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European Commission
Taxation and Customs Union
Unit C1 -VAT

Response to the Commission's consultation "Review of Existing VAT Legislation on Public Bodies and Tax Exemptions in the Public Interest"

The Association of Finnish Local and Regional Authorities (AFLRA) is a national association that represents all Finnish local and regional authorities (320 municipalities and 18 regions). In Finland the local authorities are responsible for providing a wide range of services to their residents. Their budgets represent over 50 % of the total public sector expenditure and they employ almost 20 % of the country's working population. The services of AFLRA span all areas of municipal operations. Emphasis is placed on stable and consistent relationship between local and central government, autonomy, democracy and management, regional development and employment. AFLRA plays a key role in the national level policy making process and employs almost 300 experts in Helsinki and 3 persons in the Brussels office.

Commission's consultation on VAT legislation on public bodies introduces several models for future development that could have major consequences for local and regional authorities in Finland. AFLRA has many concerns regarding these models, as they would have a strong impact on the financing of public services. Changes in VAT legislation on public bodies alter the current structure and financing models of the service providers, which have been developed over a long period of time to their current efficient and optimal form.

The Finnish VAT regulation has already taken into account in various ways the neutrality aspects between public and private actors. All services are (with minor exemptions) equally subject to VAT regardless of whether it is sold by a public or by a private actor. The municipalities have a refund scheme which allows them to recover the input VAT of basically all bought goods and services. For health care and social services there is a special refund of 5 % of the purchase price to compensate for the hidden VAT of privately produced non VAT services. These compensations are deducted from municipalities' tax incomes. This system guarantees the neutrality between the public and private sector although the VAT forms a cost for the local sector in general.

AFLRA key views for the future development of VAT legislation on public bodies:

- 1. AFLRA does not recognize the neutrality problems mentioned in the consultation. In Finland some minor neutrality problems can be identified in very specific situations, but these can best be solved with specific actions.**
- 2. In Finland the refund scheme for municipalities solves most of the neutrality issues on the input VAT. AFLRA encourages the use of refund mechanisms in other member states, but doubts the suitability of a refund mechanism at an EU level.**
- 3. It is extremely important to keep the current VAT treatment in public authority services, education and the in the social and health care sectors. Output VAT for these services is harmful for citizens, very difficult to put into practice and would not promote neutrality between the public and private sector.**
- 4. AFLRA does not see a strong need for any of the 5 different reform options described in the consultation. However, the best of the proposed models would be the sectorial reform (option 4) or the selective amendments of the current rules (option 5). The worst option is the full taxation model (option 1).**

Q1: General evaluation of the current rules

In Finland the current VAT regime for the public sector is functioning quite well. We have not experienced major neutrality problems with the VAT treatment. There have been some problems in definitions of VAT exempt services due to the multiplicity of service models, but these are minor compared to the volume. The national refund system guarantees equal treatment for private and public actors when public authorities are considering outsourcing.

Article 13 in the VAT directive is clear as regards to local governments acting as public authorities. We want to stress that local authorities have a monopoly when they act as public authorities; therefore these services (admission fees, certificates etc.) do not compete with other services. In a full taxation model these fees would increase the cost for the citizens by the VAT rate, but not solve any neutrality problems.

Articles 132-134 in the VAT directive are very important as they exempt social and health care and education from the VAT rules. Normal VAT treatment for these services is not favorable as these services are carried out in the public interest and are strongly subsidized with tax incomes.

The main VAT problems for local and regional authorities concern the different possibilities to provide services. VAT treatment might be different depending on whether the service is provided by the municipality, a municipal company, co-operation between municipalities or by some other form. These problems are mostly linked to the national refund scheme, because it applies only for municipalities and joint municipalities.

The treatment of VAT in the social and health care sector has been somewhat problematic in Finland. Most of the problems have been related to the definition of a VAT exempt service when the service is carried out by a complex supplier network. Problems have occurred for example in co-operation models, labour leasing in the health care sector, social housing and different treatments that are regarded as normal VAT services even if they are closely linked to the VAT exempted services.

Despite the various problems in past, the VAT treatment in the social and health sector is currently quite clear due to various court cases and instructions of tax authorities. There will probably exist some problems with the definitions also in the future, but these are minor compared to the fact that local authorities spend currently around 50 % of their budget in social and health care services.

In the social and health care sector, the input VAT for private and public sectors are treated differently. Public authorities get the input VAT back via the refund scheme, but VAT is a final cost for private service providers. However, the public and private sector cannot be seen as competitors in this sector. Public social and health care is very strongly subsidized and the fees cover only a small part of the costs. On the other hand, citizens get compensated for purchases from private service providers from the National Pensions Institute.

Municipalities get a 5 % special refund when they buy social and health care services from the private sector. This way the hidden VAT (=the input VAT private service providers cannot deduct) do not cause neutrality problems when public authorities consider if they should produce the service themselves or outsource it to the private sector.

VAT exempted education can only be provided, in practice, by public entities. Municipalities get the input VAT back via the refund scheme (when they purchase for example goods to be used in education), therefore they have an incentive to buy goods from the market. Education is free of charge and therefore there is no VAT problems with the output VAT.

Q2: Distortion of competition clause

We have not experienced problems in Finland with the competition clause in the second subparagraph of article 13.

Q3: Reform measures

We believe the VAT treatment of public entities and public services is functioning well in Finland. Therefore we do not see the need for any major reform in this aspect. There are some minor problems, but they can be solved with specific actions rather than with an exhaustive reform.

