THE EFTA SURVEILLANCE AUTHORITY DECISION

No 155/07/COL

of 3 May 2007

on State aid granted in connection with Article 3 of the Norwegian Act on compensation for value added tax (VAT) (Norway)

THE EFTA SURVEILLANCE AUTHORITY [1],

HAVING REGARD to the Agreement on the European Economic Area [2], in particular to Articles 61 to 63 and Protocol 26 thereof,

HAVING REGARD to the Agreement between the EFTA States on the establishment of a Surveillance Authority and a Court of Justice [3], in particular to Article 24 thereof,

HAVING REGARD to Article 1(2) of Part I and Articles 4(4), 6, 7(5), 10 and 14 of Part II of Protocol 3 to the Surveillance and Court Agreement,

HAVING REGARD to the Authority's Guidelines [4] on the application and interpretation of Articles 61 and 62 of the EEA Agreement,

HAVING REGARD to the Authority's Decision of 14 July 2004 on the implementing provisions referred to under Article 27 of Part II of Protocol 3 to the Surveillance and Court Agreement,

HAVING REGARD to the Authority's Decision No 225/06/COL of 19 July 2006 to open the formal investigation procedure with regard to Article 3 of the Norwegian Act on compensation for value added tax (VAT) [5],

HAVING CALLED on Norway and interested parties to submit their comments to this Decision and having regard to the Norwegian authorities' comments,

Whereas:

I. FACTS

1. Procedure

By letter dated 16 October 2003, the Authority received a complaint in which it was alleged that a particular kind of schools, which provide specialised services to the off-shore sector in competition with the complainant, receive State aid through the application of input tax compensation provided for in Article 3 of the Value Added Tax Compensation Act [6]. Municipal schools that provide certain educational services exempted from the application of VAT in competition with other undertakings receive a compensation for the input VAT paid on goods and services purchased in relation to the services they provide on a commercial basis, to which private competitors are not entitled. The letter was received and registered by the Authority on 20 October 2003 (*Doc. No 03-7325 A*).

After various exchanges of correspondence [7], by letter dated 19 July 2006 (Event No 363440), the Authority informed the Norwegian authorities that it had decided to open the formal investigation procedure foreseen under Article 4 in Part II of Protocol 3 to the Surveillance and Court agreement with regard to Article 3 of the Norwegian Act on compensation for value added tax (VAT) with Decision No 225/06/COL.

The Norwegian authorities submitted comments to this Decision by letter dated 18 September 2006 (Event No 388922).

The Authority's Decision No 225/06/COL was published in the Official Journal of the EU C 305 of 14 December 2006 and the EEA Supplement No 62 of the same date. No further comments from third parties were received after the publication.

2. Legal framework on VAT and VAT Compensation in Norway

The VAT Compensation Act entered into force on 1 January 2004 with the objective to mitigate distortion of competition resulting from the VAT Act.

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[1] Hereinafter referred to as the Authority.
[2] Hereinafter referred to as the EEA Agreement.
[3] Hereinafter referred to as the Surveillance and Court Agreement.
[4] Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement and Article 1 of Protocol 3 to the Surveillance and Court Agreement, adopted and issued by the EFTA Surveillance Authority on 19 January 1994, published in OJ 1994 L 231, EEA Supplements 3.9.1994 No 32. The Guidelines were last amended on 7 February 2007. Hereinafter referred to as the State Aid Guidelines.
[5] Published on the OJ C 305, 14.12.2006 and the EEA Supplement No 62, 14.12.2006, p. 1.
[6] Act No 108 of 12 December 2003 on VAT compensation to local and regional authorities (Lov om kompensasjon av merverdiavgift for kommuner, fylkeskommuner mv). Hereinafter referred to as the 'VAT Compensation Act'.
[7] For further details see the Authority's Decision No 225/06/COL, published on the OJ C 305, 14.12.2006.

VAT is a consumption tax entailing the application of a tax exactly proportionate to the price of supplies of goods and services, independently from the number of transactions taking place in the production or distribution process before the stage at which the tax is eventually charged to an ultimate customer.

As a main rule, a person engaged in trade or business and liable to VAT registration (hereinafter 'taxable person'), shall calculate and pay tax on sales of goods and services covered by the VAT Act ([1]) and may deduct input tax on goods and services for use in an enterprise from the output tax charged on sales ([2]). Thus, the VAT system taxes all supplies by all taxable persons equally. This neutrality is one of the main features of the VAT system.

However, Articles 5, 5a and 5b in Chapter I of the VAT Act exempt certain transactions from the scope of application of the VAT Act: sales by certain institutions, organisations etc. ([3]), the supply and letting of real estate or rights to real property, the supply of certain services, amongst others, the supply of health and health related services, social services, educational services, financial services, services related to the exercise of public authority, services in the form of entitlement to attend theatre, opera, ballet, cinema and circus performances, exhibitions in galleries and museums, lottery services, services connected with the serving of foodstuffs in school and student canteens, etc. ([4]).

It follows from the above that any taxable person carrying out the supply of goods and services which are exempt from the VAT Act pays input tax on its purchases of goods and services but cannot deduct the input tax from its tax liability because for such purchases the taxable person is the ultimate customer.

The consequence of the exemption is that the suppliers of the exempted goods and services have to pay input tax on the services and goods they purchase as any final consumer (without having the possibility to charge output tax to the ultimate consumer). This logical consequence of the VAT exemptions has, however, created a distortion at another level. Public entities, just as any integrated company which is tax exempted, will have an incentive to procure 'in-house' ([5]) instead of acquiring services or goods in the market. In order to create a system without any particular incentive to produce goods or services with own resources compared to external acquisition, the Norwegian authorities adopted the VAT Compensation Act.

Article 2 of the VAT Compensation Act lists the entities covered by the Act exhaustively:

(a) local and regional authorities carrying out local or regional activities in which the local council or county council or another council under the Local Government Act ([6]) or other special local governmental legislation is the supreme body;

(b) intermunicipal companies established according to the Local Government Act or other special local governmental legislation;

(c) private or non-profit undertakings in as far as they carry out health, educational or social services which are statutory obligations of local or regional authorities;

(d) day care institutions as mentioned in Article 6 of the Day Care Act ([7]);

(e) Joint Parish Council (Kirkelig fellesråd).

