

# HOW SHOULD THE U.S. TREAT GOVERNMENT ENTITIES, NONPROFIT ORGANIZATIONS, AND OTHER TAX-EXEMPT BODIES UNDER A VAT?

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Final Draft: May 27, 2009

The goods and services supplied by the sector that consists of government entities, public sector bodies, nonprofit organizations, charitable organizations and similar tax-exempt bodies (hereafter collectively referred to as the *PNC* sector) continue to elude the best practice under the value-added tax (VAT): full taxation goods and services supplied by the PNC sector, with credit for tax paid on purchases made in order to render the supplies. Although there are very few conceptual problems preventing full taxation of such supplies under the VAT, some roadblocks remain in the way. Often, they come in the form of policy concerns revolving around social objectives and income distribution. Those explain to a large extent the exceptional (and exceptionally complex) treatment of PNC supplies under the VAT in many countries. Complexity often arises because exemptions may be restricted to particular items (goods and services), or apply to supplies rendered by certain types of entities, or a combination of both.

While the consequences of the VAT-exempt treatment of the supplies made by the PNC sector are well understood at the theoretical level, there has been little quantification of its economic effects. The list includes distortions, compliance costs, administrative costs, and the cost savings from using tax or expenditure policy instruments that are better suited than the VAT to achieve distributional and other social objectives. In aggregate, the distortions from implementing the exemption under a U.S. VAT would likely be large. According to the most recent data available, the government sector (federal plus state and local) accounted for 12.6% of total U.S. value-added in 2007. Educational services, health care, and social assistance accounted for another 7.9% of total value-added.<sup>2</sup> Given that the supplies from those sectors are very often exempt under VAT, a broad exemption would concern over one-fifth of GDP, a very significant share.

This paper examines the prevalent treatment of government entities, public sector bodies, nonprofit and charitable organizations, and other similar tax-exempt entities under VAT. Under this treatment, commonly referred to as the *exemption*, supplies made by PNC sector entities are exempt -- suppliers do not charge tax on their sales of goods and services -- but the purchases they make to render their supplies are usually taxable. The paper considers options for treatment under the VAT, the exemption system and its

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<sup>2</sup> U.S. Bureau of Economic Analysis, Gross Domestic Product by Industry Data (Washington, D.C.: Department of Commerce, 2008), available at [http://www.bea.gov/industry/gdpbyind\\_data.htm](http://www.bea.gov/industry/gdpbyind_data.htm) (accessed on March 26, 2009).

economic effects, superior system that are in use in some countries, and finally implications for an add-on U.S. federal VAT. While it is acknowledged that there are important differences between the three sectors in PNC -- public, nonprofit, and charitable -- the "PNC" grouping is made for convenience and to simplify the discussion. The conceptual VAT issues facing the three sectors are very similar.

The main lessons for the U.S. are the following. First, the case for full taxation of the PNC sector under the VAT is strong. Second, the Australian-New Zealand model emerges as the best alternative to the exempt treatment of PNC sector supplies. Under this model, essentially all the goods and services supplied by PNC bodies are within the scope of the VAT and treated like any supplies from the private sector. The Australian-New Zealand model features few instances of zero-rating or exemptions. While the Canadian rebate model works reasonably well, it is complex, it gives rise to several non-neutralities, and is too gradualist.

Were the U.S. to adopt a federal VAT, it would be well advised to get the design right from the start and subject the sector to VAT along the lines of the Australian-New Zealand model and stay as close as possible to full taxation of the PNC sector -- and others -- under the VAT. To address the issue of states as taxable persons, it should modify the model slightly to provide state and local governments (and only those) with the option to collect tax. In comparison with the alternatives, this design would result in the system with the lowest efficiency costs, and possibly the lowest compliance and administrative costs.

## OPTIONS FOR TREATMENT UNDER VAT

This section first describes the possible treatment of PNC (or any other) supplies under VAT. It then reviews the economic activities of the PNC sector, and considers the main options for VAT treatment outside exemption.

### Taxable or Not?

The goods and services supplied by the PNC sector or any other fall into one of three possible *tax* treatment categories:

- a) *Taxable*. Any supply to which the tax applies at the standard (or any non-zero rate) is taxable. The supplier (seller) is entitled to a credit for the VAT incurred on the input purchases undertaken to make taxable supplies (and only taxable supplies).
- b) *Zero-rated*. Any supply to which the tax applies at a rate of 0% is said to be zero-rated. Even though the seller does not collect VAT on such supplies, it is entitled to a full refund of the VAT incurred on the input purchases undertaken to make zero-rated supplies. Under the dominant destination-based VAT system, any exported supplies are also zero-rated.
- c) *Exempt*. The seller does not collect the tax when making an exempt supply. Unlike the zero-rated case, however, the seller is not entitled to a refund of the VAT incurred on the input purchases undertaken to make exempt supplies.

Countries such as Australia, Canada and New Zealand, as well as subnational jurisdictions such as the Province of Québec (Canada), use the taxable, zero-rated and exempt categories.<sup>3</sup> In Australia, sales are said to be *taxable*, *GST-free*, and *input-taxed*,

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<sup>3</sup> Australian Taxation Office, *Tax Basics for Non-Profit Organizations* (Canberra: Commonwealth of Australia, 2003); Canada Revenue Agency, *GST/HST Information for Charities* (Ottawa: Government of Canada, 2009), available at <http://www.cra-arc.gc.ca/E/pub/gp/rc4082/rc4082-08e.pdf> (accessed on March 26, 2009); Canada Revenue Agency, *GST/HST Information for Municipalities* (Ottawa: Government of Canada, 2009), available at <http://www.cra-arc.gc.ca/E/pub/gp/rc4049/rc4049-09e.pdf> (accessed on March 26, 2009); Canada Revenue Agency, *GST/HST Information for Non-Profit Organizations* (Ottawa: Government of Canada, 2009), available at <http://www.cra-arc.gc.ca/E/pub/gp/rc4081/rc4081-09e.pdf> (accessed on March 26, 2009); New Zealand Inland Revenue Department, *Tax and Charities: A Government Discussion Document on Taxation Issues Relating to Charities and Non-Profit Bodies* (Wellington: Government of New Zealand, 2001), available at <http://www.taxpolicy.ird.govt.nz/publications/files/tax&charitiesdd.pdf> (accessed on March 28, 2009); Revenu Québec, *The QST and the GST/HST: How They Apply to Charities* (Québec: Gouvernement du Québec, 2004), available at [http://www.revenu.gouv.qc.ca/documents/eng/publications/in/in-228-v\(2004-10\).pdf](http://www.revenu.gouv.qc.ca/documents/eng/publications/in/in-228-v(2004-10).pdf) (accessed on March 28, 2009); and Revenu Québec, *The QST and the GST/HST: How They Apply to Non-Profit Organizations* (Québec: Gouvernement du Québec, 2003), available at [http://www.revenu.gouv.qc.ca/documents/eng/publications/in/in-229-v\(2003-02\).pdf](http://www.revenu.gouv.qc.ca/documents/eng/publications/in/in-229-v(2003-02).pdf) (accessed on March 28, 2009).

respectively. In New Zealand, zero-rated supplies are called *non-taxable* supplies. Even though the Australian terminology is clearer, this paper will follow the usual *taxable*, *exempt*, or *zero-rated* nomenclature. In all three countries, the VAT is called Goods and Services Tax (GST). The EU uses yet another nomenclature for nontaxable supplies.<sup>4</sup>

The exempt treatment of the PNC sector is widespread but by no means universal. To illustrate the possibilities, Table 1 describes the hypothetical interplay between that taxation of purchases made by the PNC sector bodies (or supplies rendered *to* the PNC sector), and supplies made *by* the PNC sector. For simplicity, assume that there are no mixed supplies so row and column headings describe transactions in an all or nothing fashion. The VAT chain is maintained all the way to the final consumer or any non-registered person) if PNC purchases and PNC supplies are either taxable or zero-rated (cases 1, 2, 4, and 5), but not if either purchases or supplies are exempt.