Option 1 introduced by the Commission proposes a full taxation model, which means that social and health care services as well as education and culture would be taxed (or avoids VAT if not regarded as economic activity). We strongly oppose to this model, because it would affect the majority of public services, change the optimal structure for providing the service and increase costs for citizens using public services, without solving neutrality problems.

The current network for providing public services and the fees are based on current rules. A change that would require currently VAT exempt services to be taxed with a normal VAT rate would lead to significant changes. Such a change could lead to many restructuring operations where service providers would need to change their current forms of operating. These consequences should be thoroughly examined before proposing the full taxation model.

The full taxation model would increase the costs for citizens using public services (unless 0 % tax rate). For public authority services (license fees etc.) this would only lead to higher fees without solving any neutrality problems. For social and health care services the fees would also increase by the VAT rate, which is controversial, because the fees are (politically) decided in the first place. The cost of private social and health care services for the citizens would increase even more because the fees (=tax base) are higher than those for the public sector. This would create a new neutrality problem between private and public actors.

The full taxation model would not affect education services, because they are free of charge. In some co-operation models this could mean a new output VAT, but already today municipalities as buyers get the input VAT refunded.

Culture services are already today subject to VAT, if they are considered as economic activity. For some culture services the full taxation model would mean higher entrance costs and in some cases this could lead to the end of the service, because even currently they can barely survive. Museums for example have historical values and it is difficult to interpret that these distort competition more than insignificantly.

Option 2 proposes a refund system at the European level. In Finland we already have a similar refund system for municipalities and joint municipalities. The refund mechanism abolishes the distortion between public and private sector (or self-service bias) in most cases. However, the model is complex and creates some problems even today, for example when municipalities consider to transfer the performance of a task to a fully owned company. We believe an identical refund mechanism would not necessarily suit every member state. Therefore we cannot support a strict European refund model, but member states could be encouraged to introduce refund mechanisms.

Option 3 proposes a deletion of article 13 and modernizing article 132. In Finland we have not experienced problems with article 13 and therefore we do not see the need for the changes proposed in option 3. However, this option could be suitable, if the modernized article 132 would involve the essential exemptions of the current article 13. Option 3 does not propose in detail how article 132 would be modernized, and therefore it is difficult to analyze this option further.

Option 4 proposes to keep the principles in articles 13 and 132, but modernize them in sectors where distortions of competition can clearly arise. We believe this is the best of the options proposed in the consultation paper. This option would concentrate the efforts where problems can be found without changing the whole environment of producing public services. This option is the most favorable, because the positive outcome is almost guaranteed and there are less risks of negative outcomes compared to the comprehensive reform options.

Option 5 proposes selective amendments of the current rules. This option is close to option 4 and has also similarities with option 3. The advantages are quite the same, but option 4 seems to have closer connection to the actual experienced problems, when options 3 and 5 try to reform

the rules more generally without actual experience of distortion of competition. Option 5 seems also more complex to introduce in practice. Therefore we prefer option 4 rather than option 5.

Q4: Sectorial reform

The consultation lists potential sectors as candidates for the sectorial reform. These are postal services, broadcasting, waste management and sewage, air traffic control, access to roads and parking areas.

We believe some of these sectors could qualify for the sectorial reform approach, but it needs to be further examined. As mentioned earlier in this response, we have not experienced major distortions of competition caused by VAT rules in any sector. In Finland municipalities have responsibilities in waste management and sewage and access to parking. These sectors are currently covered by a neutral VAT treatment between the public and private sector. Therefore we do not see the need for a sectorial reform in these sectors in Finland.

We are very pleased to notice that the list in the consultation paper does not include social and health care or education as these sectors have an important function in the whole welfare society in Finland. As explained earlier in this response, applying normal VAT rules and rates is not at all favorable for these sectors.

Q5: Option to tax

The *option to tax* model would benefit in Finland those private sector actors who act in a tax exempt sector and have more input VAT than output VAT. This model would in most cases not benefit municipalities in Finland due to the existing refund system. However, some municipal companies could benefit from this model. The *option to tax* would probably not lead to lower costs of outsourced social and health care services, as our refund system already takes into consideration the VAT costs for private actors.

We believe that an *option to tax* model could be the suitable way forward in the development of VAT. We already have this kind of model in the field of real estate renting to VAT subjects. However, the *option to tax* would complicate the VAT system, as mentioned in the consultation paper. Therefore the suitability of this model in different sectors needs to be further examined.

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- Non-Governmental organisation (NGO)
- Tax advisor or tax practitioner
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- Academic
- Public body
- Others. Please specify

Name of your organisation/ entity/ company

Association of Finnish Local and Regional Authorities

.....

Country of domicile

.....

Brief description of your activity or your sector

The Association of Finnish Local and Regional Authorities (AFLRA) consist of all the cities, municipalities and regions in Finland. The Association's goal is to promote the opportunities for local authorities to operate and co-operate and to enhance their vitality and viability for the benefit of citizens. The Association employs about 300 persons in Helsinki, mainly in expert duties. The Association's office in Brussels serves as its lobbying centre for EU affairs. The Association's vision for the future encompasses the core values of the Finnish welfare society: good basic services, living democracy and sustainable environment.

The Association of Finnish Local and Regional Authorities is registered in the EU's Transparency Register (ID 10235216783-84).

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Yes

No

¹ According to the Commission Recom