

## EU VAT review

### **Purpose**

1. This paper updates the Executive Group on the ongoing review of EU rules on Value Added Tax (VAT) and the potential impact upon local government if the existing VAT recovery scheme currently available to local authorities was to be phased out. The paper also seeks approval for COSLA's response to the European Union (EU) consultation on this issue.

### **Recommendations**

2. The Executive Group is asked to:
  - i. Note the ongoing EU consultation on VAT and the COSLA work with Councils and our European counterparts to influence its outcome; and
  - ii. Approve the COSLA response to the VAT consultation, as laid out in paragraph 9 and Appendix I to this report.

### **Overview**

3. Members will recall the report at the December 2013 Executive Group related to the 2014 work programme priorities with the EU and that one of the dossiers covered the proposed new EU VAT regime. The European Commission is currently consulting ahead of tabling a new VAT regime in Spring 2014. VAT is partly defined by EU rules and while most of this review will focus in simplifying VAT returns and reducing VAT fraud we also expect that there will be changes in which the VAT rules apply to local authorities.
4. As you will be aware, Councils are regarded as "Section 33" bodies that under the implementing UK VAT Act entitles them to recover the VAT they incur when purchasing goods and services. The European Commission is scoping a range of scenarios to assess whether such schemes are a barrier to EU trade or not.
5. Altering the current arrangements will have significant consequences in public finances as the existing VAT recovery scheme amounts to a level equivalent to approximately 10% of the Scottish local government block grant. Therefore a drastic change of VAT rules at EU level, though unlikely at this stage, could have a knock on effect not only in terms of the local government finances but also in the way the Scottish block grant from Westminster operates.
6. There is very little evidence that supports the concerns from the Commission that VAT regimes for local authorities are a significant barrier for EU trade. Therefore, COSLA's proposed response highlights the consequences of moving to a decision on this issue based on false assumptions or weak impact assessments of its consequences.
7. Furthermore a change of EU VAT recovery arrangements will have impact in other EU Member States, such as Austria, Denmark, Finland, France, the Netherlands, Portugal and Sweden, therefore we are already working with our counterparts from these countries and our European umbrella body CEMR to appropriately respond to these questions.

8. Building on these exchanges and previous COSLA statements we have received detailed contributions from Directors of Finance ahead of preparing the submission to this EU consultation. We have also been in touch with the Scottish Government as it will also respond to this EU consultation.

**Draft COSLA response**

9. The draft response is attached in Appendix I to this report, and the Executive Group is asked to approve the submission of this response.

**Conclusion**

10. Members are invited to note the developments on EU VAT rules and to approve the proposed COSLA submission to the ongoing EU consultation. The Brussels team will use the above submission to lobby the final decision by working with our counterparts from other countries. We will report on further developments and seek members endorsement as appropriate.

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## **Appendix I – Proposed COSLA response on EU VAT review**

The Convention of Scottish Local Authorities (COSLA) is the representative voice of all Scottish Local Authorities both nationally and internationally and it has long advocated that the European Union legislation should fully respect the local competences and autonomy of Councils to organise and provide local services.

In that regard we welcome the provisions contained in the Lisbon Treaty as regards to the Services of General Interest, and we call the Commission therefore to fully *respect “the essential role and the wide discretion of national, regional and local authorities in providing, commissioning and organising services of general economic interest as closely as possible to the needs of the users”* in any European Commission forthcoming initiative as regards to public services provision and its relationship with EU Competition and Internal Market law.

Under this context, COSLA welcomes the opportunity to contribute to this consultation following our earlier submission to the “Future of VAT” consultation in 2011. Our focus on VAT issue is primarily in relation to public bodies, including local authorities, hence this is a very relevant consultation for us. Indeed, ahead of the 2011 consultation COSLA called “on current arrangements concerning the VAT regime local authorities to be left unchanged”. In discussing the response for the present consultation COSLA confirmed that its view remain unchanged on this issue.

COSLA therefore calls for the need to maintain Article 13 of the Directive so that existing national refund schemes, which have worked well and enabled local authorities to provide better public services, are preserved.

This is not to say that we would automatically oppose any EU initiative addressing public services, including their VAT status. As an organisation COSLA has always been very clear that we do not support practices that favour undue protectionism or disturb the transparency of the public contracts for goods and services. Our point of view however, is that as regards specifically EU-wide rules, most local government activities are eminently local and therefore do not obviously distort intra EU trade. Therefore any proposed changes being eventually put forward by the Commission needs to provide detailed proof that this is the case, not just for the public sector as a whole, but also specifically concerning local government. Secondly, it would need to demonstrate that an EU wide regulation would be able to effectively address such intra EU trade distortions.

