

Contracting out: the importance of a level playing field

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Abstract

The levying of VAT in countries of the European Union creates significant distortions for local authorities in their decision-making on public provision and contracting out of public services. In several EU-countries, a refund of VAT to local governments eliminates this effect. Therefore, these schemes facilitate contracting out by local governments. In European countries with a refund scheme for the VAT costs of local governments or other ways to solve this distortion, contracting out refuse collection is relatively high compared to countries without. Moreover, the design of the scheme may have an effect on the tax rates of the included government sectors. A closed system financed by local governments only will lead to an increase of local tax rates.

1. Introduction

Over the last two decades, contracting out of government services has increased. A broad field of studies has shown that this policy generates efficiency gains because private sector companies can be more efficient than public sector companies in activities such as refuse collection, fire protection and cleaning services (Domberger and Jensen, 1997; Tang, 1997). Although competition for service contracts will lead to lower expenditure and higher efficiency, competition itself generates new problems as transaction costs, taxation issues and rent seeking (Boyne, 1998). As will be shown, the levying of VAT in the European Union influences decision-making on public provision versus contracting out. Consequently, the VAT regime for countries in the EU favours public provision over contracting out and public sector bodies are not able to achieve the maximal efficiency gains. Several countries in Europe have introduced schemes to dissolve this distortion (Aujean, Jenkins and Poddar, 1999).

In this paper, the different VAT refund schemes of the relevant countries are described with their main characteristics. As the VAT refund lowers the consumers price of contracting out, the VAT refund schemes have a positive effect on the outsourcing of local authorities and may, therefore, generate efficiency gains. Besides, the design of the scheme may have consequences for the tax rates of the included public sector bodies. There seems to be evidence that for European countries with a refund of the VAT costs, or a fiscal solution to the distortionary VAT effects, out of house refuse collection is relatively high compared to countries without these solutions.

The paper is structured as follows. Section 2 describes the economic effects for local governments of contracting out their services. In section 3, the effect of the levying of VAT on the decision-making process by local governments is described. In sections 4 and 5, an overview is given of the different VAT refund schemes in Europe intended to solve the distortionary effects of VAT. Section 6 offers the conclusions based on the analysis.

2. The economic effects of contracting out

There seems to be evidence that contracting out government services saves taxpayers money, relative to public provision. In an overview, Domberger and Jensen (1997) showed that contracting out a broad field of government services suggest cost savings of about twenty per cent without sacrificing the quality of services provided.

Especially, the cost savings of contracting out refuse collection have been discussed at length in the existing literature. Kitchen (1976) showed that the average costs are lower in case of contracting out instead of direct provision by a municipality. Pommerehne and Frey (1977) studied refuse collection in Switzerland. They showed that the private sector comes up with lower costs that amounted to 20 per cent, as far as the refuse

collection market is competitive. Stevens (1978) arrived at a cost decrease between 7 and 30 per cent due to contracting out for the USA, where the magnitude of the effect depends on the size of the municipality. Based on UK-data, Domberger, Meadowcroft and Thompson (1986) published a study on the effects of contracting out household refuse collection in the United Kingdom. They concluded that there are cost savings of 22 per cent for contracting out to private companies. Szymanski and Wilkins (1993) and Szymanski (1996) confirmed these results, based on an extension (in years) of this database. Gradus and Dijkgraaf (1997) showed similar cost savings between 15 and 20 per cent for the Netherlands, in case Dutch municipalities are contracting out refuse collection. Moreover, Ohlsson (1998) reported almost the same estimations for Sweden. Recently, Bosch, Predraja and Suarez-Pandiello (2000) presented Spanish data for 73 municipalities in Catalonia. They pointed out that the framework for competition for which the service is provided could be more relevant than the public private dichotomy. In a recent contribution Reeves and Barrow (2000) pointed out cost savings of around 45 per cent for Ireland.

Also for other government activities competitive tendering will lead to lower expenditure and higher efficiency. Tang (1997), in a critical assessment of the existing literature, came to the conclusion that the private sector is found to be more efficient in refuse collection, fire protection, cleaning services, and capital intensive waste-water treatment, while in sectors such as water supply and railways the results are more mixed.