If supplies are taxable at both ends, VAT applies in the normal way with full credit for input VAT paid (case 1). If supplies are zero-rated at both ends (case 5), or if PNC purchases are taxable but PNC supplies are zero rated (case 2), then no tax gets collected on supplies. If purchases are zero-rated but supplies are taxable (case 4), then VAT applies normally but no credit is given on purchases since no VAT is paid on them.

**Table 1**  
**Effects of Alternative VAT Treatment of PNC Purchases and Supplies**

VAT treatment of purchases by the entity	VAT treatment of supplies by the entity		
	<i>Taxable</i>	<i>Zero-rated</i>	<i>Exempt</i>
<i>Taxable</i>	1. Normal VAT	2. No tax (and refunds if no other taxable supplies)	3. VAT paid (only) on value added including purchase by the PNC entity
<i>Zero-rated</i>	4. Normal VAT	5. No tax	6. No tax
<i>Exempt</i>	7. Excessive VAT (break in chain of credits)	8. VAT paid (only) on value added prior to purchase by the PNC entity	9. VAT paid (only) on value added prior to purchase by the PNC entity (same as 8)

Cases involving exemptions are far less clean. In the prevalent situation around the world, PNC purchases are taxable but supplies are exempt so tax gets paid on the value added up to and including purchases by the PNC entity (case 3). If purchases are zero-rated but supplies are exempt, then no tax gets collected as the entity does not absorb any input VAT (case 6); the practical effect is the same as in case 5. If purchases

<sup>4</sup> Non-taxable activities in the EU are treated like exempt supplies under VAT: the seller is not entitled to a refund of the VAT incurred on the input purchases undertaken to make non-taxable supplies. This terminology is used only in the EU and originates from the Sixth VAT Directive. The economic effects of the non-taxable status are the same as those of the exempt status. The distinction arises in the EU because the Sixth Directive identifies certain activities as specifically exempt (as opposed to non-taxable).

are exempt but supplies are taxable, then excessive tax gets paid since purchases embody unrelieved VAT (case 7). If purchases are exempt but supplies are zero-rated, then tax gets paid on the value added prior to purchases by the PNC entity (case 8). Finally, if supplies are exempt at both ends, then tax is also paid on the value added prior to the purchase by the entity (case 9). In practice, there is no a priori reason to expect that most PNC purchases would not be taxable; most of the goods and services PNC bodies would purchase would be taxable outputs produced by other (non-PNC) sectors. Outputs of the PNC sector would be a small fraction of those inputs.

## **Sector Activities**

The goods and services supplied by the PNC sector are quite diverse and thus beg for a proper classification. Aujean, Jenkins and Poddar, in a major contribution to the subject considered here, noted that the VAT issues applicable to public sector bodies are the same as those for non-profit organizations and charities.<sup>5</sup> They grouped the activities of these organizations in one of the three following categories:

- a) Redistribution of income and wealth;
- b) Provision of public goods and services; and
- c) Provision of other goods and services which are similar to the goods and services supplied by the private sector.

Redistribution involves the transfer of resources among different segments of the population using taxation, grants, and subsidies. Such transfers do not constitute supplies in and of themselves and do not they create value added. The administration of such transfers does, however, use up real resources, so the organizations involved in the transfers incur VAT on inputs. Any intermediation services would be subject to VAT. This highlights the need to consider the VAT treatment of PNC purchases as is done in Table 1.

Public goods and services are provided to the population at large and it is usually impossible to match individual transactions with individual recipients or beneficiaries. Pure public goods share non-rivalry and non-excludability as characteristics. Examples include national defense, street lighting and environmental protection. Quasi-public goods are either not completely non-excludable or may be subject to congestion. Examples are streets and highways, police and fire protection, libraries and museums, preventive medicine, and sewage disposal. Health care and education are special types of quasi-public goods that have traditionally been called merit goods. Depending on the structure of the market for such goods and services, quasi public goods may fit in either category (b) or (c) above. It is important to note that the education and health sectors are politically sensitive. This perhaps helps explaining the fact that they are predominantly exempt in VAT systems at present.

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<sup>5</sup> Michel Aujean, Peter Jenkins, and Satya Poddar, "A New Approach to Public Sector Bodies", *International VAT Monitor*, 10 (3, 1999), 144-49.

Finally, the PNC sector supplies goods and services that are similar to those provided by the private sector. They include the outputs of existing or former state monopolies such as electric and water utilities, postal services, state liquor stores, and radio and television broadcasting. In the case of non-profit and charitable organizations, supplies include a myriad of goods and services, from embroidered shirts to museums and restaurants, and from the organization of cultural and sporting events, raffles, trade shows, art exhibits, to chess tournaments.

Schenk and Oldman subsequently refined the above classification to read as:<sup>6</sup>

- a) Government transfer payments to redistribute income or wealth;
- b) Provision of goods and services that do not compete with private sector sales;
- c) Provision of goods and services that compete with private sector sales but may not be priced at market rates; and
- d) Provision of goods and services that may compete with private sector sales and may be priced at market rates.

This augmented classification highlights an important difficulty: The distinction between (c) and (d) suggests that the ability to establish a proper price is sometimes restricted, which is correct. This could occur for a variety of reasons, including the inability to obtain the information necessary for appropriate pricing, or other policy objectives. The authors also point out that there are two types of treatments of PNC supplies: *item* exemptions which are limited to particular supplies of goods and services made by PNC bodies; and *entity* exemptions which apply to all or most of the supplies made by a particular type of PNC entity, e.g., a charitable organization. To recapitulate, item exemptions would apply to particular PNC supplies, while entity exemptions would apply to the particular PNC entities themselves, that is to say, to all their supplies. Entity exemptions exacerbate the distortions noted in text accompanying Table 1 and expanded upon in the next section. Mixed supplies -- a combination of either one of exempt, zero-rated, or taxable supplies -- generate further complexity. For instance, under the Canadian system to be described below, item exemptions and zero-rating interact with entity exemptions.

### **Option I: Full Taxation**

About a decade ago, with the EU as their intended target, Aujean, Jenkins, and Poddar made a convincing case for the full taxation of the PNC sector under the VAT.<sup>7</sup> They further motivated the need for change by noting that the original VAT thinking surrounding the sector was formalized at a time when there was little competition between the private and public sectors. Over half-a-century later, the exemption system that still applies to much of the PNC sector in the EU in particular is highly distorting,

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<sup>6</sup> Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (New York: Cambridge University Press, 2007), chap. 9.

<sup>7</sup> Aujean, Jenkins, and Poddar, *supra* note 5.

especially given the existing and potential competition between private and public sector provision of many goods and services. Consumers are deprived of the benefits of increased competition between public and private sector providers of goods and services. Even though the economic advantages of full taxation are obvious, it seems that the reduction in complexity that would come out of it is almost equally compelling. To sum up, the case can be made in terms of efficiency -- reduction in distortions, need for allocations, self-supply bias and various non-neutralities -- and equity of treatment between organizations in the PNC sector and taxable private sector organizations.

Poddar has identified the following key characteristics associated with the sector.<sup>8</sup> First, PNC organizations perform a wide range of activities, which include the provision of both *public* and *private* goods and services, public administration and regulatory activities, and redistribution. Second, supplies are often made for nil or nominal consideration. Third, activities are financed through a variety of means, which include fees, taxation and borrowing. Finally, there is often no direct link between supplies and the means of financing. Almost twenty years ago, McLure had considered the PNC sector in a U.S. context, asking the right questions and, for the most part, providing the right answers.<sup>9</sup>

The main remaining difficulty with the full taxation proposal relates to determining the consideration. Explicit fees are easy to deal with. But what should be done with subsidies, grant payments and mandatory levies that are earmarked for certain recipients? The challenge resides with determining the appropriate treatment of grants directly linked to supply. Table 2 synthesizes Poddar's recommendations for the equal treatment supplies of private and public goods by PNC sector entities under five performance criteria: economic neutrality, consideration, input tax credit, revenue loss, and distortion of competition. Under full taxation, all suppliers in all cases receive a deduction for all the VAT paid on their inputs (Table 1, case 1). Entities that supply private goods are treated the same way whether they are private-sector businesses or PNC entities: VAT applies at the standard rate to the supplies (again, Table 1, case 1). Public goods attract VAT as long as the consideration for the supply is positive (again, Table 1, case 1). Otherwise, public goods supplied for nil consideration call for zero tax, since a positive rate times a zero consideration for supply produces zero tax. The end result is effectively like zero rating since suppliers can obtain a refund of the VAT paid on purchases (like Table 1, case 2). Only services that are public goods (e.g., defense, fire protection, and so on) pose serious difficulties for pricing; tangible public goods can usually be priced at market rates.

