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1 Summary and conclusions

1.1 Summary

In 2003, the Dutch government introduced a VAT compensation fund to address the distortionary consequences of the European VAT regime, in particular on contracting out decisions. This study investigates the extent to which the introduction of this fund has affected the decisions of Dutch municipalities.

Chapter 2

Chapter 2 summarised the literature on the potential advantages of contracting out, the distortionary effect of the European VAT legislation on public sector bodies' contracting out decisions and the non-fiscal refund schemes that several member states of the European Union have introduced in an attempt to address this problem.

A broad range of empirical studies have documented that for a range of government services contracting out can lead to cost savings of about 20% without sacrificing the quality of the services provided. However, more recent evidence on the size of this efficiency gain is mixed at best. In addition, various other arguments are relevant for the decisions of whether to contract, such as the quality of external service provision and ideological and pragmatic reasons. However, a comprehensive explanation for the contracting out behaviour of public sector bodies is still lacking. Among the European empirical studies on this issue, to our knowledge only Dijkgraaf and Gradus (2007) described the VAT consequences of contracting out to the private sector and included a correction for this effect. The scarcity of contracting out research that takes the role of VAT legislation into account is remarkable as in the European Union contracting out leads to a VAT liability that increases the gross costs but not the net costs of service provision. If this VAT effect is not excluded, then studies that test for the cost advantage of contracting out may underestimate the size of this effect.

In Chapter 2, we stated that the non-fiscal refund schemes – as introduced for local governments by several northern member states of the European Union and Norway – are an adequate budgetary solution to this distortion. Although other elements can be relevant to achieve a level playing field, the introduction of a VAT refund scheme seems to be important to facilitate contracting out and a more efficient local government. For example, as far as the data show, countries with a solution to this distortion have largely contracted out refuse collection. In the context of VAT distortions, the

available data for Denmark, Sweden and Norway suggest that the introduction of the VAT refund schemes has led to an increase in external service delivery by local governments.

However, because such schemes leave the VAT rules unchanged, other member states of the European Union remain subject to the distortionary effects of VAT. Moreover, the distortion still holds for private and in most EU member states also public suppliers of tax-exempt activities. This may lead to significant efficiency losses in sectors such as health care and education. Thus, while VAT compensation schemes introduced at a country level may help offset distortions in decision making resulting from the VAT, such distortions will continue to exist to some extent unless the European Union modifies the VAT rules themselves.

Chapter 3

In Chapter 3, we turned our attention to the case of the Netherlands and describe the Dutch VAT compensation fund upon its implementation in 2003.

European VAT legislation implicitly makes a broad distinction between taxable activities, tax-exempt activities and non-taxable activities, most being public tasks. Public sector bodies, non-profit organisations and charities are not entitled to a refund of VAT paid on their tax-exempt and non-taxable activities. As a consequence, the VAT regime may cause distortions in these bodies' decision making, particularly with respect to the choice between self-supply and contracting out to the private sector as the latter incurs costs associated with the VAT charged, whereas the former does not. In addition, these bodies have an incentive to avoid tax. Finally, VAT potentially hinders the lending of personnel between these organisations.

Thus, if a private sector company is able to perform a certain activity at a lower cost than the public sector body can itself, under contracting out the activity might nonetheless be more expensive because the VAT charged on the services provided by the private sector increases the price of the activity. Such consequences may, therefore, influence a public body's choice between carrying out an activity itself versus contracting out to the private sector. This suggests that public sector bodies face a threshold on contracting out. When a private contractor and a public sector body compete for the supply for a service, the price offered by the private contractor has to be significantly less expensive to be competitive.

Like the VAT refund schemes introduced elsewhere in Europe, the VAT compensation fund – as introduced by the Dutch government in 2003 – offers a budgetary solution to this VAT distortion. In principle, municipalities, provinces and regional public sector bodies are entitled to a refund of the VAT costs incurred on their non-taxable activities. The arrangement was financed – in a budgetary

neutral way – by a reduction of the general grant, raised with the extra VAT receipts derived from the increase in contracting out. The assumption underlying this fund is that given a more level playing field, public sector bodies will be more likely to pursue a balanced choice between self-supply and contracting out and to take advantages of the potentially higher efficiency gains by contracting certain services out to the private sector.

