The Brewers of Europe

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VAT reduced rates: impact on the hospitality sector

Response to the European Commission consultation:
Review of existing legislation on VAT reduced rates (TAXUD/C1)

4 January 2013

Contents

Executive Summary

The following document sets out the response of *The Brewers of Europe* to the European Commission's review of existing legislation on VAT reduced rates.

The Commission's consultation document covers the broad range of issues around VAT in the EU, in line with Community competence. The response given in this document is limited to principled issues around the retention of VAT reduced rates to support specific industries/sectors, namely in this case the hospitality sector. It does not comment more widely on the appropriateness of retaining reduced rates in principle. Nor does it seek to address some of the specific issues raised that are not directly relevant to our membership, or where we feel there is little or no locus for comment.

The Brewers of Europe believes that the continuation of VAT reduced rates in certain sectors does not distort the single market and furthermore is supportive of the aims of the European Union and the single market.

The analysis in this paper is based upon the key contribution of the hospitality sector to the European economy. It shows that reduced rates of VAT play an important role in protecting low prices for basic necessities; as well as vital employment and training opportunities for low-skilled workers and for those looking for their first jobs.

In addition, reduced rates appear, from analysis of empirical data in EU Member States, to have had a sustaining effect for the sector, in comparison to the growth and employment performance of the wider economy, during the recent economic crisis.

VAT reduced rates are no impediment for the proper functioning of the internal market in this sector and, as recognised in the consultation document itself (and the Copenhagen economics study that preceded it) are not likely to create distortions of competition.

Any increase in administrative burden for businesses seems to be outweighed by the benefits in terms of sustained demand for goods and services and any changes to the current systems in place would also impose additional administration burdens and menu costs.

In conclusion, The Brewers of Europe calls for the retention of the current position, it being the best scenario for not only the hospitality sector but also the many other industries linked to thriving industries in this sector, without which jobs and growth in the EU would suffer.

1. Introduction

The following document sets out the response of The Brewers of Europe to the specific issues raised in the consultation launched in October 2012 by the European Commission ("the Commission").[1] While a reduced rate of VAT for Beer is not supported directly by EU VAT legislation, Member States are able to apply reduced VAT rates to 'restaurant and catering services'[2], 'hotel accommodation'[3] and 'foodstuffs[4]', (hereafter, the "hospitality sector"). The success of the brewing sector is linked in part to a vibrant and successful hospitality industry and hence we have an interest in the questions around these reduced rates as well as information that can inform the debate.

In responding to the consultation we have drawn from the initial output of a wider programme of work currently being undertaken, to assess the contribution of the hospitality sector to the European economy. This work will culminate in a report that will be available in the first quarter of 2013.

This paper is organised as follows:

1) **Introduction**
2) **Approach to reduced rates**
3) **Application of the review to the hospitality sector**
4) **Country Analysis**
5) **Conclusions**

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[1] Review of existing legislation on VAT reduced rates (TAXUD/C1); DG TAXUD, 8 October 2012;
[2] As defined in point 12, a) Annex III of the Council Directive on the common system of value added tax 2006/112/EC, 28 November 2006;
[3] As defined in point 12 Annex III of the Council Directive on the common system of value added tax 2006/112/EC, 28 November 2006;
[4] As defined in point 1 Annex III of the Council Directive on the common system of value added tax 2006/112/EC, 28 November 2006;

2. Approach to reduced rates

In responding to the consultation, we have been cognisant of the rationale behind the review. In particular, we note that the consultation was preceded by an economic study by Copenhagen Economics in 2007. In considering the continuing need for reduced VAT rates within the hospitality sector, we note the general preference for a single rate system in the absence of a policy reason for a different outcome was articulated:

> *"...there is a strong general argument for having uniform VAT rates in the European Union. Uniform rates is a superior instrument to maintain a high degree of economic efficiency, to minimise otherwise substantial compliance costs and to smooth the functioning of the internal market."*[5]

Given this, the European Commission communication set out its guiding principles for the consideration of existing legislation on VAT reduced rates, as follows:

- *"Abolition of those reduced rates which constitute an obstacle to the proper functioning of the internal market.*
- *Abolition of reduced rates on goods and services whose consumption is discouraged by other EU policies.*
- *Similar goods and services should be subject to the same VAT rate and progress in technology should be taken into account in this respect, so that the challenge of convergence between the on-line and the physical environment is addressed."*[6]

We can see the merit of keeping such policies under review and were pleased to note the confirmation that such review does not imply a pre-existing decision to reform reduced rates where they are working effectively. We were also pleased to note that, notwithstanding the general preference for uniform VAT rates, the Copenhagen Economics study noted that the use of reduced rates in some sectors was not only legitimate, but desirable, specifically noting the hospitality industry:

> *"...there is a convincing theoretical and empirical argument for extending reduced VAT rates (or other subsidies) to sectors whose services are easily substituted for do-it-yourself or underground work, e.g. locally supplied services and some parts of the hospitality sector."*
>
> *"there is a theoretical ... argument for extending reduced VAT rates to sectors employing many low skill workers in order to boost low skill demand, e.g. hotels, restaurants and locally supplied services"*

[5] Study on reduced VAT applied to goods and services in the Member States of the European Union: Final report; Copenhagen Economics, 21 June 2007;
[6] Review of existing legislation on VAT reduced rates (TAXUD/C1); DG TAXUD, 8 October 2012;

We believe that the consideration of the merits of particular reduced rates should consider the costs and benefits of the system. We concur that these include:

Potential Costs	**Potential Benefits**
- Cross border distortion of activity	- Reduced burden on the sector leading to:
- Any additional complexity of administration	- Employment
- Lost revenue	- Training

These are discussed in relation to the hospitality sector in Section 3.

