external consultancy helped Greve Kommune assess which part of their services that could be successfully outsourced. The administration of the wage office and HR was identified as legible for outsourcing and a call for tender was produced. The contract gave detailed descriptions of each task and interviewed the intern staff responsible for wage- and HR administration. The contract ran for 5 years, with an approximate value of DKK 7 million (approx. Euro 0.9 million) per year. The cost reduction is estimated to DKK 1 million (approx. Euro 0.1 million) per year, or equivalent to 12.5 %. Furthermore the outsourcing has led to more efficient work procedures and a higher quality of work. In addition, the outsourcing has led to innovation and further digitization.

Source: Konkurrencestyrelsen (2009).

It can be argued that outsourcing stimulates innovation since private organisations tend to be more innovative than public organisations. Private organisations are more innovative, because in many sectors, innovation is necessary for private organisations to survive and grow.

Empirical studies show that competition also fosters innovation, either through more efficient processes or through improved or new products. One force driving this is that firms are looking for first-mover advantages, i.e. to be able to increase their profit margins for a period of time before their competitors catch up with their innovation. This is an indication that competition is good for innovation. However, if the competition is too fierce, then perhaps the individual firm will not expect to be able to make enough earnings on an innovation before its competitors catch up – so there is also an argument for the case that too much competition may hinder innovation. Much empirical research in fact documents that either too little or too much

competition is bad for innovation, while a certain amount of competition is good, , cf. Table 3.4.

Table 3.4 How is innovation affected by competition?

Study	Results
Levin, R, Cohen, W, Mower, D. (1985)	Inverted U-shaped correlation. Most innovations take place when a couple of market players share alt least half the market.
Aghion, P., Bloom, N., Blundell, R., Griffith, R., Howitt, P. (2004)	Inverted U-shaped correlation between competition and innovation.
Blundel, R., Griffith, R., van Reenen, J. (1999)	More innovation in sectors with competition.
Geroski, P. A. (1990)	60% of the variation in innovation is explained by competition.
Jaumotte, F., Pain, N. (2005)	Less market regulation (OECD's PMR indicator) leads to increases in investments in R&D.

Note: An inverted U-shaped correlation means that innovation first increases in increased competition but that it flattens out and decreases at a certain level of competition.

Source: Studies in table.

To judge in which type of sectors and functions outsourcing may boost innovation through increased competition, we look at which sectors and functions are innovative to begin with. If a sector with a high degree of competition today still has a low degree of innovation, then we conclude that the sector in itself is not innovative. An example of such a sector is accountancy, where outsourcing is not likely to bring about dynamic effects in the form of innovations. An instance of the opposite is software and IT services where innovation intensity is high. If outsourcing would have a significant impact on market size or competition intensity on such a market, outsourcing might promote innovation in these sectors.

An innovation index constructed to measure innovation in different sectors in the UK suggests that the innovation intensity varies considerably between the support function sectors. Innovation is measured in three separate dimensions:

- The firms' ability to access innovation (develop ideas or obtain them from elsewhere)
- To build innovation (turn ideas into products)
- To commercialise innovation (use innovative goods or services to make money)

Indeed, innovation is low in sectors where we would not expect increased competition to stimulate innovation, e.g. accounting and legal services, while innovation is more intense in other sectors, such as software and IT-services, cf. Table 3.5.

Table 3.5 Innovation activity in support function sectors

Sector	Degree of competition	Accessing innovation	Building innovation	Commercialising innovation
Consultancy services	High	High	High	High
Software & IT services	High	High	High	High
Architectural services	High	Medium	Medium	Medium
Legal services	High	Low	Low	Medium
Accountancy	High	Low	Low	Low

Note: Based on a questionnaire to 1,500 businesses. The score is in relation to the most innovative sectors. Source: Nesta (2009).

It thus seems to be the case that innovation in a range of support services will benefit from more competition, e.g. by removing the barrier which VAT can be to outsourcing of support services, because both dynamic gains and one-off static allocative gains may be reaped. On the other hand, competition within these support is already high.

The importance of differential VAT treatment for core services

Wassenaar and Gradus (2004) summarise the amount of refuse collection contracted out to the private sector in eight member states of the EU in the 1990's. They find that countries with a level playing field with respect to public sector VAT tend to have a large share of private refuse collection, cf. Table 3.6. The table also shows that e.g. in Sweden public and private suppliers of refuse collection are treated equally with respect to VAT, and in this country, 64 percent of refuse collection is carried out by private firms. Out of the eight EU Member States in the table, the four countries with most outsourcing also have a level playing field for private and public suppliers with respect to the treatment of VAT.

Table 3.6 Contracted out refuse collection in 8 Member States of the EU

Member state	Percent of private refuse collection (year of data collection)	Level playing field with respect to VAT (in year of data collection)
United Kingdom	29 (1994)	Yes ^{b)}
Ireland	39 (1995)	No
Netherlands	40 (1998)	No ^{a)}
Italy	46 (1998)	No
Sweden	64 (1996)	Yes ^{b)}
Norway ^{e)}	73 (1997)	Yes ^{c)}
Denmark	85 (1997)	Yes ^{c)}
Finland ^{d)}	92 (1996)	Yes ^{b)}

Note: a) A VAT refund scheme is available from 2003 onwards.

b) The level playing field is achieved by the introduction of a VAT refund scheme.

c) The level playing field is achieved by considering the collection of household refuse as a taxable activity.

d) This number is only available for the Finnish county Uudenmaan Lääni.

e) Although Norway is not a member state of the European Union, because of its membership of the European Economic Area agreement it applies the VAT rules of the European Union.

Source: Wassenaar and Gradus (2004).

This does not per se prove that VAT is important to outsourcing of public core services. The reason is that there may be other factors, which matter for the share of outsourcing of refuse collection, but which happen to coincide with whether a country has a level playing field with respect to VAT. However, on the basis of Table 3.6 it is difficult to disregard VAT as something that affects outsourcing of public core services.

Just as it were the case for public support services, there is reason to believe that there are major productivity gains to be realised from outsourcing public core services. Wassenaar and Gradus (2004) review several studies on the potential for cost savings by the public sector from contracting out waste collection to the private sector, c.f. Table 3.7. Many of the estimates suggest that a 20 percent cost reduction may not be unrealistic.

Table 3.7 Cost savings from contracting out waste collection to the private sector

Country	Savings in average costs of due to contracting out waste collection to the private sector	Reference in Wassenaar & Gradus (2004)
USA	Lower	Kitchen (1976)
Switzerland	20% reduction	Pomerehene and Frey (1977)
USA	7% to 30% reduction	Stevens (1978)
UK	22% reduction	Domberger et al. (1986)
Netherlands	15%-20% reduction	Dijkgraaf and Gradus (2003)
Sweden	about 15%-20% reduction	Ohlsson (1998)
Ireland	45% reduction	Reeves and Barrow (2000)

Source: Wassenaar and Gradus (2004).

Swedish experiences also indicate that significant cost savings can be achieved by outsourcing public core services, c.f. Box 3.9.

Box 3.9 Swedish experiences with outsourcing

Swedish public procurement accounts for at least €50 billion per annum, including manufactured goods as well as services. There are a number of reports describing the effects of public procurement by municipalities, whose procurement amounts to €14 billion per annum, including procurement of property services, waste disposal, child care and care for the elderly. Many of these studies report cost savings of 10-15 percent.

An auxiliary effect of procurement is that the procurers often reduce their own production costs. There are two reasons for this; firstly, the process of defining what needs to be procured often results in an awareness of unnecessary expenses which may then be cut, and secondly a tendering procedure may drive the municipalities own entities to reduce their costs in order to be able to compete with private businesses.

A telling example of the potential benefits of outsourcing through tendering is the procurement of waste disposal services in the municipality of Täby. During the late nineties, competition in the waste disposal rose due to several market entries. The company that initially held the whole market, called Sellbergs, still provides the largest share of the services. However, two other companies, Miljöservice and Skafab, managed to enter the market by offering the best bids on parts of the services procured by the municipality. The effect of the procurement has been a 30 percent cost saving. It is also noticeable that the initial contractor, Sellbergs, has reduced its price considerably after the entrance of the competitors.

Another example of beneficial effects from outsourcing is the effects of increasing private sector care for the elderly, which has been shown to be beneficial. A meta study of six evaluations shows that cost savings were achieved in all six evaluations, although one evaluation suggests that cost savings are diminishing over time. Simultaneously, eleven evaluations of the quality of care unanimously showed that the private business responsible for the care met the municipalities' quality demands. Two evaluations even identified improving quality.

Source: Bergman (2008), Offentlig upphandling och offentliga inköp Omfattning och sammansättning, De Nordiske Konkurrensmyndigheter, (1998), Konkurrensutsetning av kommunal verksamhet, p.25, 37 and 168.

Some public core services are very difficult to outsource for purely political reasons. For example, it may be difficult to imagine private firms designing laws and performing the executive functions of government. It is also difficult to imagine the police or the Supreme Court being private firms with a mandate to keep law and order and interpret the law.

It is an important issue if a public contractor considers outsourcing but fears that private producers will provide sub-optimal quality. This may induce politicians to maintain full control over production rather than outsourcing the core service to a private supplier.

The public contractor has an option of laying down quality requirements for the private producer in rigid contracts. However, it may be difficult to define and fully describe the quality of

service in a contract. Change of producers and the preparation of tender material can be costly which introduces a transaction cost that decreases the gains from outsourcing. If the service being outsourced is of a complex nature, it can be difficult to monitor the quality of work, especially in the presence of the above arguments for erosion of quality. This type of monitoring also increases transaction costs.⁸⁸

A Danish study⁸⁹ shows that these concerns from decision makers' point of view about to decide whether or not to outsource a public service may be important, c.f. Table 3.8. The table summarises the findings from the study assessing which barriers the public decision makers gave importance when deciding on whether or not to outsource a service. The four categories of barriers are identified by the authors, while the assessments of their effects are based on literature reviews and surveys among decision makers.

Table 3.8 Perceived barriers to outsourcing in Danish municipalities

Barrier	Assessment of the effect on outsourcing
Attitudinal	Significant
Economical	Significant
Regulatory	Medium
Organisational	Medium

Note: "Attitudinal" describes barriers, where the decision maker chooses not to outsource a service, as they have a negative attitude toward outsourcing that particular service. The analysis emphasise that this is in general more based on personal bad experiences than ideology.

Source: Udbudsrådet (2010a).

3.2. METHOD FOR QUANTIFYING THE ECONOMIC EFFECTS FROM REMOVAL OF DISTORTIONS

In this section, we describe how we assess the economic impacts of the problems of the current VAT treatment and the impact of VAT policy.

To this end, we first collect information on the size of the economic sectors affected by the problems.

Second, we try to gauge how much public and private activities are substitutes, so that a difference in VAT can lead to activities moving from the public to the private sector or vice versa.

⁸⁸ Bel et. Al(2009) and Letho(2005).

⁸⁹ Udbudsrådet (2010a).

Third, we assess compliance costs of refund systems, that is, how large are the costs for society of public institutions having to administer a VAT refund system, where for every invoice received they have to decide whether it qualifies for a VAT refund.

Thus, this section provides background knowledge for understanding the size and robustness of the results.

The size of the economic sectors involved

We are looking at all sectors in the economy in our modelling exercise. However, we have chosen to focus on the sectors which are typically non-taxable or exempt. That is, the seven sectors presented in chapter 2: waste disposal, education, hospital services, broadcasting, cultural services, homes for the elderly and services in connection with sports. In the statistics we have not been able to distinguish between health and homes for the elderly, so these two sectors have been grouped together. Furthermore, we have not been able to distinguish between cultural services and services related to sports, so these have also been grouped together.

We thus focus on five sectors and group the remaining economic activity into a private sector called “rest of the economy” and a public sector called “public administration”. “Rest of the economy” encompass manufacturing, agriculture, forestry and fishery, trade and other sectors that are not in the focus-sectors. “Public administration” encompass general public administration, including ministries and local governments, defence, compulsory social security and social work. Table 3.9 summarizes the sectors we focus on in the remaining work.

We focus on these sectors because we will analyse effects of removing the special VAT treatment of public bodies. The public bodies are typically in waste disposal, education, hospital services, broadcasting, cultural services and public administration.

We have not been able to do quantitative analysis on the impacts on the charities sector, because the necessary data has not been available. In chapter 4 we perform a brief qualitative analysis of effects on the charities of the current VAT system and possible reforms of the VAT system.

Table 3.9 Modelled sectors

Sector	Share of EU27 GDP, percent
Broadcasting, public and private	0.3
Education, public and private	3.6
Hospitals, public and private	2.7
Cultural services, public and private	6.0
Waste disposal, public and private	1.0
Public administration, public	20.9
Rest of economy, private	65.5

Source: Copenhagen Economics, based on GTAP database.

Note: The sectoral shares of the economy do not correspond to those one would obtain using data with a NACE classification.

This choice of sectors to model presents us with some challenges:

1. We do not know how big a share of each sector that is private and public. This knowledge is important since the problems of VAT treatment may lead activity to shifts between the public and private suppliers in the sectors. In particular, in broadcasting and waste disposal there are differences in the VAT rates applied to public and private suppliers in the current situation. To assess the impact of these shifts we need to know the sizes of public and private parts of the sectors.
2. We do not know how much of these sectors' inputs come from self-supply and how much comes from external suppliers. This particularly becomes a problem with respect to the public sector bodies.

Public private split

In order to address challenges we initially tried to collect data using an “economic” questionnaire which was sent out along with the legal questionnaire reported in chapter 2. However, the information collected through this exercise was not sufficient for our purposes. Therefore we used data from the Amadeus database to estimate the public-private split.

For each relevant sector we calculate the relative size of the private and public part, based on data from the Amadeus database. The Amadeus database provides information on 15+ million European companies, both public and private, categorized by sector. On this basis we calculate turnover in the private and public sector and use this to split up the individual sectors.

In fact we find the entire amount of turnover in a given sector. And we then find the share that is public owned and the share that is privately owned. Then we split the total sector from

GTAP (e.g. waste disposal) into public waste disposal and private waste disposal, by splitting all input and output relative to the calculated shares

Table 3.10 Public and private producers' share of broadcasting, education, cultural services, hospitals and waste disposal sectors

Member state	Public share	Private share
France	81.7%	18.3%
Cyprus	75.8%	24.2%
Slovenia	75.5%	24.5%
Luxembourg	74.8%	25.2%
Great Britain	73.4%	26.6%
Malta	72.0%	28.0%
Poland	67.2%	32.8%
Portugal	67.1%	32.9%
Bulgaria	65.2%	34.8%
Austria	64.2%	35.8%
Romania	62.7%	37.3%
Sweden	62.5%	37.5%
Finland	61.9%	38.1%
Denmark	60.0%	40.0%
Netherlands	57.7%	42.3%
Ireland	56.5%	43.5%
Greece	54.5%	45.5%
Latvia	53.5%	46.5%
Belgium	52.3%	47.7%
Czech Republic	47.4%	52.6%
Lithuania	46.6%	53.4%
Italy	46.6%	53.4%
Slovakia	46.5%	53.5%
Spain	44.2%	55.8%
Hungary	41.4%	58.6%
Estonia	41.3%	58.7%
Germany	25.3%	74.7%
Average	54.0%	46.0%

Source: Copenhagen Economics, base don GTAP and Amadeus database

Some of the numbers in the table above seem surprising. For example, one would not expect that the private share of the ‘core’ sectors would be this large in Greece and Italy. We suspect that part of the reason lies in the fact that many of the public suppliers of hospital services, cultural services, waste disposal, education and telecommunication do not submit annual accounts and are therefore not in the Amadeus database. This means that for some countries we can get the paradoxical result that because the public companies are not in the database, it looks like the entire sector is private. This is of course not optimal, but it is our best assessment. We only focus on total EU, which makes our results less vulnerable to specific Member State outliers.

