How the municipal VAT exemptions promote tax increases in the EU

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As a general rule, local governments are exempt from VAT in the EU. Thus, VAT is not payable on the tax-financed consumption of municipalities and other local governments, at least when the services are produced in-house.

This implies that it is cheaper to finance consumption through local taxes than on the open market, which is a problem when local governments have the authority to set their own tax rates, as the VAT exemption is an implicit subsidy of local government consumption. This tend to increase local tax burdens.

New Zealand operates a model whereby all consumption, public and private, is subject to VAT. Local property taxes are also subject to VAT, implying that there is no incentive to expand local government operations for VAT reasons.

There is an ongoing discussion on the need for VAT reform in Europe. The European Commission should look to New Zealand for inspiration and push for the complete inclusion of local authorities into the VAT system.

Introduction

In many countries, local authorities and regions account for a significant share of government spending. For example, in Sweden local tax revenues amount to 16 percent of GDP according to the OECD. The fiscal policy of local governments can often influence the national economy, especially when municipalities and regions have decision-making power over taxation as well as spending. For this reason, it is important to get local politicians' incentives right.

This report shows how the exemption from value-added tax (VAT) of local and regional governments in the EU distorts the incentives of local and regional policymakers. The reason is that the VAT exemption makes it cheaper to pay for services using taxpayer funds than on the private market – at least when the services are produced by the municipality's own employees. This poses a problem when local authorities can set their own tax rates. Namely, local politicians have an incentive to expand the size of the local public sector beyond what would otherwise have been the case.

The purpose of this report is to shed light on an overlooked aspect of the European VAT system. There is an awareness among scholars and policymakers about other problems surrounding the VAT, often caused by various sectors or products being exempt from tax, but the problem identified in this report has not been explicitly discussed before to the author's knowledge.

The report discusses how the VAT system may be reformed to remedy this distortion. In particular, we show how the EU can solve the problem by expanding the scope of VAT to cover the entire public sector, as is the case in New Zealand.

The exemption from VAT of local and regional governments in the EU distorts the incentives of local and regional policymakers, as it makes it cheaper to finance pay for services using tax money than on the private market.

The public sector in the European VAT system

The European Union has a common framework for VAT as set out in the VAT Directive. A central principle of the VAT Directive is that public agencies are treated as non-taxable persons.[1] This means that they are not charged VAT on the value added that they generate and that they cannot deduct VAT on their purchases from the private sector. In some instances, the fees that municipalities impose for (e.g.) waste collection are taxable. But tax-financed operations are exempt from VAT and VAT is not added to other taxes.

A well-known problem with this principle is that it becomes cheaper for public authorities to produce services in-house rather than outsourcing to a private firm, because the private company (for example, a cleaning company) will have to add VAT on its invoice. A few member states operate VAT refund systems which allow municipalities and government agencies to file a claim with the central government to recoup their VAT expenses. This restores symmetry between in-house production and outsourcing. While it is important to address this distortion, an important asymmetry remains, which will be covered in the next section.

The European Commission is aware of the problems surrounding the current framework for public sector VAT, especially the self-supply bias discussed above, and has initiated a discussion on possible reforms. It commissioned a report from Copenhagen Economics (2013) that confirmed the existence of problems and noted that a New Zealand-type VAT system (see below) could be a way forward for the EU.

[1] Council Directive 2006/112/EC, article 13.

The problem with exempting the public sector

A central problem in the European VAT system which seems to have been overlooked in both the policy debate and the legal literature is that the exemption of local government consumption makes it cheaper to finance that consumption through taxes. This becomes a problem when municipalities and regions can set their own tax rates, as they are tempted to raise tax rates and expand the local public sector.

Imagine a country with a VAT rate of 15 percent, but where municipalities are completely exempt from VAT. A municipality increases its local tax rate to raise another €10 million of revenue. This is used to, for example, increase staffing at libraries or build a city museum. As tax-financed operations are exempt from VAT, this enables the municipality to provide its citizens with services that would have cost €11.5 million if purchased from a private firm.

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This means that the local public sector in general will be inefficiently large, due to the implicit subsidy that is the result of VAT-exempting local tax-financed expenditure.

Another aspect is that the VAT exemption is inequitable because municipalities and their inhabitants will pay different amounts of VAT even though they are similar in every respect but the local tax rate. Imagine two municipalities, each with a total income of 10 million. Municipalities finance their operations through a comprehensive income tax (as in Sweden) and set their own tax rates. VAT is 15 percent of the purchase price.

Let's say one municipality provides its citizens with only bare-bones services and has a local tax rate of 10 percent, i.e. revenues of 1 million. These revenues can be spent VAT-free by the municipality (as in the EU). The citizens spend the other 9 million and pay 1.35 million in VAT.

The other municipality chooses to provide a much larger set of tax-financed services (swimming pools, sports fields, subsidised public transport etc.) and has a local tax rate of 40 percent. The inhabitants spend the remaining 6 million of their income and pay 0.9 million in VAT.

