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## What Does the Temporary Reduction in VAT Achieve?

There's no lack of money: in its fight against the coronavirus recession, the German government has launched a series of economic stimulus packages, most recently just a few days ago. One particular measure in this latest package is stoking a controversial debate: a temporary reduction in VAT. Between July 1 and December 31, 2020, the standard rate will fall from 19 percent to 16 percent and the reduced rate from 7 percent to 5 percent. This will bring tax relief to the tune of EUR 20 billion. But is this measure really a suitable way to inject strength into the economy?

This reduction in VAT plays an important role, not only given its major financial scale but also because it is a highly visible step, affecting all citizens more or less directly in their capacity as consumers. Many people are currently worried about their jobs and future income, so they are cutting back on their spending and saving more. From a microeconomic point of view, this precautionary saving makes sense. In macroeconomic terms, however, it is exacerbating the economic downturn. The VAT cut is therefore intended to stimulate people's urge to buy, despite any concerns about their economic future.

### Tax Relief Passed On Only Partially

Whether this move will actually increase consumption depends, of course, on whether companies pass the cut on to consumers by lowering prices. Studies conclude that this happens at best partially. Between 2009 and 2012, France, Finland, and Sweden each reduced VAT, but only on restaurants. In all cases, significantly less than half the tax cut was passed on to customers. If prices do not fall, the reduced VAT rate will benefit companies. In a crisis in which many companies are suffering huge losses, this need not be a mistake. However, only those companies that are still making sales stand to gain from a reduction in VAT. The cut won't reach the companies that have been hit the hardest; for some of them, sales have fallen to zero.

### Short-Term Upturn in Consumption

Experience with temporary reductions in VAT on all goods is also mixed. During the 2008 financial crisis, the United Kingdom reduced its standard VAT rate from 17.5 percent to 15 percent for a period of 13 months. Studies show that consumer spending rose by just under 0.4 percent as a result. However, there were major differences between different product groups: while food purchases were hardly affected, spending on household appliances increased significantly. First and foremost, a lower VAT rate creates incentives to move up purchases of durable consumer goods, such as washing machines and cars, or repairs and renovations. However, the corollary of this is that demand will fall again once the rate cut expires.

In the UK, for example, there was a noticeable fall in subsequent consumer spending.

Germany plans to increase the VAT rate again after only six months. It is foreseeable that the economic crisis will not have been overcome by then; calls to prolong the VAT cut are therefore likely to arise soon. But that would be difficult for two reasons. First, a time limit is necessary to provide an incentive to move up purchases; there would be no reason to do so in the event of a permanent cut. Second, the resulting tax shortfall would be significantly higher. This means the economic boost from the rate cut would have to be large enough to justify the significant financial outlay.

### A Modest Economic Effect at Substantial Cost

However, there are legitimate doubts that this is the case. The ifo Institute has examined the impact of the present reduction in VAT on growth in a simulation model. The result is sobering: in 2020, the VAT cut will increase German gross domestic product by EUR 6.5 billion, or 0.2 percent. This means economic output will likely rise only by about one-third of the tax shortfall – due also to the fact that the increase in consumption will partly be accounted for by imported goods.

Such estimates of the economic effects are admittedly subject to a high degree of uncertainty because this crisis is difficult to compare with earlier ones. Nevertheless, it is evident that the economic stimulus is rather modest when measured against the fiscal outlay it entails. What's more, the reduction in VAT is a considerable administrative burden. Businesses will have to adapt their payment systems to the new VAT rates; accounting departments will have to pay close attention to whether services are provided in June or July in order to apply the correct rates. In particular, companies that offer many products – such as DIY stores – will have to put in considerable effort if they want to change all their prices and pass the VAT cut on to customers.

All this suggests that the reduction in VAT will play a very limited part in the fight against the crisis.

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