For cultural services and broadcasting the GTAP data does not have a sector suitable for the study. For broadcasting we define this as a share of “Rest of the economy”. We set this share to 9.4 %, following consumption statistics on “Recreation and culture” in the Eurostat COICOP statistics. The consumption share for “Recreation and culture” is 9.4 % for private households and general government in EU27.⁹⁰

For broadcasting we define this as a 0.3 % share of the “Rest of the economy”, following structural business statistics in Eurostat. This means that we split “Rest of the economy”, so 0.3 % of the input, output and expenditure is defined as broadcasting.

When we summarize this we get, on a EU27 level, the following relative sizes of output from each sector, cf. Table 3.11.

⁹⁰ Eurostat, figures for 2005 as newest available figure.

Table 3.11 Share of GDP from public and private producers on EU27 level per sector

	Public	Private	Share of GDP, public and private
Broadcasting	50,0%	50,0%	0.32%
Education	80.3%	19.7%	3.6%
Hospitals	82.3%	17.7%	2.6 &
Cultural services	30.5	69.5	6.0 %
Waste disposal	47.6 %	52.4	1.0%
Rest of the economy	0%	100%	65.5
Public administration	100%	0%	20.9%

Note: We do not have precise data on the public and private splits of broadcasting. We use a 50 % split for all EU27. The importance of this split must however be expected to be small, as Broadcasting takes up a small share of total economy

Source: Copenhagen Economics based on GTAP data and Amadeus data.

We now have the sizes of the main sectors of the economy in the model. Some of the quantities in the table above may look different from what one would expect based on conventional NACE and COFOG classifications. This is because the economic model is based on a different classification of economic activity, that from GTAP.

We are focusing on broadcasting, education, hospitals, cultural services and waste disposal, which together constitute about 13.5% of the EU27 economy. In these sectors, public and private bodies compete in the market for final output, and VAT changes may affect the market shares of public and private providers.

Furthermore, in broadcasting, education, hospitals, cultural services and waste disposal, there is no input VAT deduction. This leads to a potential self-supply bias and a disincentive to invest.

Besides the 13.5% of the EU economy where both the output side and the input side may be directly affected by a change in the VAT treatment of public bodies, there is an additional 20.9%, i.e. the share of public administration, where the input side may be affected. The public administration sector does not compete with private suppliers in the market for final output, so this sector is not affected directly on the output side. However, the public administration sector cannot deduct input VAT, which again leads to a possible self-supply bias and disincentive to invest.

Size of support services

In order to estimate the economic importance of the self-supply bias and the effect of policies that have the purpose of removing VAT-induced self-supply bias, we need to find out how large a share of public sector input that is affected by the self-supply bias.

For modeling purposes we need to design an artificial economic sector, which produces support services to the public sector and which is in competition with the private sector.

We construct the artificial economic sector named “in-house produced support services” the following way:

1. For each of the sectors: broadcasting, education, hospitals, cultural services, waste disposal and public administration we split total input into three main categories of input: capital, labour and intermediate inputs. We have these data on inputs from the GTAP database. In Table 3.12 we show how the sum of inputs to the public sector of broadcasting, education, hospitals, cultural services, waste disposal and public administration is divided into capital, labour and intermediate inputs.

Table 3.12 Input structure for public sectors, percent of total input costs

Capital	Labour	Intermediate input
17.1 %	29.2 %	53.7 %

Source: Copenhagen Economics based on GTAP database.

2. We define support services as having to do with intermediate input. One could alternatively have defined it as part of labour, but we make this choice, because it would enter into intermediate input if the private sector supplied support functions to the public sector. We want to make public and private supplied support functions close substitutes, and therefore we place them under the same input category.

We calculate the share of intermediate inputs to the public sector which comes from in-house produced support services in the following way: We take 10% of total costs and place them in intermediate inputs where we place them in the sector called in-house produced support services. The 10 % of total costs that we move to in-house produced support services, are taken from labor input, as support functions in general are labor-intense. The resulting input structure is shown in Table 3.13 below.

Table 3.13 Input structure for public sectors with support functions as percent of total input costs

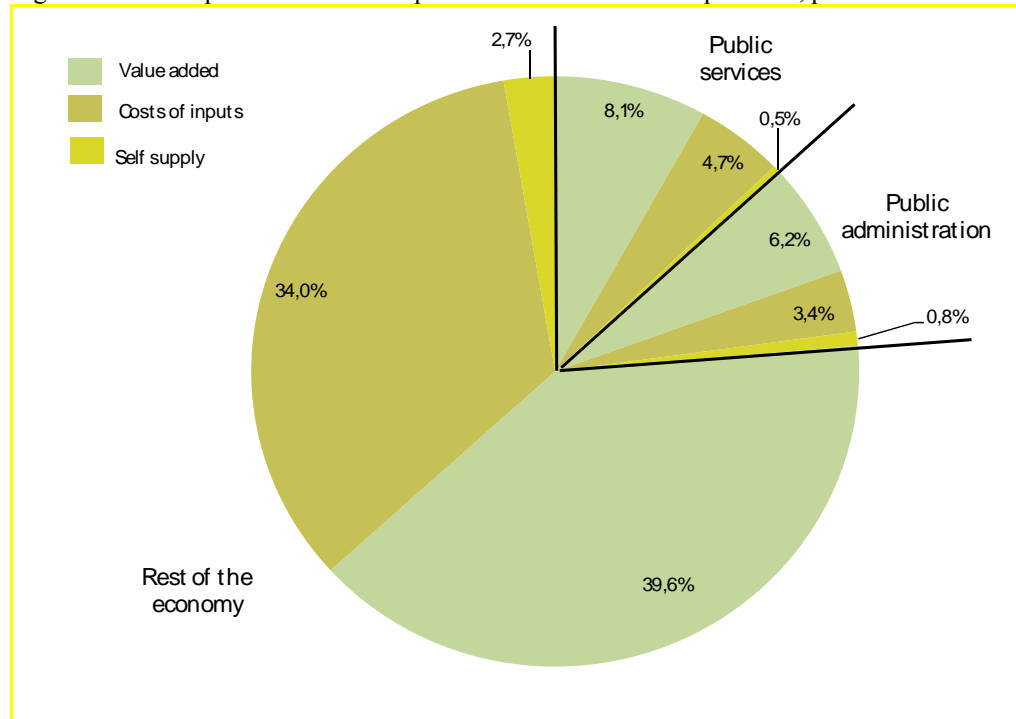
Capital	Labour	Intermediate inputs except in-house produced support services	In-house produced support services
23.4%	19.2%	49.5%	10%

Source: Copenhagen Economics based on GTAP database.

The sector in-house produced support services supplies only to the public sector, but is in intense competition with the sector “private business services”.

We can now give an overview of how much of the economy that we expect to be affected by changes in the VAT treatment of public bodies. Figure 3.2 shows how the European production is divided on value added, costs of inputs and self-supply of services. We split the European economy into public administration, public services (broadcasting, education, hospitals, cultural services and waste management) and “rest of the economy”. The figure shows that the public sectors where we are modeling changes in output VAT rates (broadcasting etc.) constitute approx. 13 percent of total output and approx. 8 percent of value added. We also note that public sector in-house produced support services constitute 1.3 percent of total output (not of total GDP).

Figure 3.2 Decomposition of total output into value added and input costs, percent



Source: Copenhagen Economics based on GTAP data

Consumer behaviour

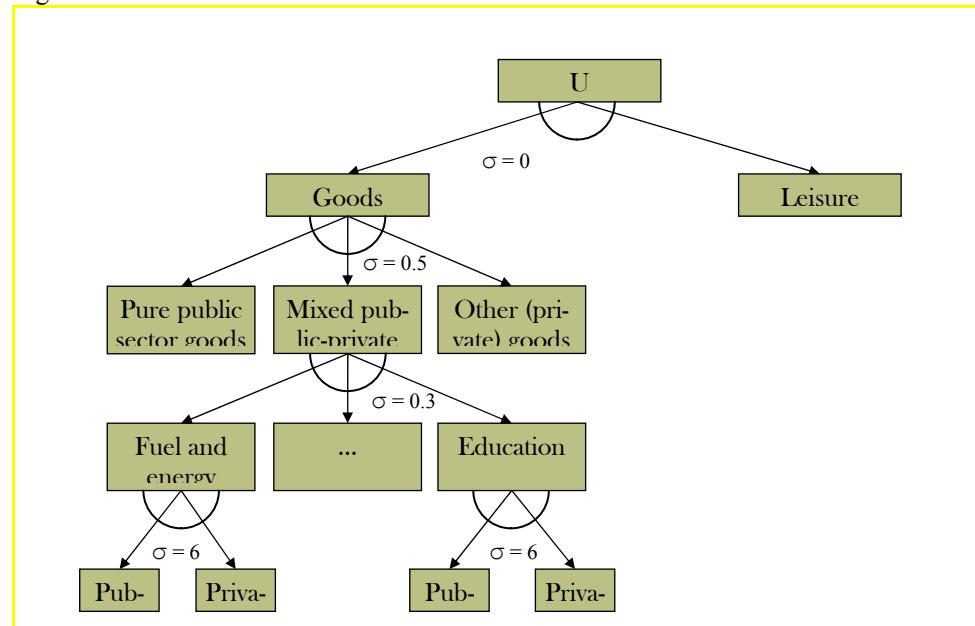
In the economic model we assume that individuals consume two overall types of goods: goods and leisure. Goods are our area of interest in this analysis.

The goods demanded by the consumers are respectively pure public sector goods (police, public administration, defence and similar services), mixed public-private goods (fuel and energy, broadcasting, education and similar services), and pure private goods (food, consumer electronics and similar goods).

We assume that individuals supply labour in-elastically, that is, a change in wages and prices of goods does not affect how much the individuals wants to work. In model terms this means that we set the substitution elasticity between goods and leisure to zero ($\sigma = 0$). We also assume that individuals are not very willing to substitute different types of goods for each other. For example, if the prices of fuel and energy go up, then the demand for fuel and energy will not decrease enough to counteract the change in prices, and the expenditure share of fuel and energy will increase (we set the substitution elasticity greater than zero, but below one). On the other hand, we assume that in the cases where there are both public and private suppliers, then there is a relatively large substitution between private and public suppliers, so that if the price of publicly supplied goods increases, then the budget share of these goods will decrease by a relatively

large amount (we set the substitution elasticity to 6). Figure 3.3 illustrates consumers' preferences.

Figure 3.3 Nest Structures of the Demand Function



Source:CEVM

We calibrate the model to fit actual behaviour, c.f. Box 3.10. An important assumption is that substitution elasticities are modelled as being equal across countries and industries. This assumption is made because we do not have empirical evidence that allow us to model different substitution elasticities for different countries. In general, the lower the substitution elasticities are, the less are firms and individuals able to substitute public sector services and private sector services for each other, and the less impact will VAT and VAT reform have on overall economic efficiency.

Box 3.10: Calibration of the model: country and industry specific parameters

The model used is a CGE model with CES-utility and production functions. This means that for an n-input technology the CES production function is usually written as

$$Y = \left(\sum_{i=1}^n (\theta_i X_i)^{\frac{1}{\rho}} \right)^{\rho}$$

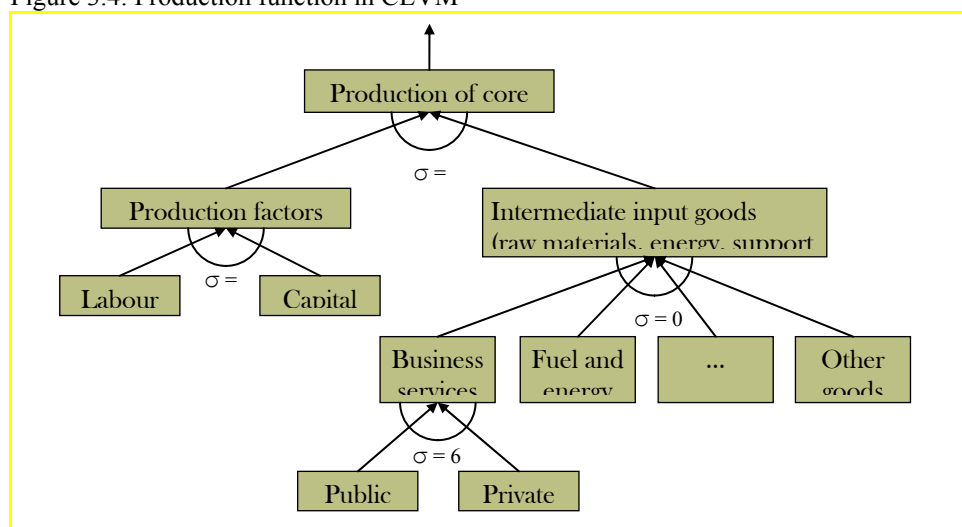
where $\rho = \frac{1}{1 - \sigma}$ and Y is output, X input, and θ_i a share parameter. In the model, this production function then relates to a cost minimization problem, where most calibration algorithms apply the first order necessary conditions to calibrate the unknown share parameters when compared with real data for Y and X (remember that σ is given explicitly.) The actual value of the share parameters will differ between countries and industries and capture the actual production possibilities for a given industry in a given country. The same applies to the consumers demand for goods, where the representative agent demands a bundle of goods. The calibration of the model to the baseline scenario is done based upon inserted input / output table data. A data description is given below.

Source: Copenhagen Economics.

Substitution between private and public provision

In understanding the substitution between private and public provision of support services, we may think of the public entities in a completely similar fashion to private sector firms: They all produce an output to the consumers using various production inputs, and they all behave economically rational drawing more on inputs which are cheaper than on more expensive inputs, everything else equal. The specific needs for input to public production are contained in the production function. The production function is a representation of inflows and outflows of production processes. In Figure 3.4 we provide a graphical representation of the production function. Please note that in the figure, “core activity” refers to e.g. broadcasting, and “business services” is where we place support functions.

Figure 3.4: Production function in CEVM



Note: The Greek letter σ denotes a given substitution elasticity.

Source: Copenhagen Economics based on CEVM

All inputs to production of the core activity (e.g. production of hospital services or social services) can be identified by looking at the lowest level of the figure. Labour, capital, and a number of input services and raw products are necessary inputs to production, but their input levels obviously depend on the specific production process.

The major issue in this report however, is how well private business services can substitute public self-supply as input to production of the core activity. If substitutability is easy because input services are very homogenous, then differential VAT will have large effects.

Our basic assumption is that support activities are very homogenous - after the motto “cleaning is cleaning”. However, we also acknowledge that the two options are never perfectly homogenous. It may make a difference to e.g. hospitals with stringent hygienic rules that management is in total control of what, when, and how there should be cleaned in the hospital. In this case, in-house provision of cleaning may be preferred irrespective of VAT rules⁹¹. Thus, substitutability may only concern a limited part of hospital cleaning, e.g., hallways.

More technically, we model the degree of substitutability by incorporating a so-called substitution elasticity, denoted by σ , determining how flexible the producers can shift between inputs. When the elasticity is low, there is not much possibility of shifting, and in the limiting case where the elasticity equals zero, the producer needs inputs in a fixed proportion to produce

⁹¹ Although contracts specifying in detail the requirements can be made.

one unit of output.⁹² On the other hand, if the substitution elasticity is high, the producer is much more flexible to use more of the cheap inputs and less of the expensive inputs. We assume a substitution-elasticity between public and private business services of 6⁹³, which is relatively high. This means that if the price of public input services increases 10 percent more than the price of private services the expenditure share of public services will drop by 60 percent.

