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VAT Contribution to Fiscal Sustainability in the Context of the Financial and Economic Crises: Can the VAT Contribute to Fiscal Sustainability?

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Governments have taken measures to stimulate demand…

Probably, everybody would agree that we are experiencing turbulent times with a deep recession of historical magnitude. As a response to the current worldwide financial and economic crisis, many countries have implemented measures of unprecedented scale. Monetary policy reacted quickly and reduced nominal central bank rates to near zero levels while further expanding money supply through the unexplored territory of quantitative easing, that is, the purchase of government and corporate bonds. Additionally, governments agreed on enormous fiscal packages to support struggling banks and to stimulate aggregate demand. Tax cuts and spending increases average more than 3 percent of GDP according to the OECD Economic Outlook[1]. More than half of discretionary policy measures have been attributed to tax measures. In a study by Ernst & Young[2], 15 of the 24 countries surveyed have taken action related to indirect taxes, most notably the value-added tax. In some cases, including the Netherlands and Switzerland, a previously scheduled VAT increase was postponed. In other cases, the VAT rate was lowered temporarily – either through targeted cuts as for automobiles in Brazil or China or for restaurants in France, or generally as in the UK were the standard rate was lowered from 17.5 to 15 percent – the lowest rate allowed under EU legislation.

[1] OECD Economic Outlook No. 85, June 2009

[2] Ernst & Young, 2009. Worldwide fiscal stimulus – Tax policy plays a major role: A guide to understanding opportunities and challenges in 24 key jurisdictions.

… resulting in large deficits and higher debt levels

However, the combination of significantly lower tax revenues on one hand and much higher total outlays due to the sheer size of fiscal packages and bail-outs of banks on the other hand, has led to record budget deficits. According to recent data by the OECD, budget deficits in 2009 and 2010 will average between 5 and 6 percent of GDP and reach more than 10 percent of GDP in Ireland, the UK and the US. In the EU, several countries recorded deficits last year that already exceeded the limit of the Stability and Growth Pact of 3 percent, including Spain, Ireland, France and Greece. The result is a surge in total debt and interest payments. As many industrialized countries were already facing structural deficits and high debt levels before the crisis, this raises serious concerns about fiscal sustainability. Debt levels in many industrialized countries are now at their highest level ever recorded during non-war times. Total OECD debt will reach 100 percent of GDP in 2010, compared with 73.5 percent in 2007 and 59 percent in 1990. According to the OECD, 11 of 18 countries exceed the limit allowed according to the Maastricht criteria for general government gross debt. The average debt level for this year is projected to be 79 percent – 19 percentage points higher than the limit allowed by the Stability and Growth Pact. This creates a potential vicious cycle of increasing interest payments and even higher debt. In some countries, interest payments on government debt could reach as much as 20 percent of revenue in the next few years. Against this background, it is not surprising that also FED Chairman Ben Bernanke testified on exit strategies by stating: "Unless we demonstrate a strong commitment to fiscal sustainability, we risk having neither financial stability nor durable economic growth".[3]

How can fiscal sustainability be achieved?

The question is thus how to attain fiscal sustainability. Unfortunately, this is not only a question of the adequate "exit" strategy. As António Afonso and Christophe Rault from the European Central Bank pointed out two years ago, several EU countries did not even follow a path of fiscal sustainability before the crisis.[4] They examined the sustainability of public finance of 15 EU member countries between 1970 and 2006 by assessing the stationarity of government debt and the existence of cointegration between government revenues and expenditures. While all tests performed pointed to the solvency of government public finances when considering the entire panel data set, they also concluded that fiscal sustainability will not be attained if past fiscal behavior is kept unchanged in the foreseeable future. Only seven countries satisfied the solvency condition. That list is further reduced when the existence of structural breaks in the series is taken into account. This is a remarkable result considering that they excluded implicit government liabilities from their analysis. It also helps to explain why deficits and debt levels have increased in such dramatic fashion. Highly indebted countries with structural deficits entered the recession unprepared. They did not

[3] The Wall Street Journal, July 22, 2009.

[4] Antonio Afonso and Christophe Rault, 2007. What do we really know about fiscal sustainability in the EU? A panel data diagnostic, Working Paper Series 820, European Central Bank.

have any room within the budget for fiscal stimulus, meaning that programs had to be financed through the issuance of additional debt.

