

# The Impact of Abolishing the VAT Exemption for Postal Services Provided by Deutsche Post AG

## A Qualitative and Quantitative Analysis

Study prepared for Bundesverband Internationaler Express- und Kurierdienste e. V.

### - Executive Summary -

## **Executive Summary**

1. The BIEK (Bundesverband Internationaler Express- und Kurierdienste e.V.) retained WIK-Consult in September 2005 to prepare a study on “the impact of abolishing the value added tax exemption for postal services provided by Deutsche Post AG. The current German turnover tax law (VAT law) exempts a number of postal services provided by Deutsche Post AG (DPAG), the privatized former postal administration in Germany.
2. This study analyses the VAT issue both qualitatively and empirically. The empirical analysis is restricted to the German market for letter services. In 2004, this market generated revenues of € 10.1 bn; roughly two thirds of which are protected by DPAG’s exclusive licence, i. e. by the postal monopoly.
3. The current VAT exemption relates not only to monopoly services but, in addition, extends to a number of services DPAG provides in competition with other operators (see no. 11 below).

## **Interpretation of study results and conclusions**

4. The current tax exemption to DPAG results in considerable distortions of competition in those market segments that have been liberalized. The grand coalition that is currently expected to come into power has agreed to increase the VAT rate from 16 to 19 percent in 2007. Such an increase of the VAT rate will lead to a corresponding further increase of distortions of competition in the liberalised postal market segments and may put at risk employment within those competitors that had entered the market when the tax rate was lower (and who thus had less of a price disadvantage in comparison to the incumbent).
5. We estimate the additional tax income that results from abolishing the current VAT exemption to be on the order of magnitude of € 150-330 m. The actual amount of additional tax income will depend on the extent to which DPAG passes on the VAT charged to its customers (see scenarios in paragraph 18 below).
6. As regards the political objective underlying the current VAT exemption, one could presume that it is to reduce the burden on consumers when purchasing postal services. Our study concludes, however, that the benefits of the current tax exemption accrue primarily to business customers that cannot reclaim VAT (including banks, insurance companies, and public authorities) rather than to consumers.

7. As a consequence of abolishing the VAT exemption, consumers would —according to our model results — be burdened with a modest additional expenditure for postal services. If DPAG completely passes on VAT to consumers, we estimate an additional annual expenditure of less than € 5 per household. Consumers would be burdened even less if DPAG passes on less of the tax to its customers.
8. From the perspective of a political cost-benefit-analysis of the VAT exemption there is one key question to be raised: does a benefit to those of DPAG's business customers that cannot deduct VAT justify foregoing potential additional tax revenues of about € 150-330 m? More generally, it appears unclear why those business customers that cannot reclaim the VAT that they pay on all their inputs ought to be subsidised when purchasing letter services but not when purchasing other good and services, e. g. stationery, consulting services or vehicles. These reflections appear to be particularly relevant in Germany today in the face of substantial public deficits and discussions over considerable tax increases (including VAT).
9. In view of the above aspects, the authors recommend elimination of the VAT exemption granted to Deutsche Post AG; i. e. deletion of § 4 Nr. 11b of the German law on turnover tax (UStG).
10. With respect to abolishing the VAT exemption of DPAG, our study reveals a possible trade-off between objectives of competition policy on the one hand and distributional objectives on the other hand. In this case, we deem the impacts related to competition policy objectives more important because competition promotes innovation, efficiency and lower prices in the postal sector. In contrast, we consider the relatively marginal distributional effects on private households as less important. In the presence of a considerable public deficit, the extra tax income that would result from abolishing the VAT exemption provides a further argument in favour of our recommendation.

### **Status Quo of VAT on postal services in Germany**

11. According to a relatively vague stipulation of the German VAT law § 4 Nr. 11b UStG), DPAG's turnover "directly related to the postal system" is exempted from VAT (in German: „die unmittelbar dem Postwesen dienenden Umsätze der Deutsche Post AG“). In a response to Parliament, the federal government (Minister of Finance) has ordered that the exemption extend to all universal services, as defined by the Postal Universal Service Ordinance (PUDLV). According to this ordinance, universal services include letter items below 2 kilograms and parcels. In practice, the tax exemption appears to be applied only to DPAG's over-the-counter-parcels; VAT is routinely charged for bulk parcels from commercial senders, even though all parcels not exceeding 20 kilograms should be considered as universal services under the ordinance.
12. According to the Sixth Council Directive on VAT (77/388/EEC), the "supply by the public postal services of services other than passenger transport and

telecommunications, and the supply of goods incidental thereto” must be exempted from VAT. Following deregulation in the postal sector — and, in particular, privatization of Deutsche Post AG — the term “public postal service” has become increasingly ambiguous. As to the German situation, therefore, there are doubts as to whether the directive can be interpreted to strictly require continuation of the exemption to DPAG services in the German law on turnover tax (UStG). Application in other Member States clearly shows that different interpretations of the Sixth Council Directive exist: In some Member States all postal operators are subject to VAT at regular rates, while in others different subsets of postal services provided by the former postal administrations are exempted from VAT.

