

The hidden vat

a case of technological fiscal drag?

Giovanni Bianchi – Lucio Fumagalli

After forty years the building is old and needs to be restored

- » In the 1970's:
 - the exemption was introduced when health care was composed by doctors, nurses, beds and medicines

- » Today we have:
 - TAC, RNM, modern, complex and expensive instruments and huge technological investments;
 - Outsourcing and web production (also in cultural foundations)

Dreams and reality

- » the **dream** of the strategy of Lisbon (COM 260/2001 of 23.05.2001) is “**EU tax policy must**”:
 - underpin the Lisbon goal for the EU to become the most competitive and dynamic knowledge-based economy in the world;
 - support the modernisation of the European Social Model”;

- » the **reality** is the “**fiscal technological drag**”:
 - the more modernization is growing, the more the impact of hidden VAT is also growing;

A semantic problem becomes a political problem

» **exemption = facilitation**

→ this is the common feeling when we speak of exemption

» **exemption = penalization**

→ this is the reality in many cases

The widespread desire to “escape from the exemption”

The **widespread desire to “escape from the exemption,”** which was found:

- in several legal cases in different European countries;
- in the efforts for legislative escaping from it (italian cooperatives, postal sector)
- in the effort of enlarging exemption in furnitures (bank and insurance sector)

is confirmed by the quantitative research carried out on the data of all Italian public health companies referring to the period 2002 -2007.

Level of awareness

The number of national lawsuit brought in front of the **Court of Justice** asking the withdrawal of the exemption recognition is a clear sign of the growing awareness of this phenomenon by some industrial sectors.

In Italy it has been developing – thanks also to the PA behavior – a series of appeals in order to obtain the reimbursement of the VAT payed for the hospitals' supply. The – false- assumption was that Italy would have not transposed the UE directive correctly.

That was a request without basis, as it was clarified by the following Court of Justice's judgments. Nevertheless this is a clear symptom of the growing awareness of the phenomenon within the private sector.

The option claimed and obtained by the Italian social cooperatives anticipates a possible solution of the problem (art. 41 bis annex A part II DPR 633/72)

In the Italian bank and assurance industrial sector was noticed an attempt to obtain an exemption for the intergroup instrumental operations (art. 6 L 133/1999, now art. 10 DPR 633/72)

Public Health Sector has used use more than Private, outsourcing despite of the higer cost connected with VAT non deductible.

Reserch question: awareness of the problem what is the real impact of the hidden VAT?

- **Critical analysis** of the matter:
 - synthesis of the study carried out in Italy in the health care sector;
 - interest in developing the study in other countries;

The research

- An estimation based on data of CE model of SSN structures – which is surely conservative – of the “hidden VAT” phenomenon shows an incidence rate approaching, at the aggregate level, the social rate (4% in Italy)
- There are relevant differentiations, to the detriment of the most technologically advanced structures where VAT is nearly 10%.
- It is therefore clear that the exclusion / exemption without the right to deduction, for sectors that have registered a growth in technology, has lost the feature of facilitation which justified its introduction at the cost of losing tax neutrality.
- Taxation in fact has increased for the same product with an automatic growth, function of the technological development and the different ways of producing the service, and became a sort of **“technological fiscal drag”** for indirect taxes
- This fact is in obvious conflict with the objective of a tax system that promotes the **“modernization of the European social model” (COM 260/2001)**, that the Community has set in Lisbon.

Exemption/Exclusion

The VAT exemption has been introduced by art 13 of the sixth directive (actually art. 132 Directive 2066/112/EC) for three reasons:

- 1) public interest;
- 2) technical reasons;
- 3) economic and financial policy criteria.