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<sup>8</sup> Satya Poddar, "Application of VAT to Public Bodies," presentation delivered at the VAT Conference, International Tax Dialogue, Rome, March 15-16, 2005.

<sup>9</sup> Charles E. McLure, Jr., *The Value-Added Tax: Key to Deficit Reduction* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1987).

**Table 2**  
**Requirements for Equal Treatment under Full Taxation**

Criterion	Taxation of private goods	Taxation of public goods
Economic neutrality	Same treatment of supplies made by private businesses and PNC bodies	Apply to any consideration charged for supplies
Consideration	Apply VAT on amounts charged as consideration (price <i>plus</i> grants directly linked to supply)	Supplies made for nil consideration call for zero tax (effectively zero-rating)
Input tax credit	Full (once supplies become taxable)	Full
Revenue loss	None	None if government collecting VAT is the one making the supply
Distortion of competition	None	None since public goods are supplied by private sector businesses

*Source:* Table 2 is an updated version of a table found in Gendron.<sup>10</sup>

Private goods supplied by PNC entities without any grants are treated the same way as private goods supplied by the private sector: VAT applies to the full amount of consideration (Table 1, case 1). In the case where grants are linked directly to the supply of private goods by PNC entities, the grant amounts must be added to the consideration charged prior to calculating VAT due (Table 1, case 1). The VAT base per unit supplied thus consists of the sum of the grant per unit and the price per unit. This treatment of grants avoids a distortion of competition between the private and public sectors -- favoring the latter -- as PNC grants are used to equalize the full consideration and thus prevent an unfair advantage for PNC entities where grants would allow them to charge a lower output price than private sector suppliers. This situation has been referred to as a distortion of competition in the literature.

### **Option II: Zero-Rating**

The zero-rating of supplies made by the PNC sector would be an expedient way for politicians to say that they are assisting entities in the sector. Such proposals have been made in the past and still come up from time to time.<sup>11</sup> Canada zero-rates certain private goods and services to suggest that the government assists the consumers of such supplies. Examples include basic groceries (milk, bread, and vegetables), prescription drugs and drug dispensing fees, and medical devices. While there are always mechanisms superior to the VAT to provide the assistance (think of expenditure and transfer policies), zero-rating has the advantage of targeting goods that are highly visible to sensitive segments of the population. Interestingly, pure transfers themselves would not be subject to zero-rating should this be the preferred policy; instead, they would simply not be subject to VAT since they do not constitute consumption nor involve value added. Arranging for the transfers themselves is a distinct activity that should be viewed as an intermediation service that uses up real resources and therefore creates value added.

<sup>10</sup> Pierre-Pascal Gendron, "Value Added Tax Treatment of Public Sector Bodies and Non-Profit Organizations: A Developing Country Perspective", *Bulletin for International Fiscal Documentation*, 59 (12, 2005), 514-26.

<sup>11</sup> McLure, *supra* note 9, lists this as one option in the case of non-profit organizations.

As noted out earlier, zero-rating is consistent with full taxation in the case of public goods and services supplied for nil or nominal consideration. Otherwise, it is inconsistent with full taxation and it will favor the consumption of zero-rated goods and services over taxable ones. Non-export (i.e. domestic) zero-rating must be limited to the largest extent possible as it poses several problems:

- It may have a significant negative impact on revenues;
- It is inconsistent with having consumption as the intended tax base (as under the VAT).
- It violates economic neutrality if the private goods supplied by PNC bodies are zero-rated while the private goods supplied by the private sector are taxable;
- It distorts consumer choice between taxable and zero-rated goods;
- It introduces complexity in the tax system by requiring that rules defining zero-rated goods and services be designed and monitored, and hence potential classification disputes; and
- It may trigger calls for more zero-rating (zero-rating creep).

In sum, zero-rating may be a useful mechanism to support full taxation if necessary. It is risky and potentially costly in terms of revenues foregone to do this on a stand-alone or generalized basis. In such situations, exemptions may be preferred to zero-rating simply to protect revenues. Not surprisingly, exemption creates problems that are similar to some of the above.

Reduced tax rates on PNC supplies may be considered a worthwhile alternative to zero-rating (the latter itself being a special case of reduced rates) in some situations and are sometimes mentioned in discussions of VAT as a means of achieving distributional objectives. As Ebrill et al. noted in commenting on their survey, the advice of the Fiscal Affairs Department of the International Monetary Fund (IMF) to have a single rate of VAT has not been followed in most cases. Multiple rates create complexity of their own, may trigger classification disputes, and present opportunities for gaming the system if different rates apply to purchases and supplies. There are better suited policy instruments to achieve distributional objectives than differential rates, including a zero rate.<sup>12</sup>

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<sup>12</sup> For a broader discussion of this issue, see Richard M. Bird and Pierre-Pascal Gendron, *The VAT in Developing and Transitional Countries* (New York: Cambridge University Press, 2007), chap. 7, and Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT* (Washington, D.C.: International Monetary Fund, 2001), chap. 7.

## EXEMPTION

Under the prevalent exemption system, the output of the PNC sector, which consists of a diverse array of goods and services, is effectively treated as final consumption by the supplying organizations themselves rather than consumption by the ultimate final consumers or non-registered (for VAT purposes) persons.<sup>13</sup> Under the pure exemption model, PNC entities are not registered for VAT. Thus not required to collect VAT on their supplies, but they are also unable to claim VAT paid in inputs purchased to make those supplies.<sup>14</sup>

### Why Exempt?

Exemptions often appear to be granted for valid reasons stemming from equity, distributional, or social concerns. Unlike zero-rating, however, exemptions violate the logic of VAT. According to that logic, the supplier of good and services that are either fully taxable or zero-rated under VAT should be able to recover all of the VAT paid on inputs or purchases made in the course of business activities. At first glance, since the production of goods and services by the PNC sector uses up real resources, it creates value added. Therefore, household consumption of goods and services provided by the sector should fall into the VAT net. Why, then, are most outputs of the PNC sector exempt?

The reasons cited the most in the literature include the following. First is the case of merit goods: while it is feasible to exclude users, measure consumption, or charge a price that reflects the full value of the supply, it is usually deemed socially undesirable to do so. The argument is that the consumption of merit goods produces positive externalities. Second, the exempt treatment of many outputs of the PNC sector is meant to achieve distributional objectives. A prominent example is the sale of education and health services at prices below market value, which amounts to granting an implicit subsidy to the consumer. This is closely related to the first rationale insofar as low-

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<sup>13</sup> For recent work that has considered the general PNC sector exemption in much broader or very different contexts, see Bird and Gendron, *supra* note 12, chap. 6, and Gendron, *supra* note 10.

<sup>14</sup> In the vast majority of VAT systems throughout the world, a registration threshold exists and is normally expressed in monetary terms, usually in terms of output sales or turnover. The purpose of the threshold is to reduce compliance costs to small suppliers and economize on administrative costs by not having to spend audit and other resources on small suppliers, while sacrificing little revenue. Small suppliers with sales below the threshold are not required to collect VAT on their supplies but cannot obtain credit for the VAT they pay on their purchases. Non-registered suppliers are therefore exempt under VAT. In many systems, suppliers with sales below the threshold can register voluntarily for VAT purposes. In that case, their compliance obligations increase because they must collect VAT on their sales, file returns, and make payments. On the other hand, they benefit because they can offset the VAT paid on purchases against the VAT collected on sales. In Canada, PNC bodies can generally register voluntarily for GST/HST (the VAT) but there are exceptions to this rule. Certain municipal bodies or charities that make only exempt supplies cannot register. In that case, they still qualify for public service bodies' rebate of a portion or the entirety to GST/HST paid. It must be noted that the registration threshold for PNC bodies is C\$50,000, an amount almost twice as high as the regular threshold of C\$30,000.

income members of society could be unfairly deprived of certain merit goods if they were priced at their market value. The exemption supports the activity, in addition to the grant or subsidy necessary to make up the difference between market value and user contribution. There is high-level support for the first two rationales: “in line with international practice, FAD [Fiscal Affairs Department of the IMF] recommends that certain services, principally health, education, and non-fee financial services, be exempt from VAT for policy and practical reasons.”<sup>15</sup> Presumably, the preference for exemption as opposed to zero-rating is motivated by the desire to tax the sector indirectly (on its inputs rather than its outputs) and limit the revenue risk and possible abuse from zero-rating.