During the years in which the VAT compensation fund was being discussed and designed, most national parties involved were convinced of the benefits of a more level playing field for contracting out, with only a few specific municipalities and provinces raising serious concerns on the proposal. Their unions paid more attention to the balance between the advantages and disadvantages. However, as an *ex ante* empirical study on the existence of the VAT distortion, the motives of Dutch municipalities and provinces for contracting out and the consequences of the introduction of the fund was lacking, an objective *ex ante* comparison between the fund's expected costs and benefits could not be made. When the bill went to parliament, it was accepted unanimously. An important explanation for this positive and relatively unquestioning opinion may be the prevailing ideology-based spirit that outsourcing and a level playing field between in-house supply and contracting out to the private sector is preferable.

Around the time of the introduction of the fund, a substantial number of practical problems became known. For instance, it became clear that the fund would result in a reduction of grants awarded by the European Union, high administrative costs and a negative budgetary impact because of the asset-related accounting problem. These issues were not clear during the parliamentary process of lawmaking. The cash-based budgetary effects, because of the difference between the cut in the general grant and the amount of compensation of VAT for an individual municipality, were relevant as well, although these effects were temporarily reduced during the first years. Thus, municipalities and provinces did not assess the fund positively, which hindered its smooth acceptance.

In addition to the introduction of a level playing field with respect to contracting out, the fund aimed to terminate the incentive to start fiscal schemes to avoid the levying of VAT and to ease the lending of employees between public sector bodies. On both issues, the extent of the VAT problem was not clear, and a recent evaluation by the Ministry of Finance suggested that the use of these schemes had diminished, although the rules for compensation had created new borders and, therefore, although on a lesser scale, incentives to maximise the compensation of VAT.

However, the introduction of the fund came with a number of positive side effects as well. For instance, the fund forced municipalities to free up resources to improve their administrative organisations. More importantly, it increased the purchasing power of municipalities for compensable

activities, as they only had to raise tax revenues sufficient to cover their net costs. The purchasing power of hidden reserves also increased upon the introduction of the fund, as expenditures could now be undertaken less the costs of VAT.

For a considerable number of municipal activities, namely tax-exempt activities such as education and welfare, the VAT distortion remained. In addition, other public sector bodies such as regional water authorities and suppliers of tax-exempt activities, as well as private and public health care organisations, remain subject to the VAT distortion. By contrast, over the past decade none of these bodies has insisted on a solution to the problem. This might be explained by both the non-existence of these distortions and the drawbacks of the solutions as a compensation fund. Nevertheless, before the elections of the Dutch parliament in 2010, almost all political parties proposed in their electoral platforms the introduction of a VAT compensation fund for the care sector in order to make the contracting out of activities to the private sector more attractive. This proposal seemed to be more the result of the structural yields of €0.2 billion, as globally expected by the CPB Netherlands Bureau for Economic Policy Analysis, than the expected benefits of the introduction of a level playing field as such.

For both the municipalities and the provinces, the fund has seen since its introduction a higher growth rate than the actual non-taxable expenditures of these bodies. This might be an indication that these bodies have slightly increased their extent of contracting out to the private sector, what can be attributed to the introduction of the fund. However, we cannot exclude that this was a pre-existing trend independent of the introduction of the fund.

Chapter 4

Chapter 4 described – based on an e-mail survey among all Dutch municipalities – the first general evaluation on the effectiveness of the VAT compensation fund on contracting out decisions.

Before the introduction of the fund, the negative opinion of most municipalities dominated, for example because of the administrative consequences, and the introduction came with several transitional problems. Therefore, we were interested in the effects on contracting out decisions and the opinions of municipalities on the fund. Based on an e-mail survey to all Dutch municipalities in 2006, three years after the fund's introduction, we investigated its effectiveness. We questioned all municipalities about (1) the actual extent of contracting out, (2) the effect of the introduction of the fund on the outsourcing of activities and (3) the opinions of the municipalities on the fund. The survey was sent to the aldermen responsible for budgetary affairs. A representative database of 198 municipalities (response rate 43%) was available for analyses.

