# Management summary

# The impact of tax adjustment to the Dutch Food and Beverage Industry

## S1 Background, aim and method research

In the Dutch government letter 'Choices for a better tax system' from September 2014, the Dutch Secretary of State for Finance (Eric Wiebes) announced a broad review of the tax system. The purposes of this review is to make the Dutch tax system less complex, to stimulate employment by lowering the burden on labour and achieving more economic growth. One of the options in the plan is to alter existing VAT rates in order to finance the reduction of taxes on labour and enterprise. As a result, products and services which currently fall under the low VAT rate of 6 percent, will be aligned with the standard rate of 21 percent. Primary foods are the only exception to the government's plans.

Since reforming the tax system is a vast, complex and politically charged issue with potentially major consequences for the Dutch food and beverage industry (F&B industry), the Federation for the Dutch Food and Grocery Industry (FNLI) is seeking to find out the impact these tax changes would have on this sector. As the exact details of the changes are still unclear, FNLI is not just interested in the effects of the proposal of the Secretary of State, but also in other specific forms of VAT on certain products or ingredients. Therefore FNLI asked economic research and consulting agency Decisio to examine relevant literature and international case studies regarding the following:

- The economic effects of an increase in VAT, including changes in administrative costs, decreases in labour costs, etc.
- The consequences of differential taxation for certain foods, drinks and ingredients.
- The cross-border effects of possible VAT changes or differentiated taxation.

The study was conducted in two phases: a general inventory phase based on an extensive literature review and an in-depth phase with additional analysis and in-depth case studies. The scope of the investigation is limited to the F&B industry, with a focus on the Dutch F&B industry. The retail and agricultural sectors do not fall within the scope of this investigation.

## S2 The proposed tax reform in perspective

The planned revision of the Dutch tax system comes as a result of different recommendations made by several committees. By reducing the burden on labour and entrepreneurship, the government wants to achieve higher employment and economic growth. Incrementing VAT in the tax mix is one of the measures mentioned to fund this plan.

Increasing VAT revenue disrupts the economy less than the current taxation mix. Moreover, VAT offers the government a more stable source of income than wage and income tax. Against the background of the recent economic crisis and with an increasingly aging population, this proves to be a major advantage for the government.

International experts agree that an increase in VAT revenue can best be achieved through uniform VAT rates. The use of different VAT rates (including tax exemptions) influences the relative prices of products and thus consumption and production decisions. With a uniform VAT rate every product and service is taxed at the same rate and consumers are more inclined to follow their own preferences rather than be influenced by artificial price differences. This results in a welfare gain. Furthermore, VAT exemptions disrupt the procurement and outsourcing policies of exempt sectors (banks, etc.) and the government. A uniform VAT rate contributes, ultimately, to a simpler tax system with lower administrative and management costs for businesses (especially SMEs) and government.

However, there are also valid arguments against the reform: in the first place, there is a strong case for working with reduced VAT rates. This is especially true for those sectors where the market is not functioning optimally (competition with the grey/black market) and in societies with large differences in earnings where an increase in the lower VAT rate in particular comes at the expense of the lower income classes. Secondly, in terms of employment and economic growth, there is little difference between taxing people on their income or their consumption. The standardisation of VAT rates does not therefore lead to increased economic growth or employment, even when it is offset by a reduction in wage and income tax.

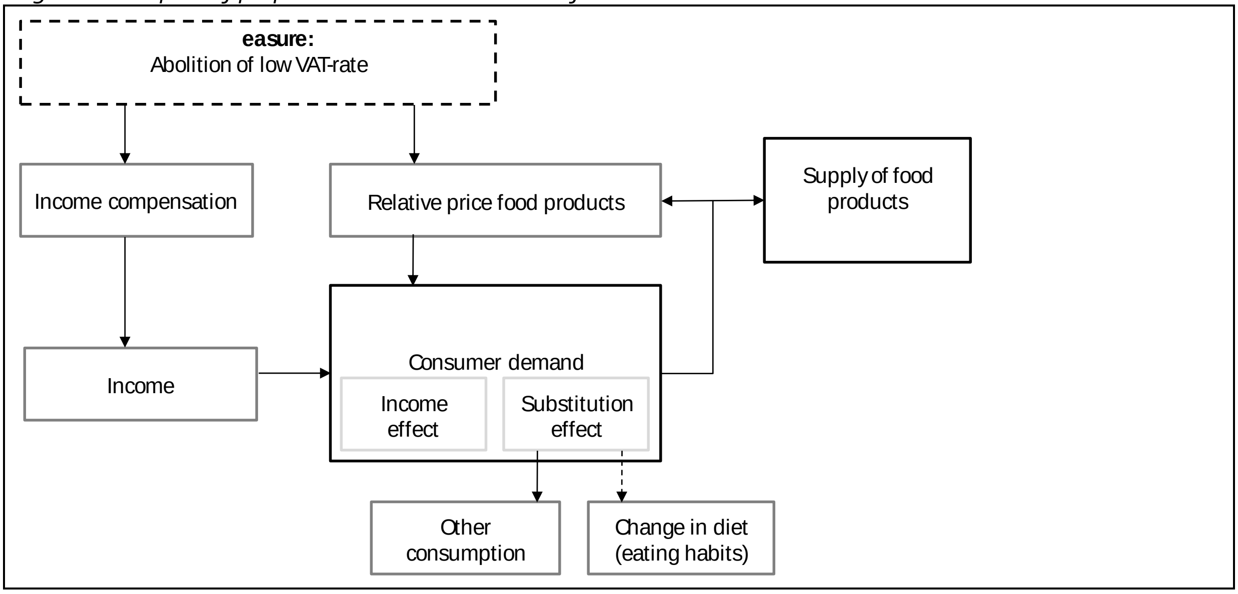
EU member states are not permitted to tax VAT exempted sectors on an individual basis. This results in a third counter-argument that, without European cooperation, the intended beneficial effects of a VAT harmonization can only be partially achieved. On top of that, the standardisation of VAT rates will cause negative cross-border effects in the case of different VAT rates between neighbouring countries (see S6).