The most critical choice concerns the substitution elasticity between public and private business services, and here we work with an elasticity of 6. We believe this represents a high degree of substitutability, while still acknowledging the presence of specific barriers to outsourcing. The choice of 6 can be confronted with substitution elasticities from some of the most widely used CGE models; the GTAP model and the GEM-E3 (specifically designed for the EU Commission).

The best type of comparison concerns the substitution between domestically produced goods and imported goods. These are definitely very close substitutes as they basically satisfy the same needs, but country-specific tastes imply that import substitution elasticities never reach the limit of infinity (perfect substitutability). In the GTAP model, the import substitution elasticity have been set to 7, while the GEM-E3 applies econometrically estimated elasticities in the range 1-5 (most estimates in the higher end).⁹⁴ Another econometric study reports substitution elasticities in the range 1-13.⁹⁵ Thus, our suggested value of 6 does not seem to be extreme in either direction.

Treatment of VAT in the general equilibrium model

The model calculates VAT in 2 different ways, depending on if the VAT is paid by producers or by consumers. These are:

- a. *Input VAT: VAT paid on input to producers (public as well as private)*
- b. *Output VAT: VAT paid on final consumption*

In the following the model treatment of these two types of VAT is described.

Input VAT

Input VAT paid on all taxable inputs by all producers. This input VAT is however deductible for all taxable and non-exempt producers. This means that the net-input VAT payment for tax-

⁹² This proportion is determined by empirical input-output data underlying the model.

⁹³ The choice is based on a survey of other models and on former versions of the CEVM. See also the appendix on model representation for references to the econometric literature.

⁹⁴ Nemeth et al (2008).

⁹⁵ Erkel-Rousse and Mirza (2002).

able producers is 0. We model this by setting the input VAT rate to zero for all taxable and non-exempt producers and to the standard rate for all non-taxable or exempt public producers.

Output VAT

Output VAT is paid on all taxable goods and services for final consumption, given they have a positive price. The end-user price on final consumption reflects the value added throughout the supply chain.

The stylized table below shows how the treatment of VAT as a tax on value added through the entire supply chain is equivalent to taxing the final consumption (for a series of taxable and non-exempt firms). In the upper half of the table we see how a final good results from three stages of production. The first firm, firm 1, uses a natural resource to produce the intermediate good, which is the result of the first production stage. Firm 1 sells its intermediate good to firm 2 for a price of 150 (including 25% VAT which equals 30). Firm 1 pays 30 in VAT to the state and keeps the 120 value added to pay wages and provide return on capital. Firm 2 in turn deducts the 30 as input VAT, adds an additional value of 30 and sells its intermediate good to firm 3 for a price of 187.5 (including 37.5 VAT). As we sum the VAT paid by firms, it turns out that it is equal to the VAT paid by the final consumer.

Table 3.14 VAT as a tax on value added versus a tax on final consumption, example with 25 % VAT rate

	Input of goods	Value added	Price excl. VAT	Input VAT	Output VAT	VAT revenue
From the supply side						
Firm 1	Natural resource	120	120		30	30
Firm 2	120	30	150	30	37,5	7,5
Firm 3	150	100	250	37,5	62,5	25
Total		250				62,5

	Price paid by consumer, excl. VAT	VAT paid by consumer
From the consumer side		
Consumer	250	62,5

Note: The calculation is done by an example with a 25 % standard VAT rate

We use this insight to model VAT on output, by a goods- and service specific VAT rate on final consumption, whenever a price is paid by the consumer. In effect, therefore, the economic model is putting VAT only on goods that are delivered for a consideration. Currently a number of sectors are treated as non-taxable or tax-exempt. We model this by setting a zero output VAT rate on these sectors, but a positive VAT rate on input purchases.

We assume that the current VAT system can be described by the following VAT rates, as shown in Table 3.14. For private support functions, the table shows the VAT rate paid by public producers, when they use support functions as input. This rate is the net-rate after any national compensations schemes. The VAT rate shown for core sectors (broadcasting, cultural services, hospital services, education, waste disposal, public administration) and rest of the economy is the VAT rate faced by consumers of these services.

Table 3.15 Benchmark VAT rates, percent

	AUT	BEL	BGR	CYP	CZE	DNK	EST	FIN	FRA	DEU	GRC	HUN	IRL	ITA	LVA	LTU	LUX	MLT	NLD	POL	PRT	ROM	SVK	SVN	ESP	SWE	GBR	
Input VAT, Public sectors use of private support functions	0,00	21,00	20,00	0,00	20,00	0,00	18,00	0,00	0,00	19,00	23,00	25,00	21,00	20,00	18,00	18,00	15,00	18,00	0,00	22,00	0,00	19,00	20,00	19,00	16,00	0,00	0,00	
Public broadcasting	10,00	21,00	0,00	0,00	0,00	25,00	0,00	9,00	2,10	0,00	0,00	0,00	0,00	0,00	21,00	0,00	15,00	0,00	0,00	0,00	21,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Private broadcasting	10,00	21,00	20,00	15,00	20,00	25,00	20,00	9,00	19,60	19,00	23,00	25,00	0,00	20,00	21,00	0,00	15,00	18,00	19,00	0,00	21,00	0,00	19,00	20,00	0,00	25,00	17,50	
Public cultural services	0,00	0,00	0,00	0,00	0,00	25,00	0,00	0,00	0,00	0,00	0,00	25,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	7,00	6,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Private cultural services	10,00	0,00	0,00	0,00	0,00	25,00	20,00	9,00	5,50	0,00	0,00	25,00	0,00	0,00	0,00	0,00	15,00	0,00	0,00	7,00	6,00	0,00	0,00	0,00	0,00	6,00	17,50	
Public waste disposal	10,00	21,00	0,00	0,00	0,00	25,00	0,00	23,00	5,50	0,00	0,00	25,00	13,50	0,00	21,00	0,00	0,00	18,00	0,00	0,00	0,00	0,00	19,00	8,50	0,00	25,00	0,00	
Private waste disposal	10,00	21,00	20,00	5,00	10,00	25,00	20,00	23,00	5,50	19,00	23,00	25,00	21,00	20,00	21,00	21,00	0,00	18,00	19,00	22,00	21,00	24,00	19,00	8,50	7,00	25,00	17,50	
Public hospitals	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	15,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Private hospitals	10,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	15,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Public education	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Private education	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	15,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	17,50	
Public administration	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Rest of economy	20,00	21,00	20,00	15,00	20,00	25,00	20,00	23,00	19,60	19,00	23,00	25,00	21,00	20,00	21,00	21,00	15,00	18,00	19,00	22,00	21,00	24,00	19,00	20,00	18,00	25,00	17,50	
Savings Good	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	

Note: A zero does not imply a zero-rate, but that the sector is exempt or non-taxable.

Source: Copenhagen Economics, KPMG AG and DGTAXUD

The table shows the two sources of distortions between public and private sector bodies:

- In a range of sectors there appears to be a differential treatment of public and private sectors on the output side.
- The VAT treatment of inputs differs for the public and private sectors

The differential treatment of output VAT can reflect several things. First of all it may reflect a genuine VAT discrimination between public and private sector bodies. Second, it may reflect incomplete transposition or implementation by some Member States of the CVSD. Third, the table is a rough attempt at characterizing the VAT system, and what appears to be differential VAT treatment may not lead to an effective distortion of competition, e.g. because private firms are by law prohibited to enter into some specific industries. It may be that legal and economic experts have deemed that the differences in VAT rates do not lead to a practical distortion of competition, and judged that there are no problems involved with the differential VAT treatment.

Similarly, our presentation of the input VAT rates is also a rough simplification, because some inputs may be subject to other VAT rates than the standard rates. However, we have not had data available to construct properly weighted input VAT rates on a sectoral level.

The level of compliance costs

Now we have described the economic importance of the sectors of interest for this model. We have also described how consumers and producers substitute between public and private supplies. Later, in chapter 4, we specify the VAT scenarios and VAT assumptions, that we use to estimate the costs of the current system and the benefits to be had from reform. What we need to describe, and which we choose to describe here, is the compliance costs associated with refund systems, where public bodies receive a compensation or refund for their input VAT expenditure from the state or some other public body.

There is not much evidence on the compliance costs of refund systems. Some evidence exists, though. A recent OECD review on the size of public and private compliance costs associated with complying with the VAT systems in Europe, reports losses in the area of 0.0-0.5 percent of GDP, cf. Table 3.16.

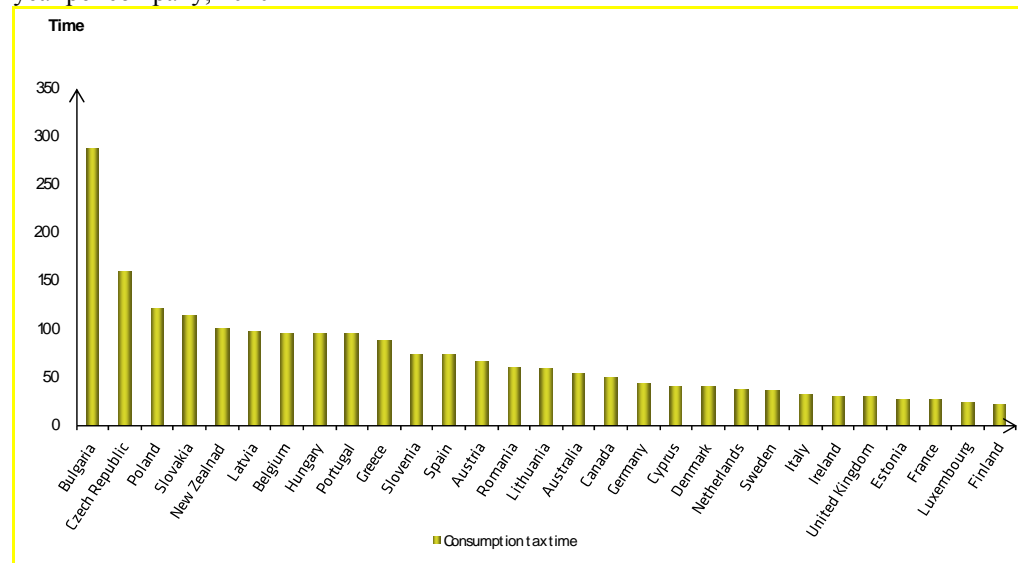
Table 3.16: Estimates of administrative costs from systems of consumption taxation

Country	Year	Pct of GDP
Austria	2007	0.1%
Denmark	2004	0.1%
Germany	2007	0.5%
Netherlands	2002	0.3%
Norway	2007	0.0%
UK	2007	0.1%

Source: OECD (2008). Eurostat GDP figures have been used to convert OECD monetary estimates into comparable shares of GDP.

Recent evidence from the World Bank and PwC (2010) looks at the burden of complying with consumption taxes in terms of the number of hours spent by firms in different countries. These results are shown in Figure 3.5 for the EU27, Australia, Canada and New Zealand.

Figure 3.5 Time spent by companies on complying with consumption tax systems, hours per year per company, 2010



Source: World Bank and PwC (2010).

The figure gives the impression that the Australian and New Zealand VAT systems are not so much easier to administrate than the EU VAT systems, which is in contrast to our line of argument in chapter 1. However, the number of hours spent on compliance with the VAT system is an imperfect indication of the economic burden of compliance, because

1. We do not know the hourly wage rate of the employees who do the compliance work.
2. Data is collected in each country from a company which may not be representative of all firms in the economy.

These problems make it difficult to assess the economic importance in each country and to compare the costs across countries. However, if we assume that the time to comply is spent by a representative employee in each company, and we assume that each company is representative, we can make a cross check of the results of OECD (2008) and World Bank and PwC (2010). This cross check indicates that the results from the two sources are different, but not systematically dissimilar.⁹⁶

In general, the basis for assessing compliance costs of VAT is not perfect, and international comparisons should be treated with caution.

We now try to assess the compliance costs of a refund system. We assess that it is not certain that complying with a refund system designed to eliminate the VAT bias is much worse than complying with differential VAT treatment under the current system. Our interviews with public authorities in the eight Member States that actually do have such systems in place seem to indicate that administrative costs are small to medium, cf. Table 3.17.

Table 3.17 Size of administrative costs from refund system in 8 EU Member States

Size of administrative costs	Number of EU Member States
High	0
Medium	2
Low	5
No answer	1

Source: Legal questionnaire, filled out by KPMG experts.

Based on these considerations, we conclude over all that the two elements of other barriers and compliance costs are likely to be non-trivial in practice. We conclude that barriers to outsourcing exist in addition to biased VAT treatment. This reduces the immediate economic gains from eliminating the VAT bias. Furthermore, that compliance costs from a refund system may

⁹⁶ As an example, take Austria. On the basis of OECD (2008) we assess that compliance costs are approx. 0.1% of GDP. In World Bank and OECD (2010) the result is that in Austria, a firm spends 67 hours per year on consumption tax compliance. The company in question has 60 employees. If we assume that the employee who does the compliance is representative, then the value of time spent by this employee is the same as the average value of time spent by the other 60 employees in the firm. If we assume an annual amount of hours of 1,600 per employee, then the compliance cost as a share of GDP becomes $67 / (60 * 1,600) = 0.000698$. When we round this to per thousands we get 0.1 percent of GDP, which is identical to the number we found from OECD (2008). However, for Germany the two sources give rise to dramatically different results: Here the result from OECD (2008) indicate a compliance cost of 0.5%, but the result from World Bank and PwC (2010) is less than 0.1%.

be non-trivial, albeit not huge, and therefore crucial to keep to a minimum in order for them *not* dwarf the initial economic gains.

Conclusion

In this chapter we have looked for empirical evidence of the negative impacts of differential VAT treatment of public and private bodies, which were described in chapter 2.

In particular, we conducted case studies which illustrated that the distortions “are real”, that is, real life managers of public and private institutions choose to refrain from making investments because they cannot deduct input VAT. Real life managers of private hospitals (in Sweden) state that they cannot compete with public hospitals in some areas, because the public hospitals get an input VAT refund whereas private hospitals do not.

We have tried to assess what the costs are for the individual firm or institution when e.g. hospitals do not outsource activities. We did this by searching at the literature for estimates of cost savings from outsourcing. The evidence we have found suggests that cost savings from outsourcing lie in the neighbourhood of 20 percent (before VAT).

To estimate the overall costs to the EU society of the problems caused by the VAT treatment, we set up an economic model.

The estimates from the model depend to a large extent on how big a share of the economy is affected by the problems caused by VAT treatment, how much economic activity is shifted from the private to the public sector due to VAT, and how more effective the private sector is relative to the public sector.

Therefore we collected information on the economic size of the economy’s sectors, and we assessed how big a share of each sector is private and public. Furthermore, for the public sector we divide activities into support activities which can be easily outsourced, and core activities where outsourcing decisions are also affected by political concerns and where the effect of VAT on outsourcing is more uncertain. We made an assessment of how much more effective the private sector is, based on the evidence presented in this chapter. Finally, we made assumptions about precisely how large the effect of prices on the market shares of public and private suppliers is.

Chapter 4 POSSIBLE SOLUTIONS

In the study, we have examined the stipulations of the CVSD on the taxation of the public sector and the transposition into national law (current EU VAT law). We have also described the compensation or refund schemes applied in several Member States as well as in Canada and the full taxation systems in certain OECD countries e.g. in Australia and New Zealand.

The conclusion was that the current EU VAT law has a lot of significant disadvantages. Several of these disadvantages do not appear in the alternative systems currently applied in certain EU Member States and OECD countries (compensation systems, full taxation). However, these solutions have been designed for single countries with their specific legal and tax systems. Also, the systems in OECD countries are independent from the common EU VAT system. Thus, a complete adoption of a currently applied alternative system does seem favourable, but not plausible

Realising this we have developed possible solutions for the current problems with the taxation of the public sector. Our approach was to find “ideal” solutions in a way that the disadvantages described in our comments about currently applied systems should be reduced as much as possible. Additionally we have analysed if there are any other solutions not mentioned before. Some of these other solutions are actually variations of the above described systems and will therefore be described in their context.