It follows from Article 3 read in conjunction with Article 4(2) of the VAT Compensation Act, that the Norwegian State compensates input tax paid by taxable persons covered by the VAT Compensation Act when buying goods and services from other taxable persons when they do not have the right to deduct input tax since they are tax exempted according to the VAT Act ([8]).

([1]) Article 10(1) in Chapter III of the VAT Act. See in this respect Chapter IV in connection with Chapter I of the VAT Act.
([2]) Article 21 in Chapter VI of the VAT Act.
([3]) Reference is made to Article 5 of the VAT Act according to which sales by certain entities like museums, theatres, non profit associations, etc, exempted from the application of VAT. Article 5(2) of the VAT Act states that the Ministry of Finance may issue regulations delimiting and supplementing the provisions in the first subsection and may stipulate that businesses referred to in the first subsection, 1 f) shall nevertheless calculate and pay output tax if the exemption brings about a significant distortion of competition in relation to other, registered businesses that supply equivalent goods and services.
([4]) See Article 5b of the VAT Act.
([5]) 'In-house' procurement is not considered as a transaction liable for VAT purposes.
([6]) Act No 107 of 25 September 1992 on Local Government (Lov om kommuner og fylkeskommuner).
([7]) Act No 64 of 17 June 2005 on Day Care Institutions (Lov om barnehager).
([8]) For a more detailed explanation on the functioning of the VAT system in Norway, reference is made to Section I.2 'Legal framework on VAT and VAT compensation in Norway' of Decision No 225/06/COL, p. 2.

3. **The doubts the Authority expressed in the Decision to open the formal investigation procedure**

In Decision No 225/06/COL to open the formal investigation procedure with regard to Article 3 of the VAT Compensation Act, the Authority's preliminary consideration was that the input tax compensation as provided for in Article 3 of the VAT Compensation Act constituted State aid within the meaning of Article 61(1) of the EEA Agreement.

The Authority considered that the compensation granted under the VAT Compensation Act was granted by the State through state resources from the State Budget. In the Authority's view it was not relevant for this assessment whether or not the State's cost of the compensation at the central level is counterbalanced by reduced transfers to the local and regional authorities as such.

The Authority further considered that, to the extent that the Norwegian authorities compensate input tax on purchases of goods and services to undertakings not subject to VAT but falling within the scope of Article 2 of the VAT Compensation Act, they grant those undertakings an economic advantage.

In the assessment of selectivity, the Authority raised doubts as to whether the VAT compensation, which in its view constituted a materially selective measure, could be justified by the nature and logic of the VAT system, i.e., whether it met the objectives inherent in the VAT system itself, or whether it pursued other objectives, external to the VAT system. According to the explanations given by the Norwegian authorities, the objective pursued with the introduction of the VAT Compensation Act was to facilitate and encourage the choice by the taxable persons covered by the VAT Compensation Act between self supply and outsourcing of goods and services subject to VAT. The Authority had doubts as to whether this purpose could be said to be in the nature and logic of the VAT system itself which is a tax on consumption. In the Authority's preliminary view, the VAT compensation was not a part of the VAT system, established in 1970, as such but a separate measure, introduced later, to rectify some of the distortions created by the VAT system.

The Authority pointed out that while mitigating distortions for municipal acquisitions, the VAT compensation had created a distortion of competition between undertakings carrying out the same economic activities in sectors exempted from the application of VAT.

The Authority recalled that, in principle, the beneficiaries under the VAT compensation scheme can receive compensation for input VAT under the conditions of the scheme, regardless of whether aid to operators in these sectors would have an effect on trade. Some of the sectors covered by the VAT Compensation Act are partly or fully open for EEA-wide competition. Aid granted to undertakings in these sectors is thus capable of affecting trade between the Contracting Parties to the EEA Agreement. The Authority had to assess the scheme as such and not its application to each individual sector covered. Based on jurisprudence, the Authority's preliminary conclusion was that, as a general nationwide scheme, the VAT Compensation Act was capable of affecting trade between the Contracting Parties.

Finally, the Authority expressed doubts that the input tax compensation could be considered compatible with the State aid rules of the EEA Agreement following the application of any of the exceptions foreseen under Articles 61(2) and (3) of the said agreement. Moreover, although aid could potentially, in some situations, be considered compatible under the derogation foreseen in Article 59(2) of the EEA Agreement, the Authority was of the preliminary view that this provision did not justify the compatibility of the VAT Compensation Act as a scheme.

4. **Comments by the Norwegian authorities**

By letter dated 18 September 2006 (Event No 388922), the Norwegian authorities submitted comments to the Authority's Decision to open the formal investigation procedure. The comments were divided into three sections:

4.1. *The framework of the VAT Compensation scheme*

The Norwegian authorities explained that VAT is a general tax that applies, in principle, to all commercial activities involving the production and distribution of goods and the provisions of services. VAT incurred on expenses is recoverable only to the extent that the tax payer provides services which are subject to VAT. Under the current VAT rules, most of the activities in the municipal sector are not subject to VAT:

'Municipal activity is generally outside the VAT system. Basic municipal activities such as health services, educational services and social services are not subject to VAT. Economic activities in which municipalities engage as a "public authority" are outside the scope of VAT. Thus, VAT incurred by the municipalities related to exempt or non-taxable activities is an unrecoverable cost. It may be referred to as a "hidden VAT cost". It may also be seen as an anomaly of the VAT system. Since the VAT system is supposed to be governed by a principle of neutrality, the VAT treatment of the municipalities may distort competition. Due to the fact that the municipalities may not claim back the VAT paid on inputs provided by the private sector, it may also introduce a bias for public authorities towards self-supply of services liable for VAT versus contracting out to the private sector.'

By compensating the municipalities for input tax on all goods and services, the Norwegian authorities argued that the purpose of the general VAT compensation scheme is to create a level playing field between self supply and outsourcing:

'The VAT will no longer distort the municipal authorities' incentives when choosing between "in-house" production of services and purchase of services liable for VAT from private service providers. […] Neutrality can therefore be deemed as the objective assigned to the VAT compensation scheme.'

