

The UK Should Increase VAT

The UK Government currently faces the challenges of fighting the recession and controlling the country's budget deficit. To some extent these are conflicting objectives, because cutting public expenditure or increasing taxes will reduce demand, at least in the short term, and work against economic recovery. But for several reasons letting the deficit grow is no viable alternative. According to the latest economic forecast of the European Commission, the UK budget deficit will equal 13% of GDP in the fiscal year 2009/10. The ratio of government debt to GDP will increase from 43% in 2007/08 to 83% in 2010/11. With the exception of Ireland, no other EU country is in a similar position. Without a correction, capital

Clemens Fuest, Professor of Business Taxation and Research Director of the Oxford University Centre for Business Taxation, discusses an increase in VAT as a strategy for fiscal consolidation

offer a clear and realistic set of policies, which strike a balance between running deficits to support economic recovery and assuring the sustainability of public finances. Clearly, this will involve both cutting expenditure and increasing taxes. The IMF has recently argued that the bulk of the consolidation should be achieved by cutting public expenditure. This is because, according to studies of earlier fiscal consolidations, cuts in public expenditure

3.25%. It is very unlikely that this can be achieved. Secondly, on the revenue side of the budget, the fiscal policy strategy is mainly based on an increase in the top income tax rate to 50%. But the revenue this will raise is only £1.2bn in 2010 and £1.8bn in 2011. This is almost negligible, compared to the average annual budget deficit of £140bn which the Government expects during the next five years. The damage the higher income tax rate may do to economic growth and the efficiency of the tax system, however, could be large. Mobile high income earners may leave the country and incentives to work for those who stay may decline. Incentives for the use of tax avoidance schemes will increase dramatically. The reputation of the UK as a country with moderate tax levels will also suffer.

Some other tax increases have been announced, including an increase in fuel tax, but it is quite clear that the revenue the entire policy package will raise – approximately £5bn in the fiscal year 2011/12 – will be insufficient to stabilise the country's fiscal position.

What is the best alternative? In my view it is an increase in the VAT rate, for a number of reasons: Most importantly, VAT can raise a lot of revenue without causing much damage. For instance, an increase in the standard VAT rate from 17.5% to 20% in 2011, one year after the scheduled phasing out of the 15% rate in 2010, would raise an additional £12.5bn per year. An increase to 22% would raise £22.5bn annually. This would make a significant contribution to bringing down the budget deficit. How would a VAT increase affect the economy? This depends, among other things, on whether or not a higher VAT rate leads to increased prices – that is, whether it can

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markets are likely to lose confidence in the sustainability of public finances in the UK and stop buying gilts. The recent announcement of a possible downgrading of UK debt by Standard and Poor's is a warning which should not be ignored.

Uncertainty slows down recovery

In addition, UK firms as well as consumers know that higher taxes and expenditure cuts will have to come at some point. The absence of a credible strategy to control the deficit creates uncertainty about future tax burdens. Firms and private households are likely to react to this uncertainty by adopting a wait-and-see attitude, postponing investment and expenditure decisions. This slows down economic recovery. Both the IMF and the OECD have recently urged the UK to be clearer about its plans to restore fiscal balance in the medium term.

A promising fiscal policy strategy should

have had a smaller contractionary effect on the economy than higher taxes. It is also true that public expenditure in the UK has grown much faster than GDP in recent years, in particular as a result of recent fiscal impulse programmes. But cuts in expenditure alone cannot do the job and will take time. Therefore some tax increases will be unavoidable.

No credible fiscal strategy

This year's budget has announced a fiscal policy strategy for the next years. It does include a commitment to a growth in public expenditure of no more than 0.7% per year on average. Nevertheless, the credibility of the announced policy is low. Firstly, the fiscal projections are based on overly optimistic growth assumptions. Just one year ago the public finance projections assumed a growth rate for the years after 2011 of 2.5%. The current projections are based on a growth rate of

be shifted to consumers. If prices remain constant, the higher VAT rate will squeeze profits and wages. But past experience with VAT changes suggests that a significant part of the tax increase will be shifted to higher prices.

Economic recovery

What are the implications of a VAT increase for short-term economic recovery and medium-term economic growth? In the short term, announcing a 20% VAT rate as from 2011 would further stabilise demand because it urges households to buy durable consumer goods and renovate their houses between now and the end of 2010, before the tax increase. In 2011, of course, the higher tax would cause a decline in demand, but by then economic recovery will hopefully be robust enough.