A related question is the popularity of contracting out of refuse collection. In the United Kingdom 30 per cent of the contracts for refuse collection is placed out of house (Szymanski, 1996). In the Netherlands 40 per cent of the municipalities uses private collectors for refuse. However, because private collectors are especially active in small villages only 20 per cent of total tonnages is in private hands (Gradus and Dijkgraaf, 1997). According to Reeves and Barrow (2000), in Ireland in 39 per cent of studied cases private providers was contracted to provide refuse collection. In Denmark 85 per cent of local authorities relies on private companies for waste collection and disposal (up from 27 per cent in 1991) (OECD, 2000). In Norway, 73 per cent of the municipalities makes use of private companies for waste collection and disposal. In Sweden, the proportion is 63 per cent. In the same study it is shown that for Italy 46 per cent and for Finland 92 per cent of the municipalities contracts out refuse collection.

Also a recent study by López-de-Silanes, Shleifer and Vishny (1997) reported on the track record of local authorities towards contracting out. Based on US data in 1987 and 1992 for 3042 counties for twelve services such as water supply, landfills, libraries etc. only 25 per cent of the services in 1987 and 35 per cent in 1992 were placed out of house. Moreover, in this article a nice empirical investigation of the mode of providing government services is given, where three leading theories (efficiency, political patronage and ideology) are investigated. The evidence presented in this article

indicates that state government laws and state laws restricting county spending encourage contracting out, whereas strong public unions discourage it. This points to the important roles played by political patronage and taxpayer resistance to government spending in the privatisation decision.

As already pointed out in the introduction, in EU-countries the fiscal system may also be an important explanation for the reservation of local authorities towards contracting out. Table 1 shows the differences in eight European countries' percentages on outsourcing of the refuse collection by local authorities.

Table 1 Out of house refuse collection in European countries

Country	Percent of out of house refuse collection	Level playing field
United Kingdom	30	yes ²
Ireland	39	no
Netherlands	40	no ¹
Italy	46	no
Sweden	63	yes ²
Norway	73	yes ³
Denmark	85	yes ³
Finland	92	yes ²

1. Current plans are that a VAT refund scheme is available in 2003.
2. The level playing field is realised by the introduction of a VAT refund scheme.
3. The level playing field is realised by considering the collection of household refuse as a taxable activity.

From this table it can be concluded that a higher percentage of contracting out is correlated with the existence of a level playing field for refuse collection. In the countries with a level playing field, this has been generated by the introduction of a VAT refund scheme or by considering the collection of household refuse as a taxable activity. As a consequence, the decision-making between self-supply and contracting out is not influenced by VAT effects. Despite its system of VAT compensation the UK has a low percentage of contracting out. A possible explanation for this could be that the data for UK are of earlier date or that contracting out is highly sensitive to ideology and political patronage.

3. VAT and public sector bodies in Europe

As shown before, local authorities can generate significant efficiency gains by contracting out their services. In the choice between self-supply and outsourcing of

services by local authorities, the levying of VAT has a distortionary effect. In case of self-supply, the local authority has to pay VAT just on the costs on the purchase of goods and services. The value added of the local authority – such as personnel costs – is due to the self-supply not raised with VAT. In case of contracting out to a private enterprise, VAT is charged on the full price. As a result, VAT costs are higher in case of outsourcing than in case of self-supply. This effect is a consequence of the European VAT legislation for particular activities of local authorities and certain specified activities performed by public or private suppliers.