The Norwegian authorities stressed the view already expressed in the preliminary phase of the investigation that the VAT compensation scheme does not constitute an aid measure for the undertakings falling within the scope of Article 2 of the VAT Compensation Act. The reason for this statement is that when the general VAT compensation scheme was introduced in 2004, the municipal appropriations in the annual fiscal budget were reduced accordingly by the expected amount of input tax compensated. The VAT compensation scheme has therefore no revenue effects for the Government. Thus the system may be described as a self-funding system through allocation of a rebate/compensation cost to municipalities.

4.2. *State aid within the meaning of Article 61(1) of the EEA Agreement*

In the letter dated 18 September 2006, the Norwegian authorities expressed their disagreement with the assessment of the Authority that the VAT Compensation Act constitutes State aid for the following reasons:

Economic advantage

The Norwegian authorities believe that it is not correct to deem the VAT compensation as an 'advantage', which relieves undertakings of charges that are normally borne from their budgets. Because the municipalities fund the VAT compensation scheme themselves through a reduction of the general grants, no factual economic relief is granted. The VAT compensation scheme neither implies any reduction in the amount of tax nor any kind of tax deferment. Consequently, in the opinion of the Norwegian authorities, it is wrong to compare the VAT compensation scheme to measures which imply a genuine reduction in the recipient's tax burden.

Selectivity

The scope of the VAT Compensation Act is positively defined in that only legal persons falling within Article 2 of the Act can be compensated for input tax on purchases.

A selective tax measure can nevertheless be justified due to the nature or general scheme of the tax system in question. The Norwegian authorities considered that by stating that the VAT compensation is not a part of the VAT system, the Authority dismissed their argument that the VAT compensation can be deemed to be in line with the nature and logic of the VAT system itself. The Norwegian authorities objected to this approach referring to Chapter 17B.3.1 et seq. of the Authority's State Aid Guidelines where various aspects of differential measures are looked into. They considered that VAT compensation is justified by the nature or general scheme of the tax system in question and referred to Chapter 17B.3.4 of the State Aid Guidelines 'Application of State aid rules to measures relating to direct business taxation'. It is a fundamental principle that the VAT system should be neutral and non-discriminatory. In the opinion of the Norwegian authorities, neutrality may therefore be seen as inherent in the VAT system itself. Neutrality, which is inherent to the VAT system, is also the objective assigned to the VAT compensation scheme. Therefore, the Norwegian authorities believed that it is fair to consider the VAT compensation scheme to be in line with the nature and logic of the VAT system itself.

Moreover, they noted that in case the VAT compensation scheme should be phased out, the distortion of competition resulting from the VAT system would be revived: 'The fact that the municipalities cannot recover VAT on inputs would distort the municipal authorities' incentives when choosing between "in-house" production of services and purchase of services liable for VAT from private service providers.'

The Norwegian authorities pointed out that, in order to mitigate distortion of competition resulting from the VAT system, the so-called Rattsø Committee assessed several possible measures before it decided that the VAT compensation scheme would be the most suitable [1]. One of the possible measures the Committee assessed was to extend the municipalities' right to deduct input VAT. Another possible measure would be to make the municipalities subject to VAT in general. The Rattsø Committee did not choose to extend the municipalities' right to deduct input VAT because this measure would imply a disruption to VAT as a general tax. It was also taken into consideration that this measure could create pressure from other groups. Nor did the Rattsø Committee choose to make the municipalities subject to VAT in general. Among other factors, the Committee pointed out that because many municipal services are performed free of charge, there is a lack of calculation basis for the VAT:

'Extension of the municipalities rights to deduction and making the municipalities subject to VAT in general would both be solutions within the VAT system. The motive of these measures, to mitigate the distortion of competition resulting from the VAT system, would, however, be exactly the same as to that of the VAT compensation scheme. Moreover, there is in an economic sense no difference between the compensation scheme and extending the municipalities right to deduct input tax. Thus, the Ministry believes that in itself the framing of the VAT compensation scheme can be of no consequence.'

[1] Norges Offentlige Utredinger (NOU) 2003: 3, Merverdiavgiften og kommunene, Konkurransevridninger mellom kommuner og private (hereinafter referred to as the 'Rattsø report').

Effect on trade

The Norwegian authorities criticised the Authority's assessment of the 'effect on trade' criteria.

'Through the VAT compensation scheme the municipalities are primarily granted refund of input tax on goods and services purchased for their mandatory activities. By law the municipalities are imposed to perform certain services. This is specially the case on the education, health and social area. For instance, in the health sector the municipalities, among other things, are instructed to provide for general practitioner services, nursing services, midwife services and nursing home services. In the social sector the municipalities are instructed to provide for practical and economic support to the receivers, e.g. social housing.'

'Pursuant to Article 2 and 3 of the VAT Compensation Act, VAT compensation may also be granted to municipalities which carry out non-mandatory activities. Besides the special training performed by the topical county municipal schools, the Ministry does, however, not know of any areas outside the scope of the VAT system where it is questioned whether the recipients of VAT compensation perform their services in competition with other undertakings within the EEA.'

The Norwegian authorities consequently believed that in sectors which are exempted from the scope of application of the VAT Act, very few undertakings established in neighbouring European countries would provide services in competition with Norwegian undertakings covered by the VAT Compensation Act. Moreover, circumstances such as physical distance to the service provider, language difficulties and other forms of cultural attachment are decisive when a service provider is chosen.

The Norwegian authorities considered that in order to perform a true assessment of the VAT compensation scheme in relation to the criteria set out in Article 61(1) of the EEA Agreement, it should be relevant that the competition between Norwegian undertakings and other undertakings in the EEA on sectors exempted from the application of VAT is quite marginal.

Thus, the Norwegian authorities believed that VAT compensation granted to undertakings in sectors exempted from the application of VAT cannot be deemed as capable of affecting trade between the Contracting Parties to the EEA Agreement.

4.3. *General comments*

The Norwegian authorities referred to several EU Member States which have introduced refund schemes for the VAT costs on non-taxable or tax-exempt activities for local governments. In Sweden, Denmark, Finland, the Netherlands and the United Kingdom different schemes which provide for refunds of VAT to local governments have been established to eliminate distortions in the decision making of public authorities between public provision and contracting out of public services. Various VAT refund systems of a broadly similar nature are also established in France, Luxembourg, Austria and Portugal.