For the medium term, the question arises whether a higher VAT rate would be more or less harmful for growth than an increase in other taxes. Empirical studies, including recent work by the OECD, have shown that a VAT increase is much less harmful for growth than higher personal income tax, corporate tax or social insurance contributions, such as NIC. This can be explained as follows. Firstly, VAT does not fall on investment. Investment goods are intermediate goods. Firms which buy investment goods can claim back the VAT paid on these goods. Secondly, higher VAT would not reduce the competitiveness of UK firms either abroad or at home. This is because exports are exempt from domestic VAT and imports to the UK would also pay the higher UK VAT rate.

The UK tax structure would also be more in line with the rest of the EU, where the average standard VAT rate in 2009 is 19.5%. Tax revenue structures would move closer to the EU average, too. In 2007 the share of VAT in overall tax revenue in the UK was approximately 18%, whereas the EU average was close to 19%.

One may also note that a number of EU countries have had to address issues of fiscal sustainability in recent years. Many of them, including Germany, Ireland and Portugal, have dealt with this by increasing their VAT rates. Clearly it has to be taken into account that this happened in a different economic environment. But at least the German VAT increase, which contributed significantly to curbing the public sector deficit, is widely considered as a success. Of course, moving closer to the EU average with tax rates or revenue structures, or following the example of other countries, does not necessarily improve things. But increasing VAT in the UK in the current situation would be more worrying if it was already much higher than



Professor Clemens Fuest

in other countries, or if other countries had experienced a failure of fiscal consolidation strategies involving an increase in VAT.

Regression

A widespread objection to using VAT as an instrument to achieve fiscal consolidation is that this tax is considered to be regressive. This refers to the fact that households with

like unemployment benefits and working family tax credits.

A high VAT rate does not mean that equity is neglected. Scandinavian countries like Denmark and Sweden, which do take distributional issues very seriously, have standard VAT rates of 25%.

One might also object that the current crisis, deep as it is, should be a transitory phenomenon, which does not justify a fundamental change of tax structures. This view neglects several aspects of the current fiscal position of the UK. Firstly, whether the UK will return to growth rates seen before the crisis is an open question. This implies that a permanent change in taxes and expenditures may be required. Secondly, UK fiscal policy was already in need of adjustment before the crisis. This was just concealed by generally favourable economic conditions. In the fiscal year 2007/08 the UK budget deficit was equal to 2.7% of GDP, which is quite significant. But GDP growth was equal to 3% in 2007, well above the long-term average. The structural budget deficit of fiscal year 2007/08, which corrects for the impact of the business cycle, was equal to 3.7% of GDP, according to estimates of the European Commission. This implies that the UK entered the crisis in a very weak

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low incomes usually spend a larger part of their incomes on consumption than households with high incomes, which save more. Therefore using VAT to reduce the deficit is widely seen as unfair to low-income households, in particular families with low incomes, pensioners and the unemployed. This is sometimes overstated, though. Firstly, not all consumer goods are subject to the standard VAT rate. Low-income households spend most of their income on rent, food and clothing. The VAT rate on food and clothing for children is zero. Rent payments are exempt from VAT. In the case of social housing, even housing construction pays zero VAT. Secondly, it has to be taken into account that households have different income positions over the life cycle. Pensioners often have low current incomes but many of them have built up savings and are relatively well off. If there are distributional concerns about poor households, these should be addressed by adjusting transfers

fiscal position. Even if the crisis can be overcome quickly, the budget deficit will not disappear without a considerable effort.

The Government may also be reluctant to increase the VAT because it has just reduced it to stabilise consumer demand in the current crisis. It may therefore find it difficult to sell the idea that the VAT rate should now be increased to 20%. But whether the VAT reduction to 15% was the best way to stimulate demand in the first place, given its budgetary cost, is controversial. And the next government, whoever is in power, should take a fresh look at how the current financial and fiscal crisis can best be overcome. Of course, whether the UK can afford to wait until after the election in 2010 is an open question. It would be desirable to act more quickly.

Professor Clemens Fuest can be contacted on e-mail: Clemens.Fuest@sbs.ox.ac.uk and tel: 01865 614846