European VAT legislation for public sector bodies distinguishes three types of activities: taxable activities, non-taxable activities and tax-exempt activities (Aujean, Jenkins and Poddar, 1999; Dijk and Lubbers, 2000). All activities of both private suppliers and public sector bodies are in general within the scope of VAT, and are called *taxable activities*. There are two exceptions on this general rule. As described in Article 4(5) of the Sixth VAT-directive, the first exception is made for activities of public sector bodies engaged in their role as public authority:

States, regional and local government authorities and other bodies governed by public law shall not be considered taxable persons in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions, or payments in connection with these activities or transactions. However, when they engage in such activities or transactions, they shall be considered taxable persons in respect of these activities or transactions where treatment as non-taxable persons would lead to significant distortions of competition. In any case, these bodies shall be considered taxable persons in relation to the activities listed in annex D, provided they are not carried out on such a small scale as to be negligible.¹

These activities are called *non-taxable activities*. However, as the second part of this article describes, an exception to this general rule can be made in case the non-taxable character of these activities could lead to significant distortions of competition.

The second exception is made for specific activities listed in Article 13 of the Sixth VAT directive as for health, education and banking services (Genser and Winker, 1997). These activities are known as *tax-exempt activities*. This exception is relevant for private and other public suppliers as well.

In case a public sector body performs taxable activities, the services are subject to VAT. The local government carrying out this activity is entitled to recover the input VAT acquired for the purposes of a VAT taxable activity. Since the municipality will be able to recover any input VAT incurred relating to this activity, the VAT consequences will

¹ Dijk and Lubbers, 2000.

not be a consideration when a municipality chooses between carrying out the activity itself or contracting out services to the private sector.

In case a public sector body performs non-taxable or tax-exempt activities, these activities are outside the scope of VAT. The municipality carrying out this kind of activity will thus be unable to recover any input VAT related to this activity. The respective VAT consequences will then become an important consideration when the municipality chooses between carrying out the activity itself and contracting out the activities to the private sector. If, for example, the private sector is able to perform activities for an amount which is lower than the costs to the municipality in the case of self-supply, the private sector could still be more expensive since the additional VAT charged on the supplies from the private sector would increase the price by the relevant VAT-rate (Dijk and Lubbers, 2000).

As a result, these VAT costs are a relevant aspect when a public sector body considers the choice between carrying out the activity itself and contracting out the service to the private sector. Therefore, for both non-taxable and tax-exempt activities, the present VAT legislation disturbs the level playing field between the self-supply of services and contracting out of governmental activities and causes significant economic distortions (Aujean, Jenkins and Poddar, 1999; Gradus and Dijkgraaf, 1997). The last years, these distortions may have increased because of the rise of the tax rates of VAT in some European countries (for example in the Netherlands in 2001 the VAT rate is raised from 17,5 to 19 per cent).

There are two general options to solve this VAT distortion (Aujean, Jenkins and Poddar, 1999). The first option is the change of the European VAT legislation by widening the application of the regular VAT regime to the non-taxable and the tax-exempt activities as well. Then, the VAT input costs can be recovered and are not relevant in the comparison between the self-supply of services and contracting out. However, such a thorough change of the European VAT legislation is not to be expected for the next years.

The second option is to finance the VAT costs of public sector bodies by a refund outside the VAT regime. This non-fiscal, budgetary solution has as effect the creation of a level playing field between the self-supply of services and contracting out (European Commission, 2000). This system is or will be implemented in six European countries (see table 2). The funding of the system differs for each of the schemes and a global distinction can be made between open and closed models. Both models create a level-playing field between the self-supply of services and contracting out. The two types of models differ in the way they are funded for the extra costs of the scheme in case the payments of the fund increase as a result of a growing level of outsourcing of public sector bodies. In an open model, the extra costs are funded by the extra VAT receipts for the central government. In a closed model, the public sector bodies themselves fund

the extra costs. The choice for one of the models has only an effect on the budgetary flows between central and local governments.

In some countries, the VAT distortion for public sector bodies is solved by using the exceptive clause that in case considering the activity as a non-taxable activity would lead to significant distortions of competition, the activity is considered to be taxable. As shown in table 1 both Norway and Denmark have chosen this solution for mitigating the VAT effects on the collection of household refuse.

4. VAT refund schemes in Europe

Six European countries have or will get a refund scheme for the VAT costs on non-taxable or tax-exempt activities for local governments.² In this paragraph, the main characteristics are discussed.