As the results of this study show, for most of the municipalities VAT did in practice not hinder the contracting out of public services. Therefore, the fund largely lacks legitimacy. In general, municipalities have a negative opinion on this fund and judge it to be redundant because of the administrative consequences (partly due to the unfamiliarity with the VAT legislation), the budgetary effects and, more importantly, the absence of the VAT distortion. In addition, a large share of their activities had already been contracted out before the introduction of the fund and the outsourcing of services was not a political item. Therefore, the cost effects of contracting out – being the balance between the potential efficiency of private suppliers and the extra costs of VAT – play a minor role in considering whether to contract out. In addition, the introduction of the fund did not cause a significant increase in contracting out during the first years. Municipalities argue that factors other than the budgetary effects – such as institutional and pragmatic considerations – are more relevant to the decision-making process on outsourcing. For example, they mention the optimal size of their own organisations, the necessary knowledge for specific activities, the vulnerability of municipal activities, the lack of capacity in their own organisations, the legal status of municipal employees and concern for employment in the municipality itself. Although in some municipalities outsourcing is expected to take place in the coming years, most municipalities state that there is no relationship between this expectation and the introduction of the VAT compensation fund.

Chapter 5

As chapter 4 showed, motives other than budgetary consequences might be more relevant to decision making on contracting out. In an explorative study involving direct interviews with 17 municipal managers, we investigated the motives behind the decisions to contract out activities or not.

As the analysis in chapter 5 showed, the mode of service provision is, in general, not a managerial issue. Municipalities do not regularly evaluate the costs or quality of their service provisions in comparison with alternatives. If the activity shows an adequate performance without complaints, a cause for considering a change of supplier is, in general, absent. By contrast, in the case of structural underperformance, initiating complaints about the performance of the municipal organisation or the quality of the activities, the mode of task execution develops into an issue for evaluation. As a result, outsourcing the service is an option. In addition, institutional changes, such as the introduction of new legislation, the decentralisation of tasks, or the construction of new buildings, may be an opportunity to consider contracting out. However, a merger of municipalities is not a relevant juncture for changing the mode of service provision. In most municipalities, in-house service provision might be explained by the lack of a cause for considering contracting out, as this is the default position. This

may be an additional explanation for the fact that the explanatory power of previous empirical studies on municipal contracting out decisions is generally low.

The efficiency motive is the most relevant aspect when a municipality is weighing up the pros and cons of contracting out. In comparison to previous empirical studies, the relevance of this motive seems to be independent of the size of the municipality. For smaller municipalities, other motives such as the stability of service provision and the quality of external service providers are far more relevant. Therefore, these motives might be a more relevant explanation for the statistically significant negative relationship between municipal size and outsourcing found in previous empirical studies. With respect to ideological motives, left-wing municipalities are less prone to contract out their service deliveries than are right-wing ones, especially to private providers. Some municipalities report that the private ideological opinion of strong local politicians or municipal managers about the positive consequences of contracting out is relevant as well.

When contracting out, municipalities decide between the external public and private execution of their activities for various reasons. In general, the efficiency motive and the quality of service provision are most relevant. Contracting out to a private party is preferred to get to grips with the execution, although other municipal managers explain that service provision by a public organisation provides more opportunity to have influence.

In addition to the common public choice and transaction cost motives, the study shows the importance of institutional motives such as the stability of service provision, the independence of external providers and the legal status and retirement decisions of municipal employees. These motives are especially relevant for smaller municipalities. However, the most important institutional aspect is that the actual contracting out discussion is caused by a structural dissatisfaction with the service provision or a change in the task because of new legislation or other external factors. In addition, pragmatic/organisational motives such as the lack of availability of enough personnel and the lack of availability of expertise in the organisation are relevant for outsourcing considerations, especially for smaller municipalities.

This study, therefore, bridges institutional and rational choice explanations of action, as both types of motivations are used to explain contracting out behaviour by Dutch municipalities. Institutional motives seem to be particularly relevant as catalysts for initiating the evaluation of organisational performance, whereas rational/economical motives are used to compare alternative service providers. In addition, municipal decision making is influenced by more pragmatic motives.

1.2 General conclusion

Based on the analyses in the previous chapters, as summarized in section 6.1, we will now answer the central question of this study:

What are the benefits of the introduction of the Dutch VAT compensation fund, in particular on municipalities' decisions of whether to contract out?