### **Impact in Scotland**

The Value Added Tax Act 1994 is the main legislation concerning VAT in the UK and implements the current VAT Directive. Section 33 enables local authorities, in addition to many other public bodies, to recover VAT.

If Section 33 status was removed it is estimated that approximately £1.29bn VAT would have been irrecoverable from HM Revenue and Customs in 2012-13. This amounts to a level equivalent to 10% of the 2013/14 Scottish local government block grant for the 32 Scottish Councils. **Eliminating the VAT recovery scheme would have serious consequences for Scottish local finances.**

If the current scheme were to be removed, it would mean that not only that very big gap would have to be addressed but crucially, **that this change to the current UK VAT recovery schemes would have a knock on effect on the internal UK fiscal and domestic taxation arrangements not covered by EU legislation.**

This is because if the recoverable VAT scheme were scrapped the UK Government would have to significantly alter the budget allocation arrangements across the UK home nations to compensate for this. Needless to say that such a change of territorial equalisation formulas is sensitive at the best of times and the political and fiscal upheaval it would create clearly outweigh any theoretical gain sought by the Commission.

**Thus what appears to be only a EU matter would indirectly shape internal Member State taxation** and internal fiscal transfer arrangements which according to the current Treaties would be **against the principles of conferral, subsidiarity** (as the EU has not powers on domestic taxation) **and indeed proportionality** (for the theoretical gains of doing away with the VAT recovery schemes are outweighed by the significant distortion of internal fiscal arrangements that they would entail).

### **Arguments used to support eliminating recoverable VAT**

The ability to recover VAT under the terms of the current Directives does not apply to UK local authorities alone. Other Member States such as Austria, Denmark, Finland, France, the Netherlands, Portugal and Sweden have introduced systems designed to enable public bodies to recover the VAT they pay.

This following paragraphs take the Commission arguments for eliminating recoverable VAT and explains why such an approach would not have the desired impact.

#### *“Lack of harmonisation” and “Complexity”*

In previous Commission papers and studies, *“lack of harmonisation”* and *“complexity”* are painted as negative in relation to VAT. As regards to the harmonisation argument, that there is no EU approach to defined what is a “public body” for VAT purposes as this is left to Member States to define. As regard to the “complexity” argument, the EU Treaties (and in particular Protocol 26 on Services of General Interest recognise the ability of Member States authorities (national and local) to define the public services the way they consider more appropriate. Therefore, diversity of public service arrangements is not in itself something that should automatically been regarded as a barrier to intra-EU trade but a fact of life recognised by the EU treaties that the Internal Market needs to accommodate that rather than doing away with it.

#### *“Disincentive to externalise services”*

In line with the Lisbon Treaty Services of General Interest protocol 26, the decision to provide in-house services or not is based on a number of factors and it is ultimately a political choice for democratically elected local representatives to make, not necessarily on cost grounds alone but also according to other factors such as the quality and reliability of the services provided.

#### *“Incentive to in-house supply” and “Distortion of competition”*

Another further argument used in Commission VAT literature is that recovery schemes act as an *“incentive to in-house supply”* and avoid more efficient solutions that might be provided by the market, i.e. *distortion of competition*. It is our view that failure to recover VAT would actually make competition more expensive and favour the in-house provision: without VAT recovery any external bid would be immediately 20% higher than at present (in the UK case) and this significant price increase would act as a strong incentive for in house provision.

In terms of the argument of *“distortion of competition”* we see in Scotland little evidence that VAT recovery schemes affect local competition. Particularly in many towns and cities there is a very proactive private sector provision of services that are also partly supplied by local authorities (such as leisure facilities), so COSLA would argue strongly that there is no distortion of competition. One of the strengths of local authorities is that they supply services, such as leisure, in areas where the private sector could not provide services at a profit. In

many parts of Scotland population scarcity and geography makes the provision of services using private suppliers unviable in an economic sense without significant public subsidy.

This is, without doubt, the case in the rural communities that exist in many parts of Scotland where services provided by local authorities are absolutely essential for the survival and wellbeing of those areas. It is highly unlikely that private providers would ever provide services there. Councils would indeed welcome this as a sign of a more viable local economy but providing services in those areas is often uneconomic for private operators. This is an argument we have also strongly made in the recent Services of General Interest State Aid Guidelines and subsequent compliance reports.