As a result we came to the following solutions which might be suitable for the EU:

- Full taxation
- Refund system
- Treated as taxable persons (public bodies treated as taxable persons as a rule, with certain exemptions)
- Treated as taxable persons with an option to tax (public bodies treated as taxable persons as a rule, with certain exemptions and an option to tax for exempt taxable persons)

4.1. FULL TAXATION

Introduction

In the following we describe the main characteristics of a full taxation system. Afterwards we discuss whether it is suitable for the EU to introduce a full taxation system where also supplies for no consideration are taxed (as deemed supplies) or whether only supplies for consideration should be taxed. Finally, we discuss how the impacts on tax revenue could be compensated.

General characteristics

The main change introduced with a full taxation system would be a fundamental alteration of the taxation of output supplies. All supplies within the public sector which are currently treated as non-taxable (Art. 13 CVSD) or tax-exempt (Art. 132 CVSD) in the future would be treated as taxable and non-exempt. Special rules leaving discretionary power to the Member States (e.g. Art. 133, 371 ff. CVSD) would be deleted if they are concerning the public sector.

Generally, the full taxation model can be introduced in two basic modifications.⁹⁷ In the first one, all supplies of public bodies are taxed regardless whether a consideration is provided or not⁹⁸ (e.g. also on supplies of police, fire brigades or charities which are only receiving donations). In the second one, the output VAT is applied to supplies only if an explicit fee is charged.⁹⁹ Supplies funded e.g. from taxation or other comparable sources thus remain outside the scope of the VAT.¹⁰⁰ These other types of costs, which we cannot model, will make it difficult to compare the solution with the other solutions we present, which do not involve fundamental changes in the EU VAT system.

However, either way full taxation of the output supplies would lead, according to the CVSD, automatically to the possibility to deduct the input VAT as regards the input side.

Limitation to supplies for consideration

In a system of full taxation of supplies for consideration, in principle, all supplies for remuneration would be taxed. Differentiations whether a public entity is acting based on public law or whether a hospital or museum is fulfilling the requirements of a tax-exemption would not be necessary. The assessment base could be calculated easily according to the consideration. Also, for the purposes of the calculation of input VAT it would, in principle, not be necessary to split-up deductible and non-deductible input VAT anymore.

In the following we discuss the advantages and disadvantages of the introduction of a full taxation system for supplies for consideration.

⁹⁷ For more details about possible approaches see M.Aujean, P.Jenkins, S.Poddar, "A New Approach to Public Sector Bodies", IBFD, VAT Monitor, Vol. 10, No.4, July/August 1999, pg. 146 et seqq.

⁹⁸ M.Aujean, P.Jenkins, S.Poddar, "A New Approach to Public Sector Bodies", IBFD, VAT Monitor, Vol. 10, No.4, July/August 1999, pg. 147

⁹⁹ Pierre-Pascal Gendor, "Value-Added Tax Treatment of Public Sector Bodies and Non-Profit Organisations: A Developing Country Perspective", ITP Paper 0514, July 2005, pg. 33

¹⁰⁰ This could be solved by treating supplies not for consideration as deemed supplies, however doing so would introduce costs of compliance and administrative burdens which are much larger than those associated with the other models we consider.

Distortions of competition

Introducing full taxation of supplies for consideration would contribute to removing the distortion of competition between public and private service providers, by creating a level playing field for public and private suppliers in the cases where private suppliers compete with public suppliers, and where they charge a fee or price for their services. In the cases where public supplies are financed by taxes instead of fees or prices, and where competition exists between public and private providers, there is still a distortion of competition between public and private suppliers, however.

We do not have precise information about the share of output from our five modelled core services that are provided for consideration and not for consideration. We therefore need to make assumptions about this split. For the five private produced services covered in this study, we assume that they are predominantly provided at a consideration. The basic intuition is that if a fee cannot be charged, they would not be provided by a private supplier. For the equivalent public produced services, we assume that hospital and waste management services are provided for a consideration, whereas broadcasting, education and cultural services are predominantly provided without charging a fee (financed via subsidies), but a small fee is indeed charged on the services. This is an important assumption: if even a minor fee is charged, taxing this fee with the VAT rate applicable to the similar private output removes a distortion and economic efficiency is increased. If on the other hand, no fee is charged at all, there is nothing to tax and hence no VAT differentiation and distortion to eliminate. The split inserted in the model is shown below.

Table 4.1 Split of public and private consumption share

	Public consumption share (not for consideration)	Private consumption share (for consideration)	Total
Public Broadcasting	90,0%	10,0%	100%
Private Broadcasting	10,0%	90,0%	100%
Public Education	90,0%	10,0%	100%
Private Education	10,0%	90,0%	100%
Public Hospital Service	10,0%	90,0%	100%
Private Hospital Services	10,0%	90,0%	100%
Public Cultural Services	90,0%	10,0%	100%
Private Cultural Services	10,0%	90,0%	100%
Public Waste Disposal	10,0%	90,0%	100%
Private Waste Disposal	10,0%	90,0%	100%

Source: *Copenhagen Economics*

We perform quantitative analysis of the effects of implementing the full taxation model by assuming that the resulting VAT system can be described by the VAT rates show in the table below. In the full taxation solution we set VAT on output from core functions to the standard VAT rate, both for public and private bodies. We do this, because the objective of the full taxation model is to reduce distortions on the output and input side between public and private suppliers.

To clarify the above description of the full taxation solution, we have below illustrated how this solution affects VAT rates on selected sectors in Germany, cf. Table 4.2.

Table 4.2 Current output VAT rates and VAT rates under full taxation in Germany

	Current output VAT rate	Output VAT rate under full taxation
Private produced waste disposal	19 %	19 %
Public produced waste disposal	0 %	19 %
Private hospital services	0 %	19 %
Public hospital services	0 %	19 %

Source: Copenhagen Economics and KPMG

Following the above system we assess the VAT rates for full taxation as stated in Table 4.3.

Table 4.3 VAT rates as modeled in “full taxation”, percent

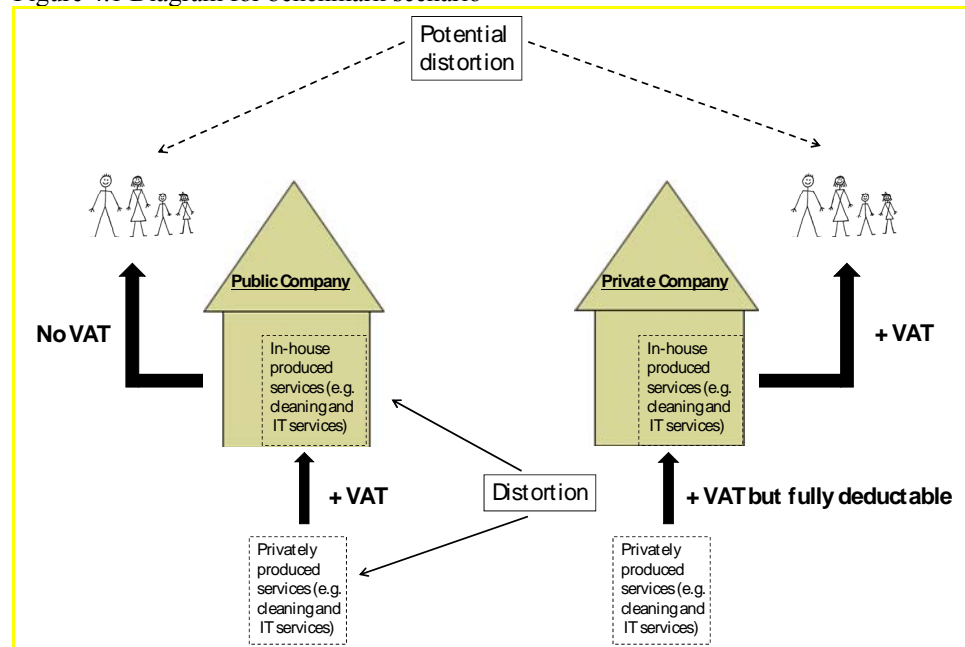
	AUT	BEL	BGR	CYP	CZE	DNK	EST	FIN	FRA	DEU	GRC	HUN	IRL	ITA	LVA	LTU	LUX	MLT	NLD	POL	PRT	ROM	SVK	SVN	ESP	SWE	GBR
Input VAT, Public sectors use of private support functions	0.0	21.0	20.0	0.0	20.0	0.0	18.0	0.0	0.0	19.0	23.0	25.0	21.0	20.0	18.0	18.0	15.0	18.0	0.0	22.0	0.0	19.0	20.0	19.0	16.0	0.0	0.0
Public broadcasting	10.0	21.0	20.0	15.0	20.0	25.0	20.0	9.0	19.6	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	22.0	21.0	19.0	19.0	20.0	16.0	25.0	17.5
Private broadcasting	10.0	21.0	20.0	15.0	20.0	25.0	20.0	9.0	19.6	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	22.0	21.0	19.0	19.0	20.0	16.0	25.0	17.5
Public cultural services	10.0	21.0	20.0	15.0	20.0	25.0	20.0	9.0	5.5	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	7.0	6.0	19.0	19.0	20.0	16.0	6.0	17.5
Private cultural services	10.0	21.0	20.0	15.0	20.0	25.0	20.0	9.0	5.5	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	7.0	6.0	19.0	19.0	20.0	16.0	6.0	17.5
Public waste disposal	20.0	21.0	20.0	15.0	20.0	25.0	18.0	22.0	19.6	19.0	23.0	25.0	21.0	20.0	18.0	18.0	15.0	18.0	19.0	22.0	21.0	19.0	20.0	19.0	16.0	25.0	17.5
Private waste disposal	20.0	21.0	20.0	15.0	20.0	25.0	18.0	22.0	19.6	19.0	23.0	25.0	21.0	20.0	18.0	18.0	15.0	18.0	19.0	22.0	21.0	19.0	20.0	19.0	16.0	25.0	17.5
Public hospitals	10.0	21.0	20.0	5.0	10.0	25.0	20.0	23.0	5.5	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	22.0	21.0	24.0	19.0	8.5	7.0	25.0	17.5
Private hospitals	10.0	21.0	20.0	5.0	10.0	25.0	20.0	23.0	5.5	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	22.0	21.0	24.0	19.0	8.5	7.0	25.0	17.5
Public education	10.0	21.0	20.0	15.0	20.0	25.0	20.0	22.0	19.6	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	22.0	21.0	19.0	19.0	20.0	16.0	25.0	17.5
Private education	10.0	21.0	20.0	15.0	20.0	25.0	20.0	22.0	19.6	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	22.0	21.0	19.0	19.0	20.0	16.0	25.0	17.5
Public administration	20.0	21.0	20.0	15.0	20.0	25.0	20.0	22.0	19.6	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	22.0	21.0	19.0	19.0	20.0	16.0	25.0	17.5
Rest of economy	20.0	21.0	20.0	15.0	20.0	25.0	20.0	22.0	19.6	19.0	23.0	25.0	21.0	20.0	21.0	21.0	15.0	18.0	19.0	22.0	21.0	19.0	19.0	20.0	16.0	25.0	17.5
Savings Good	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0

Note: A zero does not imply a zero-rate, but that the sector is exempt or non-taxable.

Source: Copenhagen Economics, KPMG AG and DGTAXUD

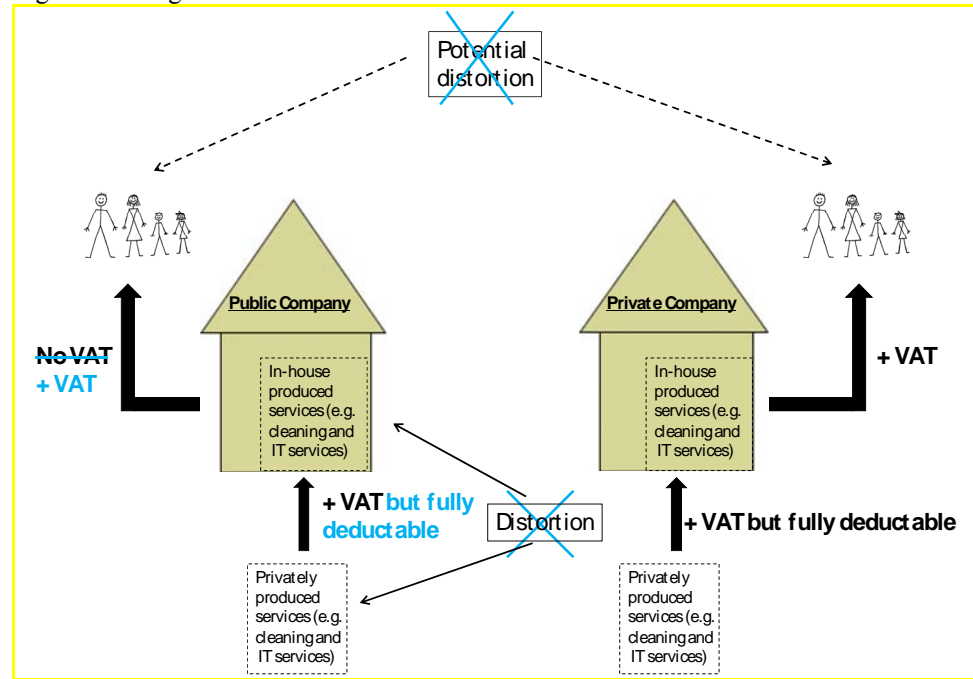
Introducing the full taxation model means increasing the VAT rate significantly for public suppliers. We assume that public and private suppliers are relatively close substitutes. We illustrate how the current system creates distortions of competition, and how a full taxation system can remove these, in Figure 4.1 and Figure 4.2. On the basis of competition distortion, it shall specifically be noted that we assume that if the price of a public service increases by one percent, then the demand for the public service decreases by approximately 6 percent – but the demand shifts to the private sector.

Figure 4.1 Diagram for benchmark scenario



Source: Copenhagen Economics.

Figure 4.2 Diagram for full taxation



Source: Copenhagen Economics.

We analyse 2 different scenarios for the full taxation solution. As an upper bound for the effects we assume that there is competition between public and private sectors on the output side, with a substitution elasticity of 6. As a lower bound we make the assumption that, due to legal and other barriers, there is no competition between public and private sectors on the output side, so we set the substitution elasticity between public and private supplies of final goods and services to zero.

Revenue effects from a full taxation scheme

Introducing a full taxation scheme or model will increase VAT revenue, if it is implemented as described in this chapter. However, the purpose of the full taxation scheme is not to increase VAT revenue, but to remove some distortions coming from differential VAT treatment of public and private bodies. It is natural to re-balance the public budgets by reducing the standard VAT rate, so that all changes involved in the full taxation scheme are kept within the VAT system.

Below we consider how much the standard VAT rate should be reduced to re-balance the public budgets following the introduction of a full taxation scheme. To do so we first need to calculate how much VAT revenue will increase, when a full taxation model is introduced. This re-

quires us to define the VAT base, to which the new rates will apply. For the purpose of this calculation we define the VAT base as total final consumption. Eurostat gives us this figure as 9,530 bio. euro in EU27 in 2009. The calculation is based on the same VAT rates, which are used in the model analysis. We assume that the GDP share of each of the relevant sectors is equal to their share of the total VAT base. This assumption is necessary to calculate how much extra revenue will be generated following the increase of the VAT rates in these sectors.