The Community Case-Law has detailed how the first category of exemptions given to charitable activities, health and education, as well as the postal sector⁶ has been provided in order to reduce the burden of costs on users due to the VAT imposition

It can be argued, therefore, that the exemption, not surprisingly constantly referred to in the Directive and in official documents as a **“benefit”**, **aims to establish an economic advantage to the users of certain activities.**

Moreover, these areas were very labor intensive at that time and, since the cost of labor is not regarded by VAT, **the Hidden VAT would have had an impact lower than the determined benefit.**

VAT reduced rates

The legislature established from the outset a standard rate and one or two reduced rates to be applied at the discretion of the Member State to a restricted list of goods and services. (art. 98 Directive 2066/112/EC)

Reading **Annex H to the Directive 77/388/EEC as well as the existing annex III to the Directive 2066/112/EC** it is absolutely clear that the legislator intended

1. that **the exemption would still have represented a benefit in specific socially relevant sectors**, where (at that time) the service production – which was mainly labor intensive and not very technological – would have suffered very slightly from the negativity related to the impossibility to deduct VAT on purchases;
2. that **the application of a ‘reduced rate, resulting in the principle of tax neutrality, would still have represented a minor benefit compared to the exemption**, so as to provide for the possibility of applying it to similar services but provided by people that Member States would have considered less eligible. In this case, moreover, not explicitly stating to allow Member States the faculty to accord the right to tax as an option.

Model of analysis for the quantification of the Hidden VAT phenomenon in the exemption/exclusion regime

Cost Type	Rate	Costs in percentage	VAT on purchases	Total expenditure
VAT Exempted-Excluded		50%	-	50,00
Subject to VAT	4%	10%	0,40	10,40
Subject to VAT	10%	20%	2,00	22,00
Subject to VAT	20%	20%	4,00	24,00
Average	0,06%	100%	6,40	106,40

The average impact of VAT on purchases will obviously depend on:

a) **the tax rate level** (first column) that can be determined by the different Member States under the freedom granted to them by Articles 96 to 101 and Annex III to the Directive 112/2006. In this chart the level is shown as an example based on current tax rates in Italy in force from October 1, 1997, but it can be changed according to the different rates applicable in the various member countries.

b) **the weight of the various factors of production subject to the different rates** for the production of the service (the percentages in the second column here in approximate values) which in turn depends on:

b.1) the choices of each Member State regarding the rate attributable to each factor of production under the freedom granted by Annex III and possibly historically established exceptions such as the rate 0;

b.2) **the different way of producing the services**: depending on aspects such as the incidence of costs from Human Resources, spending on technology, the level of outsourcing, etc., the impact of the cascading effect will have different relevance. For example, in the health area, a long-term care facility will probably need less

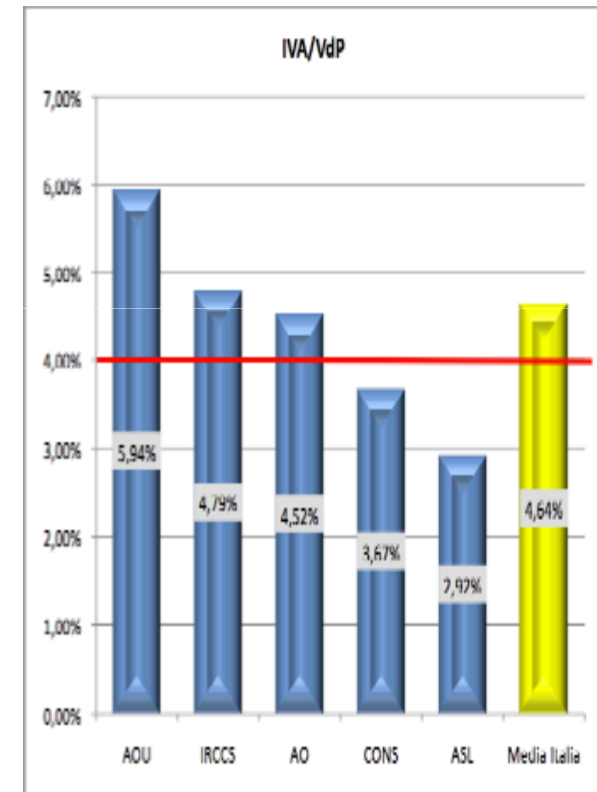
Percentage amounts of hidden VAT registered

We report the percentage amounts of hidden VAT we have registered, divided by type of structure, as they are shown in the official data of the Ministry.