Possible measures

Possible measures to achieve fiscal sustainability are rather limited, however. Assuming that central banks are fully independent and willing to ensure price stability, that is, resist any political pressure to solve fiscal problems by printing new money and thereby increasing inflation (seignorage), only tax increases or spending cuts (or a combination of the two) are available. Tax increases, however, are highly unpopular, particularly during and shortly after heavy recessions. International tax competition and the high mobility of production factors further constrain any effort to raise taxes. And finally, many industrialized countries are already facing a high tax burden. In the OECD, average total revenue as a percentage of GDP has been relatively stable between 37 and 39 percent over the past twenty years, indicating that it might be neither possible nor desirable to have higher taxes. Further reductions of disposable household income would also increase the size of the informal economy and tax evasion.[5]

On the expenditure side, several factors limit the possibility of substantial spending cuts. First, a large share of total outlays is defined by law, particularly for social welfare and interest payments, and cannot be changed over night or at will. Second, some of the discretionary measures taken to support aggregate demand are difficult to reverse. This is because they are either permanent instead of temporary or because a premature reduction poses the risk for fiscal policy to become procyclical which would hamper the economic recovery. Third, spending will soar due to demographic changes and related increases in expenditure for health care, long-term care and pensions and health, even without any fiscal adjustment. If current policies remain unchanged, public spending on health care, long-term care and pensions could increase by more than 10 percent of GDP on average in OECD countries between 2005 and 2050. The OECD data show strong cross-country variation, reaching from around 5 percent in Sweden to almost 17 percent in Greece, but all member countries will be significantly affected.[6] All in all, there is not much space for political maneuver.

How can the VAT contribute to fiscal sustainability?

In this context with narrow political degrees of freedom, the VAT has the potential to contribute to fiscal sustainability. Some experts like Richard M. Bird consider the VAT the "most successful fiscal innovation of the last half-century".[7] He claims that no other significant tax spread as quickly around the world as the VAT did. Starting in the late 60's with countries such as Denmark, France or Germany, this tax has now been implemented in over 150 coun-

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[5] Friedrich Schneider, Benno Torgler and Christoph A. Schaltegger, 2008, Schattenwirtschaft und Steuermoral, Rüegger, Chur.

[6] OECD Economic Outlook No. 84, December 2008.

[7] Richard M. Bird, 2009, Value Added Tax and Excises, commentary; Prepared for the Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrless.

tries. Within the OECD, all member countries with the exception of the United States who continue to rely on their Retail Sales Tax, have implemented the VAT. This remarkable success is often explained by pointing out that the VAT is much less distortionary than other taxes. It is also a rather efficient form of taxation as the costs of fundraising for governments are low. But given the wide array of different rates, thresholds and exemptions, there is considerable variation between countries in the revenue performance of their respective VAT systems. One indicator measuring this performance is the VAT Revenue Ratio. This indicator is defined as the ratio between VAT revenue and the theoretical revenue raised if the VAT was applied at the standard rate to total final consumption. Within the OECD, values range from 0.33 in Mexico to 1.05 in New Zealand.[8]

By lowering the costs of taxation, the implementation or expansion of a VAT system makes it relatively cheap for governments to increase their level of state activity. Michael Keen and Ben Lockwood show that countries with a VAT raise more revenue than those without. Others on the other hand see this argument as a reason to oppose the VAT because it is a "money machine".[9] This was probably one of the reasons why the United States has thus far rejected the implementation of the VAT. Members of the President's Advisory Panel for Federal Tax Reform were afraid that public well-being might be lowered and that the government would turn into a Leviathan.[10]

But given the fact that the VAT distorts economic incentives for workers, consumers and firms less than alternative taxes and that its revenue fluctuates much less over the course of the business cycle than the corporate and the income tax, the VAT is able to contribute to fiscal sustainability. Even though, admittedly the stabilizing effect on the business cycle is weaker with VAT as compared to income taxes. However, the pros of the VAT seem to justify a further shift to indirect taxes of which the VAT is usually the most important. Indeed, taxes on general consumption have risen substantially over time – both as a percentage of total taxation as well as in relation to GDP. According to OECD Revenue Statistics, the taxes on general consumption as a share of total taxation have risen from 15 percent in 1965 to 20 percent in 2006.[11] The increase as a percentage of GDP has increased from 4.1 percent to 7.6 percent. In Switzerland on the federal level, the VAT provides about a third of total revenue. Since its introduction in 1995, revenue has decreased only once in 2002 – by 1 percent. But as Keen and Lockwood point out, the VAT is not that much of a "money machine" as a third of additional revenue raised is offset by reduced revenues from other taxes. They conclude that the shift to VAT has been driven by the desire to exploit its greater effectiveness rather than by generalized pressures to finance bigger government.

