Indirect Taxation, Corporate Pricing Strategy and Competitive Positioning: the Reaction of Romanian Firms to Value-Added Tax Increase

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Abstract: From a theoretical perspective, the most significant reaction to an increase in an indirect tax calculated as a percentage of the final price should come from the competitors positioned both at the lowest and at the highest price-to-quality segments of the market. Taking into consideration the pricing reaction of Romanian firms to the 1st of August 2010 increase in Value Added Tax (the biggest VAT hike in Europe), we argue that their reaction was weak based most probable on the comfort that such a tax increase would not change their competitive positioning. The market segment most affected by such a tax hike, the luxury segment, seems to purely and simply ignore the situation while price sensitive distributors have used "tax deductions" techniques as a transitory step.

Key words: indirect taxation, pricing strategy, VAT increase, competitive positioning

1. Corporate pricing policy and taxes

It is rather obvious that end consumers are concerned in fact by the after-tax pricing of the goods they acquire. For them, the final paid price is what counts from a buying perspective. For example, in the case of the auto industry, the end consumer is interested in the cash price he has to pay. The practice of distributors to quote prices with no VAT, for minimal configurations or including rebates on trade-ins of scrapped (or more than a number of years old) cars is employed in order to „underprice". The only case when consumers are not interested in the structure and level of taxes is when they are allowed to deduct their paid taxes for the acquisition of certain goods. Except few instances, the vast majority of them are however very sensitive to the structure, level and modifications in taxation. From this perspective, it seems that each pricing policy at corporate level is impacted by taxes as long as the final price that reaches the end consumer (the after-tax price) is the sum of the producer price (before-tax price) plus taxes.

However, marketing manuals seem to start in the majority of cases from the implicit assumption that taxes are indiscriminately falling on consumers and on competitors. From this perspective, taxes seem to be largely irrelevant and, consequently, ignored for the pricing strategy of companies.

Taxation is however not neutral in the sense that the structure and level of taxes have a different impact on end consumers' decision to buy. Starting from the way they are calculated, we can argue that taxes have a different incidence on certain categories of goods differentiated by their pricing (which is by itself the result of other competitive factors).

Moreover, any modification in taxation – and especially indirect taxation – should be taken into account as a significant event in the competitive strategy of any company.

2. Incidence of indirect taxation

It must be noted that a critical difference can be traced between direct taxation (personal or corporate income tax) and indirect taxation (Value Added Tax - VAT, sales taxes). While the impact of the first category of taxes on particular goods or services is difficult to quantify as they are levied against global income of taxpayers, the impact of the second one is more immediate and apparently easier to analyze. Indirect taxes are levied on particular transactions with goods and services and their impact on pricing and, consequently, buyers' decision seems to be immediate. In this paper, we will explore exclusively the impact of VAT modification on corporate pricing strategy.

While mainstream literature in taxation argues that indirect taxes fall at the bottom-end on end consumers, several economists have argued that, in reality, producers are also sharing the burden [1]. Several economists have argued that, ultimately, every product a consumer buys competes with every other product in the value scale of that particular consumer. It is not, accordingly, an easy task to „define" a market. From such perspective, a car can compete with a motorcycle. However, the business literature has largely defined „markets" according to technological and utility substitutability. That reality comes from the simple wisdom that the any increase in the final price leads to a reduction in the demand for the product (assuming a normal elasticity function) which leads to lower sales for the industry. The reduction in sales at the industry level can be shared differently by producers in that industry.

In an industry confronted with reduced aggregate sales, a particular competitor can follow one of the possible scenarios: I. its sales remain at the same level or even increase (in dollar terms), which suggests that the decrease of industry sales is born by other competitors; II. its sales decrease at the pace of the industry so the competitive structure of the industry remains broadly the same (competitors are proportionately affected by the reduction in aggregate sales); III. its sales decrease at a rate higher than the industry so that particular competitor looses in competitive positioning.

In the case that the entire industry knows reduced aggregate sales, we can argue that the intensity of competition among producers is increased. They all battle for the fidelity of less numerous consumers and those competitors who succeed in keeping their end consumers will be the least affected by reduced sales.

A firm confronted with lower sales will have to reduce the price or to radically change its positioning on the market, that is, to change its marketing mix.

3. Impact of indirect taxation on competitive positioning

The immediate impact of an increase in indirect taxation will be, *ceteris paribus*, a reduction of aggregate sales at the industry level. Firms could normally react on short term mainly in two ways: A. compensate the tax increase (that is, a very probable reduction in sales) so they can normally choose between a reduction in price or an increase in marketing efforts; B. no reaction: the competitors ignore the tax modification assuming that this is neutral.