3. Application of the review to the hospitality sector

3.1. Nature of the sector

The hospitality sector in Europe employs around 9.5 million people, in 1.7 million enterprises.[7] In addition to this significant direct contribution to the European economy, the hospitality sector also plays a fundamental role in supporting job creation across many other sectors linked to a successful and thriving hospitality sector, including transportation, tourism, culture, construction, agriculture and brewing. The agricultural sector is notable as a contributor of raw materials for the hospitality sector i.e. constituent ingredients in restaurant food and beverages and as such the hospitality sector has a key role in supporting rural economies. The hospitality sector is therefore essential to securing jobs and growth, not only directly within associated enterprises, but indirectly for large parts of the European economy including the brewing sector.

In terms of direct support for EU socio-economic aims, the hospitality sector is the largest employer of migrant labour in the EU. It also provides vital opportunities for lower skilled workers. This enables greater EU labour mobility and higher participation in the labour market, contributing to a flexible and responsive labour market that can adjust quickly to changing economic conditions.

As noted above, the hospitality sector is a vital contributor to the European economy not only in terms of direct employment, growth and tax revenues, but also through its indirect support for supply chains and positive impact on *inter alia* broader tourism, construction, manufacturing and brewing industries.

Customers of the hospitality sector are, to a large extent, final consumers. It is a typical business-to-consumer (B2C) business which makes it susceptible to general developments of the economy which influence aggregate demand. In addition, there is strong competition in the sector. Manpower is a large cost factor of the industry which creates a strong added value. The sector is a strong contributor to the VAT revenue of countries.

Although the sector employs a number of highly qualified workers, it is also a source of employment for the less skilled. It provides them with a working experience which will teach them the necessary skills for the sector but many of which are also useful for working in other sectors. It thus provides many young people with their first professional experience allowing them to enter the working world. The sector opens the door to future jobs. Similarly the sector helps the unemployed to reintegrate into the working environment. It also offers many (parents, students, rural workers etc.) the flexibility of having a part-time job which allows them to pursue their other activities.

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[7] From the HOTREC website (http://www.hotrec.eu/about-us/facts-figures.aspx) HOTREC is the umbrella association of national trade associations representing the hotels, restaurants, cafés and similar establishments in Europe. Original data source: Eurostat.

A study carried out by EIM (Small Business Research and Consultancy) in November 1999 for the hospitality sector[8] showed that the hotel and restaurant sector is the most important provider of "first jobs".

3.2. Why reduced rates?

In general, indirect taxes such as VAT are broadly recognised to be more efficient than direct taxes such as those on income or earnings, since consumers can theoretically choose whether or not to pay them through their consumption choices. In practice we see that basic necessities such as food, heating, transport and fuel have a relatively low sensitivity to price (evidenced by a low price elasticity of demand[9]). For these goods and services, VAT can be highly regressive, since poorer households tend to spend a greater percentage of their household income on them than richer households[10]. In pursuing distributional and social objectives (reducing the incidence of the tax on the poor), the regressive nature of VAT can be reduced by applying reduced rates to goods and services that are expected to be consumed disproportionately by lower-income households.

Many countries choose to favour the hospitality sector over the general economy given its contribution to skills and employment and given that it competes with lower value-added (in economic terms) substitutes such as take-aways and stay-at-home meals. A reduced VAT rate is one of the mechanisms used and a preferred option for many Member States.

3.3. Potential costs: cross-border distortions?

One issue raised by the Commission in relation to reduced rates of VAT is whether they have a distortionary effect on the single market. We will see from below that the answer to this question is sector specific.

While one can envisage scenarios where the demand for highly exportable and manufactured goods could be distorted by relative differences in price (which could result from differences between countries' application of VAT reduced rates), this does not obviously hold for the hospitality sector. Restaurants, hotels and caterers provide local services which are in general consumed immediately. According to the EU VAT directive, the place of supply is where the services are physically carried out (article 55) or – for hotel accommodation - the place where the immovable property is located (article 47). There seems little risk that by applying a lower VAT rate in the hospitality sector, a Member State could materially steer the consumers' behaviour and prevent the internal market from functioning properly.