The United Kingdom

The main reason for the introduction of the VAT refund scheme in the United Kingdom simultaneous with the introduction of VAT in 1973 was to prevent VAT falling on the activities of local governments funded by the local taxpayer. The VAT refund scheme is part of the regular VAT legislation (sections 33 and 42 of VAT Act 1994) and only applies to non-taxable activities carried out by local and police authorities.^{3,4} Compensation is not given for VAT incurred in other EU-member states and for certain specified purchases as motorcars (HM Customs and Excise, 1997).

The scheme is fully financed by the central government by the VAT receipts. Increases in payments of the scheme are therefore financed by higher VAT receipts as well. The scheme costs about £3.3bn in 2001 (about 0,4 per cent of GDP). At the moment of introduction of the refund scheme (1973), the concept of contracting out had not been widely implemented. Consequently, there are no figures available about the effect of the scheme on the level of contracting out. Furthermore, the imposition of Compulsory Competitive Tendering by the central government in 1988 seems also important in stimulating contracting out.

² In the United Kingdom, Denmark, Sweden, Finland and the Netherlands specific regimes for the VAT compensation on the level of central government exist as well. These regimes deviate from the character of the funds for local authorities.

³ The scheme applies as well to organisations that have the power to raise revenue via the council tax and perform activities that are the statutory responsibility of local authorities.

⁴ Compensation is given for tax-exempt activities as well in case their size remains below 5 per cent of the total VAT refund on non-taxable activities.

Denmark

The reason for the introduction of the VAT compensation fund in 1985 was to ensure equal competition between goods and services produced by the public sector and the private sector. From 1970 to 1984 the Danish municipalities were imposed VAT on their own production to ensure equal competition, but from 1985 the actual VAT equalisation scheme was introduced as it was more simple to administrate. The scheme includes municipal and county authorities and inter-authority companies. Compensation is given for both VAT on non-taxable and tax-exempt activities. Only VAT paid to the Danish government is refunded by the VAT compensation fund. The VAT costs for tax-exempt activities that are supplied by a private enterprise are not recovered by the regular refund rules. To prevent an unequal treatment of self-supply of tax-exempt activities and outsourcing of these activities, a reimbursement – equal to a percentage of the price – is given by the refund scheme as well. The VAT costs on the tax-exempt activities are calculated by a fixed percentage for each relevant activity.

In Denmark, the VAT compensation fund is fully financed by the municipalities and counties by an equalisation scheme. The inter-authority companies do not contribute to the scheme. The costs are distributed among the counties and municipalities according to their estimated income tax base. Higher refunds are financed by higher contributions and are not funded by the central government. The fund costs about 13.5 bn DKK in 2001 (about 1,0 per cent of GDP). There are no data available about how the VAT compensation fund influences the level of contracting out of activities. However, the growth of the size of the local government VAT fund since 1993 has been interpreted by the Danish government as a sign of a growing level of contracting out by local governments.

Finland

The Finnish VAT refund scheme was introduced in 1994 simultaneously with the introduction of VAT in Finland. The refund scheme turned out to be necessary because services became taxable to a larger extent than in the previous consumption tax system. The refund right covers the VAT on all non-taxable and tax-exempt activities of the municipalities and the municipal federations that do not entitle to a right a deduction in accordance with the normal VAT-system. Refund is not given for VAT paid to other EU-countries and for the VAT costs on certain specified purchases.

The municipalities themselves finance the Finnish refund scheme. An increase in the refund is paid by the municipalities as well. The financing share is determined on the basis of their number of inhabitants. Because the share of the refunds to the municipalities does not have a direct relation with the number of inhabitants of the municipality redistribution effects are caused. The municipal federations receive compensation, but do not contribute to the scheme. Both issues are part of a review of the Finnish scheme.

The fund costs about 5.2 bn Finnish marks in 2001 (about 0,6 per cent of GDP). The total sum of the refunds paid to the municipalities and the municipal federations has increased steadily during the application of the scheme. The impact of the refund in comparison with other economic factors has not been examined. Therefore, conclusions about the impact of the scheme on the level of contracting out by local governments are not available.