VAT issues to be addressed

[8] OECD Consumption Tax Trends 2008, OECD 2008.
[9] Michael Keen and Ben Lockwood, 2006, Is the VAT a Money machine?, *National Tax Journal* 59, 905-28.
[10] http://www.taxreformpanl.gov/final-report/
[11] OECD Revenue Statistics 2008, OECD 2008.

While the VAT is relatively successful in raising money at a low cost, there are also several issues that need to be addressed. The literature strongly indicates that many VAT systems are currently outdated. According to a report by the Institute for Fiscal Studies ("Mirrlees Review") there are three principles that have to hold for an efficient VAT system: A broad tax base, a single rate (no exemptions) and an easy handling.[12] In this context, countries such as New Zealand, Australia and Canada are mentioned among countries with good and efficient VAT systems. New Zealand is often cited as a prime example. A single rate of 12.5 percent applies everywhere from food, clothing, medical care, education services, publications, energy and other necessities of life. The consumption base is therefore broadly defined and the single tax rate enhances administrative simplicity and reduces costs for firms. This model enjoys a high level of acceptance as there have not been any serious attempts for any changes. A policy review did not produce any recommended structural changes. The threshold is relatively low, but there are simplified accounting requirements for micro and small businesses.

In contrast, many countries within the EU know a long list of standard exemptions and differentiated rates due to equity considerations. Among VAT experts, these rate structures are ill-targeted instruments to correct the income and wealth distribution while also significantly increasing the administrative complexity and compliance costs. Taxing all necessities of life at a single rate would generate more revenue which could then be redistributed more efficiently and better targeted than with differentiated rates. As of now, the VAT is often regressive, meaning that in absolute terms high-income workers benefit much more from reduced rates than middle and low-income workers. Pensioners and recipients of social security received a one-off benefit adjustment when the new VAT system was introduced in New Zealand while low-income workers were targeted with income tax credits. Concerns about equity can thus be dealt with effectively.

Switzerland's VAT reform as a good example

Switzerland's current VAT reform is a good example of a project that draws upon the lessons learnt. The Swiss federal council intends to abolish a system that has three different rates (standard rate of 7.6 percent, 2.4 percent for basic necessities and 3.6 percent for accommodation services) and a long list of exemptions, triggering high administrative costs and demarcation problems. The aim is to establish a single tax rate of 6.1 percent and abolish all but five exemptions, most notably for financial and real estate services as well as for the primary sector. Administrative costs are further reduced by raising the general threshold to 100'000 Swiss francs. A general input tax reduction is introduced to tackle the shadow tax – the so-called tax occulte. More than 50 technical changes were made to improve transparency, legal certainty and customer orientation. The VAT reform would add up to 0.7 percent to GDP, reduce administrative costs for firms between 10 and 30 percent and have no impact on household income as 380 million Swiss francs are reserved to compensate low-

[12] http://www.ifs.org.uk/mirrleesReview

income households. However, as Mancur Olson pointed out long ago in his "logic of collective action", such a fundamental reform is not easy to implement as winners are diverse while losers of the reform are well organized.[13] As a result, the parliament has already extended the reduced rate of 3.6 percent for the hotel industry for three more years until 2013. It will not be easy to convince the Parliament for a single VAT-rate with only few exemptions. Nevertheless, these turbulent times may also be a "window of opportunity" for reformers.

Conclusion

In conclusion, an efficient VAT system can contribute to fiscal sustainability as distortionary effects are reduced and the cost of taxation for both the government and the private sector lowered. However, fiscal deficits and debt levels have reached such dramatic proportions that substantial spending cuts in all industrialized countries will be inevitable. While the timing of those cuts is essential to avoid procyclical effects, fiscal sustainability cannot be achieved if governments now decide to abstain from consolidation – particularly when taking into account the financial challenges of demographic developments.

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[13] Mancur Olson, 1965, *The Logic of Collective Action*. Cambridge: Harvard University Press.