Finally, there is the often cited notion that the output of the PNC sector is hard to tax. According to this rationale, the outputs from PNC activities are hard to tax for a variety of conceptual, compliance and administrative reasons. Thus, it is preferable to sacrifice taxing household consumption and instead collect some VAT revenue on the inputs used by registered entities along the supply chain. Are there really sound conceptual reasons, though? According to Aujean, Jenkins, and Poddar, the apparent conceptual (or perhaps mental) roadblock to the full taxation of the sector's outputs is:

[T]he insistence under existing models on identifying explicit consideration before a supply is seen to be made. In fact, much of the confusion that arises in the application of VAT to public bodies is caused by supplies for which no explicit fee is charged or where the link between the fee charged and the benefit provided is not direct.<sup>16</sup>

The authors suggested breaking the traditional mould of thinking by treating the PNC sector as a supplier -- as opposed to a final consumer as is now usually the case -- in all its activities, whether or not a consideration is charged. This would avoid the conceptual error of treating the PNC sector as a final consumer of the goods and services it supplies. In addition to this circularity problem, the existing treatment ignores the true VAT base, which is consumption by final consumers and other non-registered persons. The second target they chose was the EU system and the recent debates around this issue since that system represents the best established but unfortunately the most complex -- and resistant to change -- case of the status quo in VAT thinking:

[O]nce one concludes, under the full taxation model, that almost all activities of public sector bodies should be classified as supplies [to someone else], all problems of taxation of these supplies become linked to determining the value of the consideration for the supplies, rather than determining whether the activity is inside or outside the scope of VAT, exempt, or taxable.<sup>17</sup>

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<sup>15</sup> Ebrill et al. *supra* note 12, at 65.

<sup>16</sup> Aujean, Jenkins, and Poddar, *supra* note 5, at 146.

<sup>17</sup> *Id.*

## Economic Effects

The exemption system produces economic effects that can be usefully organized in a handful of categories, now quite standard.<sup>18</sup> The most serious problems attached to exemption in the PNC sector would include revenue effects, mixed supplies, exemption creep, self supply bias and input choice distortions, and compliance and administrative costs.<sup>19</sup> The first three mainly concern tax administration, the rest taxpayers.

The fundamental source of inertia against changing the exemption system is that it produces VAT revenue despite giving the appearance to the public that the VAT does not apply. VAT revenue is collected when suppliers purchase inputs along the supply chain. On the one hand, revenue that would have been obtained from the retail stage (via sales to consumers and other non-registered persons) is sacrificed. As a result, the effective tax rate on non-registered traders and consumers falls below the statutory rate and is uneven. On the other hand, VAT on purchases is not credited to businesses that make exempt supplies. Cascading takes place along the chain and therefore the revenue effect depends on the stage at which the exemption occurs.

When PNC organizations make a mix of taxable and exempt supplies, as is often the case with government authorities and non-profit organizations, the issue arises as to how much VAT paid on purchases applies to taxable versus exempt supplies. Answering this question first requires that inputs be allocated between the two types of activities. In principle, tracking may be done based on actual input use or based on some allocation formula. All of this can consume non-trivial taxpayer resources which some charitable and non-profit organizations can ill afford. In addition, it will require attention from the tax administration since the allocations open VAT credits to gaming by taxpayers, hence increasing revenue uncertainty. The latter problem would be exacerbated further should exemption creep take place. This phenomenon manifests itself when businesses that make taxable supplies to the exempt sector lobby for similar exempt treatment on equity grounds, to *level the playing field*. Experience around the world with exemptions suggests that this can be a powerful force and seriously undermine the integrity of any VAT system. As noted earlier, the problem would also arise with domestic zero-rating, only with more serious revenue consequences (Table 1, cases 5 and 6 but upstream).

In fact, an equity problem that is overlooked in much of the literature concerns suppliers of different sizes. The exemption pits small (and usually non-registered) versus large and registered suppliers. Under the exemption system, small suppliers are penalized relatively to large ones since they have fewer resources to absorb the irrecoverable VAT they incur on inputs purchased to make exempt supplies. Either they have to absorb the

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<sup>18</sup> Closely follows the standard classification established by Ebrill et al, *supra* note 12, chap 8.

<sup>19</sup> This discussion ignores the complications that arise from considering purchases of services from foreign suppliers with or without a reverse charge rule. Since the activities of PNC bodies are often labor-intensive and would chiefly involve the purchase of domestically-produced services, the treatment of imported services purchased by PNC bodies appears to be a fairly minor issue. See the discussion of the reverse charge on imported services in Alan Schenk (this volume).

tax by accepting a lower amount of leftover income or pass it to consumers in the form of higher prices. Either way, larger and necessarily registered suppliers have an advantage. Under full taxation with voluntary registration, much of this disadvantage can be mitigated as small suppliers with sales below the VAT registration threshold may elect to register. In that case, they can claim the VAT they pay on inputs in exchange for the obligation to collect VAT on goods and services and fulfill other duties to comply.<sup>20</sup>

PNC entities that produce exempt supplies have an incentive to produce taxable goods and services in-house (self-supply) rather than purchase or outsource them. Classic examples include hospitals that run their own laundry or food services. The reason is that such suppliers cannot claim credit for the input VAT they would incur on outside purchases of taxable goods and services -- precisely because the supplies that are produced using those inputs are exempt. As noted earlier, the situation would be very different if purchases by PNC entities were themselves zero-rated supplies (Table 1, case 6), but there is little reason to expect that this scenario in practice.<sup>21</sup> The impact of the exemption system on the decision to contract out public services has received much attention in the literature for some time, predictably in the EU.<sup>22</sup> Any public authority that renders exempt services faces a disincentive to contract services out to the private sector since it can avoid incurring irrecoverable VAT by self-supplying inputs. The disincentive is, of course, proportional to the importance of the self-supply bias and the level of the VAT rate. The critical consequence of this is that it hinders the ability of the private sector to compete with the public sector and creates a barrier to privatization. In EU parlance, it creates a *distortion of competition* but in reality, it simply creates inefficiency by thwarting competition.

Finally, perhaps as a result of all the problems identified above, exemptions considerably complicate the administration of a VAT and increase the amount of taxpayer resources required to discharge obligations. In the end, they do not produce benefits that could not be better replicated at a lower efficiency cost using different policies such as expenditures. If an exemption is weighted against zero-rating in a particular case, perhaps the former may be preferred to protect revenues but then again, there will be circumstances where zero-rating is the correct treatment, not exemption. That would effectively be the case for public goods supplied for nil consideration. In the end, since the intended VAT base is consumption, what is the point of taxing consumers of the PNC sector indirectly when full taxation can do it directly? Put another way, the government operating the tax has no interest in doing this; only suppliers can benefit because they can hide the tax in prices.

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<sup>20</sup> See *supra* note 14 for a related discussion.

<sup>21</sup> In the hospital example, sheets, cleaning products, foodstuffs, and other furnishings would be taxable. Under Canada's GST, for instance, zero-rated goods and services aside from exports include basic groceries, agricultural and fishery products, prescription drugs, and medical devices.