To summarise there are certainly good arguments for harmonization of the VAT system, but the main benefits of this can be expressed more in terms of convenience rather than extra jobs. Abolition of reduced VAT rates also adversely affects the low-income groups and can lead to cross-border effects, meaning that this type of measure should really be implemented at EU level.

## S3 The effects of a VAT increase on the food and beverage industry

A standardisation of the VAT rate primarily affects the demand for and supply of goods and services covered by the low VAT rate. Thus, consumers will see a reduction in their disposable income when the relative price of food rises (the income effect) and they will replace the purchase of food products by purchasing similar (cheaper) products and/or other products such as clothing and electronics (the substitution effect). Producers will adjust their assortment in an attempt to respond to changed market conditions. The effects of the proposed VAT measure for foods are shown schematically in Figure S.1.

*Figure S.1: Impact of proposed VAT measures on the food market*




Due to the relatively low price elasticity for food and non-alcoholic beverages in the Netherlands, the average effects on the F&B industry will be relatively limited. Economic models, however, predict that standardisation of VAT rates can have a relatively large impact on households with lower incomes. To prevent this, corrective action is of great importance. These measures are complex and this would lead to all kinds of allowances and other regulations which is exactly what the Dutch tax office is actually at this point attempting to get rid of it. Also these measures are accompanied by transaction costs which are sensitive to possible abuse. Furthermore it is also important that the government ensures that these measures do not reduce the incentive to work, otherwise it is at the expense of employment and GDP.

The substitution effect (the degree to which, due to the VAT increase, consumers buy *substitute* products whose purchase price has not increased) largely depends on the price elasticity of food and other products. There is little hard information on the price elasticity of food products in the Netherlands. However, it is clear that the elasticity of most food is relatively low (compared to other types of goods). As a result, the effects on the F&B industry on average, will be relatively limited, subject to any cross-border effects which may occur. These are discussed below in (S6). It may be the case when taken at individual product level, there may be more price elasticity. Individual products are namely much easier to replace with other products, than an entire product group.

Moreover, an increase in VAT would lead to higher inflation; such a proposal will not be supported by pensioners, pension funds, savers and wealthier individuals.

## S4 Effects of differentiated tax rates on the food and beverage industry

Another possibility for the Dutch government to generate additional tax revenue is through the imposition of differential taxes on certain foods and non-alcoholic beverages (e.g. the Danish fat tax or a soft drink tax). In this scenario, the reduced VAT rate remains, but certain foods and non-alcoholic beverages are taxed higher.

Since the early nineties there has been a growing interest shown by governments worldwide in taxing items, which, especially in excess, have adverse health effects. An inventory of the differentiated tax on food and (non-alcoholic) drinks (in these studies abbreviated with the term DTFD) shows that these relate mainly to sweetened drinks, followed at a distance by DTFD on confectionery and ice cream. Most DTFDs are levied in the form of taxes or duties, but in countries such as Ireland and the United Kingdom certain types of foods and non-alcoholic beverages fall under the general (high) VAT rate and not that of the reduced VAT rate. There are also special consumption taxes for non-alcoholic drinks in the Netherlands, and, for example, a packaging tax for soft drinks in Belgium.

The empirical studies on DTFDs used in this study show that DTFDs in the short term lead to a (limited) diminished demand of the respective products. In the long term, however, eating habits are much more dependent on habits and income than fiscal measures. The studies also indicate that there are all kinds of substitution effects that do not necessarily contribute to a "healthy" diet. These substitution effects manifest themselves not only in the purchase of other products (for example, products with sugar instead of fat), but also in the purchase of cheaper brands and/or other variants of the same product (switch to discount brands, etc.).