Sweden

In 1995 the VAT refund scheme was introduced to remove the distortion between self-supply and contracting out for municipalities and county councils. Before, Sweden was not a member of the European Union and the general right of deduction for local authorities was not in accordance with the European VAT directive. The distortionary effect of VAT was solved by refunding all input VAT, regardless whether the activity was taxable or not. The present system is based on the Danish VAT refund scheme. The scheme applies to municipalities and county councils. Refund is given for both VAT on non-taxable and tax-exempt activities. VAT paid in other member states and purchase of passenger cars is excluded. There is also a compensation for hidden VAT when tax-exempt services are procured from subcontractors, such as private hospitals and dentists or when a tax-exempt activity is subsidized by the local authorities. Because of the tax-exempt character of these activities, the input VAT costs are not a separate part of the procurement price. Instead, a calculated flat rate of 5, 6 or 18 per cent of the price is reimbursed in the system. This should correspond with the hidden VAT in the price of the service.

In Sweden, the compensation fund is based on a principle of self-financing. The total amount of refunds from the system must be paid back to the fund by the collective of municipalities and county councils. The payment is the same amount per inhabitant in each municipality or county. Furthermore, when the present system was introduced, the general state subsidy to the local authorities was raised. This means that the state also contributes with a fixed amount to the funding of the system. An increase in the refunds is funded by the contributions of the municipalities and the provinces. The fund costs about 27 bn SEK in 2001 (about 1,2 per cent of GDP). No information is available about the effects of the refund scheme on the contracting out by municipalities and county councils.

In 1999, a Swedish governmental committee presented a report on the functioning of the compensation system and suggested a few changes (SOU, 1999). The Committee found that one of the main problems of the compensation scheme appeared to be the unequal treatment of non-governmental providers of tax-exempts as private schools and private health clinics and comparable governmental bodies. The former complain because they are not entitled to have the same kind of direct reimbursement of input VAT as the governmental bodies have. Besides, the financing of the system has been

too low which has created a deficiency of the fund and the reattribution of resources (since the contribution is just dependent on the number of inhabitants).

Norway

In Norway, in 1995 the VAT refund-scheme was introduced to remove the distortion between self-supply and contracting out as it might lead to a more perfect allocation of resources. Local authorities can get a refund for VAT costs of some specified governmental activities, restricted to tasks defined in the VAT compensation Act, as building contractor services, engineering services, laundry services and services by consultants. The fund costs about 1,2 bn NOK in 2001 (about 0,1 per cent of GDP). Refund is given only for Norwegian VAT costs. The fund is financed by a reduction in the general grant (about 80 per cent in 2000) en partly (about 20 per cent in 2000) by higher VAT receipts as a consequence of increased contracting out. Higher refunds are financed by the higher VAT receipts of the central government. The claims for VAT refund have increased by 20 per cent (adjusted for inflation) in the period 1995 – 1999. The increase in the share of the funding by VAT receipts is seen by the Norwegian government as an indication of the growth of contracting out in Norway. By presenting the National Budget 2001, the Norwegian government proposed a huge VAT reform that may have consequences for the VAT refund scheme.

The Netherlands

In the Netherlands, a compensation fund is to be introduced in the year 2003 (Dijk and Lubbers, 2000). The reason for the introduction is twofold. The main reason is the creation of a level playing field between self-supply and contracting out. Besides, with the introduction, the incentive for local authorities will disappear to start fiscal schemes for avoiding the paying VAT. The scheme will apply to municipalities and provinces. Compensation will be given for VAT costs on non-taxable activities, except the VAT costs for aid in kind to other organisations. The compensation fund provides refunds for both Dutch VAT as VAT from other countries from the European Union.⁵

The scheme will be funded by a structural reduction of the general grants for municipalities and provinces equal to the value of compensation in the year of introduction and will be completed by the addition of extra VAT receipts resulting from the expected growth in contracting out. By the design of the grant-reduction, differences in cost structure between municipalities and provinces will be taken into account. Therefore, the fund will not lead to a significant redistribution of funds between individual municipalities and provinces. At this moment no expectations about the size and the efficiency gains of the introduction of the fund are available.