13. In the German market for letter services, severe distortions of competition result from DPAG’s VAT exemption: When competing in many market segments, DPAG needs to charge lower (net) tariffs in order to achieve the same margins as its competitors. This advantage adds to other advantages of the market dominant incumbent Deutsche Post that is still largely protected by a monopoly (on letters below 100 gram, which account for approximately two thirds of the total letter market). An increase of the VAT rate — as agreed by the grand coalition likely to come into power in Germany in November 2005 — would further intensify existing market distortions.
14. Abolition of a VAT exemption could only burden those customers that cannot reclaim the tax. These customers include consumers as well as public authorities and institutions. In addition, corporations cannot reclaim VAT (or less VAT) that they paid in order to provide goods or services that are likewise exempt from VAT. This is the case for banks and insurance companies, the real estate industry, hospitals, medical profession, and educational institutions among others. The extent to which these postal customers will be affected by the abolition of the VAT exemption of DPAG, depends on how much of the tax DPAG passes on to its customers.
15. Businesses that can reclaim VAT are not affected negatively by the abolition of the VAT exemption. Compared to other industries, it is a peculiarity of the letter market that an unusually large portion of market revenues results from corporate customers that cannot reclaim VAT. Of all revenue from customers that cannot reclaim VAT, about one third stems from individual consumers (i. e. approx. 15 percent of total market revenues). About two thirds of all demand from customers that cannot reclaim VAT is from business customers (including banks, insurance companies and public authorities). Thus, this group is the major beneficiary of the current VAT exemption.
16. The VAT exemption induces higher costs for DPAG since the company cannot reclaim the VAT associated with its input purchases and its investments. For DPAG’s corporate division “MAIL”, we estimate the amount of irrecoverable VAT at approx. € 500-650 m. This burden is partially offset by a corresponding competitive advantage for the incumbent (that was not quantified in this study).

## Quantitative effects of an abolishment of the value added tax exemption

17. The results of the model rest on a parameterisation of the model which we view as pertinent and most likely to be compatible with the actual market conditions. The model was parameterised based on publicly available data on the market for letter services in Germany as well as on comparable data sources from abroad. On the basis of our sensitivity analyses, we regard the results, overall, as robust against changes of the parameters of the model. Nonetheless, it is fair to say that the quantitative results have to be interpreted in the context of the model assumptions. They reflect orders of magnitude rather than precise estimates.
18. Model calculations have been carried out for three scenarios. Essentially, these scenarios differ with regard to the extent DPAG is able to pass on the value added tax to its customers.
- **Scenario 1** stipulates that the net prices of DPAG do not change after the imposition of the value added tax. This scenario reflects the assertion made by the CEO of DPAG in various newspaper interviews that current prices are actually net prices and that value added tax would entail an increase of the gross price equalling the value added tax rate.
  - **Scenario 2** is based on the model assumption that the letter prices are adapted in such a way as to exactly offset changes in DPAG's earnings implied by the elimination of the value added tax exemption. This scenario reflects both the cost savings due to the deduction of irrecoverable VAT (i.e. prior input tax) and changing demand. Contrary to the first scenario, DPAG in this scenario passes on its cost savings to its customers by decreasing net prices. To the extent that the current prices for letter mail are cost oriented this scenario therefore follows the principle of cost orientation laid down in the Postal Act.
  - **In scenario 3** the net prices are adjusted exactly in the way to leave the current gross prices unchanged. Thus, this scenario mirrors the introduction of value added tax for Deutsche Telekom AG in the beginning of 1996 – at that time the gross prices (for monopoly services) were left unchanged after the introduction of the value added tax.
19. In both scenarios 1 and 2, the state represents an overall increase in tax revenues — the order of magnitude is at around 300 mill. € (combined effect at Federal, Bundesland and municipal levels). The third scenario represents an overall increase in tax revenues of about 150 mill. €. Thus, the abolition of the value added tax exemption for letter services unequivocally leads to an increase of tax revenues.
20. Business customers eligible to deduct prior input tax („companies subject to normal value added tax“) are „winners“ if the value added tax exemption for letter services is eliminated. In scenario 1 (net prices unchanged), they are neither burdened nor do they benefit. In scenario 2 (cost oriented adaptation of net prices) their earnings increase at an order of magnitude of 100 mill. € (reduced expense for postal

services less additional profit tax). Earnings increase at about 300 mill. € in the third scenario.