Further, the Norwegian authorities quoted former Commissioner Mr Bolkestein. In a letter of 1 February 2000 to Michel Hansenne (Belgium), who had asked the European Parliament whether the VAT compensation scheme in the United Kingdom was in compliance with the sixth VAT Directive, Mr Bolkestein stated that a VAT compensation scheme 'does not conflict with the sixth VAT Directive' since 'it entails a purely financial operation between different public bodies and is governed by the respective national policy for the financing of public authorities'.

Mr Bolkestein also commented on 'a possible scheme whereby the Irish Government would give a subsidy to Irish charities of an amount equivalent to the non-deductive VAT that they had incurred'. He stated that 'the granting of government subsidies is in itself not contrary to the European Union VAT law'.

The Norwegian authorities admitted that none of these quotations directly addressed the State aid rules. However, in their opinion, it appears from these quotations that the VAT compensation schemes are not deemed to be in conflict with the sixth VAT Directive. In their view, this reflects the fact that VAT compensation schemes are in line with the nature and logic of the VAT system itself.

II. **APPRECIATION**

1. **The presence of State aid**

1.1. *Introduction*

Article 61(1) of the EEA Agreement reads as follows:

'Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Contracting Parties, be incompatible with the functioning of this Agreement.'

The Authority would like to make a preliminary remark regarding the scope of the current assessment. This Decision does not address the decision of the Norwegian authorities to exempt certain transactions from the scope of the application of the VAT Act. It only concerns the compensation for input tax paid by certain persons falling within the scope of the VAT Compensation Act.

Further, the Authority would also like to stress three remarks it already made in Decision No 225/06/COL:

Firstly, as a general rule, the tax system of an EFTA State is not covered by the EEA Agreement. It is for each EFTA State to design and apply a tax system according to its own choices of policy. However, application of a tax measure, such as the input tax compensation provided for in Article 3 of the VAT Compensation Act, may have consequences that would bring it within the scope of Article 61(1) of the EEA Agreement. According to the case-law ([1]), Article 61(1) does not distinguish between measures of State intervention by reference to their causes or aims but defines them in relation to their effects.

Secondly, the question as to whether the measure at issue constitutes State aid arises only in so far as it concerns an economic activity, that is, an activity consisting of offering goods and services on a given market ([2]). A measure constitutes State aid only if it benefits undertakings. For the purposes of application of the rules on competition, the concept of an undertaking encompasses entities 'engaged in an economic activity, regardless of the legal status of the entity and the way in which it is financed' ([3]). Although some of the entities which receive input tax refunds do not fulfil the condition of being an undertaking, the fact that some beneficiaries of the VAT Compensation Act are undertakings constitutes sufficient grounds to assess the scheme as such for State aid purposes ([4]).

Thirdly, aid may be granted to public undertakings as well as to private undertakings ([5]). A public undertaking, in order to be regarded as a recipient of State aid does not necessarily need to have a legal identity separate from the State. That an entity is governed by public law and is a non-profit making institution does not necessarily mean that it is not an 'undertaking' within the meaning of the State aid rules ([6]).

Fourthly, regarding the general comments from the Norwegian authorities about the existence of similar schemes within the European Union, the Authority would like to note that these systems may be different from the VAT Compensation Act and that it has informed the European Commission about the observations of the Norwegian authorities. Moreover, according to case law 'any breach by a Member State of an obligation under the Treaty in connection with the prohibition laid down in Article 92 cannot be justified by the fact that other Member States are also failing to fulfil this obligation' ([7])

In the following, the Authority will assess whether the VAT Compensation Act as a scheme ([8]) fulfils the criteria foreseen under Article 61(1) of the EEA Agreement to be considered State aid.

1.2. *State resources*

In order to constitute State aid within the meaning of Article 61(1) of the EEA Agreement, the aid must be granted by the State through state resources.

The compensation is granted by the State directly and is therefore granted by the State through state resources.

The Norwegian authorities have argued that the VAT compensation scheme does not constitute an aid measure because it is a self-funding system. In their opinion, municipalities fund the VAT Compensation scheme themselves through a reduction of the general transfers from the State budget to the municipalities. With the introduction of the VAT compensation scheme in 2004, the municipal appropriations in the annual fiscal budget were reduced in accordance with the expected amount of input tax compensated.

The Authority considers that for State aid purposes it is not relevant whether the amount of money received by the municipalities has been diminished or not. What is important is whether undertakings within the meaning of the competition rules have received financial support by the State through state resources. When a municipality acts as an undertaking it should be viewed for State aid purposes separately from the municipality as a public authority. Whether the State's cost of the compensation at the central level is counterbalanced by reduced transfers to the local and regional authorities as such does not alter this conclusion. The refund for input tax paid is financed from the state budget and therefore constitutes state resources.

Moreover, in the Authority's understanding, each municipality does not get a reduction in the state transfer exactly corresponding to the exact VAT compensation it receives.

([1]) Case E-6/98 *Norway v EFTA Surveillance Authority* [1999] EFTA Court Report, p. 76, paragraph 34; Joined Cases E-5/04, E-6/04 and E-7/04 *Fesil and Finnfjord, PIL and others and Norway v EFTA Surveillance Authority* [2005] Report of the EFTA Court, p. 121, paragraph 76; Case 173/73 *Italy v Commission* [1974] ECR 709, paragraph 13; and Case C-241/94 *France v Commission* [1996] ECR I-4551, paragraph 20.

([2]) Joined Cases C-180/98 to C-184/98 *Pavlov and others* [2000] ECR I-6451, paragraph 75.

([3]) Case C-41/90 *Höfner and Elser* [1991] ECR I-1979, paragraph 21.

([4]) Case E-2/05 *EFTA Surveillance Authority v Iceland* [2005] Report of the EFTA Court, p. 202, paragraph 24.

([5]) Case C-387/92 *Banco Exterior de España* [1994] ECR I-877, paragraph 11.

([6]) Case C-244/94 *Fédération Française des Sociétés d'Assurance et a.* [1995] ECR I-4013, paragraph 21; and Case 78/76 *Steinike & Weinlig* [1977] ECR 595, paragraph 1.

([7]) Case 78/76 *Steinike & Weinlig*, cited above paragraph 24, Case T-214/95 *Het Vlaamse Gewest v Commission* [1998] ECR II-717, paragraph 54.

([8]) The Authority assessed in Section II.2.1 of Decision No 225/06/COL that the VAT Compensation Act constitutes an aid scheme. Reference is made to that assessment.