The VAT compensation fund addresses the VAT distortion for a range of activities pursued by municipalities, provinces and regional public sector bodies. The budgetary solution is by definition only adequate for those parts of the activities of these bodies that are entitled to compensation. The solution is largely similar with the refund schemes in other member states of the European Union such as Denmark, Sweden and Finland. However, this indirect budgetary solution is still second best, as the distortion should be addressed by a change in European VAT legislation.

The introduction of the fund was based on the premise that municipalities, provinces and regional public sector bodies faced a significant threshold on contracting out to the private sector. Remarkably, during the preparation of the Dutch VAT compensation fund, an integral *ex ante* empirical comparison of costs and benefits of the proposals was not made. Therefore, the introduction was more based on a belief in the potential advantages of contracting out and the distortionary effect of VAT in line with the positive market-oriented thinking during the 1990s. Although formally the only purpose of the fund was to achieve a level playing field between self-supply and contracting out, implicitly an increase in contracting out to the private sector was expected. However, as this study shows, municipalities do not perceive the distortionary effect of VAT explicitly. For most activities, VAT did not hinder outsourcing and the introduction of VAT compensation did not cause a significant increase in contracting out since motives other than budgetary effects led the decision-making process on outsourcing. Municipalities have a far broader range of motives in favour or against contracting out, although the efficiency argument is still relevant. Institutional motives, such as the stability of service provision, are relevant, in particular for smaller municipalities. Even more relevant is that only in the case of structural underperformance, a change in their tasks or other institutional changes do municipalities start to consider an alternative mode of service provision. As this study shows, the introduction of the VAT compensation fund was not such a momentum. Nevertheless, because of the introduction of a level playing field with respect to VAT, the choice to contract out for other than budgetary reasons no longer had a fiscal threshold. The introduction and execution of the fund came with substantial transition costs, because of the complexity of the fund legislation and its subsequent administrative consequences. Finally, the fund had significant distributive budgetary effects, as the receipts from the VAT compensation fund might deviate from the share of the municipality in the cut

in the general grant, made to fund the regime. In many cases, these effects were negative. We can conclude that the VAT compensation fund, therefore, lacks a great deal of its legitimacy as the municipalities explain that levying of VAT did not explicitly hinder the decision to contract out their activities.

By contrast, next to a range of other motives, municipalities report that the efficiency motive is relevant when they consider a change in the mode of service provision of an activity. However, a higher external efficiency is often supposed to be included because municipalities do not always make a cost comparison between contracting out and in-house supply. Therefore, the fund should – at least implicitly – have a positive gradual effect on outsourcing by municipalities, the costs of their task execution and the efficiency of local government. For both municipalities and provinces, the fund has since its introduction seen a higher growth rate than the actual non-taxable expenditures of these bodies. This might be an indication that these bodies have slightly increased their contracting out to the private sector. However, this might be a pre-existing trend independent of the introduction of the fund. This finding is consistent with the cautious positive conclusions on the effectiveness of comparable systems in other European countries.

In addition to the introduction of a level playing field with respect to contracting out, the fund had to two other objectives: the termination of the incentive to start fiscal schemes to avoid the levying of VAT and to ease the lending of employees between public sector bodies. In theory, the introduction of the fund should have had a positive effect on both issues. However, neither this study nor other evaluations have provided evidence on either the extent of the problem or the impact of the introduction of the fund.

As this study shows, the outsourcing of activities is more attractive for smaller than it is for larger municipalities. Over future years, a new series of municipal mergers is expected, leading to a far smaller number of smaller municipalities, what might lead to less pressure on contracting out. By contrast, as the budgetary positions of Dutch municipalities decline because of the impact of the recent financial crises, municipalities may wish to profit from the potential efficiency gains of outsourcing activities to the private sector. Budget cuts as they result from the central government's fiscal policy may be another institutional factor, instigating a search for opportunities for cost reductions. Therefore it is possible that the fund will still provide impetus to outsourcing, and thereby might be assessed more positively.

With respect to the negative opinions of some municipalities, it would be useful if the Dutch central government supported the proper evaluation of municipal task execution and the development of

municipal purchase capacity because both aspects might help achieve a more positive assessment of the fund.