21. For private households, the elimination of the value added tax exemption for letter services leads to an average burden of slightly less than 5 € per year (scenario 1). Scenario 2 yields an annual additional burden of about 3 €. In the third scenario, the elimination of the value added tax exemption is neutral for private households.
22. Business customers that cannot deduct prior input tax (such as banks, insurance companies, public authorities, institutions and social insurance companies) are burdened by an elimination of the value added tax exemption for letter mail services. Altogether, we calculate a burden for this customer group at an order of magnitude of 250 mill. € (scenario 2) to 350 mill. € (scenario 1) due to the higher input costs. In the third scenario, the introduction of a value added tax is neutral for this type of sender.
23. DPAG would gain in the first scenario (net prices unchanged) from the elimination of the value added tax exemption for letter mail services. We calculate additional earnings at an order of magnitude of 200 mill. €, corresponding to more than 10 % of the income after taxes reported by Deutsche Post World Net's corporate division MAIL in 2004. By definition, DPAG would not benefit from the elimination of the value added tax exemption in the second scenario: its earnings and margins remain unchanged. In the third scenario, the company's earnings would decrease at an order of magnitude of 400 mill. €, equalling around 19 % of the EBITA reported by its MAIL division in 2004. Thus, the revenue margin would decrease from around 16 % to around 13 %.

### **Assumptions and inherent logic of the model**

24. The empirical investigations are based on a model for the quantitative assessment of the effects of an elimination of the value added tax exemption in the letters market. The model considers a stylised two-product firm offering two types of letter services. Thus, it reflects essentially the business activities of DPAG's MAIL division. The two letter products in the model are transaction mail and (addressed) direct mail.
25. The model takes account of DPAG and three (macroeconomic) sectors: private households, business customers and the State. The model is based on a comparative static approach, i.e. it compares two situations: a world in which particular services of DPAG are not subject to the value added tax regime (situation 0) and a world in which this value added tax exemption is abolished (situation 1). Moreover, the model is a partial one, i.e. it essentially takes into account only „first order effects“ with the four entities involved. The effects of additional interdependencies among the economic sectors that actually exist in reality are not considered.

26. In the model, DPAG represents the entire market for letter mail services. That is, the model does not take account of competitive reactions between DPAG and its competitors. We nonetheless consider this approach to be pertinent for the purposes of the present study as DPAG today accounts for 95 % market share in the letters market (and thus serves almost the entire market).
27. After the elimination of the tax exemption (situation 1) a value added tax rate of 16 % is imposed on DPAG's turnover from letter services that had so far been exempted from VAT (in the model: transaction mail and direct mail). For each of these products, the model distinguishes price elasticities of private households on the one hand, and of business customers on the other hand. Direct mail services are exclusively demanded by business customers. The model thus assumes that customers will adapt their demand for letter services in response to the price changes that result from the introduction of VAT (from the customer's perspective).
28. For DPAG, elimination of the value added tax exemption essentially induces the following effects: First, revenues are altered under the value added tax regime which so far have not been subject to value added tax, depending on the prices set by DPAG (model scenarios). Second, prior input tax contained in purchased inputs and capital expenditures — which so far has not been deductible — can now be reclaimed. Third, the prior input tax which now is deductible *ceteris paribus* affects profits and, in turn, profit taxes (in Germany: corporation tax and trade tax).
29. Private households and business customers that cannot deduct prior input tax adapt their demand for letters in response to increasing gross prices including VAT (in scenarios 1 and 2). However, the demand for letters on the part of business customers that can reclaim prior input tax is not affected by the value added tax (presuming that net prices remain constant). The changes in the quantities demanded by all customers cause corresponding changes in their expenditure for letter services. The latter change *ceteris paribus* has an effect on the business customers' earnings and thus induces a change in the profit tax burden (of those business customers subject to profit taxation).
30. The governments tax revenues on the one hand collectively benefit from a net increase in value added tax revenues from DPAG that is reduced by the amount of prior input tax deducted by DPAG and business customers. On the other hand, revenues from profit taxes change as DPAG's and business customers' earnings change. The model thus calculates the combined effect on tax revenues of the government (at Federal, Bundesland and municipal levels) but does not take account, however, of possible additional expenditures by public authorities due to a higher gross price for letter mail.