Of course, the choice depends also on the amplitude of the tax modification as small changes will normally attract few reactions.

In fact, taking into account the effects of the tax increase on the industry, a particular competitor faces what could be qualified as "a prisoner dilemma". Its reaction is dependent and influences the reactions of other producers. We took into consideration the simple situation of an industry with two producers.

Table 1.

\ Producer A Producer B \	„Compensate" tax increase	No reaction
„Compensate" tax increase	Scenario A: ***soft landing***	Scenario C: ***turbulence***
No reaction	Scenario C: ***turbulence***	Scenario B: ***hard landing***

Each of these possible scenarios has its own challenges for the particular producer:

Scenario A: if all the producers in a particular industry decide to compensate the tax increase by a form of before-tax price reduction, the competitive outcome should be the least dramatic from the perspective of the entire industry. We can call this scenario a "soft-landing" as the factors that would affect the competitive positioning of the process in the industry should not be endogenous (the prices remain for all producers the same) but exogenous (like the modification of the available aggregate income of the end consumers) as all the products and services in the purchasing basket of the end consumers start to compete one with the other. The core challenge to this approach, which could be called the "cooperative" scenario in the prisoners' dilemma, is the public policy reaction. A similar and industry-wide reaction to the tax modification could be interpreted as a cartel or tacit collusion by the competition authorities and be sanctioned.

Scenario B: the lack of any reaction from the part of the producers in the industry can be called the "hard-landing" scenario. The probability that producers would be equally impacted by the reduction of the aggregate sales of the industry, while it cannot be ruled out (which leads to scenario A) is not very high. Producers in a particular industry are in a process of dynamic positioning and there are always differences in consumers' fidelity ("elasticity" in economics language), price/quality offering and so on. The impact of the tax increase would be significant on the after-tax prices and lead to a significant repositioning on the market in question.

Scenario C: taking into account the potential blocking from the part of competition authorities of scenario A (which should lead to the least dramatic effects on the industry) but also a lack of awareness of the potential industry-wide effects of some competitors, this scenario should be the most probable one. In this case, some producers will react to the tax increase by a form of before-tax price reduction at the producer level.

4. "Hard landing" scenario: the case of Romanian tobacco excise in 2006

The impact of the way taxes are calculated as well as of the impact of modification of taxes on the competitive positioning is a poorly analyzed issue in marketing. However, there is a very significant interest from the part of economics literature dealing with taxation and competition.

Maybe one of the most analyzed issues in this regard is the impact of excise taxes on prices and competitive positioning, especially in tobacco and alcohol markets (some of the most heavily taxed products in the world). The literature in this field differentiated between the impact of per unit (or specific) tax (lump-sum taxes levied per unit – eg. 30 Euros per tone) and ad valorem taxes (percentage of value of the unit – 10% of the final price) . The general conclusion is that while per unit taxes have a "regressive" effect (they represent a higher percentage of the final value of lower priced products), the ad valorem taxes have a so-called "progressive effect" (they have a more significant dollar value for higher priced products) [2]. Of course, from a simple mathematic point, the same percentage (a "flat" tax), as it is applied to a larger income (or price, in our case) leads always to a larger tax expressed in dollars. A "real" progressive tax is when a higher income / price is more heavily tax (as percentage). However, the idea of a "progressive effect" comes from the theoretical challenge of how should the tax be calculated. For a person who considers that taxes should be "lump-sum", a flat tax has a seemingly "progressive effect" [3].

In the particular case of Romanian tobacco market, the 2006 introduction of the minimum excise duty (expressed per unit but calculated as a percentage of the most popular sold cigarette) as a consequence of the Romanian integration in the European Union had the impact of the elimination of the lower priced brands (like the local Romanian Tobacco brands) and a significant reduction in the spread (the difference between the highest price and the lowest price) of prices as percentage of the lowest price for the entire industry. It can be argued that it favored the brands positioned on the middle to top price/quality segment as it narrowed the price difference from the cheap brands [4].

It can be argued that higher priced brands benefited from the introduction of a large per unit excise as they succeeded in the past in creating a luxury image. As lower priced brands have less fidelity from the part of their consumers, the narrowing of the price spread determined two significant effects: A. a significant number of consumers entirely gave up consumption as a result of the increase in the lowest priced products. B. a significant number of other customers more easily migrated towards luxury brands, which were closely priced in dollar terms.