⁵ Due to legal reasons, compensation is given for VAT from the ESA-states Norway, Liechtenstein and Iceland as well.

5. Overview

In this section an overview of the different schemes to solve the VAT distortion used in different countries will be given. Table 2 shows the main characteristics of the models described in this paper.

Table 2 VAT refund schemes in Europe

	Percentage of outdoors refuse collection	type of model	non-taxable activities ?	tax-exempt activities?	EU-VAT compensated?	budget in % GDP	year of introduction
United Kingdom	30	open	all	none ¹	no	0,4	1973
Denmark	85	closed	all	all	no	1,0	1985
Finland	92	closed	all	all	no	0,6	1994
Sweden	63	closed	all	all	no	1,2	1995
Norway	73	open	some ²	none	no	0,1	1995
The Netherlands	40	open	all	none	yes	-	2003

1. Compensation is given for tax-exempt activities in case their size remain below 5 per cent of the expenditures of the public body.
2. Compensation is restricted to contractor, engineering, laundry, and consultancy services.

Contracting out refuse collection

Table 1 shows that European countries differ in the level of contracting out of the refuse collection and that the percentage outdoors refuse collection in the countries having a level playing field at the household refuse collection. Comparing these figures with countries without such a level playing field (Ireland, 39 per cent, the Netherlands, 40 per cent, Italy 46 per cent) we conclude that having a level playing field stimulates the outdoors refuse collection by local authorities. In three countries, the level playing field is realised by the introduction of a VAT refund scheme for non-taxable activities. In Denmark and Norway, the choice is made to consider the collection of household refuse to be a taxable activity. The present Dutch fiscal system is a disincentive for contracting out.

In spite of the VAT compensation, in the UK the method of contracting refuse collection is beyond less popular than in-house provision (see table 2). It should be

noticed that the data for the UK are of earlier date (1984 – 1994) (e.g. Szymanski, 1996). Moreover, political patronage seems more important in the British government than in the other countries (Painter, 1991) and competition may not be intensive in the United Kingdom (Gómez-Lobo and Szymanski, 2001)). In other countries measures have been taken to enhance the likelihood that several firms will be in a position to compete when the time comes for re-tendering. For example, in Denmark Odense split its geographical area into four parts and invited separate tenders for each of the four regions and in Sweden Uppsala divided its area into sub-regions and organised tenders for each region sequentially with one tender coming up for renewal each year (OECD, 2000, p. 35).

In a similar study Dijkgraaf, Gradus and Melenberg (1999) examined for the Netherlands the determinants of the provision mode of refuse collection. They found evidence for political patronage and the wealthy of the local government as a ground for contracting out, but also the possible efficiency gain of contracting out plays a role. Dutch municipalities put more weight on efficiency-ground and therefore the introduction of the VAT compensation fund in 2003 will certainly stimulate contracting out of refuse collection on other local governments activities.

Open vs. closed models

The VAT refund schemes differ in the way the extra costs for the fund are financed. Open and closed models are distinguished. In a closed model, higher refunds are financed by a higher contribution to the scheme, and therefore have a negative budgetary effect on each of the individual bodies. The benefits of the scheme for an individual public sector body therefore depend on the efficiency gains that it may realise by contracting out, and the losses made by the contribution to the scheme to pay the refunds for other bodies. In case these benefits are negative, the public sector body has to increase its tax rates to meet these costs. Therefore, this model is only applicable in case the public sector bodies are able to pass the extra expenses by increasing their tax rates. In this model, the central government has a profit equal to the extra VAT receipts.

In an open model, higher refunds to all public bodies are financed by the higher tax receipts of the central government which are added to the fund. The individual local government is able to generate the efficiency gains by contracting out, without the side-effect of higher contributions to the scheme.

The United Kingdom, Norway and the Netherlands have an open model for the compensation of VAT costs. An increase in contracting out of local authorities leads to a payment of the central government to finance the higher VAT costs.