<sup>22</sup> See E. Dijkgraaf and R. H. J. M. Gradus, "Cost Savings of Contracting Out Refuse Collection", *Empirica*, 30 (2003), 149-61; and M. C. Wassenaar and R. H. J. M. Gradus, "Contracting Out: The Importance of a Solution for the VAT Distortion", *CESifo Economic Studies*, 50 (2, 2004), 377-96. Those discussions have even extended to procurement in the U.S., the EU, and China; see Xiaoqiang Yang, "VAT Treatment of Government Procurement: A Comparative Analysis", *International VAT Monitor*, 16 (5, 2005), 342-48.

## ALTERNATIVE SYSTEMS IN PRACTICE

Countries that have departed from the exemption system as usually applied to the PNC sector have done it in very different ways. Australia and New Zealand have moved the furthest from the exemption, followed by Canada somewhere in the middle, and then the EU. This section briefly reviews the experiences in those cases and compares them in order to identify the best practice.

### Australian System

All activities of public bodies and non-profit organizations (the “PN” of PNC) are within the scope of the GST. Two important features of the system as it applies to the PN are worth noting. First, there is no exemption system applying specifically to supplies by PN bodies. Second, expenditure budgets approved by Parliament for such bodies are viewed as consideration for the supply of public administration or other functions of the body.

Examples of supplies made by a non-profit organization that will be taxable under GST include:

- Entry to an event such as a show, concert, or exhibition;
- Hiring out rooms or equipment for a fee;
- Providing membership to an organization; and
- Selling items such as books, clothing and most food items.

Most education, child care, and health services are zero-rated (*GST-free*). Some transactions remain exempt (*input taxed*) however. An example would include the supply of food and beverages provided at school tuck shops run by non-profit organizations.

A few special rules apply to charities (the “C” of PNC), gift-deductible entities and government schools.<sup>23</sup> The following goods and services are zero-rated when supplied by charities, gift-deductible entities or government schools:

- Sales of donated second-hand goods;
- Raffles and bingos; and
- Non-commercial sales of goods and services (including accommodation).

Sales by such entities will be zero-rated when deemed non-commercial. This determination requires that the amount charged by the organization for the good or service be either less than 50% (75% for accommodation) of the market value, or less than 75% of the amount the organization paid to acquire the good or service.

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<sup>23</sup> Australian Taxation Office, *supra* note 3, and Poddar, *supra* note 8.

A charity, gift-deductible entity or government school may also elect to make its sales at a fund-raising event exempt if the event does not recur regularly. This would effectively relieve the organization from the obligation to collect GST on the supplies, calculating GST on supplies and purchases, filing GST returns and making payments.<sup>24</sup> Activities eligible for the exemption election would include shows, dinners, and performances, events where all goods except alcohol and tobacco are sold for A\$20 or less, and approved fundraising events. Supplies made at regularly occurring events (15 times per year or more) will be automatically taxable.

## **New Zealand System**

The base of New Zealand's VAT (GST) is probably the broadest in operation today. The treatment of the PNC sector contributes to this state of affairs. As in the case of Australia, New Zealand's GST distinguishes itself from other VATs around the world by treating entities in the PNC sector as suppliers to both the private and the public sector.<sup>25</sup> This treatment means that goods and services provided by the PNC sector are taxable. Fees and charges are used to measure the value of supplies to the private sector, and supplies to the government are measured by the corresponding parliamentary budget appropriations. Generally speaking, PNC bodies add VAT to their invoices and obtain credit for the VAT paid on purchases from private *or* PNC sector suppliers. This simple and neutral treatment effectively solves the numerous non-neutralities encountered when PNC supplies are exempt while similar private sector supplies are taxable.

There are some differences with Australia, however. The New Zealand system allows for even fewer zero-ratings and optional exemptions. Going further that Australia and Canada, the New Zealand GST taxes the "untouchables" such as food, children's clothing, and books and medicine.<sup>26</sup> There remain some concessions under the New Zealand system, however. For examples, nonprofits funded by donations effectively receive zero-rated treatment (Table 1, case 2, and in some cases, perhaps Table 2, nil consideration cell). More importantly, administrative concessions are granted to nonprofit organizations to facilitate compliance rather than as a matter of tax policy. Those concessions relate to accounting methods, registration thresholds, and group taxation. A desirable feature of such concessions is that they do not fundamentally undermine the functioning of the VAT, unlike exemptions, unwarranted domestic zero-rating, multiple rates, or thresholds that are set too low.

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<sup>24</sup> As an additional measure to relieve the compliance burden, non-profit organizations that are members of the same non-profit association can elect to form a GST group if they make many sales and purchases among themselves. With group treatment, the members do not have to pay GST on group transactions and, of course, no credits can be claimed.

<sup>25</sup> Schenk and Oldman, *supra* note 6, at 289; and New Zealand Inland Revenue Department, *supra* note 3.

<sup>26</sup> "Untouchables" are, in the mind of the public, what should just not be taxed. See David White, "The Serious Research Gap on VAT/GST: A New Zealand Perspective after 20 Years of GST", *International VAT Monitor*, 18 (5, 2007), 343-351, at 343. There are obviously other differences between the Australian and New Zealand regimes but they are not essential to this exposition and are therefore omitted here.

## Canadian System

Three VAT systems are currently in operation in Canada: the federal goods and services tax (GST), the harmonized sales tax (HST) -- operated jointly with the GST in the provinces of New Brunswick (NB), Newfoundland and Labrador (NL), and Nova Scotia (NS), collectively referred to as the three *participating provinces* -- and the Québec sales tax (QST) in operation in the Province of Quebec. The GST applies in all 10 provinces and three territories at a rate of 5 %. The HST (normally referred to as *GST/HST* in government literature) is a joint federal-provincial VAT that applies at a combined rate of 13 percent (5% federal GST plus 8% provincial component) in the three participating provinces. The QST is a VAT that applies in Québec at a rate of 7.5% on the GST-inclusive price. The intended base of all three taxes consists of domestic consumption plus imports. The scope of VAT in Canada will expand shortly and in a significant way as the Province of Ontario announced in its 2009 Budget that it will harmonize its retail sales tax with the GST with a provincial component of 8% on July 1, 2010.<sup>27</sup>

The federal government is considered a single entity for GST/HST purposes, and includes all departments, branches, corporations, and agencies. The federal government pays GST/HST on its purchases, and charges GST/HST on its taxable supplies. Municipalities are subject to the same treatment with the key difference that many supplies of goods and services by municipalities and para-municipal organizations are exempt.

Special arrangements exist with respect to the treatment of sales or supplies to provincial and territorial governments under the GST/HST. The governments of the three participating HST provinces have agreed to pay GST/HST on their taxable purchases. Also, all government departments and agencies in the Province of Prince Edward Island (interestingly, an RST province) and the territory of Nunavut (which has no territorial sales tax) pay GST/HST on their taxable purchases (effectively as in Table 1, case 1).

The remaining provincial and territorial governments, however, do not pay GST/HST on their taxable purchases subject to the provision of certification that purchases are made with Crown (government) funds. Government authorities eligible under this arrangement include all departments or ministries, and some of their Crown corporations, boards, commissions and agencies. Businesses that make supplies to the remaining governments do not charge GST/HST but they are entitled to input tax credits for any GST/HST paid on purchases made to those supplies. The supplies are effectively zero-rated in that case (as in Table 1, case 2, except that it applies here to businesses that make supplies to PNC entities).

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<sup>27</sup> Ontario Ministry of Finance, *2009 Ontario Budget Backgrounder: Comprehensive Tax Reform Package* (Toronto: Government of Ontario, 2009), available at [http://www.fin.gov.on.ca/english/budget/ontariobudgets/2009/bk\\_tax.pdf](http://www.fin.gov.on.ca/english/budget/ontariobudgets/2009/bk_tax.pdf) (accessed on March 26, 2009). See Bird and Gendron (this volume) for details.

Under a reciprocal federal-Québec tax agreement, the federal government, its corporations and agencies are generally not required to pay QST on their purchases which are effectively zero-rated. Agencies not covered by the agreement must pay QST. Québec government corporations and agencies listed in the agreement are not required to pay GST (or the Québec Sales Tax (QST)) on their purchases. The Québec government, its corporations, agencies, and agents are required to collect GST and QST on their taxable sales, unless those are specifically zero-rated. Similar to the federal system, the Québec authority must deliver a certification that purchases have been made with public funds (Table 1, cases 4 or 5).