1.3. *Economic advantage*

A financial measure granted by the State or through state resources to an undertaking which would relieve it from costs which would normally have to be borne by its own budget constitutes an economic advantage ([1]).

The Norwegian authorities have argued that the VAT compensation scheme does not constitute an advantage because the scheme neither entails a reduction in the amount of tax nor any tax deferment. The VAT compensation scheme does not imply any reduction in the recipient's tax burden.

The Authority does not share this approach. In its opinion the Norwegian authorities do not make the necessary differentiation between the various spheres of the State, i.e., in this case the State as tax authority, the municipalities as state bodies and municipal undertakings as separate entities for State aid purposes.

To determine whether an economic advantage has been granted, the Authority has to assess whether a measure relieves its beneficiaries of charges that they normally bear in the course of their business. The payment of input tax is an operating cost related to purchases in the normal course of an undertakings' economic activity, which is normally borne by the undertaking itself. To the extent that the Norwegian authorities compensate input tax on purchases of goods and services to undertakings falling within the scope of Article 2 of the VAT Compensation Act, they grant those undertakings an economic advantage. They are granted an advantage because the operating costs which those undertakings will have to put up with are reduced in accordance with the amount of input tax compensated.

The VAT Compensation Act therefore entails the granting of an economic advantage to the beneficiaries of the scheme.

1.4. *Selectivity*

Further, to constitute State aid within the meaning of Article 61(1) of the EEA Agreement, the aid measure must be selective in that it favours 'certain undertakings or the production of certain goods'.

In Decision No 225/06/COL, the Authority considered that the VAT Compensation Act constituted a materially selective measure. The scope of the VAT Compensation Act is positively defined in that only taxable persons falling within Article 2 of the VAT Compensation Act can be compensated for input tax on purchases. The advantage granted under the VAT Compensation Act for undertakings refunded for their input tax implies a relief from the obligation that follows from the general VAT system applicable to all buyers of goods and services.

The Court's jurisprudence has established that a specific tax measure can nevertheless be justified by the internal logic of the tax system if it is consistent with it ([2]). Any measure intended partially or wholly to exempt firms in a particular sector from the charges arising from the normal application of the general system constitutes State aid if there is no justification for this exemption on the basis of the nature and logic of the general system ([3]).

The Authority will assess whether the input tax refund provided for in Article 3 of the VAT Compensation Act falls within the logic of the VAT system. For this assessment, the Authority must consider whether the input tax refund meets the objectives inherent in the VAT system itself, or whether it pursues other objectives not enshrined in the VAT system.

The primary objective of the VAT system is to tax certain supplies of goods or services. The VAT is an indirect tax on the consumption of goods and services. As a rule, VAT is calculated at all stages of the supply chain and on the import of goods and services from abroad. The ultimate consumer pays VAT as part of the purchase price, without the right to deduct the tax.

Although, in principle, all sales of goods and services are liable to VAT, some transactions may be exempt (and as a consequence without a credit for input tax) which means that such supplies are not taxable.

Articles 5, 5a and 5b in Chapter I of the Norwegian VAT Act exempt transactions such as supply and letting of real estate, supply of health and health-related services, social services, educational services, financial services, etc. The providers of these goods and services are treated as final consumers for VAT purposes since they have to pay input tax without being able to request output tax. The consequence of the logic of the system is that exempted supplies of goods and services and final consumers pay input tax without having the possibility to deduct it.

([1]) Joined Cases E-5/04, E-6/04 and E-7/04 *Fesil and Finnfjord, PIL and others and Norway v EFTA Surveillance Authority*, cited above, paragraphs 76 and 78-79; Case C-301/87 *France v Commission* [1990] ECR I-307, paragraph 41.

([2]) Case E-6/98 *Norway v EFTA Surveillance Authority*, cited above, paragraph 38; Joined Cases E-5/04, E-6/04 and E-7/04 *Fesil and Finnfjord, PIL and others and Norway v EFTA Surveillance Authority*, cited above, paragraphs 84-85; Joined Cases T-127/99, T-129/99 and T-148/99 *Territorio Histórico de Alava et a v Commission* [2002] ECR II-1275, paragraph 163, Case C-143/99 Adria-Wien Pipeline [2001] ECR I-8365, paragraph 42; Case T-308/00 *Salzgitter v Commission* [2004] ECR II-1933 paragraph 42, Case C-172/03 *Wolfgang Heiser* [2005] ECR I-1627, paragraph 43.

([3]) Case E-6/98 *Norway v EFTA Surveillance Authority* [1999] EFTA Court Report, p. 76, paragraph 38; Joined Cases E-5/04, E-6/04 and E-7/04 *Fesil and Finnfjord, PIL and others and Norway v EFTA Surveillance Authority*, cited above, paragraphs 76-89; Case 173/73 *Italy v Commission* [1974] ECR 709, paragraph 16.

This logical consequence of the VAT system had created, however, a distortion at another level, which the Norwegian authorities have tried to offset with the introduction of the VAT Compensation Act. Thus, it follows that the logic of the VAT Compensation Act is to counterbalance the natural logical consequence of the VAT system when exempting certain supplies. Hence, the logic of the VAT Compensation Act is not to tax end users, as it is in the general VAT system, but to alleviate a certain group of final consumers to avoid distortion of competition between 'in-house' and outsourcing for transactions subject to VAT.

The Norwegian authorities have explained that, according to Article 1 of the VAT Compensation Act, the objective of the input tax compensation was to create a level playing field between self-supply and outsourcing of goods and services subject to VAT.

The Authority considers that to compensate for paid input tax for other reasons than the ones set in the VAT system, is not justified by the objective of taxation of a given activity, which primarily inspires the VAT system. The objective pursued by the Norwegian authorities in creating a level playing field between self supply and outsourcing by public entities of goods and services subject to VAT should be seen as commendable as such but can hardly be said to be in the nature and logic of the VAT system itself. In this sense, the Authority refers in particular to the *Heiser* [1] jurisprudence according to which the mere fact that a measure has a laudable purpose does not suffice to exclude it from classification as aid within the meaning of Article 61(1) of the EEA Agreement. Article 61(1) of the EEA Agreement does not distinguish between measures of State intervention by reference to their causes or aims but defines them in relation to their effects [2].