[8] "Reduced VAT rates: a must for a sustainable European hospitality sector", page 23; HOTREC, May 2008

[9] "Examples of this are necessities like food and fuel. Consumers will not reduce their food purchases if food prices rise, although there may be shifts in the types of food they purchase. Also, consumers will not greatly change their driving behavior if gasoline prices rise." Don Hofstrand, Univeristy of Iowa: http://www.extension.iastate.edu/agdm/wholefarm/pdf/c5-207.pdf

[10] "Who Pays: A Distributional Analysis of the Tax System in All 50 States"; Institute on Taxation and Economic Policy, November 2009.

The Copenhagen Economics study (produced for the European Commission, to consider such questions) analysed the issue of cross border impacts of reduced rates and found no material impact:

> "*...the consequences, in economic terms, of the functioning of the most significant elements of the current EU VAT system. The evaluation study did not signal any specific distortions in the Single Market resulting from reduced rates.*"[11]

In fact, the consultation document itself recognises that strong evidence of the impact of distortion of the single market has not been produced:

> "*...while the issue of the potential for distortion of competition was raised on several occasions in the past, neither the two public consultations (the most recent in 2011 with the Green Paper on the future of VAT), nor the two studies, have revealed any major anomalies in this respect with the reduced rates as they are applied today.*"[12]

3.4. Potential costs: compliance burden?

The issue of a potential compliance burden faced by businesses that have to implement and comply with complex VAT reduced rates is raised by both the consultation document and the Copenhagen study:

> "*Uniform rates is a superior instrument to maintain a high degree of economic efficiency, to minimise otherwise substantial compliance costs and to smooth the functioning of the internal market.*"[13]

While a uniform, standardised VAT rate should in theory be simpler to administer and comply with, those who currently administer reduced rates are strongly in support of their retention and so seem willing to bear any additional costs from administration and compliance. It is also the case that any change to the system would also create costs and so for those who currently apply reduced rates it would be a source of additional compliance costs to standardise rates.

3.5. Potential costs: lost revenues?

Reduced rates of VAT do of course mean that government VAT receipts are lower (other things being equal) than if rates were uniform at the standard rate. However, this depends on a static view of receipts and does not take into account the demand impact of lower prices on sectors where a reduced rate is applied, nor does it consider second round effects on supply chains or increases in employment and social security tax receipts from additional job creation in these sectors. The data in the appendix and analysis set out in Section 4 below show that, in countries where reduced rates are applied, we see better performance in the hospitality sector than in the wider economy. It is difficult to quantify these effects but it may be that lost revenues are offset or even outweighed by the other benefits described.

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[11] Study on reduced VAT applied to goods and services in the Member States of the European Union: Final report; Copenhagen Economics, 21 June 2007
[12] Review of existing legislation on VAT reduced rates (TAXUD/C1); DG TAXUD, 8 October 2012
[13] Study on reduced VAT applied to goods and services in the Member States of the European Union: Final report; Copenhagen Economics, 21 June 2007

3.6. Potential benefits: effects of lower burdens

As noted above, many countries favour the hospitality sector with a reduced rate of VAT, reflecting a number of socio-economic factors and positive externalities from the sector:

- Restaurant services and foodstuffs tend to be basic necessities which, if subject to standard VAT, would render the system more regressive;
- The sector is an important provider of “first jobs“ and, jobs for low-skilled workers, encouraging greater opportunity, employment and participation across the EU.

4. Country analysis

The impact of reduced rates of VAT has been considered in a selection of countries, the findings from which are annexed to this document (see Appendix). The analysis is high level and considers the performance of the hospitality sector (in which a reduced rate of VAT applies) against general employment and growth performance of the economy. The impact of the reduced rates is also marked following the global economic crisis in 2008.

The countries examined represent a cross section of European economies selected from both the older and newer member states. The length of time that reduced rates have been in place varies from those that were introduced in the 1960s, to those that have only appeared in the last decade. As a comparator, we have also analysed the performance of the hospitality sector in the UK, which does not apply a reduced rate of VAT in the hospitality sector.

The data show variations between countries in the apparent impact of VAT reduced rates but with a number of key, over-arching trends.

Data collected on a selection of countries where reduced rates of VAT are applied (see appendix), show that growth in the hospitality sector outperformed growth in the wider economy across the period. For example, in Estonia, which introduced a reduced VAT rate of 5% in 2000, growth in the hospitality sector appears to immediately diverge from GDP performance in the years following the introduction of the reduced rate. Figure 4.1, below, shows that this divergence continued and accelerated up until the economic crisis of 2008, when both GDP and the hospitality sector contracted sharply. By 2009 growth returned to the economy and the hospitality sector was again outperforming GDP.

Figure 4.1: Index of GDP and hospitality output growth in Estonia (2000 = 100)

Estonia:

The same pattern as found in Estonia was also seen in Austria, Bulgaria, France and Portugal. In each of the selected countries with a reduced rate, growth in the hospitality sector outperformed the national average across the period and in three of the five countries the reduced rate appears to have a "sustaining" effect on growth in the hospitality sector after the economic crisis (when eating out and hotel stays might be expected to come under pressure due to shrinking disposable incomes).