Finally, this study shows that an *ex ante* policy evaluation should be executed properly in case of a thorough policy implementation with far-reaching implications. Such a study should include both an adequate empirical analysis of the benefits and an overview of the side effects, where administrative aspects should not be neglected. In particular, the pros and cons of the introduction of a VAT compensation fund for the care sector, which is part of the coalition agreement of the new Dutch administration, should be assessed thoroughly.

1.3 Directions for future research

This study analyses the effectiveness of the VAT compensation fund for municipalities, provinces and regional public sector bodies to address a number of distortions on their decision making as far as their non-taxable activities are concerned. Based on the results of this study, four future research projects can be defined that could increase the insight into the contracting out decisions of (public) organisations and the resulting impact of the VAT distortion.

Relevance of the VAT distortion for tax-exempt activities and other types of organisations

As chapter 3 described, despite the VAT distortion for different types of activities (tax-exempt and non-taxable) in different types of organisations, such as regional water authorities, police organisations, health care institutions, educational bodies and financial institutions, the regime of the VAT compensation fund is limited to three decentralised tiers of government and most of their non-taxable activities. Despite the various motives for the exclusion of the other types of activities and organisations for compensation, it would be relevant to investigate whether the VAT distortion is important for these bodies. Because some of these bodies act in a competitive environment, they might have more incentives to focus on the costs of activities and the opportunities of service delivery and task execution by other organisations. This study might be especially interesting because almost all political parties intend to introduce a VAT compensation fund for the health care sector, with an expected positive budgetary effect of € 0.2 billion. Furthermore, the coalition agreement of the new administration has pledged to investigate the introduction of a VAT compensation fund for both the care and cure sectors.

Differences in the refund schemes for the VAT distortion

Chapter 2 described the solutions for the VAT distortion that have been introduced in several EU member states. On a number of aspects – such as the funding of the refund schemes and the

delineation of compensation with respect to VAT-exempt activities, the involved governments have made different arrangements. A more in-depth analysis of these refund schemes – for example, by comparing the extent of contracting out in these states for different types of activities – might provide insight into the impact of these choices on the use and effectiveness of the solutions. In particular, the impact of the inclusion of tax-exempt activities on the contracting out of these services might be interesting to study.

Institutional and pragmatic motives for contracting out

As chapter 4 and 5 concluded, in addition to the hypotheses of public choice and transaction cost theory, other motives are relevant when deciding modes of service provision of activities. In particular, chapter 5 showed that when a catalyst for considering a change of provider is lacking, a comparison between different types of task execution would not be made. Institutional theories assume that a primary determinant of organisational structure is the pressure exerted by external and internal constituencies on the organisation to conform to a set of expectations to gain legitimacy and so secure access to vital resources and long-term survival. In particular, the stability of service provision – in particular in smaller municipalities – and the potential difference between internal- and external-oriented activities were noted in this study. In addition, pragmatic/organizational motives such as the lack of availability of expertise or sufficient personnel in the organisation are relevant. It would be interesting to extend this study by both the number of municipalities and the number of activities in order to investigate the modes and impacts of institutional and pragmatic motives more thoroughly. In addition, it would also be appropriate to investigate whether these motives are relevant for other types of public and private organisations such as health care organisations and regional water authorities.

Relevance of the efficiency motive and the solution to the VAT distortion in the case of declining budgets

Chapter 5 concluded that when considering an alternative mode of service provision, the efficiency motive is most relevant. However, chapters 4 and 5 also concluded that the municipalities consider the fund redundant because as a solution for the VAT distortion would be irrelevant for their decision making. Therefore, the efficiency motive seems to have more of an implicit relevance, as municipalities use other motives to start evaluating the mode of service provision or decide whether to contract out. The consequences of the recent financial crisis indicate that more municipalities will have an incentive to start a discussion on the actual modes of their service provision. Therefore, it would be relevant to investigate whether the lagging development of their budgets is a relevant momentum and leads to an increase in contracting out activities. In particular, it would be relevant to investigate whether municipalities faced with a negative budgetary effect because of the introduction of the VAT compensation fund increased their contracting out following its introduction. Opponents of the fund

suggested its introduction would not only create a level playing field, but also introduce a force for contracting out to address this negative budgetary effect.