Impact of increasing the reduced VAT rate for selected agricultural and food products

Jörg Radeke

German Economic Team Moldova

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Structure

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7. What are the additional costs for consumers?
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Appendix

1. Background

Question: What is the impact of an increase of the reduced VAT rate for selected agriculture and food products on:

1. Value added tax revenues
2. Costs for businesses
3. Costs for consumers

Current situation: A reduced VAT rate of 8% applies to a range of products

Scenario: Increase of VAT rate from 8% to 20% for

- Agricultural products
- Bakery products
- Diary products
- Sugar

3. Current VAT revenues from products with a reduced rate

How much VAT revenue is collected from those agricultural and food products with a reduced rate?

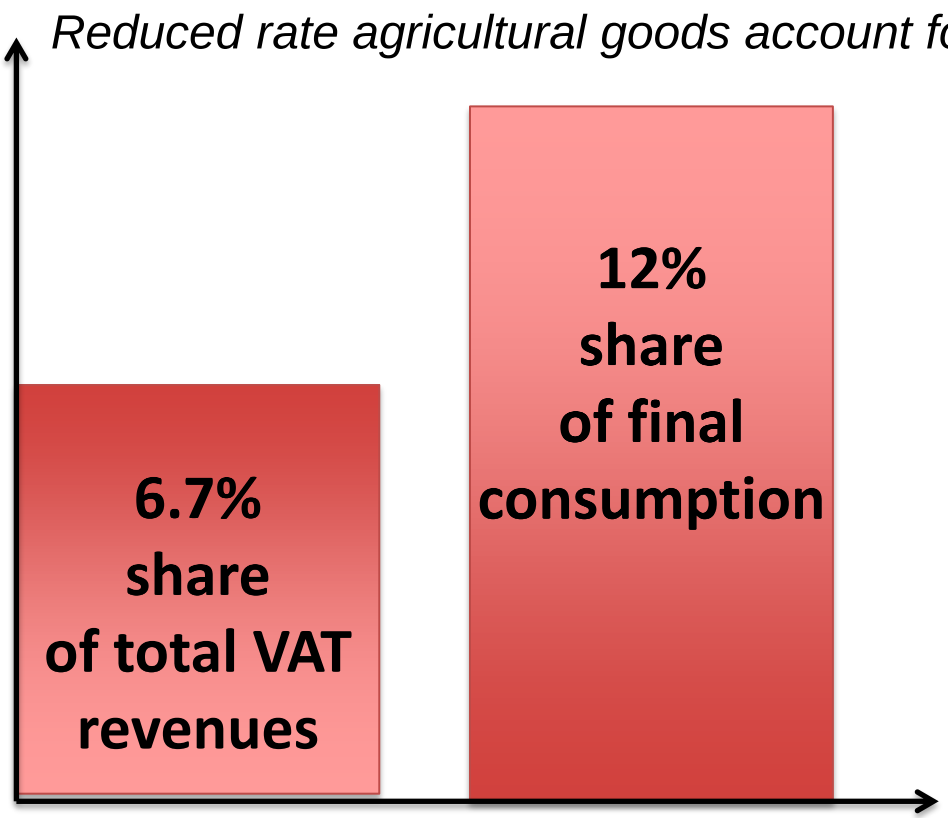
Estimated annual VAT revenues in 2014, MDL m

MDL m	Net VAT receipts
Agriculture*	MDL 615 m
Bakery products	MDL 89 m
Dairy products	MDL 122 m
Sugar	MDL 58 m
Total	**MDL 884 m**

Source: own calculations

- **Approach:** VAT data not available by types of goods
  -> amount of revenues has to be estimated using national account input output tables
- Agriculture: Only selected goods have reduced VAT rate, reduced rate goods account for about 85% of expenditure for agriculture goods

Data suggest potential for increase of VAT revenue



4. How will consumers react to VAT increase?

- Demand reaction determines impact of VAT increase on revenues and costs for businesses and consumers
- Demand for food products is generally stable, not sensitive to price changes

Elasticity of demand = reaction of consumers to price increase	
High (sensitive demand)	Low (stable demand)

‚Pass through rate‘	
Businesses can pass only small share of VAT increase to consumers	Businesses pass larger share to consumers