We can see the contrast if we compare the performance of the hospitality sector against general economic performance in the UK, a country which does not apply a VAT reduced rate.

Figure 4.2: Index of GDP and hospitality output growth in UK (2000 = 100)

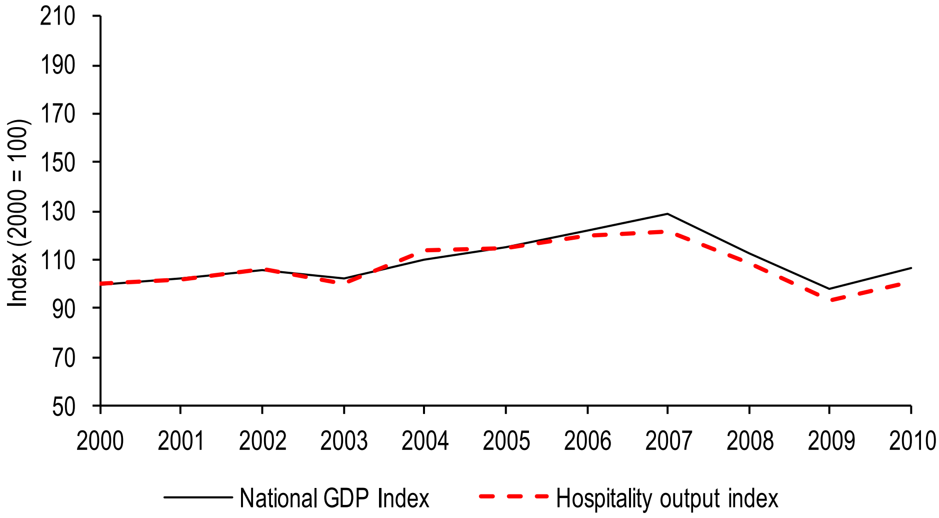
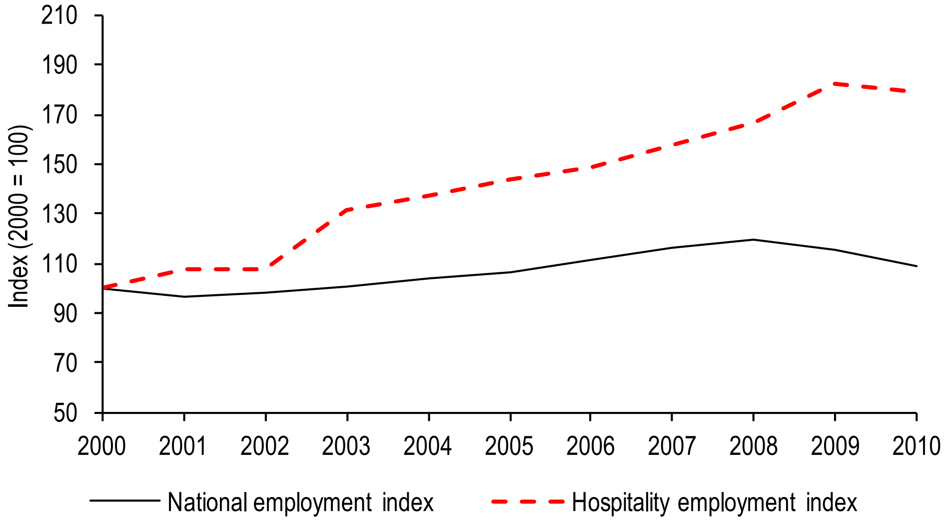


Figure 4.2 shows that economic performance in the UK hospitality sector was much more closely linked to that of the wider economy. Growth in the sector mirrored the national average more closely than we see in the reduced rate countries and performs worse than the average for the whole economy during the economic downturn from 2008 to 2010.

The conclusions drawn above for GDP/sector growth comparisons are also seen in performance of the labour market, where all five of the countries with VAT reduced rates for hospitality saw labour market performance which outstripped the average in the national labour market. This may reflect that the flexible labour market conditions in the hospitality sector allowed enterprises to respond better to harder economic circumstances, partly perhaps because of the beneficial impacts of reduced rates allowing prices to remain competitive against alternative options such as eating at home and reducing holidays/hotel stays.

In Bulgaria (see Figure 4.3 below), which introduced a reduced rate on the hospitality sector in 2007, we see that employment performance outstrips the average of the national labour market across the period, with the divergence between hospitality and the general labour market accelerating noticeably immediately after the introduction of the reduced rate in 2007.