The Authority does not ignore that the aim pursued by the Norwegian authorities with the introduction of the VAT Compensation Act was to create neutrality in the procurement of goods and services subject to VAT for the public administration. This neutrality cannot be confused with the neutrality inherent in the VAT system.

Since the purpose of creating a level playing field between 'in-house' supply and outsourcing of supplies of goods and services for public authorities is not in line with the logic of the VAT system, this aim could only be taken into consideration in the assessment of compatibility of the measure in question.

For the above-mentioned reasons, the Authority concludes that the VAT compensation cannot be justified by the nature and logic of the VAT system. It therefore constitutes a selective measure.

1.5. *Distortion of competition*

A measure must distort or threaten to distort competition for it to fall within the scope of Article 61(1) of the EEA Agreement.

Only public and private entities falling within the scope of Article 2 of the VAT Compensation Act benefit from input tax compensation. However, when these entities provide services exempted from the application of VAT in competition with undertakings falling outside the scope of Article 2 of the VAT Compensation Act, the latter will have to put up with higher purchase costs even though they carry out similar services. Although the input tax compensation has been aimed at mitigating distortions for municipal acquisitions, it has created a distortion of competition between public authorities carrying out economic activities and private undertakings carrying out the same economic activities in sectors exempted from the application of VAT. Accordingly, due to the intervention of the State, the products offered by private operators would, all other factors being similar, be more expensive. Thus competition is distorted. In areas where both public and private operators are compensated, the aid would still threaten to distort competition between national and other EEA operators operating in the same market.

Thus, regarding compensation granted to undertakings producing goods or offering services exempted from the application of VAT, the Authority considers that there is a distortion of competition between undertakings.

1.6. *Effect on trade*

A State aid measure falls within the scope of Article 61(1) of the EEA Agreement only in so far as it affects trade between the Contracting Parties to the EEA Agreement.

In their comments to the Authority's Decision No 225/06/COL, the Norwegian authorities have contested the Authority's assessment of the effect on trade criterion which was, in their opinion, not based on a fair conception of the situation. In their view, through the VAT compensation scheme municipalities are primarily granted refunds of input tax on goods and services purchased for their mandatory activities. Regarding the non-mandatory activities which municipalities may carry out, the Norwegian authorities failed to see any areas exempted from the application of VAT where the recipients of VAT compensation perform their services in competition with other undertakings within the EEA, apart from the particular kind of schools addressed by the complainant. The Norwegian authorities believe that there are very few undertakings established in neighbouring European countries which compete with Norwegian undertakings covered by the VAT Compensation Act.

[1] Case C-172/03 *Wolfgang Heiser*, cited above.
[2] Case C-159/01 *Netherlands v Commission* [2004] ECR I-4461, paragraph 51.

The Authority reiterates its position expressed in Decision No 225/06/COL regarding the assessment of the effect on trade. The Authority is required to examine whether an aid scheme is liable to affect trade within the EEA and not to determine its actual effect ([1]). In principle, all beneficiaries under the VAT compensation scheme can receive compensation for input VAT under the conditions of the scheme, regardless of whether aid to a concrete operator would have an effect on trade. Case law of the ECJ has established that 'in the case of an aid scheme, the Commission may confine itself to examining the general characteristics of the scheme in question without being required to examine each particular case in which it applies.' ([2]). The EFTA Court has also endorsed this interpretation ([3]).

The criterion of the effect on trade has been traditionally interpreted to the effect that, in general terms, a measure is considered to be State aid if it is capable of affecting trade between the EEA States ([4]). Even if the Norwegian authorities are correct in their estimation that only a few undertakings within the EEA compete with the beneficiaries of the VAT Compensation Act, the aid measure may nevertheless affect trade since neither the number of beneficiaries nor the number of competitors are significant elements for the assessment of the criterion effect on trade within the meaning of Article 61(1) of the EEA Agreement ([5]).

The granting of state support to an undertaking may lead to the internal supply being maintained or increased, with the consequence being that the opportunities for other undertakings to penetrate the market of the EEA States concerned are reduced ([6]). Therefore, the character of the aid does not depend on the local or regional character of the services supplied or on the scale of the field of activity concerned ([7]).

There is no threshold or percentage below which it may be considered that trade between the Contracting Parties is not affected ([8]). Rather on the contrary, according to the jurisprudence ([9]), whenever state financial aid strengthens the position of an undertaking compared with other undertakings competing in intra-EEA trade, the latter must be regarded as affected by that aid.

Articles 5 and 5a in Chapter I of the VAT Act exempt certain transactions from the scope of application of the VAT Act. Furthermore, Article 5b of the same Act foresees that the supply of certain services, amongst others the supply of health and health related services, social services, educational services, financial services, services related to the exercise of public authority, services in the form of entitlement to attend theatre, opera, ballet, cinema and circus performances, exhibitions in galleries and museums, lottery services, services connected with the serving of foodstuffs in school and student canteens, etc., are not covered by the Act. All theses services are hence exempted from the application of VAT but are, in principle, covered by the VAT Compensation Act ([10]). Some of these sectors, such as, for example, financial services, services connected with the serving of foodstuffs in schools and students canteens, some dental services, some educational services provided for remuneration, some cinema services, are partly or fully open for EEA-wide competition. Aid granted to undertakings in sectors which are open to competition is thus capable of affecting trade between the Contracting Parties to the EEA Agreement.

For these reasons, and taking into account the Court's jurisprudence, the Authority considers that the VAT Compensation Act is a general nationwide compensation scheme which is capable of affecting trade between the Contracting Parties to the EEA Agreement.

1.7. *Conclusion*

For the above-mentioned reasons, the Authority concludes that the VAT Compensation Act constitutes a State aid scheme within the meaning of Article 61(1) of the EEA Agreement.

([1]) Case C-298/00 P *Italy v Commission* [2004] ECR I-4087, paragraph 49, and Case C-372/97 *Italy v Commission* [2004] ECR I-3679, paragraph 44.

([2]) Case T-171/02 *Regione autonoma della Sardegna v Commission* [2005] ECR II-2123, paragraph 102; Case 248/84 *Germany v Commission* [1987] ECR 4013, paragraph 18; Case C-75/97 *Belgium v Commission* [1999] ECR I-3671, paragraph 48; and Case C-278/00 *Greece v Commission* [2004] ECR I-3997, paragraph 24.