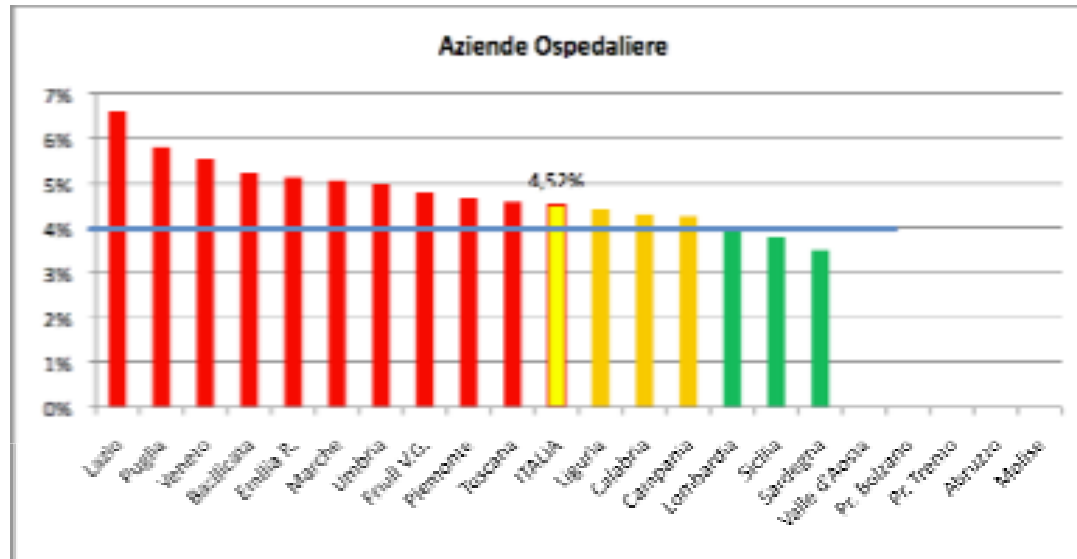
It is significant to indicate that the values reported here are certainly underestimated due not only to the presence of what we can define as indirect hidden VAT, but most of all the fact that the hidden VAT relates only to the ordinary management of companies, not including that related to real estate, technology and general investments is considered.

Despite their increasing importance nowadays and in the future, these components are not represented in the CE model.

Even with these caveats, it is possible to appreciate that the hidden VAT incidence is near and in many cases even significantly exceeds the incidence of the social rate established in our country. This is even more significant when considering the regional level, for which we report here the detailed list of the hospitals.



Regional and variability of datas



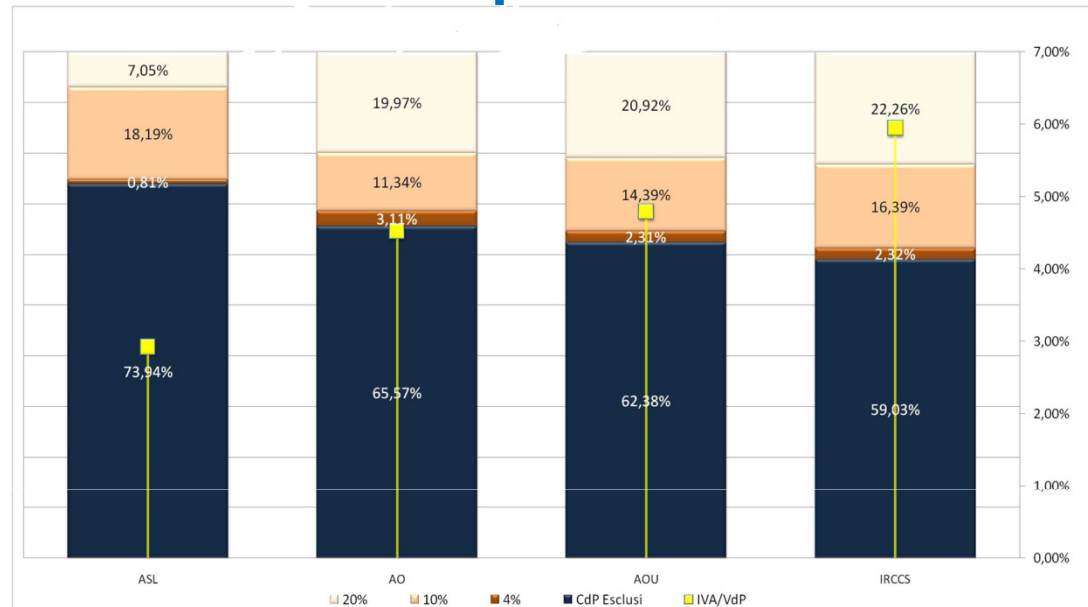
	AO	AOU	IRCCS	TOTALE
Mediana	4,243%	5,386%	4,659%	4,448%
MAX	9,867%	8,326%	6,650%	9,867%
MIN	1,316%	3,219%	3,268%	1,316%

The study points out that, although certainly welcome to further insights that we reserve to realize afterwards, the data on the incidence of hidden VAT have a significant variability. It is therefore clear that the solutions to find to the hidden VAT phenomenon must consider this variability.