From an overall system perspective, most of the goods and services supplied by the PNC sector in Canada are exempt, although some are taxable and some are zero-rated. Taxes incurred by PNC entities on purchases made to deliver taxable or zero-rated supplies are fully creditable. There are specific exemptions for hospital and clinical care, medical and dental services, public and private nursing home services, educational and social welfare agencies, recreational public-sector programs for youth, municipal services, and most supplies made by charitable organizations. In dealing with exempt supplies, the GST/HST and QST systems depart from the pure exemption model by granting rebates of some or all of the tax paid on the inputs purchased to make exempt supplies. These rebates are granted ex post and at variable rates. It should be noted that medical devices and prescription drugs (which may be rendered by exempt organizations) are actually zero-rated. In situations where PNC entities supply those, zero-rating clashes with the sector's exempt treatment and increases compliance costs.

The GST/HST and QST systems have featured rebates from their inception in recognition of the problems a pure exemption causes.<sup>28</sup> Under a rebate system, PNC entities are within the scope of the GST/HST and QST (if applicable) but supplies are treated as exempt, with a fraction of the GST/HST or QST paid on purchases rebated at the tax return stage.

Table 3 shows rebate rates for the GST, HST and the QST by type of supplier. Rebates are available if an organization is either one of the following:

- Charity;
- Qualifying non-profit organization;
- Selected public service body; and
- First Nation or Inuit Government.

The rebate program in the first three cases is called the *GST/HST Public Service Bodies' Rebate*, and the last is called *GST Self-Government Refund*. Non-profit organizations and public service bodies are eligible for a 100% refund subject to approval by the Canada Revenue Agency. A First Nation or Inuit Government is also eligible provided that it has entered in an agreement with the Government of Canada that provides for a 100% refund of GST for goods and services acquired for self-government

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<sup>28</sup> See discussion of previous section.

activities. Certain special supplies by PNC bodies are also eligible for rebates as follows: books (100% of GST/HST, federal component only); goods and services exported by a registered charity or public institution (100% of GST/HST, both federal and provincial components); and eligible facility operators or external suppliers (83% of GST/HST, federal component only).

Rebates are funded out of general government revenues. Interestingly, even though the GST/HST is a joint system, HST provinces do exert some control over their tax base -- on the side of base expansion -- by deviating from GST rebate rates for some components. GST rebates have been enhanced over time, most notably in the case of municipalities. The rebate rose from 57.14% of the tax paid on purchases to 100% in 2004. The rebate applies to the GST and the federal portion of the HST but it is interesting to note that the rebate rate for the provincial portion of the HST has remained at the old rate, and it is actually zero in NL. One year later, the federal government extended the 83% GST rebate rate for hospitals to eligible charities, non-profit organizations, and public institutions that render services similar to those usually rendered by hospitals. Again, the rebate is most generous for the federal portion of the HST, but much less so for the provincial portion outside NS. Overall, NS has harmonized its rebate rates to the GST the most. QST rebates are less generous than GST rebates but more so than those in NB and NL.

**Table 3**  
**GST, QST and HST Rebate Rates (%) in Canada, 2009**

Organization	GST	QST	HST NB	HST NS	HST NL
Municipality	100	0	57.14	57.14	0
University <sup>a</sup>	67	47	0	67	0
School authority	68	47	0 <sup>c</sup>	68	0
Public college	67	47	0	67	0
Hospital authority	83 <sup>b</sup>	51.5	0 <sup>c</sup>	83	0
Charity or public institution	50	50	50	50	50
Non-profit organization	50	50	50	50	50

**Notes:**

- (a): Includes affiliated colleges or research institutes under the GST.
- (b): Health care rebate applies to charities, non-profit organization and public institutions that render services similar to those usually rendered by hospitals.
- (c): In New Brunswick, hospital and school authorities that are part of the provincial government pay HST on their purchases, but the full amount of HST (100% of the provincial component) is rebated to them.

**Source:** KPMG, *Tax Facts 2008-2009* (Canada: KPMG LLP, 2008).

The rebate system only mimics zero-rating in two cases: first, regarding the GST municipalities pay on purchases, or the federal portion of the HST municipalities pay in the participating provinces, and second, with respect to the provincial component of HST paid on purchases by government-run hospitals and schools in New Brunswick. All eligible bodies must file the same tax return form to receive their *GST/HST Public*

*Service Bodies' Rebate*, whether they are municipalities subject to the 100% GST rebate or any other type of eligible to the rebate. Thus, no eligible PNC body handles GST/HST like an ordinary commercial business would. In an effort to alleviate compliance costs, however, the authorities allow charities to use special simplified tax calculation methods.

The value of the rebates can be substantial in aggregate. In the case of local governments, for example, GST/HST rebates granted over an 11-month period from February to December 2004 ranged from a low of C\$0.4 million in Yukon Territory to a high of C\$173.3 million in Ontario, and C\$372.8 million for Canada as a whole.<sup>29</sup> As a fraction of local general government expenditures, rebates range from a low of 0.5% in Yukon Territory to a high of 1.5% in the Northwest Territories, with an average of 0.7% for Canada as a whole. In aggregate, rebates therefore account for about one percent of total local government expenditures.

A system with fixed rebate rates appears, at first glance, quite simple and predictable for registrants. It may be the latter, but certainly note the former due to the heterogeneous treatment of entity and supplier types, and actual supplies. Rebate rates do indeed vary by type of supplier, by the place where supplies are made, and by type of goods or service supplies. As a result, there is non-neutral treatment of similar supplies made by different types of suppliers in different provinces. The varying rates also create incentives to choose certain organizational forms over others to deliver certain goods and services over others. Finally, businesses that operate in several provinces (e.g., New Brunswick and Québec) must fill two rebate claim forms that feature three sets of calculations. Ironically, despite the rigid harmonization model underlying the HST, rebate rates that vary across those provinces and vary from rebate rates that relate to the federal (GST) component. It is striking to see such departures from a harmonized base under what is supposed to be one *harmonized* system (GST/HST).

In spite of the fact that the GST and QST are relatively well harmonized, the Québec rebate system is far less generous on average. Different rates for the same supplier-activity combinations introduce additional compliance costs. Under the Québec system, the apparently equal -- featuring 50% rebate rates in both cases -- treatment of charitable and nonprofit organizations effectively penalizes charitable organizations, since most of the supplies they make are exempt while most supplies made by non-profit organizations are taxable. As a consequence, nonprofit organizations recover a larger fraction of the total QST paid on inputs than charities do. Beyond non-neutralities, the problem of the Canadian system is its failure to make a choice between full taxation or zero-rating of the PNC sector, even though it has already moved part of the way towards either goal in some cases. The Canadian system is stuck, in some way, since full zero-rating is unrealistic from a revenue perspective and inappropriate as an overall policy as it would fail to tax the consumption of the outputs of the PNC sector and therefore create its own non-neutralities. David and Poddar, writing in the business press in Canada, concluded that the GST in Australia and New Zealand applies to organizations in the

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<sup>29</sup> Canadian Tax Foundation, *Canadian Tax Highlights*, 13 (6, 2005), 3-4. The figures are dated but they do illustrate the magnitudes.

PNC sector in the same manner as to private sector organizations and have called for the same treatment to be implemented in Canada.<sup>30</sup> Their plea remains unanswered to this day and there is no evidence that Finance Canada—the federal government department responsible for tax policy—is considering this issue at this time.

In closing, it should be noted that the GST/HST and QST systems operate independently of provincial RSTs, without any coordination. Services are usually not an issue since the vast majority of them is non taxable under RSTs, but certainly many goods purchased and sold by PNC entities would be subject to RST unless specifically exempt by law.<sup>31</sup>

## EU System

A voluminous literature on the VAT in EU Member States has been accumulating for quite some time. The system is complex and reviewing all the important issues that pertain to the PNC sector would require a full-length paper.<sup>32</sup> Rather, this section will outline the essential features of the treatment of the PNC sector under the EU VAT to allow comparison with the experience in other countries that departed from the pure exemption.