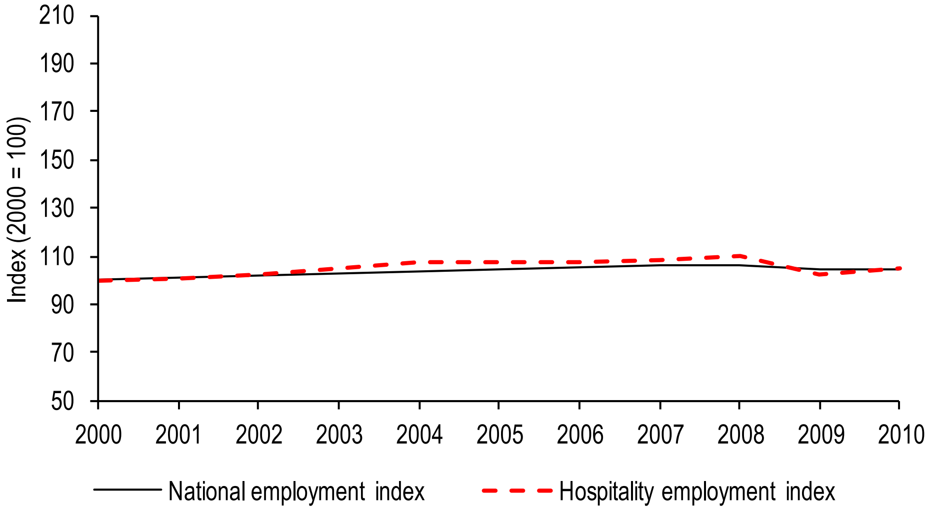
Figure 4.3: Index of national and hospitality employment growth in Bulgaria (2000 = 100)



The data also show that the employment performance following the 2008 crisis is again better in the hospitality sector than in the economy as a whole in Austria, France, Portugal and Bulgaria, suggesting a "sustaining" effect of the reduced rate.

If we contrast this with labour market performance in the UK, with no reduced rate, (shown in Figure 4.4 below), we see that the hospitality sector underperformed against the national labour market and that there was no "sustaining" effect during the downturn as seen in those countries which do apply a reduced rate.

Figure 4.4: Index of national and hospitality employment growth in UK (2000 = 100)



Emerging evidence may therefore suggest that VAT reduced rates are embedded in the pricing and therefore decision making of consumers, supporting strong output growth in the sector which can sustain growth over time above national growth. The data also show that, in countries where a reduced rate of VAT is in place, when economic factors cause disposable incomes to shrink, the hospitality sector can become a relatively more attractive option than other areas of consumption.[14]

[14] In times of reduced disposable incomes aggregate demand in the economy falls for general goods and services and the percentage of household expenditure on “necessities” increases. Where the VAT reduced rate can maintain the relative price of eating out to be competitive with home-cooked meals, the impact on growth and employment in this sector can be maintained, helping the economy to recover and grow.

5. Conclusions

As has been set out above, the hospitality sector is a key contributor to the European economy and in many Member States are subject to reduced rates of VAT.

There is evidence that these reduced rates play an important role for vital services that provide lower-priced (than they would be at standard VAT rates) goods and services for consumers as well as vital employment and training opportunities for vulnerable groups in the labour market, such as low skilled workers and those looking for their first jobs. In addition, reduced rates appear, from analysis of empirical data in EU Member States, to have had a sustaining effect for the sector, in comparison to the growth and employment performance of the wider economy, during the recent economic crisis.

Potential costs of VAT reduced rates, identified in the Commission consultation document, such as distortion of the single market, whilst potentially true and an issue for some sectors, do not appear to hold for the hospitality sector. As we have shown, reduced rates in the hospitality sector are no impediment for the proper functioning of the internal market. The services provided are mainly local and not likely to create distortions of competition. As such, the way a Member State taxes these services does not affect taxation in other States. Reduced and differing rates have been in use for many years and have not created major issues to the functioning of the EU VAT system. As recognised in the Copenhagen study, no such cross-border impact was identified.

Any increase in administrative burden for businesses seems to be outweighed by the benefits in terms of sustained demand for goods and services and any changes to the current systems in place would also impose additional administration burdens and menu costs.[15]

In conclusion, The Brewers of Europe calls for the retention of the current position, it being the best scenario for not only the hospitality sector but also the many other industries linked to thriving industries in this sector, without which jobs and growth would suffer.

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[15] They are in fact the very definition of the term “menu costs”!

Appendix - Impact of VAT reduced rates in selected countries

Austria

Austria introduced its a reduced rate of VAT in 1973.
The rate has not changed since 1984

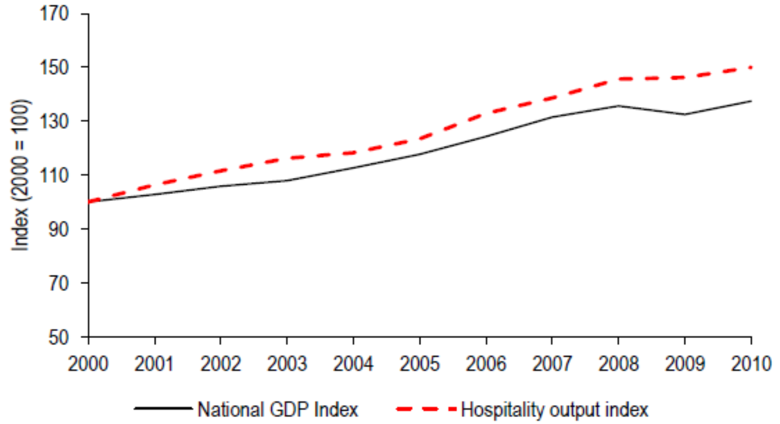
The reduced rate is applied to hotels as well as food and non alcoholic drinks served in hospitality establishments