The impact of the introduction of the minimum excise duties in the case of Romanian tobacco market was dramatic. In the case of the lowest priced product, excise represented more than 90% of the final price. Such a calculation of the excise duties amounted to a minimum price for tobacco. For example, if product A is priced at 10 monetary units (per 100 cigarettes) and product B is priced at 30 m.u., a lump-sum tax of 90 m.u. per 100 cigarettes would lead to a price of 100 for product A and 120 for product B. While one of the clear effects would be a significant number of consumers giving up consumption, it can be argued that the difference between "cheap" and "luxury" segments is significantly blurred. On such a "new" market, the advantage would be for the luxury brands which invested heavily in brand positioning. Cheap brands are denied their core advantage on the "old" market. The spread (difference between the two prices as percentage of the lowest price) is significantly reduced from 200% to 20%. In consequence, consumer "migration" seems to be easier.

The case demonstrated the impact of indirect taxation on competitive positioning and the need of corporate pricing policy to take it into account. While there are no other cases of such a dramatic impact on industry (maybe fuels), the impact of taxation is real and significant. It will have a deep impact on the producers positioned at low pricing segments as the loose their entire competitive advantage.

5. An increase in ad valorem indirect taxes

The case of an increase in an indirect tax calculated ad valorem is markedly different than the above-mentioned case. Increases in such a tax should normally lead to two significant effects: I. a number of consumers gave up consumption as a result of the increase in the lowest priced products. However, without the effect of "minimum price" as in the case of per unit taxes, the impact seems to be more modest. II. it amplifies the spread of prices among different quality segments so there would be two categories of producers that should be mostly affected: the producers positioned at high pricing segments and the producers positioned at low pricing segments with highly price-sensitive consumers.

The case of VAT increase has the above mentioned "progressive" effect in that, as in the case of any percentage tax, it will have a multiplying effect on price. As the spread of prices will be significantly augmented, the VAT increase will fall in the high pricing segments. Producers who are positioned there should normally react by taking over at least a part of the additional burden of taxation.

6. Pricing reactions to tax modifications: the case of firms on the Romanian market

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The vast majority of Romanian producers have ignored the VAT increase and they didn't have a significant reaction to such an indirect tax modification. However, the decision of Romanian authorities to increase from 1st of August 2010 the VAT from 19% to 24% is one of the largest VAT hikes in Europe. The most probable cause of such a situation lies in the firms' opinion that such a tax hike remains however low (5% of the final price) from a competitive positioning perspective.

Among the producers that did react to such a tax increase, the bulk of them opted for two approaches: A. "*my word is my bond*": some firms have kept the "old prices" constant based on the argument that their pricing catalogue was a firm offer to the consumers so they observe the terms of a contract. This is however a transitory reaction and fundamentally lacks substance (the level of taxes is not a contractual obligation so any Court would waive the liability of the sellers) but highlights the "respect" of the firms towards its clients. This is the case of IKEA (for its entire catalogue) and Metro (for its promotion catalogue); B. "*hit and run*": some firms have used the situation in a tactical way to tie the tax modification to a marketing hit. They also used the reduction in pre-tax price on a transitory basis as it was offered only on short term (usually 1 month) with no promise for further pricing repositioning. This is the case of EMAG in the electronics field and FIAT in the auto distribution (only for some models like Linea).

What can be however noticed is that the quasi-totality of firms which chose to react to VAT increase came from budget / value segments (or arguably targeting very narrow margins) which are obviously the most sensitive to after-price increases. They all realize that even a 5% increase in the final price may have a significant impact on the costumers' decision to buy. What is absolutely intriguing is the lack of reaction from the part of the upper segments of markets in the price/quality criterion [5].

Why is the reaction among the "luxury brands" so weak? The core argument seems to lie in the trap laid by their own pricing strategy: they usually attempt to avoid a "price war" which is perceived as self-destructive and focus on other strategies like promoting brand image and client fidelity. They are typically betting on their ability to attract clients from competitors and compensate the decrease. It is obvious that, on the aggregate, the luxury brands sales should decrease and that means that the intensity of competition will rise in the segment.

Conclusion

The increase in Value Added Tax in a large number of European countries could become a starting point in the reevaluation of the link between taxation and pricing strategies of firms. The working hypothesis of present-day marketing manuals – namely taxes are neutral from a strategic approach – seems to be too simplistic.

The Romanian experience seems to confirm the fact that competitors are not fully aware of the consequences of such regulatory measures. The existing reactions were exploratory and tentative. The most striking aspect is the lack of any reaction from the part of luxury brands producers or distributors – arguably the most affected - which could be argued that they are trapped into their own marketing strategy ("no price wars"). We expect a significant repositioning in the following period into these market segments.

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