In the EU, so-called public bodies are governed by public law and are within the scope of the VAT for the integrality of their economic activities. In principle, supplies by public bodies are taxable but then public bodies that engage in transactions in their role as public authorities are non-taxable persons placed outside the scope of the VAT. An example would be a local government that collects refuse. Such entities do not charge VAT on their supplies and they cannot obtain credit for VAT paid on their purchases. This is subject to exceptions; de la Feria highlights the convoluted decision-tree nature of the problem as follows: “Overall, the VAT treatment of public sector bodies is dependent on the answers given to two fundamental questions: is the transaction taxable or non-taxable, and, if it is taxable, is it exempt or not exempt?”<sup>33</sup> To complicate matters further, exempt status features a derogation for taxation, while taxable (with “not negligible” supplies) status allows for a derogation for exemption.

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<sup>30</sup> Irene David and Satya Poddar, “Now Fix Rest of GST”, *National Post* [Toronto], February 6, 2004, at FP15.

<sup>31</sup> See Bird and Gendron (this volume).

<sup>32</sup> A very recent paper that fits the bill and provides a critical analysis of this issue from both legal and economic perspectives is Rita de la Feria, “The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction”, Working Paper 08/08 (Oxford: Oxford University Centre for Business Taxation, 2008), available at <http://users.ox.ac.uk/~mast1732/RePEc/pdf/WP0808.pdf> (accessed on March 29, 2009). I thank Michel Aujean for suggesting the reference.

<sup>33</sup> *Id.* at 4.

Moreover, some services are exempt in the EU. Important examples include:

- Public postal services;
- Hospital and medical care;
- Education and university education; and
- Activities of charitable organizations.

This list also contains the major exempt supplies made by public bodies under Canada's GST/HST system, except for postal services which are taxable in Canada. In fact, their presence in this list points to a problem: the fact that potential competition from private sector providers exists in several of those areas.

One of the notable results of the system sketched in the foregoing paragraphs is that public bodies often need to compute complicated input VAT apportionments and may still end up bearing a significant amount of unrelieved input VAT anyway. In response to this reality, authorities in five EU Member States -- Denmark, Finland, the Netherlands, Sweden, and the United Kingdom -- have established systems to compensate public bodies for the input VAT paid to make exempt or non-taxable supplies. Just outside the EU, Norway also features such a system. Those refund systems are run outside the VAT framework and may be funded out of general revenues or by subnational governments directly (so-called self-funded in the later case). On the surface, those refund systems appear similar to the Canadian rebate model. Their application in the EU is far less uniform, widespread, and certain though, as is illustrated next.

An illuminating example is given by VAT refund schemes for refuse collection.<sup>34</sup> The schemes are general and apply to non-taxable or exempt activities of local governments. Norway, even though it is not a Member State, is added for comparative purposes. Table 4 summarizes the key characteristics of the schemes in operation to compensate European suppliers of refuse services for the VAT paid on inputs and hence level the playing field between government and private sector supplies. Individual refund rates are unavailable but they are known to vary by activity, and it is suspected that they are beneath 100%. As it should, the Netherlands provides refunds for the VAT incurred in the Netherlands or in other EU Member States, while none of the other refund schemes covers the VAT paid to other EU Member States. The United Kingdom's refund scheme is the only one that is funded by the central government. All the others create vertical imbalances by forcing local authorities to contribute the majority of the cost of the refunds by bearing offsetting reductions in grants from the central or federal government. Unfortunately, increased VAT receipts appear to be far from sufficient to pay for the refund schemes. In situations of imbalance, central governments may benefit from net revenue windfalls while local public bodies are left to pay the bills and may need to increase local property taxes, fees, and other levies to make up for the shortfall.

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<sup>34</sup> Wassenaar and Gradus, *supra* note 22.

**Table 4**  
**Input VAT Compensation on Public Sector Services in Europe**

Country	Compensation scheme <sup>a</sup>	Suppliers	Funding of scheme
Denmark	VAT refund, taxable activity (refuse collection)	Counties, municipalities, inter-authority companies	Municipalities fund a “VAT Compensation Fund”
Finland	VAT refund	Municipalities, municipal federations	Municipalities fund the refund scheme
Netherlands	VAT refund	Municipalities, provinces	Through reduction in grants <sup>b</sup>
Norway	VAT refund, taxable activities (postal services, refuse collection, etc.)	Local governments	Through reduction in general grant to municipalities <sup>b</sup>
Sweden	VAT refund	Municipalities, country councils	Municipalities and country councils fund the refund scheme
United Kingdom	VAT refund	Local and police authorities	Central government revenues, no contribution by local authorities

*Notes:*

<sup>a</sup> For further details, including exceptions and exclusions, see Wassenar and Gradus, note 22.

<sup>b</sup> Extra VAT receipts from increased contracting out are added to the fund, but that does not cover the drop in grants.

**Source:** Table 4 is adapted from Gendron, note 10.

## Benchmarking

The Australian-New Zealand system comes closest to the ideal of full taxation of the PNC sector. It does so in a relatively clean way and with some administrative accommodations for entities that would otherwise incur disproportionate compliance costs. It is by far the simplest of all alternatives considered here. The Canadian system occupies an interesting middle ground with a broad exemption that is partly offset by rebates that can be quite generous in some cases. While GST rebate rates have been stable or have become more generous over time, the system is not simple. The EU system is somewhat a prisoner of its history with respect to the exemption. As a result, it is unable to address the problems from exemption (real or effective) in a comprehensive and cost-effective way or with a reasonable amount of certainty. Pressure to change is resisted as well. A country with a good tax administration will find full taxation an attractive proposition. Both public and private sector providers of goods and services can avoid the self-supply bias and other non-neutralities, while consumers can benefit from increased competition.

## IMPLICATIONS FOR A U.S. FEDERAL VAT

This section presents a selective review of some of the key tax policy issues that would arise in designing an add-on U.S. federal VAT regime for the PNC sector: economic nonneutralities, states as taxable persons, and coordination with income taxes. It concludes by considering the lessons from international experience for the U.S. Administrative issues are highly important but are not covered here.<sup>35</sup>

The discussion that follows assumes that the U.S. VAT would be designed to be operated by the federal government on a stand-alone basis with or without prior tax policy coordination between the federal and state governments, and with or without tax harmonization *ex post*. Obviously, as experience in Canada, the EU and elsewhere shows, tax coordination and harmonization are highly desirable, but not absolutely essential to a sales tax system's ability to actually run.<sup>36</sup> The point of this section is not to present full analyses of these issues but rather to present a concise discussion.<sup>37</sup>

### Economic Non-Neutralities

Services rendered by the PNC sector often represent a sizeable portion of the GDP of high-income countries. This is certainly true in the U.S., Canada, and the EU. As noted earlier, supplies by the PNC sector accounted for about one-fifth of U.S. GDP in 2007. In Canada, the GST/HST system recognizes the broad scope of the supplies provided by the PNC sector (Table 3). In many instances, goods and services supplied by the PNC sector compete with the private sector. Given the size of the sector, the potential economic distortions from giving special treatment to PNC sector entities appear to be considerable, if unquantified. Schenk and Oldman reviewed the special treatment (in the sense of tax preferences) of the PNC sector and raised many questions as to its appropriateness. That treatment is responsible in a large part for the incredibly complex -- in the EU but of course elsewhere in the developed world -- VAT on the sector and moves it in a direction opposite of the best practices observed in Australia and New Zealand (see above).<sup>38</sup> The system produces administrative and compliance costs that are commensurate with that complexity. Those costs must be added to the economic inefficiencies caused by the exempt treatment, as identified earlier in the paper. In closing, it is important to note that the distortions from VAT exemption would be amplified if the tax ratio were to increase.

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<sup>35</sup> See Harley Duncan (this volume).

<sup>36</sup> Bird and Gendron (this volume) describe Canadian tax harmonization in some detail.

<sup>37</sup> Bird and Gendron, *supra* note 12, discuss many other related issues of interest but beyond the scope of this paper.

<sup>38</sup> Schenk and Oldman, *supra* note 6, at 283.