The revenue gain assumes that the entire value of output is taxed. This may not be the case if only the value of e.g. public output corresponding to the consideration is taxed, and if the consideration does not reflect the entire output value. However, we do not know how large a share of the output value that may be financed through a consideration in a future full taxation solution. So we are only able to provide this upper bound for revenue increase.

For clarification we look at the example of public education. The public education share of GDP is 2.9 %. We then define the VAT base as 2.9 % of 9,530 bio. euro = 276.4 bio. euro. With a weighted average increase in the public education VAT rate of 17.44 % following full taxation, the increase in VAT revenue from public education is $2.9 \% * 9,530 \text{ bio. euro} * 17.44 \% \text{ VAT} = 48.20 \text{ bio. euro}$. In total the increase in VAT revenue is estimated to be 194.7 bio. euro, cf. Table 4.4.

Table 4.4 Revenue effects from full taxation

	Increase in EU average VAT rate (a)	Value of VAT base, bio. euro (b)	Increase in VAT revenue, bio. euro (a * b)
Public broadcasting	15.35%	15.2	2.34
Private broadcasting	13.13%	15.2	2.00
Public education	17.44%	276.69	48.25
Private education	17.43%	67.93	11.84
Public hospital services	17.39%	207.79	36.13
Private hospital services	17.35%	44.71	7.76
Public cultural services	14.65%	172.51	25.27
Private cultural services	14.36%	402.55	57.80
Public waste disposal	7.44%	43.42	3.23
private waste disposal	0.01%	47.77	0,00
Total increase in VAT revenue, bio. Euro.			194.64

Note: The total VAT base is set to final consumption in EU27 of 9,000 bio. euro. Share of VAT base set to share of GDP.

Source: Copenhagen Economics and Eurostat.

Total current VAT revenue is today 845 bio. euro. The extra VAT revenue of 194.6 bio. euro constitutes an increase of 23 % in total VAT revenue. The increase in VAT revenue could be cancelled by a 18.7 % proportional decrease of the standard VAT rate following the introduction of the full taxation model, cf. Table 4.5.

Table 4.5 Neutralising increased VAT revenue from full taxation through a reduced standard rate

Current EU VAT revenue, bio. euro (a)	845
Increase in EU VAT revenue, bio. euro (b)	194.6
Proportional decrease in VAT rate to neutralise increased revenue (b/(a+b))	18.7 %

Source: Copenhagen Economics based on GTAP data and legal questionnaire

Budgetary impact of input VAT deduction for public producers

When we introduce a full refund system, all parts of the public sector in all EU27 can get a refund for the VAT they pay on their taxable input purchases. We have estimated that the total input VAT paid by public producer to 100 bio. euro for the EU27. The 100 bio. euro is calculated as the standard VAT rate paid by public entities per Member State multiplied by the total input of private goods and services to public production, which we take from the GTAP input-output tables. This means that the 100 bio. euro takes into account, that a number of Member States already have implemented refund mechanisms for the public sector. The budgetary impact per Member State is shown below, cf. Table 4.6.

Table 4.6 Budgetary impact of input VAT deduction for public producers

Country	Standard VAT rate on input to public sector	Budgetary impact, mio. Euro
BEL	0.21	5,972
BGR	0.2	1,264
CZE	0.2	1,894
DEU	0.19	33,861
ESP	0.16	9,711
EST	0.18	184
GRC	0.23	2,629
HUN	0.25	1,674
IRL	0.21	1,902
ITA	0.2	32,935
LTU	0.18	329
LUX	0.15	379
LVA	0.18	216
MLT	0.18	132
POL	0.22	4,329

ROM	0.19	957
SVK	0.2	729
SVN	0.19	684
Grand Total		99,782

Note: Member states with an implemented refund mechanism is left out from table. We assume standard VAT rate on all input.

Source: Copenhagen Economics

Below we give two examples of how much the output VAT rate should be increased if one were to choose to rebalance budgets in this way.

Examples of revenue loss from input VAT deduction and recovery through output VAT

Public waste management in Germany

Output from public waste management sector in Germany is approx. 15 bio. euro. Total intermediate input is 646 mio. euro. We assume that input to public waste management in Germany is taxed with the standard VAT rate of 19 %. This gives input VAT revenue of 125 mio. euro, which with a refund scheme will be fully reimbursed for producers of public waste management. To recover this input VAT revenue loss, the VAT rate on output should be increased with just below 1 percentage point, which is from 19 to 20 per cent, cf. Table 4.7.

Table 4.7 Recovery of deductible input VAT revenue, public waste management in Germany

	Current system	Current system with output VAT and input VAT deduction
Intermediate inputs, bio. Euro	0.65	0.65
VAT rate on intermediate inputs	19 %	0 %
Revenue from input VAT, bio. Euro	0.13	0
Revenue to cover through output VAT, bio. euro (a)	-	0.13
Total output, bio. euro (b)	15	15
Output VAT rate necessary to offset input VAT deduction (a / b)	-	1 %

Note: Value of intermediate inputs is excl.

Source: Copenhagen Economics

Public hospital services in Spain

Output from public hospital services in Spain is approx. 32 bio. euro. Total intermediate input is 11 bio. euro. We assume that input to public hospital services in Spain is taxed with the standard VAT rate of 16 %. This gives an input VAT revenue of 1.8 bio. euro, which with a refund scheme will be fully reimbursed for producers of public hospital services. To recover this

input VAT revenue loss, the VAT rate on output should be increased by approx. 6 percentage points, cf. Table 4.8.

Table 4.8 Recovery of deductible input VAT revenue, public hospital services in Spain

	Current system	Current system with output VAT and input VAT deduction
Intermediate inputs, bio. euro	11	11
VAT rate on intermediate inputs	16 %	0 %
Revenue from input VAT, bio. euro	1.8	0
Revenue to cover through output VAT, bio. euro (a)	-	1.8
Total output, bio. euro (b)	32	30
Output VAT rate necessary to recover input VAT deduction (a / b)	-	6 %

Note: Value of intermediate inputs is excl. VAT

Source: Copenhagen Economics

Model analysis of full taxation scenario

In the following we describe the results from the computable general equilibrium model. In the full taxation we find a shift in the market shares of private suppliers in the public sector of 0.48 percentage points, from 55.6 % to 56.2 % in the case where we assume there is competition on the output side between public and private suppliers. This indicates that differentiated VAT-treatment between public and private producers does shift demand between public and private provision of goods and services. This is the result when we assume full competition. When we assume no competition, the only shift stems from the fact, that the public sector becomes more efficient in its production because it outsources more support functions, which increases efficiency. In this scenario the private sectors share of core functions (final goods and services) is reduced by 0.12 %. These results and others concerning the full taxation scenario are summarized below in Table 4.10

Barriers to entry into existing markets

Under a full taxation, where the public and private sectors are equally treated, the VAT treatment could not be a market entry barrier anymore. However, it should be noted that a reform of VAT would not overcome national rules outside of the VAT law prohibiting competition in the public sector (e.g. state monopolies). As an example, national legislation in Austria stipulates that use of public service offerings is mandatory in the area of waste disposal. In this example, a change in VAT treatment of public bodies would not make it easier for private providers of waste disposal services to enter the market.

Level and structure of investment

One of the effects of a full taxation model with input VAT deduction is that it would encourage public sector entities to invest more, because investment becomes cheaper. On the other hand, in the case where we assume that there is competition between the public and the private sector, the increased competition with the private sector leads to a reduction of total activity level in the public sector, driving down investment. It turns out the latter effect dominates.

When we assume that there is no competition between public and private production the investment in the public sector goes down. The decrease in public own production of support functions drives down the total capital use, and this effect dominates the reduced disincentive to invest and the effect of the increase in total public sector activity.

Under a simple tax system like a full taxation system, it would not be necessary to find special ways of acquiring goods for VAT purposes, e.g. like public-private-partnership schemes, leasing agreements etc. This would save advisory costs.

The investment in the private sector goes up. This is because the total activity level increases in the private sector, driving up demand for capital. As we can from Table 4.9 the effect on private sector investments is strong in broadcasting where there is a strong distortion on the output side in the current system and in the private business services, which supplies support services to the public sector.

Table 4.9 Change in capital use, public sector and private support services sector under full taxation

Capital Use	Change in capital use, without competition	Change in capital use, with competition
Public sector	-0.33%	-1.01%
Total private sector	0.24%	2.15%
Private support services	0.82%	11.28%
Private Broadcasting	-0.03%	0.94%
Private Education	-2.63%	6.88%
Private Hospital services	-3.53%	-2.74%
Private Cultural services	-1.29%	-0.04%
Private waste management	-0.44%	-0.07%
Rest of economy	0.22%	0.51%

Source: Copenhagen Economics.

Level and structure of employment

As outsourcing decisions are encouraged this also means that the employment in public sector entities will decline as outsourcing becomes more attractive, all other things being equal.¹⁰¹

The increase in outsourcing will generate employment in the private sector. In the short run, however, the increase in employment in the private sector which stems from outsourcing of activities from the public sector to the private sector, will not suffice to cover the loss of employment in the public sector following the increase in outsourcing. This is because we expect the private sector to be more effective than the public sector, as described in chapter 3. In the longer run, the employment effect will become neutral, as wages, labour markets and economic structures adjust to the lower labour demand by the public sector, and labour flows into other uses.

In theory the increased capital investment in the public sector would drive up the public labour productivity, thereby in turn decreasing the labour efficiency gap between the public and private sector. The model though does not take this effect into account. We also believe that this effect will be small.

The results from the economic model are that public sector employment decreases by 1.07 percent following the introduction of the full taxation model, if we assume that private and public sectors compete in the market for final goods and services. On the other hand, if we assume that private and public sectors do not compete in the market for final goods and services, the public sector employment only goes down by 0.46 percent. As public sector activities go up, the small drop in public employment is driven by outsourcing of support functions in the public sector.

Efficiency in delivering public services

A full taxation model with more outsourcing would lead to more efficient produced services because private suppliers will take over a larger share of activities, and we assess that private suppliers are more cost effective than public suppliers.¹⁰² This and the competition in the private sector itself should lead to lower prices and innovation. Further the value chain could be sliced and public entities could concentrate on their core services.

The shift in production from the public to the private sector involves a total shift in production from the public to the private sector of 5 percent, for the goods and services in public interest

¹⁰¹ Christian Amand, "VAT for Public Entities and Charities - Should the Sixth Directive Be Renegotiated?", IBFD, International VAT Monitor, November/December 2006, pg. 435

¹⁰² M.C.Wassenaar, R.H.J.M.Gradus: "Contracting out: The importance of a Solution for the VAT Distortion", CESifo Economic Studies, Vol. 50, 2/2004, pg. 377-378

when we assume competition between public and private producers in the market for final goods. The production which shifts from the public sector to the private sector will be produced 15 % more efficiently, resulting in an overall 0.75 % ($0.05 * 0.15$) improved efficiency in the production of core services.

Impact on public revenues

A full taxation model would lead to an improvement of public budgets. This comes from the full taxation of services which are currently not taxed, and the fact that the most services that are being allowed to deduct input VAT are public. Allowing public sector to deduct input VAT has a zero-net effect on national public revenue, meaning that the public revenues go up by the full output taxation of public core service.¹⁰³

The magnitude of this can be expressed by the required change in VAT rate on core functions to neutralise the effects on the VAT revenue. The increase in VAT revenue would be cancelled by an 19 % reduction in the standard VAT rate. This e. g. means that the resulting Danish VAT rate on these sectors would be 20.25 % = $(0.25 * (1-0.19))$.

It has to be noted that a reform does not have the intention of raising tax revenues. The positive impact is a side effect. It could be compensated within the Member States, and in general we assess the impact of the full taxation model, assuming that the standard VAT rate is adjusted so as to maintain the public budgets unchanged.

Welfare cost

Introducing the full taxation model will remove some important distortions of competition and allow more cost efficient suppliers to solve a larger share of the public sector's tasks. This reduces the welfare cost associated with VAT and improves the general welfare of the EU27 population.

We have chosen to indicate the welfare effect using GDP. Our analysis using the general equilibrium model estimates a welfare gain following the introduction of the full taxation model of approx. 0.21% increase in EU27 GDP with full competition. With no competition the only effects comes from outsourcing of support function. In this scenario GDP increases by 0.05 %.

An important caveat here is that our economic model which we use for estimating impacts of VAT reforms does not include legal and other non-economic barriers to outsourcing or to establishment. This means that our estimate of the economic gain from VAT reform probably overestimates the gains, because it assumes that once the VAT differential between the private and public sector is gone, there will be no more barriers to outsourcing and establishment. In

¹⁰³ We are aware that this system would always let charity organisations deduct input VAT, which will lead to a public revenue loss. We do not have enough detail to quantify the size of these figures.

order to realize these gains, however, VAT reform is not sufficient, but the legal barriers should also be removed.

There are no negative effects for other businesses due to tax cascading.¹⁰⁴

Prices to be paid by consumers

A full taxation would lead to higher prices as services which are currently not taxed will be taxed, and the input VAT deduction will not compensate this effect entirely. The precise increase in prices will depend on the VAT rate and the amount of recoverable VAT.

Furthermore, the introduction of a full taxation model would have implications for the financing flows between the government, those paying social security contributions, and social security institutions owing to e.g. higher final prices for medicines and health care.

This may have negative social effects. This effect of the reform could be counteracted by changing income tax law or by social transfer payments if the compensation does not take place within the VAT system or the public funding system. Another solution is to apply a reduced VAT on public services.

However, the impact on prices could be compensated for public bodies like municipalities, regions, federal states etc. because the higher tax revenue could be paid back to these public bodies within the public funding system. It has to be noted that in some Member States this internal compensation might be complex because of the autonomy of the different levels of public bodies.

This internal compensation might be extended to private entities currently rendering tax-exempt services (like hospitals, culture, and education) because these activities are often partially financed by the state or state-run social security systems. The higher tax revenues could be shifted back to the public sector entities. However, this might be a very complex process and depends on the law of the respective Member States.

Tax compliance cost

A full taxation would reduce the administrative and compliance costs connected with fulfilling VAT obligations.¹⁰⁵ As neither non-taxable nor tax-exempt supplies are provided and, thus, the

¹⁰⁴ M.Aujean, P.Jenkins, S.Poddar, "A New Approach to Public Sector Bodies", IBFD, VAT Monitor, Vol. 10, No. 4, July/August 1999, pg. 146

Dr. Rita de la Feria, "The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction", INTERTAX, Volume 37, Issue 3, 2009, Kluwer Law International, The Netherlands, pg. 160

¹⁰⁵ Pierre-Pascal Gendron, "How should the U.S. treat government entities, non-profit organisations, and other tax-exempt bodies under a VAT?", May 27, 2009, source: www.americantaxpolicynstitute.org/research.html, pg. 13

full input VAT is deductible, no complex calculation methods for input VAT and legal assessments for output services would be necessary any more.¹⁰⁶ Less VAT issues have to be solved. This saves personnel costs and tax advisory costs as well as costs for the fiscal administration.

The introduction of a full taxation would lead to a harmonisation of EU VAT law. This could overall lead to a reduction in the compliance costs of running the VAT schemes. The effects are though thought to be small, and are not modelled. The magnitude of compliance costs and effect on overall qualitative results are discussed in model of the refund system scheme.

In the transition phase the administration costs would, of course, be higher. This effect would eventually be levelled out.

Impact on charities

The impact on charities of the full taxation model described here will depend on the extent of their activities rendered for consideration. The possibility to deduct input VAT will generally improve the economic situation of charities in the EU. However, services rendered for consideration will become taxable and non-exempt, which may impose an economic burden on charities. We do not have sufficient data to estimate the economic effect for charities.