The refund schemes in Denmark, Finland and Sweden are closed. Higher refunds of the scheme are financed by the local authorities themselves and will lead to higher local

taxes.⁶ Therefore, it may have consequences on the opinion of the local authorities about the scheme (SOU, 1999).

Non-taxable and tax-exempt activities

In the United Kingdom, Norway and the Netherlands refund is given only for VAT costs on non-taxable activities.⁷ In Sweden, Denmark and Finland refund is given for tax-exempt activities as well. This choice might be related to the difference in the scope of activities of local governments in these countries. In the UK as well as the Netherlands health care and education – the most relevant tax-exempt activities - are provided by the private sector as well. A VAT refund scheme for public sector bodies including these activities might therefore lead to an unequal treatment between private and public suppliers. As a result, in Sweden non-governmental providers of tax-exempts as private schools and private health clinics complain because they are not entitled to have the same kind of direct reimbursement if input VAT as well as the comparable governmental bodies have (SOU 1999). In Norway and Denmark, the refund is restricted to certain specified non-taxable activities.

In table 2, a relation is shown up between the choice for the compensation of VAT on tax-exempt activities and the choice for a closed model. This can be explained by the text of article 17 of the Sixth VAT-directive. This article states that the full refund of VAT is excluded for tax-exempt activities (Terra and Kajus, 1991). In a closed model, not a pure refund is given, but more a redistribution of means (European Commission, 2000). Therefore, by the choice for a closed model, it is with respect to the text of article 17, possible to generate a level playing field for tax-exempt activities as well.

As far as tax-exempt activities are performed by private suppliers, no compensation of VAT costs is given. This may still lead to significant efficiency losses as decision-making of these suppliers also is distorted by the effect of VAT.

Non-national VAT

Only in the Netherlands, the planned refund scheme allows a refund of non-national VAT costs. For this part of the Dutch system, the model is closed. The local governments themselves pay the higher costs of this part of the refund. The choice of other countries to restrict the refund to national VAT costs might be in contrary with the European common market rules. As a consequence of this exception, the costs for

⁶ In Denmark, the expenditures of local authorities and counties to the VAT compensation fund are part of the general estimates of the economic outlook for the next year when local authorities and counties negotiate with the central government on the average tax level for both local authorities and counties for the next year. So rising VAT costs are not directly being compensated, but they are taken into consideration in general negotiations.

⁷ In the United Kingdom compensation is given for tax-exempt activities as well as in case their size remain below 5 per cent of the expenditures of the public body.

national supplies are lower than those of non-national suppliers and the level playing field is restricted to the national market.

Efficiency gains

At this moment, no founded information is available about the efficiency gains that are consequence of the introduction of the different refund schemes. For the United Kingdom and Finland, the schemes were simultaneously introduced with the introduction of VAT. For the Netherlands the scheme is to be introduced in 2003. Only for Denmark, Sweden and Norway indications are available that after the introduction of the scheme the outsourcing of local governments has increased. This might be explained by the introduction of the refund schemes.

6. Conclusion

The levying of VAT in Europe on public sector bodies and suppliers of tax-exempt activities significantly disturbs the decision-making of these actors in their choice between public provision and contracting out of services. A refund scheme for local governments – as used in several European countries – is a sufficient solution to this distortion.

The introduction of VAT refund schemes stimulates the contracting out by local governments and therefore a more efficient government. In European countries with a refund scheme for the VAT costs of local governments, out of doors refuse collection is relatively high compared to countries without. In Denmark and Norway a level playing field is created by considering refuse collection as a taxable activity.

An important aspect is in what way the extra costs of the refund are financed. A closed scheme – financed just by the local governments themselves will lead to an increase of local tax rates and windfalls for the central government. Due to the fact that in a closed system no pure refund is given it is possible to include tax-exempt activities in the fund as well. However, this gives raise to new distortions in mixed sectors with public and private suppliers.

The distortion in decision-making as an effect of the levying of VAT is still relevant for private suppliers of tax-exempt activities and in some countries for public suppliers as well. This may lead to significant efficiency losses in economic sectors as health care and education. Only at the EU-level these distortions can be solved.

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