## States as Taxable Persons

Based on the Canadian Constitution and existing federal-fiscal arrangements, the federal government of Canada can compel provincial and municipal governments to collect the GST/HST on its behalf. In addition, there has been a history of significant federal-provincial cooperation in both income and sales taxation matters in Canada.<sup>39</sup> In the U.S., constitutional limitations would prevent the federal government from compelling state governments to collect a federal VAT on its behalf. There is precedent for this assertion.<sup>40</sup> This restriction is serious but it is important to note that it would apply only to state and local governments (including their agencies); it would not apply to nonprofit and charitable organizations as well as similar tax-exempt entities as long as they are not the responsibility of state or local governments. In other words, the supplies made by the “NC” portion of the PNC sector could in principle be subject to full taxation under VAT. The same goes for supplies made by the federal government and its agencies.

Consistency of treatment of the entities that make up the PNC sector has emerged, from earlier discussion, as a desirable policy objective. Is there a way to maximize this consistency without simply saying that VAT cannot apply to the supplies of any state or local government entity? Is there a way out of resorting to the convenient but flawed default of exemption? The *option to collect tax* under VAT is a possible solution.<sup>41</sup> This is a method to reduce the negative impacts of the exemption system. In the usual situation, supplies are exempt by default unless the supplier elects to be taxable on some or all of its supplies. Once the election is made, the supplier charges VAT on the supplies to which the option to collect tax applies and then receives credit for the VAT on

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<sup>39</sup> See Bird and Gendron (this volume).

<sup>40</sup> If states were deemed to be taxable persons under a federal VAT, and compelled to comply with federal administration of such a tax, it would raise serious federal constitutional questions. In *Printz v. United States*, 521 U.S. 898 (1997), the U.S. Supreme Court held that the federal Brady Handgun Violence Prevention Act’s requirement that state officials conduct background checks on prospective handgun purchasers imposed unconstitutional obligations on state officers to execute federal laws. Indeed, the Court was categorical in its articulation of the proposition that the Federal Government could not compel the states to enforce a federal program:

The Federal Government may neither issue directives requiring the States to address particular problems, nor command the States’ officers, or those of their political subdivisions, to administer or enforce a federal regulatory program. It matters not whether policymaking is involved, and no case-by-case weighing of the burdens or benefits is necessary; such commands are fundamentally incompatible with our constitutional system of dual sovereignty.

*Id.* at 935. Moreover, in explicitly referring to historical discussion suggesting that “Congress will probably ‘make use of the State officers and State regulations, for collecting’ federal taxes, *The Federalist* No. 36, p. 221 (C. Rossiter ed. 1961) (A. Hamilton),” *id.* at 910, and predicting that “‘the eventual collection [of internal revenue] under the immediate authority of the Union, will generally be made by the officers, and according to the rules, appointed by the several States,’ *id.*, No. 45, at 292 (J. Madison),” *id.*, the Court declared: “But none of these statements necessarily implies -- what is the critical point here -- that Congress could impose these responsibilities without the consent of the States.” *Id.* at 910-11 (emphasis in original). Presumably, however, the Federal Government could induce the states to act as taxable persons with their consent by attaching conditions to federal funds if they refused to cooperate with the federal VAT administration or by providing them with a share of VAT revenues for their cooperation. (I thank Walter Hellerstein for preparing and providing the text of this note.)

<sup>41</sup> I thank Satya Poddar for suggesting the option in the present context.

purchases that are made to deliver the supplies subject to the option. This is simple if all supplies are eligible for the option; then all VAT on purchases is credited against VAT on supplies in determining the net VAT due. If sales consist of mixed supplies, e.g. (a) taxable under the option, and (b) exempt, then input VAT allocations will be necessary to determine the fraction of total VAT paid on purchases that can be credited against the VAT collected on taxable supplies. The option to collect tax is available for financial services in a handful of EU countries at the moment (Belgium, Estonia, France, Germany, and Lithuania). The option is restrictive in that it applies only in those countries and on selected services, and appeals to financial institutions that deal mostly with business customers that can claim credit for VAT paid.<sup>42</sup>

The option to collect tax would be appealing to the states because it would allow recovery of VAT incurred on purchases which would not be recoverable if sales are exempt. Government entities that supply public goods for nil consideration would also find the option -- consistent with full taxation under VAT (Table 2) -- more attractive than exemption since their supplies under the option to tax would be effectively zero-rated: they would not charge any VAT but would be allowed to recover all VAT on purchases.

The main recommendations for VAT design can be summarized as follows:

- Subject the supplies made by the federal government and its agencies, nonprofit and charitable organizations, and similar (non-governmental) *tax exempt* bodies to full taxation under the VAT;
- Exempt the supplies made by state and local governments and their agencies but allow any such organization to elect to make supplies taxable under the option to collect tax; and
- Avoid compensating exemptions or zero-rating upstream in the supply chain.

### **Coordination with Income Taxes**

Adoption of a federal VAT would create opportunities for policy coordination between the said VAT and existing federal and state income taxes. Since there is no reason to expect the income tax-exempt status of nonprofit and charitable organizations to be revoked in the future, and given that this paper argues for full taxation of the PNC sector under VAT, it is important to clarify why there is no inconsistency between VAT and income tax treatments of the PNC sector. Full taxation under VAT is fully consistent with exempt status under the income tax as the former simply implies that registered entities in the PNC sector (as other registered businesses in other sectors) simply act as VAT collection agents for the government. Under full taxation, assuming away exemptions and assuming that all participants are VAT-registered, PNC entities would not bear any VAT on the inputs they purchase. As a result, the tax burden would fall on final consumers and

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<sup>42</sup> EUbusiness, *Modernizing VAT Rules Applied on Financial Services and Insurance – Guide* (Brussels: European Commission, November 29, 2007), available at <http://www.eubusiness.com/Finance/vat-rules-guide/> (accessed on March 30, 2009).

non-registered persons, which is consistent with having consumption as the base. In practice, some non-registered persons may choose to avoid bearing VAT on purchases by registering voluntarily for VAT purposes. This incentive will contribute to moving the base closer to its intended definition.

One of the many advantages of full taxation under VAT is that it creates a paper trail and thus facilitates the coordination of audits between income taxes and the VAT. Based on existing GST and income tax returns, the Canada Revenue Agency can easily check, for example, whether GST collected on supplies is consistent with sales or revenue reported in income tax returns. Since public bodies, in particular, fall under government oversight and since there are already documentation requirements related to nonprofit and charitable status, the tax authority should be able to track taxable transactions in the PNC sector without undue effort. This being said, the system could be made more efficient by harmonizing the tax rules that govern nonprofit, charitable, and other income tax-exempt entities between the federal government and states, and across states. It would be highly desirable for the overall tax treatment of the PNC sector to be neutral with respect to the choice of organizational form.

### **Lessons for the U.S.**

The proper application of VAT to the activities of the PNC sector has long been stifled by apparent conceptual difficulties in capturing the sector's supplies and distributional and other social concerns. This is in spite of a complex treatment revolving around the most common treatment -- exemption, with all the attendant and well-recognized economic non-neutralities. The foregoing discussion has shown those conceptual (rather than economic) concerns to be unfounded, at least in the context of a developed economy with a strong federal or central tax administration such as the U.S.

The main lessons for the U.S. are the following. First, the case for full taxation of the PNC sector under the VAT is strong. Second, the Australian-New Zealand model emerges as the best alternative to the exempt treatment of PNC sector supplies. Under this model, essentially all the goods and services supplied by PNC bodies are within the scope of the VAT and treated like any supplies from the private sector. The Australian-New Zealand model features few instances of zero-rating or exemptions. While the Canadian rebate model works reasonably well, it is complex, it gives rise to several non-neutralities, and is too gradualist.

Were the U.S. to adopt a federal VAT, it would be well advised to get the design right from the start and subject the sector to VAT along the lines of the Australian-New Zealand model and stay as close as possible to full taxation of the PNC sector -- and others -- under the VAT. To address the issue of states as taxable persons, it should modify the model slightly to provide state and local governments (and only those) with the option to collect tax. In comparison with the alternatives, this design would result in the system with the lowest efficiency costs, and possibly the lowest compliance and administrative costs.