Conclusion

The full taxation of all outgoing supplies at standard rate appears to be the best option to replace the current treatment.¹⁰⁷ The system, in general, is already operated successfully in Australia and New Zealand.¹⁰⁸ The only disadvantage is the undesired side effect of a higher taxation of outputs in the public sector which seems difficult to compensate. When estimating the effects on GDP, employment, investment and efficiency, we already adjust the standard VAT rate in the EU27 countries to keep the public fiscal balance unchanged after the introduction of the full tax model. We do this, because we want to model the effects of removing the distortions of competition between the public and private sectors, but we do not want to model the effects of a general increase in the level of taxation. Below we show the main economic effects from the full taxation option, cf. Table 4.10.

¹⁰⁶ Dr. Rita de la Feria, *"The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction"*, INTERTAX, Volume 37, Issue 3, 2009, Kluwer Law International, The Netherlands, pg. 159
M.Aujean, P.Jenkins, S.Poddar, *"A New Approach to Public Sector Bodies"*, IBFD, VAT Monitor, Vol. 10, No. 4, July/August 1999, pg. 149

¹⁰⁷ M. Aujean, *"The treatment of Government entities, non-profit organisations and other exempt bodies under a VAT: a discussion paper"*; 2009, source: www.americantaxpolicyinstitute.org/research.html, pg. 6

¹⁰⁸ Pierre-Pascal Gendron, *"How should the U.S. treat government entities, non-profit organisations, and other tax-exempt bodies under a VAT?"*, May 27, 2009, source: www.americantaxpolicyinstitute.org/research.html, pg. 14-15

Table 4.10 Main results for the full taxation option, without and with competition

	Solution 1: Full taxation	
	Without competition	With competition
Change in GDP	0.04%	0.19%
Change in public sectors use of private business services	1.50%	1.42%
Change in public sectors use of own production of support functions	-1.81%	-1.74%
Change in private core sectors share of core production, Percentage points	-0.05	0.78
Change in core functions share of total output, Percentage points	-0.08	-0.06%
- Change in public core functions share of total output, Percentage points	-0.02	-0.09
- Change in private core functions share of total output, Percentage points	-0.06	0.03
Change in public sector output	-0.09%	-0.91 %
Change in public sector employment	-0.46%	-1.07%
Change in total employment**	0%	0%
VAT rate calibration for revenue balance	19 % proportional reduction in rate for all VAT rates	

Note: * In this option we don't model any public revenue loss. **: By definition zero in the long run.

Source: Copenhagen Economics

4.2. REFUND SYSTEM

The main problem with the current VAT treatment of the public sectors outsourcing is connected with the non-deductibility of input VAT. Under a system where the supplies of public sector entities are either non-taxable or taxable but tax-exempt the deduction of input VAT is not possible. This leads to a self-supply bias, disincentives to invest and a cascade effect. A refund system would solve the problem with the input VAT. The idea of compensation is not new. Several Member States are already operating refund systems outside of the VAT system.¹⁰⁹ The Canadian rebate system is another example for this idea¹¹⁰. So a refund system would solve the problem with the input VAT and could rely on a practice in several countries. However, under a refund system there would still be a differential VAT treatment with legal uncertainties, possible distortions of competition on the output side and compliance costs.

¹⁰⁹ VAT refund system has been already introduced in the following European countries: Sweden, Finland, Denmark, France, Spain, Portugal, the Netherlands, United Kingdom.

¹¹⁰ For more information about the Canadian system see H. van Dijk and G.Lubbers, "The VAT Compensation Fun(d)?" IBFD, VAT Monitor, January/February 2000, pg. 8-9

For the EU it would be difficult to introduce a refund system outside of the VAT system because only the VAT law is harmonised law pursuant to Art. 113 Treaty on the Functioning of the European Union.

The alternatives are to amend the stipulations about input VAT in the CVSD, granting input VAT to certain public sector entities even if they do not have taxable and non-exempt supplies or to introduce a zero-rate for the supplies of the public sector. Both would lead to a system change.

In the following the general characteristics of a refund system are described. Afterwards the advantages and disadvantages are discussed.

General characteristics

Contrary to a full taxation system the introduction of a refund system would basically leave the CVSD's stipulations about the taxation of output supplies unchanged. The main amendments would be made at the input VAT side.

Thus, it would still be necessary to differentiate between taxable and non-taxable supplies (Art. 13 CVSD) and between tax-exempt and non-exempt supplies (Art. 132 ff. CVSD). Even the special rules about reduced rates in the Member States (Art. 98 ff. CVSD) and the stand still clauses (Art. 371 ff. CVSD) might be left unchanged.

The main feature of the refund system is the deductibility of input VAT although no taxable and non-exempt supplies are made. This would be contrary to the current Art. 168 CVSD which stipulates one of the main principles of the common VAT system. There are two major alternatives to introduce the deduction of input VAT. The first one is creating a new stipulation in title X chapter 1 of the CVSD about input VAT (f.i. within Art. 169 CVSD or as a new Art. 169a CVSD), which allows the deduction of input VAT for costs incurred by services that are either non-taxable (pursuant to Art. 13 CVSD) or tax-exempt (according to Art. 132 CVSD). As described above this would be a derivation from one of the main principles of the common VAT system. The second alternative would be the introduction of a "zero-rate" for the supplies of the public sector. This zero-rate could be introduced directly in Art. 13 and 132 CVSD or, systematically more correct, as a new Art. 97a CVSD about the mandatory introduction of a zero-rate as a kind of super-reduced rate for the services currently handled in Art. 13 and 132 CVSD (effectively this would mean a shift of Art. 13 and 132 CVSD to this new Article 97a CVSD).

As a consequence, the Member States with refund systems would have to dispose their systems.

Under a refund system the tax revenues would decline. This effect would have to be compensated, either within the VAT system (rise of standard rate, reduced rate instead of zero-rate or outside of the VAT system, i.e. reducing the public funding if there is any). The introduction of a reduced rate would be identical with the reduced rate in a full taxation system as already described above.

New stipulation within title X of the CVSD about input VAT

As described above the refund system could be introduced in a way that the stipulations about the deduction of input VAT is amended by a rule, which allows the deduction of input VAT for services which are either non-taxable pursuant to Art. 13 CVSD or tax-exempt according to Art. 132 CVSD. The advantage would be that there would be no major effect on the taxation of outputs. Also, this way would be very simple and there would be very limited amendments of the CVSD text.

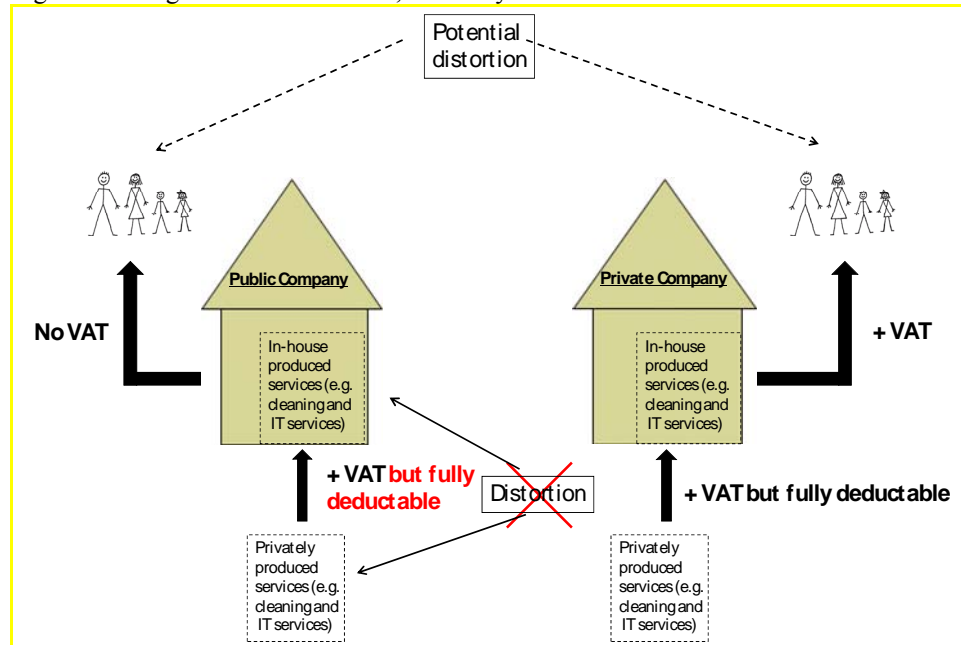
One main disadvantage would be that such an amendment of one of the basic rules of the common VAT system could be considered as a massive violation of the consistence and coherence of the CVSD. This violation would be very visible and it would be a question of time that other business sectors would question their input VAT treatment. The other main disadvantage would be the differential VAT treatment of public and private sector entities.¹¹¹ The VAT treatment would still mainly depend on the legal status of the supplier and not on the nature of the services. It is foreseeable that this would maintain legal uncertainty. Further, this could cause an even worse distortion between public and private sector.¹¹² The entities currently benefiting from a non-taxability or a tax-exemption are strengthened by the additional deduction of input VAT.

In the below diagram we illustrate how this option affects VAT rates on the input side for the public sector, and how this in turn removes the distortion of competition on the input side. The diagram also shows how the scheme is practically inserted in the CEVM model.

¹¹¹ Satya Poddar, “*Application of VAT to Public Bodies*”, presentation delivered at the VAT Conference, International Tax Dialogue, Rome, March 15-16, 2005

¹¹² M. Aujean, “*The treatment of Government entities, non-profit organisations and other exempt bodies under a VAT: a discussion paper*”; 2009, source: www.americantaxpolicynstitute.org/research.html, pg. 5

Figure 4.3 Diagram for full taxation, refund system



Source: Copenhagen Economics.

When we model the economic effects of introducing a VAT refund system, we do two analyses. In the first analysis, we estimate the economic impact of the refund system under the assumption that the refund system does not generate additional compliance costs for the private sector, compared with the current system. We have in chapter 3 estimated that additional costs of running a refund system could be non-trivial.

We model the refund system so that only public bodies gain a VAT refund for their input VAT. This means that we do not model any changes for private producers and charities. We do this as we do not have detailed economic data for charities. This modelling choice does not reflect any normative considerations of how an actual refund system should be designed.

New stipulation within the title VIII of the CVSD about tax rates

The disadvantages described for a new stipulation within title X could be limited if the refund system is introduced within the title VIII about tax rates. Such a solution could claim at least a minimum of consistence and coherence with the basic principles of VAT law as it would treat the public sector's supplies as "taxed" (even though it is a super reduced tax rate of zero). This would allow the deduction input VAT according to Art. 168 CVSD. Also, it would be possible to introduce this zero-rate for a whole sector, regardless the legal status of the supplier. This could lead to more neutrality.

The only disadvantage, compared with the above describe solution, would be that this solution would require several amendments of the CVSD text. Art. 13 and Art. 132 CVSD would have to be deleted. The catalogue of Art. 132 CVSD could be taken as a catalogue of activities that are taxed at the zero-rate. More difficult this would be in the case of Art. 13 CVSD. Currently this article stipulates in a negative way which services are non-taxable. For a refund system one would have to find a positive list of services subject to the zero-rate.

As both sub-solutions have, apparent from this, the same features we comment them together in the following.

Distortions of competition

A refund system would grant the neutrality of outsourcing decisions.¹¹³ There would be no unfair competition between an in-house solution and contracting-out as VAT plays no role in this context anymore. The VAT on contracted-out services could be deducted in a refund system.

However, the refund system cannot solve the problem of differential VAT treatment on the output side. The services of the public sector would still not be treated like supplies of other business sectors. It is still necessary to differentiate between non-taxed and taxed supplies. The uncertainties in the legal practice could lead to distortions although theoretically there should be no distortion.

We can get an impression of how the refund system affects the distortion of competition by looking at how the relative sizes of the public and private sectors change in response to the introduction of the refund system. If we assume that there no extra compliance costs associated with the refund system, relative to the situation today, then the refund system reduces the public sector's share of the total output by 0.12 percentage points.

Barriers to entry into existing markets

The refund system affects barriers to entry into markets for support services. It does not, however, affect entry into markets for final goods and services. Barriers to entry into markets for support services will be reduced, as illustrated in the sub-section about distortions of competition.

Level and structure of investment

The refund system solution with input VAT deduction would encourage public sector entities to invest. As we can see from Table 4.11 the public sector increases its capital use by 0.01 % in

¹¹³ Christian Amand, "VAT for Public Entities and Charities - Should the Sixth Directive Be Renegotiated?", IBFD, International VAT Monitor, November/December 2006, pg. 435

the full refund system. This mainly is because total production in the public sector increases. The private sector's total capital use decrease, as the private activity goes down, as part of the private sectors's activities is crowded out. With the inclusion of compliance costs the public sector loses some of its productivity, so that the substitution to public production is smaller. The modelling of this is though left out, as we do not have exact estimates on the size of compliance costs.

Table 4.11 Change in capital use, public sector and private business services sector under refund system

Capital Use	Change in capital use, w/ Compliance	Change in capital use, w/o compliance
Public sector	-	0.01%.
Total private sector	-	-0.23%.
Private business services	-	-1.41%.
Private Broadcasting	-	-0.13%.
Private Education	-	0.11%.
Private Hospital services	-	0.09%.
Private Cultural services	-	0.14%.
Private Waste management	-	-0.14%.
Rest of economy	-	-0.01%.

Source: Copenhagen Economics based on CEVM

Level and structure of employment

As outsourcing decisions are encouraged this also means that the employment in public sector entities will decline as outsourcing becomes more attractive.¹¹⁴

The increase in outsourcing will generate employment in the private sector. However, in the short run, the increase in employment in the private sector which stems from outsourcing of activities from the public sector to the private sector, will not suffice to cover the loss of employment in the public sector following the increase in outsourcing. This is because we expect the private sector to be more effective than the public sector, as described in chapter 3. In the longer run, unemployment will return to its previous structural level, as it were the case in the full taxation model.

¹¹⁴ Christian Amand, "VAT for Public Entities and Charities - Should the Sixth Directive Be Renegotiated?", IBFD, International VAT Monitor, November/December 2006, pg. 435

In the table below, we can see the long run effects of introducing the refund system on employment. If we assume that there are no compliance costs, then we estimate that the refund system will lead to a decrease in public sector employment of 0.14 % and an increase in employment in the private sector of by 0.11 %. In the longer run, this change along with adjustments in the rest of the private sector leads to net unchanged employment in the long run. If we assume the presence of significant compliance costs, then the structural change in the economy is less pronounced.

Table 4.12 Change in employment with refund system

	Without compliance costs	With compliance costs
Public sector	-0.14 %	-
Private sector	0.11 %	-

Note: Private sector employment only encompasses business services, broadcasting, education, hospital services, cultural services, waste management and water supply.

Source: Copenhagen Economics

Efficiency in delivering public services

A refund system with more outsourcing would lead to more efficient produced services because in-house solutions are competing with external solutions.¹¹⁵ This and the competition in the private sector itself should lead to lower prices and more innovation. Further, the value chain could be sliced and public entities could concentrate on core services. These arguments are just like above for the full taxation model.

The shift from own production of support functions to the private sector is 1.5 %, which is produced 15 % more efficiently. This increases average efficiency in the relevant services with 0.23 %.

Impact on public revenues

As only the public sector gains the right to deduct VAT, due to technical model limitations as explained above, we do not find any effect on overall public sector net revenue. However, if the refund system was extended to non-profit organisations and private firms, then there would be a decrease in public net revenue.

Welfare cost

If the refund system model encourages outsourcing decisions and these are leading to more efficient services this would lower the welfare costs.