Distribution of cost of VAT rate rise	
Larger share of cost on businesses	Cost fall mainly on consumers

Price increase depends on demand reaction

- Responsiveness of demand difficult to predict
- Thus: we calculate impact for two scenarios: stable demand and large reaction of demand

Relationship between demand elasticity and price pass through

	Scenario 1: Stable demand	Scenario 2: Sensitive demand
Elasticity of "official" demand	-0.5	-2.0
Share of additional VAT cost passed on to final consumer (price pass through)	70%	33%
Resulting price increase	6.9%	3.3%

Source: own analysis

5. Will the increase deliver additional VAT revenues?

VAT revenues per year, MDL m

MDL million	Net VAT from food and agricultural products	Absolute increase	Relative increase	Increase compared to total tax revenues
Status quo (2014)	*884*	*0*	*0%*	*0%*
Scenario 1 "low elasticity"	2043	**1159**	131%	9%
Scenario 2 "high elasticity"	1925	**1041**	118%	8%

Source: own analysis

Conclusion: Substantial VAT revenue increase of around MDL 1 bn under both scenarios

What happens to refunds for input VAT?

- Both output VAT and input VAT will rise following VAT increase
- Government has to refund more input VAT
- Nevertheless even after refund still very large net VAT revenue increase

Development of gross, input and net VAT revenues after tax rate increase

Scenario 1 (stable demand)	Gross VAT	Input VAT	Net VAT
VAT rate 8%	1,632	748	884
VAT rate 20%	3,913	1,870	2,043
absolute change	2,282	1,122	1,159
relative change	140%	150%	131%

Source: own analysis

6. What are the additional costs for businesses?

- Which share of additional revenues has to be paid by businesses?
- Additional cost depending on how much of VAT rate rise can be passed on to consumers through higher prices

Impact on production value and profits resulting from VAT tax increase

	Scenario 1 **“stable demand"**	**Scenario 2** **“sensitive demand"**
VAT revenues	1,159	1,041
Cost for businesses	MDL 550 m	MDL 870 m
of which domestic businesses	**MDL 450 m**	**MDL 709 m**
As share of revenues	1.4%	2.2%

Source: own analysis

- In case of sensitive demand significant cost for business
- But: Profit decline not entirely born by producers of affected goods

-> impact distributed along the value chain

- Government should consider appropriate counter measures

7. Costs for consumers

- In case of **strong demand response**: 0.3% increase of household expenditures
- In case of **weak response**: 0.5% increase of household expenditures
- Financial burden might be higher for low-income households, as they spend a higher share of income for food products.
- This problem can be solved through <u>more targeted social policy</u> instruments
- For example an increase of the minimum guaranteed income

Conclusion: Additional burden from VAT rate rise consumers in both scenarios rather small

8. Conclusions

Overview impacts from VAT rate increase

	Scenario 1 “stable demand"	Scenario 2 “sensitive demand"
Impact on VAT revenues	MDL 1,159 m	MDL 1,041 m
Additional cost for domestic companies	MDL 450 m	MDL 709 m
Additional cost for consumers	MDL 360 per year	MDL 180 per year

Source: own calculatiuons

- A VAT rate rise for agricultural and food products will deliver substantial additional revenue in any scenario
- However, in case of strong demand reaction significant additional fiscal burden for companies
- Cost for consumers is low, no reason for concern

Conclusion: several arguments in favour of VAT rate rise

Discussion of possible off-set measures

Need for suitable policy measures to avoid unreasonable cost for businesses and consumers

- Provide a significant part of the additional revenue (ca. MDL 400 m) as direct support for agriculture and food businesses
  - avoid blanket subsidies
  - e.g. investment support scheme
- Increase the minimum guaranteed income by at least MDL 300 p.a. to provide targeted social assistance for the really poor
- Remainder of revenue could be partly used to finance reform of personal income tax – boost for business and consumers

Contact

Jörg Radeke

radeke@berlin-economics.com

German Economic Team Moldova

c/o BE Berlin Economics GmbH

Schillerstr. 59, D-10627 Berlin

Tel: +49 30 / 20 61 34 64 0

Fax: +49 30 / 20 61 34 64 9

www.get-moldova.de

Twitter: @BerlinEconomics