During the period 2000 - 2010, both turnover and employment of the hospitality sector have grown more quickly than GDP

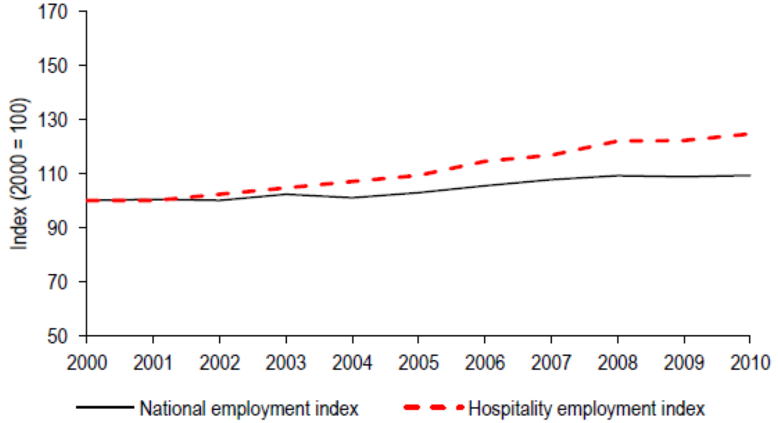
Rate changes

	Reduced rate (%)	Standard Rate (%)
01/01/1973	8	16
01/01/1976	8	18
01/01/1978	8	18
01/01/1981	13 | 8	18
01/01/1984	10	20
01/01/1992	10	20
01/01/1995	10	20

Index of GDP and hospitality output growth (2000 = 100)



Index of national and hospitality employment growth (2000 = 100)



Bulgaria

Bulgaria introduced a reduced VAT rate of 7% in 2007, which rose to 9% in 2011

The reduced rate is applied to spending on hotels

Whilst growth in the period shown was strong, the introduction of the reduced rate in 2007 coincided with a jump in both GDP and the hospitality sector turnover

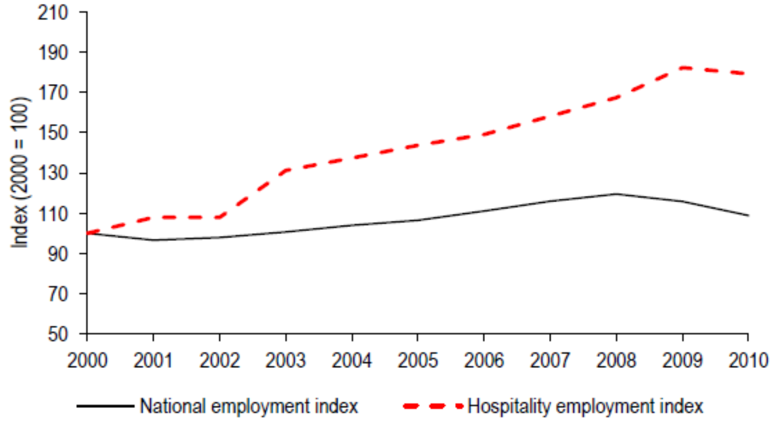
Employment in Bulgaria fell in 2009, but hospitality sector employment fell less sharply than in the wider economy

Rate changes

	Reduced rate (%)	Standard Rate (%)
01/04/1994	-	18
01/07/1996	-	22
01/01/1999	-	20
01/01/2007	7	20
01/04/2011	9	20

Index of GDP and hospitality output growth (2000 = 100)

Index of national and hospitality employment growth (2000 = 100)



Estonia

Estonia introduced a reduced rate of 5% in 2000, which increased to 9% in 2009

The reduced rate is applied to spending on hotels

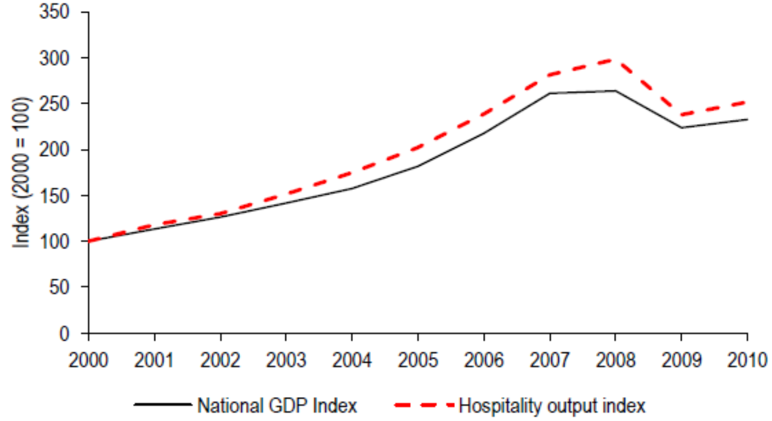
Growth of both GDP and the hospitality sector were fast during the period show, but hospitality remained ahead of GDP in each year. The introduction of a higher reduced rate in 2009 was followed by a slight slow down in the growth of both