The effects of a DTFD for F&B industry does not just lead to lower sales, but also creates a significant administrative burden on business, uncertainty about future investments and, on commercial level, reduces the competitive position as regard to fellow manufacturers not covered by the DTFD or who focus on the discount markets. The literature shows that SMEs are more affected by DTFDs than the bigger producers. Partly since SMEs often do not have the resources to invest in product innovation/adjustment and partly because smaller companies already have a relatively heavy administrative burden. A side effect of DTFDs which has been seen in the case studies is that the retailers use the DTFD to boost their own and B/C brands at the expense of A-brands by calculating the DTFD in different ways into the retail price.

In short, according to the literature, DTFDs are effective in terms of tax revenue, but due to the high managerial and administrative burden it is not an efficient method of taxation. In the empirical literature there is considerable doubt on the effectiveness of DTFDs regarding the intended health benefits, especially in the long term. In addition, authorities need to be alert not just to the possible cross-border effects of DTFD, but also to unforeseen effects as a result of mutual influencing on demand (for example, in the case of bread and butter). Finally, the European Commission needs to be alert to improper state aid and unfair advantage of foreign producers due DTFD. Experts see more potential in a combination of measures which can alter the eating habits of people on a long-term basis (e.g. educational and advertising campaigns). Taxes and subsidies can play a role, but only for investment in creating 'healthy' eating patterns.

## S5 Results from case studies in differentiated taxation

In a democratic society the acceptance of differentiated taxes on food and beverages by the general public is crucial for a successful implementation and a long-lasting tax. The case studies and literature both show that the public acceptance of DTFDs varies widely from country to country and that it can change quickly. In the case studies, we see that planned DTFDs have eventually not been implemented in many cases, or were quickly abolished (Denmark) or restricted (Finland). Substantively, the case studies draw more or less the same conclusions as the general literature on DTFDs, namely:

- that the health benefits are questionable, partly due to substitution and certainly in the long term;
- that these are complex forms of taxation which are associated with relatively high administration costs for business and a bureaucratic burden for government;
- that low income groups are relatively the most affected;

- that DTFDs lead to undesirable cross-border effects and that they may lead to preferential treatment of certain sub-sectors, which may conflict with (EU) competition rules.

Whether a DTFD is effective, is primarily dependent on its intended purpose. Nowadays this often particularly applies to the reduction of the consumption of salt, saturated fat and calories (sugars and fats) and contributing to health goals, but case studies suggest that many countries (also) implement a DTFD for fiscal reasons. Looking at the case studies, we see that the Finnish, Hungarian and French governments are satisfied with the generated tax revenues. In Denmark, there were too many negative economic effects, for example due to (risk of) job losses, cross-border effects and smuggling.

Whether or not a DTFD influences consumption very much depends on whether the tax is actually passed on by the F&B industry. Then the question is whether the consumption actually decreases due to the increase in price (price elasticity). In practice, consumers get used to new price levels and soon forget new tax rates.

In the case studies presented from Finland, Denmark and Hungary there are complex substitution effects which undermine the effectiveness of the DTFD. When people start paying more for crisps, but not nuts, demand will increase for the latter. In France, for example, by introducing a tax on sweetened beverages less nectar was sold and more fruit juices (which contain more sugar). Basically, the bottom line is that DTFDs seem to have little effect, but this is difficult to prove.

## S6 Cross-border effects of VAT increases and differentiated taxes

VAT increases and DTFDs lead to higher revenues for the treasury, but people obviously look for ways to circumvent the additional taxes, for example, by consuming more on the other side of the nearest border.

An analysis of various national and international empirical studies of cross-border effects suggests that in countries like Denmark the government, partly because of the economic crisis, became more aware of the negative impact of cross-border effects. By lowering the excise taxes on beer and soft drinks, chocolate and sweets, the Danish government has managed to significantly reduce the cross-border effect (especially for beer and soft drinks). Also countries like Canada, Mexico and Ireland are clearly aware of this issue. In the latter countries the exchange rate and factors such as differences in fuel prices, also plays a role. In countries like Finland and Belgium the beverage industry suffers from cross-border consumption, but for the Finnish and Belgian governments this has not yet been reason enough to change taxes. However, the impact is significant; in Finland the loss of excise duties and VAT as a result of the cross-border effect is estimated to be the same amount as the revenue from the Finnish confectionery tax (see section 5.3). While in Belgium, the cross-border purchases of water and soft drinks (which mainly arises from the packaging tax) currently accounts for more than four percent of the total market for non-alcoholic beverages.

In the Netherlands, little is known about the cross-border effects of VAT increases or DTFDs. The available studies of cross-border effects focus mainly on the (recent) tax increases on tobacco, alcohol and fuel. The Netherlands has so far a positive balance in terms of international purchase flows. An increase in VAT could not only lead to more cross-border purchases of Dutch people abroad, but also to less spending by German and Belgian consumers in the Netherlands.