([3]) Case E-6/98 *Norway v EFTA Surveillance Authority*, cited above, paragraph 57 and Case E-2/05 *EFTA Surveillance Authority v Iceland* [2005] Report of the EFTA Court, p. 202, paragraph 24.

([4]) Joined Cases T-298/97-T-312/97 e.a. *Alzetta a.o. v Commission* [2000] ECR II-2319, paragraphs 76-78.

([5]) Case C-71/04 *Administración del Estado v Xunta de Galicia* [2005] ECR I-7419, paragraph 41; Case C-280/00 *Altmark Trans* [2003] ECR I-7747, paragraph 81; Joined Cases C-34/01 to C-38/01 *Enirisorse* [2003] ECR I-14243, paragraph 28; Case C-142/87 *Belgium v Commission* ('Tubemeuse') [1990] ECR I-959, paragraph 43; Joined Cases C-278/92 to C-280/92 *Spain v Commission* [1994] ECR I-4103, paragraph 42.

([6]) Case E-6/98 *Norway v EFTA Surveillance Authority*, cited above, paragraph 59; Case C-303/88 *Italy v Commission* [1991] ECR I-1433, paragraph 27; Joined Cases C-278/92 to C-280/92 *Spain v Commission* [1994] ECR I-4103, paragraph 40, Case C-280/00 Altmark Trans, cited above, paragraph 78.

([7]) Case C-280/00 *Altmark Trans*, cited above, paragraph 77; Case C-172/03 *Wolfgang Heiser* [2005] ECR I-1627, paragraph 33; Case C-71/04 *Administración del Estado v Xunta de Galicia* [2005] ECR I-7419, paragraph 40.

([8]) Case C-280/00 *Altmark Trans* [2003] ECR I-7747, paragraph 81, Case C-172/03 *Wolfgang Heiser* [2005] ECR I-1627, paragraph 32.

([9]) Case E-6/98 *Norway v EFTA Surveillance Authority*, cited above, paragraph 59; Case 730/79 *Philip Morris v Commission* [1980] ECR 2671, paragraph 11.

([10]) Article 4 of the VAT Compensation Act introduces some limitation of the possibility to be compensated.

2. **Procedural requirements**

Pursuant to Article 1(3) of Part I of Protocol 3 to the Surveillance and Court Agreement, 'the EFTA Surveillance Authority shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid (…). The State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision'.

The Norwegian authorities did not notify the VAT Compensation Act to the Authority before it was put into effect. The Authority therefore concludes that the Norwegian authorities have not respected their obligations pursuant to Article 1(3) of Part I of Protocol 3 to the Surveillance and Court Agreement.

3. **Compatibility of the aid**

The Authority considers that none of the derogations mentioned in Article 61(2) of the EEA Agreement can be applied to the case at hand.

As far as the application of Article 61(3) of the EEA Agreement is concerned, the input tax compensation cannot be considered within the framework of Article 61(3)(a) of the EEA Agreement since none of the Norwegian regions qualify for this provision, which requires an abnormally low standard of living or serious underemployment. This compensation does not seem to promote the execution of an important project of common European interest or remedy a serious disturbance in the economy of a State, as is requested for compatibility on the basis of Article 61(3)(b) of the EEA Agreement.

Concerning Article 61(3)(c) of the EEA Agreement, aid could be deemed compatible with the EEA Agreement if it facilitates the development of certain economic activities or of certain economic areas without adversely affecting trading conditions to an extent contrary to the common interest. The aid scheme at hand does not seem to facilitate the development of certain economic activities or areas but, as the Norwegian authorities have stated, it pursues the objective of establishing a level playing field for goods and services subject to VAT between 'in-house' provisions and outsourcing of services within municipalities.

The Authority considers that a reduction in the running costs of an undertaking, such as the input tax, constitutes operating aid. This type of aid is, in principle, prohibited. Therefore, the Authority considers that the VAT Compensation Act constitutes an aid scheme which, as it stands today, cannot be considered compatible with the State aid rules of the EEA Agreement.

This notwithstanding, the Authority recalls that, as mentioned above, the question as to whether the measure constitutes State aid only arises in so far as it concerns an economic activity, that is, an activity consisting of offering goods and services on a given market. This implies for the case at hand that in as far as the beneficiaries of the scheme carry out public administration tasks or statutory obligations which do not constitute an economic activity, the State aid assessment including the assessment of the compatibility of the measure is not applicable to them.

Furthermore, according to Article 59(2) of the EEA Agreement, the State aid rules are not applicable to undertakings entrusted with the operation of services of general economic interest in so far as the application of such rules would obstruct the performance of the particular tasks assigned to them and in so far that trade is not affected contrary to the interests of the Contracting Parties to the Agreement.

In general, the States have a wide margin of discretion in the definition of services that could be classified as being services of general economic interest. In this regard, the Authority's task is to ensure that there is no manifest error as regards the definition of services of general economic interest. The Authority cannot, in the present context, carry out a detailed assessment of whether all suppliers in the sectors exempted from the application of VAT which benefit from the refund of input tax, i.e. which are covered by the aid scheme, comply with the conditions laid down in Article 59(2) of the EEA Agreement. The Authority can only limit itself to indicating that, in the case of the fulfilment of these conditions, the refund of input VAT granted to a given undertaking or to a specific group of undertakings might be considered to constitute compatible State aid within the meaning of Article 59(2) of the EEA Agreement. The VAT Compensation Act is not limited in such a way.

On 28 November 2005, the European Commission adopted a Decision on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest [1]. This Decision was incorporated into the EEA Agreement in July 2006 [2].

According to this Decision [3], hospitals and undertakings in charge of social housing which are entrusted with tasks involving services of general economic interest have specific characteristics that need to be taken into consideration. The intensity of distortion of competition in those sectors at the current stage of development of the internal market is not necessarily proportionate to the level of turnover and compensation. Therefore, hospitals providing medical care, including where applicable, emergency services and ancillary services directly related to the main activities, notably in the field of research, and undertakings in charge of social housing providing housing for disadvantaged citizens or socially less advantaged groups which, due to solvability constraints, are unable to obtain housing at market conditions, are exempted from notification.

[1] Published on the OJ L 312, 29.11.2005, p. 67.