Employment in Estonia was steady from 2000 - 2010, but the hospitality sector employment growth remained robust

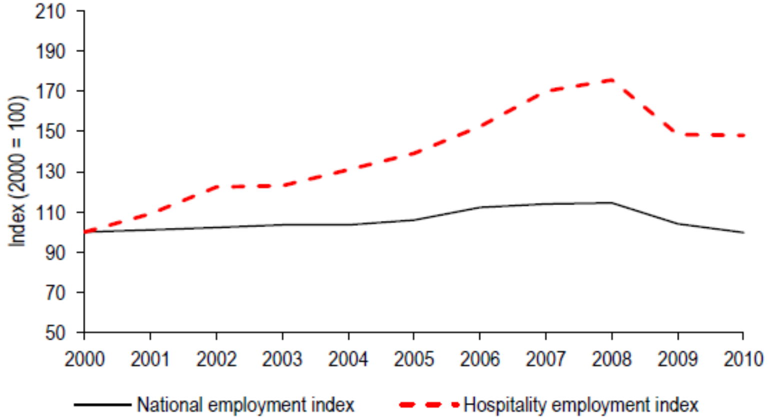
Rate changes

	Reduced rate (%)	Standard Rate (%)
1991	-	10
1993-2000	-	18
2000-2008	5	18
01/01/2009	9	18
01/07/2009	9	20

Index of GDP and hospitality output growth (2000 = 100)



Index of national and hospitality employment growth (2000 = 100)



France

France introduced its current reduced rate of VAT in 1991

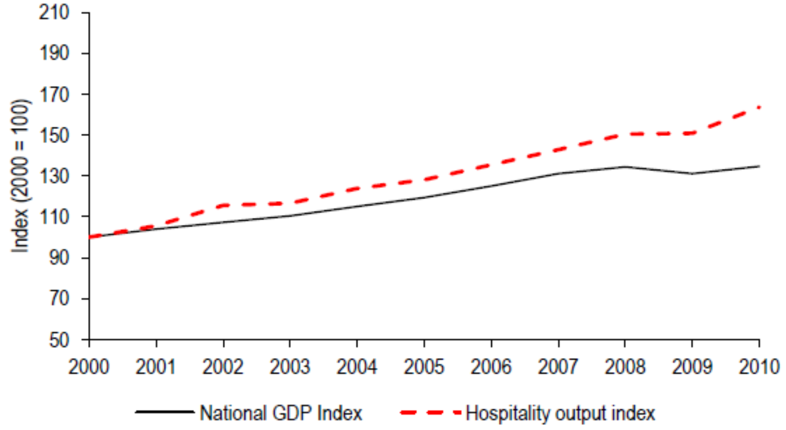
The reduced rate is applied to hotels as well as food and non alcoholic drinks served in hospitality establishments

During the period 2000 - 2010, both turnover and employment of the hospitality sector have grown more quickly than GDP

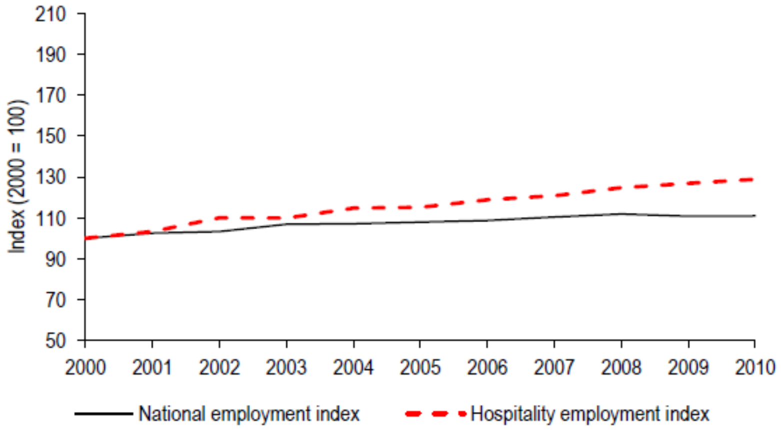
Rate changes

	Reduced rate (%)	Standard Rate (%)
01/01/1968	6	16.66
01/12/1968	7	19
01/01/1970	7.5	23
01/01/1973	7	20
01/01/1977	7	17.6
01/07/1982	4 | 5.5 | 7	18.6
01/01/1986	4 | 5.5 | 7	18.6
01/07/1986	2.1 | 4 | 5.5 | 7 | 13	18.6
17/09/1987	2.1 | 4 | 5.5 | 7 | 13	18.6
01/12/1988	2.1 | 4 | 5.5 | 7 | 13	18.6
01/01/1989	2.1 | 5.5 | 13	18.6
08/09/1989	2.1 | 5.5 | 13	18.6
01/01/1990	2.1 | 5.5 | 13	18.6
13/09/1990	2.1 | 5.5 | 13	18.6
29/07/1991	2.1 | 5.5	18.6
01/01/1993	2.1 | 5.5	18.6
01/08/1995	2.1 | 5.5	20.6
01/04/2000	2.1 | 5.5	19.6
01/01/2012	2.1 | 5.5 | 7	19.6