¹¹⁵ M.C.Wassenaar, R.H.J.M.Gradus: "Contracting out: The importance of a Solution for the VAT Distortion", CESifo Economic Studies, Vol. 50, 2/2004, pg. 377-378

Dr. Rita de la Feria, "The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction", INTERTAX, Volume 37, Issue 3, 2009, Kluwer Law International, The Netherlands, pg. 160

There are no negative effects for other businesses due to tax cascading.¹¹⁶

The total GDP effects depend on what one assumes about the compliance costs associated with the system. With no compliance costs the GDP effects from the refund system is 0.01 %. This figure could potential be zero, with the inclusion of relative large compliance costs.

Prices to be paid by consumers

As the public sector is granted a deduction of input VAT the costs could be reduced correspondingly. The public sector entities could decide to use this cost saving to reduce the prices for the consumers. It has to be noted that the suppliers are not legally obliged to lower the prices unless there are regulatory requirements. However, as many public sector entities are welfare-orientated it could be expected that prices would be reduced in a larger extent than it is often noticed in connection with reduced rates.

Tax compliance cost

The administration costs for VAT would remain the same for the output side, as the taxation rules would not change fundamentally.

On the input side it would not be necessary to differentiate for the purposes of input VAT as all supplies would entitle to deduct input VAT. Less VAT issues have to be solved and less complex calculation would be necessary. This saves personnel costs and tax advisory costs.

Impact on charities

The impact on charities of the refund model described here is positive for the charities. The possibility to deduct input VAT will generally improve the economic situation of charities in the EU. We do not have sufficient data to estimate the economic effect for charities.

Conclusion

The refund system is able to deal with all problems resulting from the non-deductibility in the current system, i.e. outsourcing decisions are encouraged. Insofar this system is better than the current system when it comes to distortions on the input side. A refund system could also rely on a number of Member States and Canada where this system, in general, is already in place.

¹¹⁶ M.Aujean, P.Jenkins, S.Poddar, "A New Approach to Public Sector Bodies", IBFD, VAT Monitor, Vol. 10, No.4, July/August 1999, pg. 146

On the other hand a refund system violates basic legal principles of the common VAT system. It would be quite difficult to find clear stipulations in the CVSD to realise a refund system. Further, this system would not overcome the differentiated VAT treatment of output supplies. Below we show the main economic effects from the refund system scheme, cf. Table 4.13.

Table 4.13 Main economic effects from the refund system scheme

	Refund system, low (compliance costs)	Refund system , high (No compliance costs)
Change in GDP	Potential zero	0.01 %
Change in public sectors use of private business services, percentage points	-	1.43 %
Change in public sectors use of own production of support functions, percentage points	-	-1.74 %
Change in public core services input share to public sector, percentage points	-	- 0.01
Change in private core services input share to public sector, percentage points	-	0.01
Change in public sector employment	-	-0.14 %
VAT rate calibration for revenue balance	-*	-*

*Note: * In this option we do not model any public revenue loss.*

Source: Copenhagen Economics

All in all the refund system may be better than the current system but not as good as the full taxation system.

Compensation of the tax revenue impacts within VAT system

The refund system scheme allows deduction of input VAT on public sectors and other entities, who today cannot deduct input VAT. As stated in the description of full taxation, the effects on public revenue on a national level will be small, as the payment of input VAT from public bodies does not affect total public net revenue. It shall though be commented that the possibility of input VAT deduction also will go for charity organisations. As stated under full taxation, we do not have detailed enough information to model this, but the effects on overall public revenue are expected to be near to insignificant.

Even though the revenue effects on a national level will be neutral, the refund system scheme

can have distributional effects between public bodies. This can be the case, when the input VAT is paid by a public body, but the VAT revenue is collected by a public body running on a different account. For instance, this scheme will in Denmark reduce VAT revenue collected by the national government, but positively effect the budgets of decentralized public bodies, carrying out a function where VAT on input becomes deductible. This distributional effect could for example be neutralised by a reduction in the subsidies to the public sector.

4.3. PUBLIC BODIES TREATED AS TAXABLE PERSONS, WITH CERTAIN EXEMPTIONS

In the current EU VAT law system, no output VAT is generally applied on supplies of public sector entities, as these are often regarded as either being outside the scope of VAT system (non-taxable) or tax-exempt. Only under certain circumstances supplies of public sector entities have to be taxed. The price for general non-taxation of supplies provided is however the denial of the right to deduct input VAT by purchases made exclusively for purposes of such supplies. In case of “mixed used” purchases (i.e. purchases used both for taxed and for non-taxable and/or tax-exempt supplies), public bodies have to apply special calculation mechanisms in order to assess the deductible part of input VAT.

The current provisions of EU VAT law about VAT in the public sector were created under significant different market conditions as the competition between public and private sector entities as regards provision of certain supplies was formerly at a very low level. Therefore, it was not a burning issue at all to ensure the equal treatment of both groups and useful outsourcing decisions in the time of introduction of common VAT system, and the special VAT regime for public sector entities¹¹⁷.

An option for a better treatment of the public sector could be based on basically abolishing the special VAT regime for the public sector in order to equalize VAT treatment for the public and private sector.

General characteristics

In this option, the special status of the public sector entities based on the provision of the Article 13 CVSD would be removed by deleting Article 13 CVSD completely. Public bodies would thus be regarded as taxable persons with respect to all their supplies for consideration and consequently, only the character of the supplies provided would be relevant for the determination of the VAT regime applicable. If considered as necessary, some of the currently non-taxable activities pursuant to Art. 13 CVSD could be treated as tax-exempt under Article 132 CVSD.

¹¹⁷ For an overview as regards the origins of the European stipulations see: C. Amand (2006), ‘VAT for Public Entities and Charities – Should the Sixth Directive be Renegotiated?’, *International VAT Monitor*: 433-443, page 433.

Furthermore, the Article 132 CVSD should be modernised as regards the scope of supplies covered. The tax-exemptions of a modernised Article 13 CVSD should only depend on the nature of the supply, and not on the characteristics of the supplier.

As a result, supplies of public bodies lying presently outside the scope of VAT (Article 13 CVSD) would become taxable supplies (either tax-exempt or non-exempt supplies). This would for example affect such services as waste management, sewage, air traffic control, parking and road tolls and crematoriums. Since the VAT treatment of some activities varies among the Member States as regards non-taxability, the impact of deleting Article 13 CVSD would also be different¹¹⁸. The supplies not covered by the new Article 132 CVSD would automatically be treated as the taxable (non-exempt) supplies. In this regard it would be feasible to extend the scope of Article 132 to services provided by public authority such as for example justice, identity cards, passports which in some Member States may be supplied for a consideration and are generally considered as services which should not be taxed.

The decision of which additional public sector activities to exempt should probably rely mostly on political considerations, as it is hard to find economic reasons for exempting certain sectors. From an economic point of view, taxation has several roles:

- Generating public revenue
- Correcting for market imperfections
- Contributing to a desired distribution of consumption possibilities in the population

These objectives should be pursued in the way which least distorts individuals' behaviour (except for undesirable behaviour, such as e.g. pollution).

However, none of these objectives appear to justify why public bodies should be exempt and private bodies not be exempt. If a service is a poor vehicle for generating public revenue (which speaks in favour of exemption) then this should be the case regardless of whether the supplier is public or private. The same logic applies for the objectives of correcting for market imperfections and improving upon the distribution of consumption possibilities.

When it comes to exempting selected services regardless of whether the supplier is public or private, the above principles do not help much. All the services we consider can be assumed to be potentially good vehicles for generating public revenue, because for none of them it is reasonable to expect that demand would drop dramatically in response to a small price change.

¹¹⁸ For a detailed information about the VAT treatment of the sectors of waste disposal, cultural services, education, hospital services, homes for elderly, sport and broadcasting please see chapter 2.3 above.

Furthermore, exempting some of the services at this general level would probably create at least as many market imperfections as they remove. Some very specific services might be associated with important externalities that might warrant exemption, but we do not have sufficiently detailed information to determine which these services are. That would require an in-depth analysis and quantification of consumption externalities of some very detailed services, and we have not done that analysis for the purpose of this report.

Finally, one could make a reasonable case for exempting some services for distributional reasons. However, given the pitfalls and potential costs associated with exempting selected services, we would propose to instead use traditional social policy instruments such as direct income transfers to individuals or progressive income taxation in order to pursue distributional objectives. Thereby one could give money to poor people without also giving money to rich people.

Distortions of competition

The deletion of Article 13 CVSD would not completely remove non-taxability of the public sector since all activities not qualifying as an economic activity in the sense of Article 9 CVSD would remain non-taxable. Accordingly, a considerable part of the public sector would still be denied the deduction of input VAT incurred. As a result, there would still remain unfair competition insofar that in-house solutions are – from a VAT perspective – more favourable than outsourcing.

Furthermore, it has to be noted that the deletion of Article 13 CVSD could trigger a tax planning in the public sector. Instead of charging fees or other remuneration to finance a public body's activity it could also be decided to finance the public body through higher public financing (e.g. using tax revenues). In such a case the public activity would not be taxable anymore. The private sector would not be protected by a distortion clause anymore (like now in Article 13(1) CVSD).

However, the distortions resulting from an unfair competition on the output side could effectively be neutralised, since for all activities regardless of whether carried out by a public body or a private entity the same conditions would apply in terms of taxability. This would considerably reduce the current legal uncertainty. Modernizing Article 132 CVSD by implementing tax-exemptions that only relate to the nature of a service and not the characteristics of the supplier would further reduce current distortions.

We can get an impression of how this scheme affects the distortion of competition by looking at how the relative sizes of the public and private sectors change in response to the introduction of the refund system, cf. Table 4.14.

Table 4.14 Public and private share of the total economy

	Change in share of total economy, percentage points
Public sector	-0.01
Private sectors	0.01

Source: Copenhagen Economics

Note: The private sector is the total private sector, including privately produced goods.

Barriers to entry into existing markets

By deleting Article 13 CVSD and redesigning Article 132 CVSD all outputs regardless of the supplier being public or private would be treated equally. In this respect, the VAT would not any more prevent private competitors from entering into existing markets dominated by public suppliers. However, it has to be noted that a public body could still generate a barrier for private competitors by choosing to finance public services or supplies by tax income instead of a consideration, resulting in non-taxability because of the absence of an economic activity in the sense of Article 9 CVSD. In this regard, a partial financing of public services or supplies by subsidies would have the same effect, since subsidies are currently not regarded as a part of the taxable amount apart from those which are directly linked to the price of a supply (Article 73 CVSD).

Level and structure of investment

The solution for treating public sectors as taxable persons would encourage public sector entities to invest, because investment becomes cheaper.¹¹⁹

Under a tax system like solution for treating public sectors as taxable persons it would not be necessary to find special ways of acquiring goods for VAT purposes, e.g. like public-private-partnership schemes, leasing agreements etc. This would save advisory costs.

However, the main effect on investment is probably that the public sector experiences reduced activity. This reduction is due to a substitution away from own labor use, why the capital investment would decrease.

From Table 4.15 we see that that the net effect on the public sectors capital uses is negative. On the other hand the private sector uses more capital as their activity level increases following the improved terms of competition for the private broadcasting and waste management sectors.

¹¹⁹ Christian Amand, "VAT for Public Entities and Charities - Should the Sixth Directive Be Renegotiated?", IBFD, International VAT Monitor, November/December 2006, pg. 435
M. Aujean, "The treatment of Government entities, non-profit organisations and other exempt bodies under a VAT: a discussion paper"; 2009, source: www.americantaxpolicynstitute.org/research.html , pg. 3

Table 4.15 Change in capital use, public and private sector under treatment as taxable bodies, with certain exemptions

Capital Use	Change in capital use
Public sector	-0.28%
Total private sector	0.04%

Source: *Copenhagen Economics*

The increased investment by the private sectors leads to an increase in total investment in the economy.

Level and structure of employment

For the activities where the deletion of Article 13 CVSD and adjustment of Article 132 CVSD have the effect of shifting public sector activities from non-taxable to taxable and non-exempt, the self-supply bias would be removed. Insofar the result of this option would be a shift of employment from public bodies to the private sector. Nevertheless, this would not affect the part of the public sector engaged in activities which do not qualify as economic activities, or which are exempt

As outsourcing decisions in the covered sectors are encouraged this means that the employment in public sector entities will decline as outsourcing becomes more attractive.¹²⁰

It is not clear a-priori what the increase in investment would mean for public sector employment. We expect that the increase in investment would lead to increasing public sector employment, because a higher level of capital input generally increases the productivity of labour inputs. We do not expect capital to drive out labour.

The increase in outsourcing will generate employment in the private sector. However, the increase in employment in the private sector which stems from outsourcing of activities from the public sector to the private sector will not suffice to cover the loss of employment in the public sector following the increase in outsourcing. This is because we expect the private sector to be more effective than the public sector, as described in chapter 3.

The results from the economic model are that public sector employment decreases by 0.04 percent following the introduction of the treatment of public bodies as taxable persons. The

¹²⁰ Christian Amand, "VAT for Public Entities and Charities - Should the Sixth Directive Be Renegotiated?", IBFD, International VAT Monitor, November/December 2006, pg. 435

private sectors employment increases by 0.03 % due to increased activity in private broadcasting and waste management.

Efficiency in delivering public services

As far as public sector activities do not qualify as an economic activity the deletion of Article 13 CVSD would not affect the self-supply bias with respect to VAT as the public sector entities do not only base their decisions on the economical efficiency, but take into account the particular VAT consequences as well. For instance, by comparing two basic alternatives how to obtain inputs needed – self-supply and contracting out – the price of the second alternative is usually negatively influenced by the non-deductibility of input VAT. This often results in encouraging of internalisation¹²¹ and preference of self-supply over contracting out.¹²² In doing so, the public service entities go often the less efficient way as it has been indicated by several studies that private bodies are generally able to provide supplies of similar quality with lower costs.¹²³

On the other hand a positive impact on the efficiency in delivering public services can be expected where the deletion of Article 13 CVSD results in formerly non taxable activities shifting to taxable and non-exempt activities, because the VAT burden would insofar not any more hinder efficiency gains through contracting out.

The shift from public to private production is nearly zero when looking at the entire economy. The reason for this is, that the solution only have effect on two (relative small in comparison to the total public production) sectors. Zooming in on the two sectors the shift from own produced support function to private produced support functions is approx. 1 percentage points, which would be produced 15 % more efficiently.

Impact on public revenues

The impact on public revenues highly depends on the decision which public activities are to be treated as tax exempt according to the redesigned Article 132 CVSD. However, on a general basis it can be pointed out that the deletion of Article 13 CVSD would result in higher tax revenues provided that public bodies formerly treated as non-taxable are not exempt according to the new Article 132 CVSD and have a taxable output which exceeds their taxable input.

¹²¹ C. Amand (2006), 'VAT for Public Entities and Charities – Should the Sixth Directive be Renegotiated?', *International VAT Monitor*: 433-443, page 435.

¹²² M. C. Wassenaar & R. H. J. M. Gradus (2004), 'Contracting out: The Importance of a Solution for the VAT Distortion', *CESifo Economic Studies* 2: 377-396, on page 377.

¹²³ M. C. Wassenaar & R. H. J. M. Gradus (2004), 'Contracting out: The Importance of a Solution for the VAT Distortion', *CESifo Economic Studies* 2: 377-396, on page 378.

Allowing public sector to deduct input VAT has a zero-net effect on national public revenue, meaning that the public revenues goes up by the full output taxation of these two sectors.¹²⁴

The magnitude of this can be expressed by the required change in VAT rate on core functions to neutralize the effects on the VAT revenue. We estimate that this requires an 1 % reduction in the overall VAT rate on the modelled core functions.

Welfare cost

Introducing the solution for treating public sectors as taxable persons will remove some important distortions of competition and allow more cost efficient suppliers in waste management and broadcasting. This reduces the welfare cost associated with VAT and improves the general welfare of the EU27 population.