[2] Commission Decision 2005/842/EC of 28 November 2005 on the application of Article 86(2) of the EC Treaty to State aid in the form of public service compensation granted to certain undertakings entrusted with the operation of services of general economic interest, was incorporated into Annex XV to the EEA Agreement as point 1h by Decision No 91/2006 (OJ L 289, 19.10.2006, p. 31 and EEA Supplement No 52, 19.10.2006, p. 24), e.i.f. 8.7.2006.

[3] Point 15.

However, any refund of input tax granted to an undertaking for the part of the economic activities it carries out which are not part of this public service obligation is not covered by this exception. As assessed above, this refund scheme constitutes State aid and cannot be considered compatible with the rules of the EEA Agreement. In this context, reference can be made to some of the sectors of activity concerned, i.e., to the sectors which are exempted from the application of VAT and regarding which it is clear from the existing case practice either from the European Commission, from the Authority or from existing jurisprudence that the activity constitutes an economic activity which is carried out in competition with others. This is in particular the case of dentists ([1]) or ambulance services ([2]).

Moreover, some of the recipients of aid under the VAT compensation scheme can benefit from other exemptions such as *de minimis* aid, the application of the provisions of block exemption regulations such as the block exemption regulation on SMEs, etc.

However, the scheme as it stands now is not construed to address only public service obligations or any of the above-mentioned exemptions. The VAT Compensation Act is broad in its application and conception. It does not contain the required criteria which would ensure fulfilment of these exemptions. Therefore, the scheme as such cannot be considered compatible with the State aid rules of the EEA Agreement.

4. **Conclusion**

The Authority finds that the Norwegian authorities have unlawfully implemented the VAT Compensation Act in breach of Article 1(3) of Part I to Protocol 3 to the Surveillance and Court Agreement. The refund of input tax foreseen under this Act as it stands today is not compatible with the functioning of the EEA Agreement for the reasons set out above.

According to Article 14 in Part II of Protocol 3 to the Surveillance and Court Agreement, in cases of unlawful aid, should it be found incompatible, the Authority orders, as a rule, the EFTA State concerned to reclaim aid from the recipient.

The Authority is of the opinion that no general principles preclude recovery in the present case. According to settled case-law, abolishing unlawful aid by means of recovery is the logical consequence of a finding that it is unlawful. Consequently, the recovery of State aid unlawfully granted, for the purpose of restoring the previously existing situation, cannot in principle be regarded as disproportionate to the objectives of the EEA Agreement in regard to State aid. By repaying the aid, the recipient forfeits the advantage which it had enjoyed over its competitors on the market, and the situation prior to payment of the aid is restored ([3]). It also follows from that function of repayment of aid that, as a general rule save in exceptional circumstances, the Authority will not exceed the bounds of its discretion, recognised by the case-law of the Court of Justice, if it asks the EFTA State concerned to recover the sums granted by way of unlawful aid since it is only restoring the previous situation ([4]).

Moreover, in view of the mandatory nature of the supervision of State aid by the Authority under Protocol 3 of the Surveillance and Court Agreement, undertakings to which aid has been granted cannot, in principle, entertain a legitimate expectation that the aid is lawful unless it has been granted in compliance with the procedure laid down in the provisions of that Protocol ([5]).

The statements made by Commissioner Bolkestein mentioned by the Norwegian authorities referred to the compliance of the concerned schemes with the VAT rules as such. Moreover, at least in one of the statements, Mr Bolkestein included the disclaimer 'provided that the State aid rules are observed'. Thus, the Authority considers that no legitimate expectations can be justified in these statements.

Furthermore, the Norwegian authorities have not referred to any similar State aid scheme which has been approved by either the European Commission or the Authority on the basis of which the existence of legitimate expectations regarding the VAT Compensation Act could be substantiated.

For these reasons, the Authority considers that there are no exceptional circumstances apparent in this case, which would have led to legitimate expectations on the side of the aid beneficiaries.

The recovery should include compound interests, in line with Article 14(2) in Part II of Protocol 3 to the Surveillance and Court Agreement and Article 9 and 11 of the Authority's Decision No 195/04/COL of 14 July 2004 ([6]).

([1]) Case C-172/03 *Wolfgang Heiser*, cited above.
([2]) Case C-475/99, *Firma Ambulanz Glöckner v Landkreis Südwestpfalz* [2001] ECR I-8089.
([3]) Case C-350/93 *Commission v Italy* [1995] ECR I-699, paragraph 22.
([4]) Case C-75/97 *Belgium v Commission* [1999] ECR I-3671, paragraph 66, and Case C-310/99 *Italy v Commission* [2002] ECR I-2289, paragraph 99.
([5]) Case C-169/95 *Spain v Commission* [1997] ECR I-135, paragraph 51.
([6]) Published on the OJ L 139, 25.5.2006, p. 37 and the EEA Supplement No 26 of 25.5.2006, p. 1.

The Norwegian authorities are therefore requested to take the necessary measures to recover any incompatible aid granted on the basis of Article 3 of the VAT Compensation Act and inform the Authority thereof within two months.

The Norwegian authorities shall amend the VAT Compensation Act with immediate effect in order to exclude the granting of State aid. Within two months, they shall inform the Authority of the necessary legislative amendments undertaken,

HAS ADOPTED THIS DECISION:

Article 1

The State aid granted in connection with the VAT Compensation Act implemented by the Norwegian authorities is not compatible with the functioning of the EEA Agreement.

Article 2

Norway shall amend the VAT Compensation Act with immediate effect in order to exclude the granting of State aid.

Article 3

The Norwegian authorities shall take all necessary measures to recover from any beneficiary undertaking the aid referred to in Article 1.

Article 4

Recovery shall be affected without delay and in accordance with the procedures of national law provided that they allow the immediate and effective execution of the decision. The aid to be recovered shall include interest and compound interest from the date on which it was at the disposal of the beneficiary until the date of its recovery. Interest shall be calculated on the basis of Article 9 and 11 in the EFTA Surveillance Authority Decision No 195/04/COL.

Article 5

The Norwegian authorities shall inform the EFTA Surveillance Authority, within two months of notification of this Decision, of the measures taken to comply with it.

Article 6

This Decision is addressed to the Kingdom of Norway.

Article 7

Only the English version is authentic.

Done at Brussels, 3 May 2007.

For the EFTA Surveillance Authority

Bjørn T. GRYDELAND	Kurt JÄGER
President	*College Member*