A final remark on this argument is that the Commission's role is to avoid distortion of competition between the Member States, not within the Member States. The argument of "potential" EU trade impact to even the most local transactions is not very solid as discussed below.

#### *"Barrier to Intra-EU trade"*

Successive Commission impact assessments have foreseen that a harmonisation of the VAT regime across the EU would provide around 0.1% and 0.4% increase of the EU GNI<sup>1</sup>. While in the current context any source of growth would be welcome these forecasts ignore the transaction costs of eliminating such different VAT regimes.

We would strongly argue that in terms of recoverable VAT schemes the transactional costs of overhauling the current system would offset any gain in terms of GDP growth. To put into context the amount of VAT recovered by Scottish Councils it is not only at a level equivalent to 10% of its annual budget, but it is also 0.7% of the Scottish GDP.

If the similar amounts from other countries with a recovery scheme are added it is reasonable to anticipate the presumed gains would be offset by the cost of overhauling the current arrangements.

Finally Scottish local authorities overwhelmingly purchase goods and services from elsewhere in the UK. This mirrors the Commission own findings in terms of the volume of procurement outside Member States of 1.6% of contracts and we believe that this proportion is generally representative of the volume of transactions that Councils do with providers outside the UK<sup>2</sup>

The Commission appears to regard the existence of perceived barriers which may prevent the opportunity for a firm in one part of the EU to provide services in another Member State, as sufficient argument to remove those perceived barriers. However, when it comes to services provided by local authorities in Scotland, this is in practice quite unlikely. Services provided by Scottish local authorities often fill the gaps that the private providers are unable to address.

COSLA is clearly against creating or maintaining any barrier that actively prevents any service provider, local or from elsewhere in the EU, from operating in an area. We simply believe that the current regime, including the VAT recovery scheme, does not have an effect in EU wide trade because service providers from elsewhere in the EU would find it uneconomical to provide many of services provided by Scottish Councils.

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<sup>1</sup>[http://ec.europa.eu/taxation\\_customs/resources/documents/common/consultations/tax/future\\_vat/com\(2010\)695\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/future_vat/com(2010)695_en.pdf)

<sup>2</sup> [http://ec.europa.eu/internal\\_market/publicprocurement/docs/modernising\\_rules/estimating-benefits-procurement-directives\\_en.pdf](http://ec.europa.eu/internal_market/publicprocurement/docs/modernising_rules/estimating-benefits-procurement-directives_en.pdf)

### *Public service reform*

There are across the EU processes of public service reform involving local authorities and other public bodies commonly providing services. In Scotland we have Welfare Reform and Health and Social Care integration that involves Local Authorities, the NHS, the Scottish Government and others aiming to provide better and more efficient services by joint working toward shared outcomes. The EU consultation paper refers to the fact that different bodies might be subject to different VAT regimes as an argument for harmonisation or abolition of recoverable VAT schemes.

We believe this is this a flawed argument: VAT recovery schemes exist to enable local authorities to provide better local services. If there are new joint working arrangements between local authorities and other public authorities to enhance services that were previously delivery separately, then recoverable VAT should continue to apply to those part of the joint activity delivered by local authorities. This means that in the Scottish Health and Social Care integration mentioned above the different VAT rules for Councils and other public partners are an issue that should be addressed as part of that integration process.

### **COSLA views on Options on VAT reform**

In view of the above COSLA is strongly **against Option 1** (Full Taxation) and **Option 3** (abolition of Article 13), we consider Option 2 (EU wide refund system) unrealistic given the great differences in local authority systems and public service provision across the EU.

We do however fully recognise the fact that the Commission must ensure that there are not distortions of competition and undue barriers across the EU. We do not think it is the case as per the services provided by Scottish Councils, however we are open to examine potential issues on a case by case basis, hence we are **open to Option 4** of the consultation (sectoral reform).

We are thus happy to look at those sectors where distortions of competition can clearly arise but we stress the need for a full, sufficiently representative and direct engagement of local government representatives in any impact assessment or pre-legislative consultation exercise.

As regards to sectoral reform, this directly impacts on processes of public service reform involving local authorities and other public bodies commonly providing services. We would be keen to look at how local authorities can continue to be subject to VAT recovery arrangements even in the case of joint delivery of services with other public bodies.

If you require further information or clarification then please contact Serafin Pazos-Vidal, Head of COSLA's Brussels office on [serafin@cosla.gov.uk](mailto:serafin@cosla.gov.uk)