We have chosen to indicate the welfare effect using GDP. Our analysis using the general equilibrium model estimates though that the welfare gain following the introduction of the solution for treating public sectors as taxable persons is approximately 0.00 % of the EU27 GDP.

There are no negative effects for other businesses due to tax cascading.¹²⁵

Prices to be paid by consumers

Where formerly non-taxable activities according to Article 13 CVSD shift to taxable and are not covered by any exemption of the new Article 132 CVSD, an increase in prices can be expected. However, in this respect it must be pointed out that the ability of the respective public body to deduct incurred input VAT removes the effect of hidden VAT formerly included in the price of the public body's supply. As a consequence, depending on the circumstances of each case, a slight increase in prices should be expected. On the other hand, as regards activities, which do not qualify as economic activities according to Article 9 CVSD and activities which are to be covered by the provisions of the new Article 132 CVSD, the situation of the public bodies basically remains the same (no input VAT deduction, self-supply bias). As result, no effect on the prices for consumers should be expected.

Tax compliance cost

As a result of a reclassification of the supplies provided for consideration, generally only two categories of the outgoing supplies exist – tax-exempt and non-exempt. This fact would lead to

¹²⁴ We are aware that this system would always let charity organisations deduct input VAT, which will lead to a public revenue loss. We do not have enough detail to quantify the size of these figures.

¹²⁵ M.Aujean, P.Jenkins, S.Poddar, "A New Approach to Public Sector Bodies", IBFD, VAT Monitor, Vol. 10, No. 4, July/August 1999, pg. 146

Dr. Rita de la Feria, "The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction", INTERTAX, Volume 37, Issue 3, 2009, Kluwer Law International, The Netherlands, pg. 160

certain reductions of administrative and compliance costs, as the distinction only between these two VAT regimes has to be made and only one mechanism for a calculation of the amount of the deductible part of the input VAT has to be used.¹²⁶

However, the disadvantage of current system as regards the input VAT issue would still be the complexity of methods designed for determining the deductible part of input VAT in cases, where the public sector entity provides both non-exempt and tax-exempt supplies and therefore is entitled only to a partial input VAT deduction.¹²⁷ In this respect, the CVSD provides only very general principles and leaves it to the Member States to design convenient methods for determining the deductible part of VAT. Therefore, the national rules in this area differ significantly within the Member States and can be a source of further distortion, as the amounts of deductible input VAT can considerably vary.¹²⁸ Especially in cross-border transactions, it can generate unreasonable competition advantage, as the market operators do not act under same cost conditions.

Conclusion

The option to delete Article 13 CVSD and to modernise Article 132 CVSD would provide considerable improvement as regards legal certainty. Although some special rules are eliminated within this system, the complexity of the system remains preserved. Furthermore, problems with the classification of the supplies provided should be expected, if the borderline between taxable and tax-exempt supplies is not sufficiently clear defined.

Maybe the most considerable advantage of this option is that it does not involve a radical change of the current system. By introduction only of a slightly changed system in this form, additional costs associated with the comprehensive reform¹²⁹ could be avoided. This factor can be of high relevancy with respect to the questionable readiness of Member States to adopt a new legislation at the EU level. Especially considering the fact, that from the state budget per-

¹²⁶ R. De la Feria (2009), 'The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction', *Intertax* 37 No 3, on page 159; M. Aujean/P. Jenkins/S. Poddar (1999), 'A new approach to public sector bodies', *VAT Monitor* 1999: 144-149, on page 149.

¹²⁷ R. De la Feria (2009), 'The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction', *Intertax* 37 No 3, on page 159.

M. Aujean/P. Jenkins/S. Poddar (1999), 'A new approach to public sector bodies', *VAT Monitor* 1999: 144-149, on page 149.

¹²⁸ "It is clear that results reached based on the calculation with pro-rata will differ from the results of other methods, e.g. a method based on the "direct use" criterion or a method called "fair estimation", since for each of these methods other criteria are relevant. Member States are free to use the method of their choice to allow, respectively disallow deduction of input VAT. The deductible VAT thus ranges between 0 % and 80 % of the total input VAT." For more see C. Amand (2006), 'VAT for Public Entities and Charities - Should the Sixth Directive be Renegotiated?', *International VAT Monitor*: 433-443, on page 434.

¹²⁹ P. Gendron (2005) 'Value-Added Tax Treatment of Public Sector Bodies and Non-Profit Organisations: A Developing Country Perspective', ITP Paper 0514, URL:<http://www.rotman.utoronto.ca/riib/> (last checked: 11 January 2011), on page 12.

spective, the current system has positive impacts as it enables to gain VAT revenue by taxing input prior to the final consumption stage, it can be assumed that some Member States will be rather reluctant to agree to any “radical” changes.

In addition, from a political point of view, there could be also found some arguments supporting existence of the special VAT regime for some supplies¹³⁰, such as continuity in tax practices after introduction of the current VAT system, avoidance of conceptual problems created by “difficult to tax” transactions¹³¹ or possible price reductions which are in line with distributional targets of e.g. merit goods.

However, a major disadvantage would be the still-existing non-deductibility of input VAT in respect of non-economic activities of the public sector, leaving the problem of self supply-bias. Where former non-taxable activities of Article 13 CVSD are to be covered by an exemption of the new extended Article 132 CVSD the problem of irrecoverable input VAT would persist. This also applies to the exemption of the current Article 132 CVSD which are to be included in the modernised version. The non-deductible input VAT will still generate so-called tax cascading in all cases where the supply provided by the public body is only an intermediate step in the production or distribution chain, i.e. where the public body cannot be regarded as a final consumer of particular purchase.¹³² Such results are conceptual incoherent with the general principles of the EU VAT system, especially it is against the principle of fiscal neutrality of VAT, and it causes erosion of VAT base.

The quantitative conclusions on the effects from solution for treating public sectors as taxable persons are in all respects alike the conclusion from the full taxation, though on a much smaller scale as fewer sectors are affected.

The only disadvantage is the undesired side effect of a higher taxation of outputs in the public sector which seems difficult to compensate. When we estimate effects on GD etc. we balance the public VAT revenue by decreasing the standard VAT rate in the EU27 countries. This is done, because we want to model the effects of removing the distortions of competition, and not the effects of a general increase in the level of taxation. Below we list the main economic effects from the solution for treating public sectors as taxable persons, cf. Table 4.16.

¹³⁰ M. C. Wassenaar & R. H. J. M. Gradus (2004), ‘Contracting out: The Importance of a Solution for the VAT Distortion’, CESifo Economic Studies 2: 377-396, on page 381.

¹³¹ For instance, taxation of supplies by public bodies for their provision no consideration is provided.

¹³² M. Aujean/P. Jenkins/S. Poddar (1999), ‘A new approach to public sector bodies’, VAT Monitor 1999: 144-149, page 146.

Table 4.16 Main economic effects from the solution for treating public sectors as taxable persons.

	Treated as taxable persons
Change in GDP	0.00%
Change in public sectors use of private support services	0.00%
Change in public sectors use of own production of support functions	0.00%
Change in private core services share of total output, percentage points	0.01
Change in public core services share of total output, percentage points	-0.01
Change in public sector output	-0.18%
Change in public sector employment	-0.04%
Change in public sector capital use	-0.28 %
VAT rate calibration for revenue balance	_*

*Note: * In this option we do not model any public revenue loss.*

Source: Copenhagen Economics

Summary of economic effects

In below table we have collected some key results from the quantification of the different schemes, cf. Table 4.17.

Table 4.17 Key results from quantification of the modelled solutions

	Solution 1: Full taxation		Solution 2: Refund system		Solution 3: Treated as taxable persons
	without competition	with competition	with compliance costs	without compliance costs	with competition***
Change in GDP	0.04%	0.19%	Potentially zero	0.013% (€ 1.38 billion)	0.00% (app. € 0)
Change in public core services share of total output, pct.-points	-0.02	-0.09	-	0,01	-0,01
Change in private core services share of total output, pct.-points	-0.06	0.03	-	-0,01	0,01
Change in private business services input share to public sector, pct.-points	1.50	1.42	-	1.43	0.00
Change in public business services input share to public sectors, pct.-points	-1.81	-1.74	-	-1.74	0.00
Change in public sector employment	-0.40 %	-1.10 %	-	-0.14 %	-0.04 %
Change in total employment	0	0	-	0	0
Change in wages	0.02%	0.10 %	-	0.00%	0.00%

Source: Copenhagen Economics

Solution 1 is the full taxation solution. This generates an increase in GDP of around 0.04 percent, cf. the first row when we assume no competition between public and private production.

We find an increase of 1.50 percent of public sector use of private produced support services, and a drop of 1.81 percent in public in-house produced support services. This is the shift from in-house produced support services to private produced – outsourced – support services that we expect from eliminating the distortion on the input: private produced support services become relatively cheaper than public in-house produced support services. Because we assume that private support services are produced more efficiently than public in-house produced services, we get the positive impact on overall GDP.

Public sector employment falls in this solution-scenario by 0.40 percent. The drop in public jobs is compensated for by an increase of jobs in the private sector in the medium to longer run.

Finally, we see that wages rise. This is due to the increased efficiency in the economy, because of a larger share of more efficiently produced private support services at the expense of less efficiently in-house public produced support services. Higher average efficiency means higher average wages.

The second column shows the full taxation solution 1 with the assumption of competition between public and private production. By eliminating the distortion on the output side (and of course also on the input side) under this assumption, results in economic gains of 0.19 percent of GDP. This is a significantly larger gain compared to the 0.04 percent with the 'without competition' assumption. The difference of 0.15 percent of GDP between 0.04 and 0.19 percent can thus be attributed to elimination of the distortion on the output side. Hence, in Member States where competition on the output side exists in large public sectors e.g. water supply and cultural services, but differential VAT treatment is a key factor in distorting competition, there may be significant economic gains from a full taxation model. It must be kept in mind, however, that other significant barriers to distortion of competition may still exist, so that elimination of differential VAT treatment may not bring about these economic gains.

We indeed find a shift towards private produced core services share of total output (up 0.03 percent) from public produced core services share of total output (down 0.09 percent).

Together with more public sector use of private produced support services (up by 1.42 percent) and a drop in own produced support services (down by 1.74 percent), we get the 0.19 percent increase in GDP. This is because we assume that private services are produced more efficiently than public services.

The result for the refund system solution 2 does not include compliance costs, in the column labelled 'w/o compliance'. We have not modelled the solution with introduction of compliance costs, as the exact size of such is unclear. We use the refund system solution to quantify the potential costs savings for the public sector from removing the distortions on the input side.

We estimate this to be 5.2 bio. euro, as the total cost reduction is 0.3, which corresponds to € 5.2 bio. EU27-wide.¹³³

¹³³ We calculate this on basis of total government expenditure of 2,563 bio. Euro (excl. transfers), Eurostat (Government Finance Statistics)

In the solution 3 ‘treated as taxable persons’, only waste management and broadcasting services are taxed on the output side and allowed deduction of incoming VAT on the input side. As these sectors represent an insignificant part of the economy, the economy wide impact as modelled in our model, is bound to be very small. This is reflected in the percentage changes of around zero percent on GDP and for all other variables in the table. Hence, this solution does not solve the self supply distortions of support services for the public sector as such.

Finally, we assess that the estimate of the economic gains are likely to be in the higher end of what can be expected in reality. The reason is that many other barriers than differentiated VAT exists. This means that even with a solution eliminating the distortions due to VAT, other barriers may exist that maintain this distortion, whereby elimination of differential VAT treatment has no immediate impact on efficiency and economic gains.

4.4. OPTION TO TAX FOR TAX-EXEMPT PERSONS

General characteristics

A certain modification to the third option (treatment of public bodies as taxable persons) would be the introduction of an option to tax for taxable but exempt persons.¹³⁴ The VAT rate would be applied on the basis of the existing VAT rules (standard or reduced rate). Alternatively, a super-reduced rate could be implemented (between 0 % and 5 %).

In an option to tax model, the providers of the tax-exempt services as defined in the Article 132 CVSD would have a possibility to decide for the application of the output VAT on their supplies and thus open themselves the right to deduct the input VAT of purchases incurred for purposes of these outgoing supplies. This option could be implemented in different ways, e.g. as a single option for all exempt supplies provided within a certain period or by the means of a “cherry picking” (i.e. decision case by case).

In this connection it is worth to mention that the option to tax was already granted in the CVSD for certain kind of supplies (e.g. financial services)¹³⁵ and has been implemented in various forms into national law by several Member States. Like in Art. 137 CVSD it could be left to the discretion of the Member States to decide the details.

¹³⁴ Obligatory introduction of an option for taxation in all Member States is currently discussed at the EU level as a possible solution of existing distortions as regards the VAT treatment of financial and insurance services. For more information see European Commission (2006), DG TAXUD, Consultation Paper on modernising Value Added Tax obligations for financial services and insurances, URL: <http://ec.europa.eu> (last checked: 11 January 2011).

¹³⁵ See Art. 137 CVSD.

From a legal point of view a new Art. 134a CVSD would be introduced that would set out the details of the option to tax.

Advantages and disadvantages

For the advantages and disadvantages in the case that the taxable persons are not opting to tax, we refer to our comments about the deletion of Article 13 CVSD and modernization of Article 132 CVSD (third option). Where the taxable person opts to VAT our comments about a full taxation are applicable in general.

Generally, the option for taxation could bring additional benefits in the two basic situations. Firstly, if large investments are realised, the use of the option to tax can be advantageous in the periods, in which the higher input VAT is expected in comparison to the output VAT. Secondly, if a consideration provided for a supply is lower than the true costs on its provision (e.g. public transport tickets) or if the provider of the supply is in the red numbers, the output VAT is lower in comparison the input VAT and the option for taxation reduces the tax burden of the provider of supplies. Where a super-reduced rate is introduced, more taxable persons would opt to tax.

The distortions of competition between in-house solutions and outsourcing would still exist in all cases where the taxable persons do not opt to tax. Only where the option to tax leads to a deduction of input VAT which exceeds the VAT due on output supplies the self-supply bias and disincentive to invest as well as tax cascading could be eliminated. However, in these cases an option to tax would lead to even more distortions of competition with other suppliers than the current law, i.e. when it is granted as a cherry picking for every single supply. The situation would be even worse if a super-reduced rate were applicable.

The tax revenues would slightly drop as the option would only be carried out where the input VAT exceeds the output VAT. The reduction would be higher if a super-reduced rate were introduced. This could have a positive effect on consumer prices.

Additionally it has to be noted that the option to tax would be a further legal complexity in a very complex legal system which causes additional administration costs for the taxpayers. However, from the perspective of the administration and compliance costs, the taxation of outgoing supplies brings a simplification with respect the requirements on accounting system, since only one VAT regime (non-exempt supplies) is applied where a taxpayer opts to tax broadly. Similarly, no complex calculation mechanism is needed for purposes of the determination of the deductible part of the input VAT. The input VAT is deductible in the full amount.¹³⁶

¹³⁶ R. De la Feria (2009), 'The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction', *Intertax* 37 No 3, on page 159.

Conclusion

The option to tax could lead to partial improvements as regards self-supply bias, disincentive to invest and tax cascading. A major advantage is that this solution would only require few amendments of the EU VAT law.

On the other hand the positive effects are limited to the cases where the option to tax is useful from an economic point of view (input VAT exceeds VAT on output supplies). Also, it is limited to tax-exempt supplies and does not cover non-taxable supplies of public sector entities.

A significant disadvantage is that current distortions of competition could be worsened because public sector entities could decide about their taxation whereas private competitors are taxed anyway.

M. Aujean/P. Jenkins/S. Poddar (1999), 'A new approach to public sector bodies', VAT Monitor 1999: 144-149, on page 149.

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