Index of GDP and hospitality output growth (2000 = 100)



Index of national and hospitality employment growth (2000 = 100)



Portugal

Portugal introduced a reduced rate of VAT in 1986. In 2010, it changed for the first time since 1995

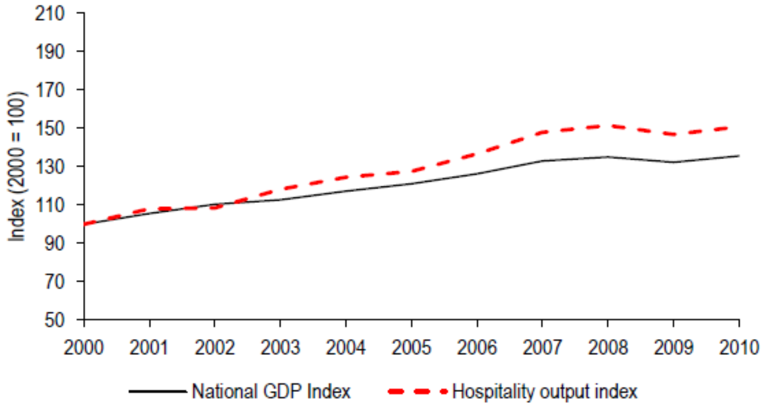
The reduced rate is applied to spending on hotels

During the period 2000 - 2010, both turnover and employment of the hospitality sector have grown more quickly than GDP

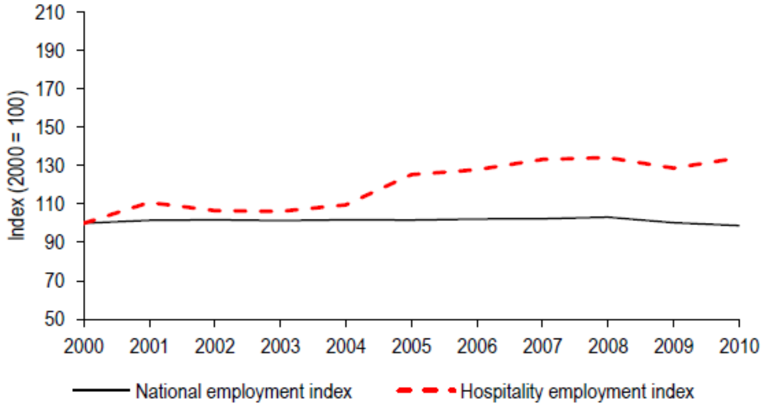
Rate changes

	Reduced rate (%)	Standard Rate (%)
01/01/1986	8	16
01/02/1988	8	17
24/03/1992	5	16
01/01/1995	5	17
01/07/1996	5 | 12	17
05/06/2002	5 | 12	19
01/07/2005	5 | 12	21
01/07/2008	5 | 12	20
01/07/2010	6 | 13	21
01/01/2011	6 | 13	23

Index of GDP and hospitality output growth (2000 = 100)



Index of national and hospitality employment growth (2000 = 100)



United Kingdom

The UK introduced a reduced rate of VAT in 1995, and it was set at its current level of 5% in 1997

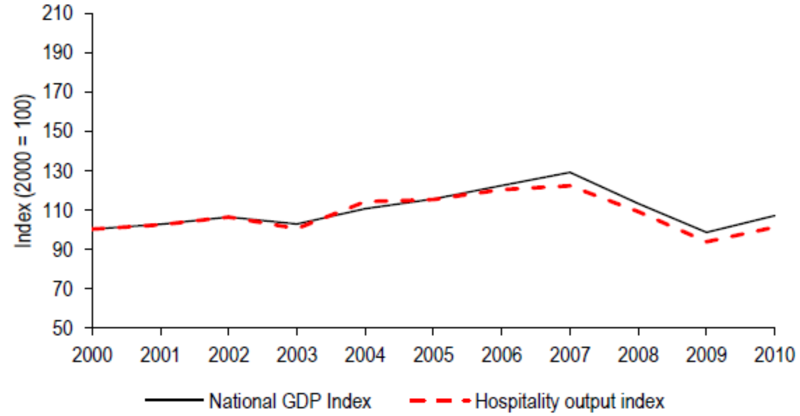
The UK does not apply the reduced rate of VAT in the hospitality sector

The hospitality sector turnover and employment have grown in line with the national Economy

Rate changes

	Reduced rate (%)	Standard Rate (%)
01/04/1973	-	10
29/07/1974	-	8
18/11/1974	-	8
12/04/1976	-	8
18/06/1979	-	15
01/04/1991	-	17.5
01/04/1994	-	17.5
01/01/1995	8	17.5
01/09/1997	5	17.5
01/12/2008	5	15
01/01/2010	5	17.5
04/01/2011	5	20

Index of GDP and hospitality output growth (2000 = 100)



Index of national and hospitality employment growth (2000 = 100)