So from the perspective of the local voters, financing consumption through the local tax bill rather than on the private market will result in lower VAT payments to the central government. This encourages local politicians to expand tax-financed operations and raise local tax rates.

Figure 1 summarizes municipalities' decision-making in the EU. First, the municipality decides whether a particular service should be paid for through taxes, or whether taxes should be lower so that citizens can spend their money on the private market (where VAT generally applies). Second, if the municipality decides that the service is to be tax-funded, it decides whether to produce the service in-house or contract it out to a private firm. In the first case, no VAT will apply. In the second case, the municipality will have to pay VAT unless the member state in which it is located operates a VAT refund scheme.

VAT in New Zealand

New Zealand's value-added tax is called the Goods and Services Tax (GST). It was introduced later than VAT in Europe and adopted more modern principles and a broader tax base. Therefore, New Zealand's GST is generally viewed as a model VAT system by tax experts.[2]

According to the OECD (2016), 97 percent of consumption, public and private, is subject to

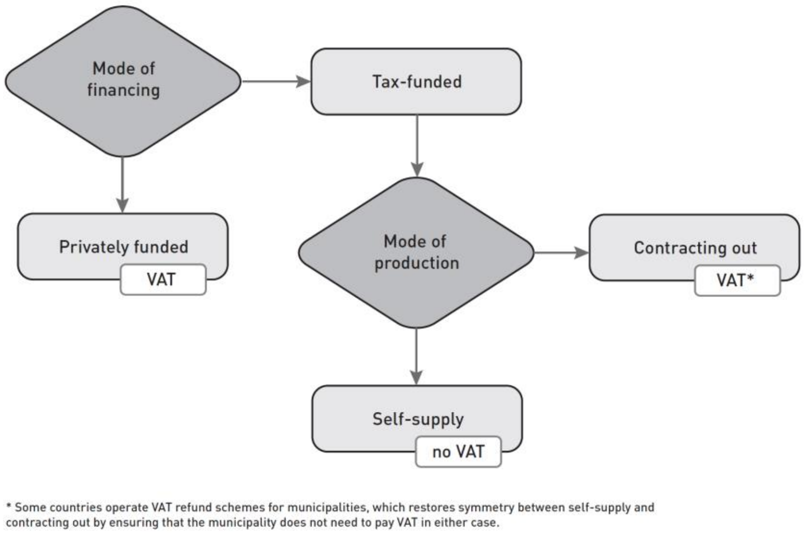

Figure 1. How European local politicians' decision-making is distorted by VAT rules.

[2] "The economic and administrative case for full taxation under VAT of supplies made by public-sector, nonprofit, and charitable entities is strong. The system used in Australia and New Zealand is the best alternative. Under it, essentially all goods and services supplied by the [public] sector are treated like any supplies from the private sector." (Gendron, 2011)

GST in New Zealand. In New Zealand, goods and services supplied by government agencies are subject to VAT. For instance, the New Zealand Defence Force is viewed as selling services to the Crown, which are taxable. Local authorities are fully integrated into the GST system. Their single largest source of revenue is local property taxes, called rates. These are also subject to GST.[3] On their website, the New Zealand Department of Internal Affairs explains why:

> **Why is there GST on rates?**
>
> GST is a tax based on consumption of goods and services. Rates are the price paid for consumption of services provided by local authorities, so rates are eligible for GST.
>
> While rates are a tax, so-called 'tax on tax' situations are not uncommon – for example petrol, alcohol and tobacco prices and the few goods still subject to import duties.
>
> Exempting some services from GST and not others creates extra administration costs and inequitable situations. For example, why should ratepayers whose water is provided by a company such as Metrowater have to pay GST if ratepayers across the border in Waitakere whose water is delivered by the council do not?[1]

The fact that GST is added to rates means that there is neutrality between financing services through the normal market mechanism and through local taxes. Unlike in Europe, there is no incentive to raise local tax rates from a VAT perspective.

Conclusion

The fact that VAT is not payable on tax-financed government operations in the European Union, which stems from the VAT Directive, incentivises those local and regional governments that can set their own tax rates to raise taxes to make use of an implicit subsidy. This could lead to local government expenditures being inefficiently large.

In order to remedy this, the EU should adopt a New Zealand-type VAT, where the public sector is fully integrated into the VAT system. Exactly how this should be implemented may be left to the member states. One could imagine levying VAT on local taxes, as is the case with New Zealand's local property taxes. Another solution would be to view the municipal treasury as a final user for VAT purposes, and consider municipal departments (e.g., the department of parks and recreation) to be selling services to the treasury. The departments would be required to add VAT on their invoice, and remit this to the central government. This is analogous to the VAT treatment of central government agencies in New Zealand.

Of course, the central government could then return these VAT receipts to the local governments in the form of block grants. The point is to get municipalities' incentives right.

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[3] Henkow (2013), Millar (2013).