There are – even in the health sector – activities for which the incidence of hidden VAT can still be considered a “benefit”, even if it is certain by this time that for most users this feature is lost.

Hence the need highlighted by the European Commission to address and resolve the problem.

Values that result for the different Italian public healthcare providers.



The hidden VAT estimate method was set according to the effect of the tax-free purchases and of the different tax rates. The following chart points out the different values that result for the different Italian public healthcare providers. It is evident that the influence of the hidden VAT grows when the tax-free elements decline (dark blue in the chart) and when the taxed element grows (light colored in the chart). Obviously this methodology can be used for further analysis.

It is therefore clear that the solutions to find to the hidden VAT phenomenon must consider this variability. There are - even in the health sector - activities for which the incidence of hidden VAT can still be considered a "benefit", even if it is certain by this time that for most users this feature is lost. Hence the need highlighted by the European Commission to address and resolve the problem.

Level of unawareness decision makers National level

- in some Countries the problem was tackled with the “**refund scheme**”. In Italy the “refund scheme” was introduced by the law in the healthcare sector, but:
 - it is not funded, so it does not operate;
 - --it’s limited to the public sector only, with obvious distortions to the detriment of the private operators;
 - in Italy cooperatives operating in social health sector has an option between exemption or 4% rate of VAT taxation (n. 41bis of Table A annex to the DPR 633/72);
 - in Italy banks and insurance groups has an exemption for intergroup operations (art. 6 Law 133/1999 and now art 10 DPR 633/72);

Level of awareness of the problem: decision makers European Commission

European Commission has awareness of the problem since 1996:

- COM 328/1996 of 22.07.1996
- COM 348/2000 of 07.06.2000
- COM 260/2001 of 23.05.2001
- COM 234/2003 of 05.05.2003
- COM 614/2003 of 20.10.2003
- COM 747/2007 of 28.11.2007
- Open invitation tender in TAXUD/2009/AO-03

COM 695/2010 of 01.12.2010 - GREEN PAPER

On the future of VAT: Towards a simpler, more robust and efficient VAT system

COM 695/2010 of 01.12.2010

- Q1. Do you think that the current VAT arrangements for intra-EU trade are suitable enough for the single market or are they an obstacle to maximising its benefits?
- Q2. If the latter, what would you consider the most suitable VAT arrangements for intra-EU supplies? In particular, do you think that taxation in the Member State of origin is still a relevant and achievable objective?
- Q3. Do you think that the current VAT rules for public authorities and holding companies are acceptable, particularly in terms of tax neutrality, and if not, why not?**
- Q4. What other problems have you encountered in relation to the scope of VAT?**
- Q5. What should be done to overcome these problems?**
- Q6. Which of the current VAT exemptions should no longer be kept? Please explain why you consider them problematic. Are there any exemptions which should be kept and, if so, why?**
- Q7. Do you think that the current system of taxation of passenger transport creates problems either in terms of tax neutrality or for other reasons? Should VAT be applied to passenger transport irrespective of the means of transport used?

COM 695/2010 of 01.12.2010

- Q8. What should be done to overcome these problems?
- Q9. What do you consider to be the main problems with the right of deduction?
- Q10. What changes would you like to see to improve the neutrality and fairness of the rules on deduction of input VAT?
- Q11. What are the main problems with the current VAT rules for international services, in terms of competition and tax neutrality or other factors?
- Q12. What should be done to overcome these problems? Do you think that more coordination is needed at international level?
- Q13. Which, if any, provisions of EU VAT law should be laid down in a Council regulation instead of a directive?
- Q14. Do you consider that implementing rules should be laid down in a Commission decision?