

# Will EU VAT rises defy inflation and recession?

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The plan was simple, if politically hazardous: a massive shift of the tax burden away from businesses onto the consumer. It was fundamental to European Union economies holding onto their competitive position as a location for international commerce, and fighting the tide of globalisation. Germany led the way in spectacular fashion in 2007; others joined the queue.

**T**he latest TMF EU VAT Tracker highlights this strategy, but also illustrates the fresh impact of resurgent inflation and recessionary threats. The Tracker calculates a GNP-weighted average for VAT amongst the European Union member states.

In the past three years, the Tracker has shown an increase of the weighted EU VAT rate from 18.6 percent to 19.2 percent in 2007 – predicting a further rise to 19.9 percent in 2008. However, as Richard Asquith, who heads-up TMF VAT, explains, European VAT went into reverse with recent rises in inflation has now fallen back to 19 percent for the end of 2008. However, the Irish Ministry of Finance and others may now beg to differ as a new foe, recession, comes over the horizon.

## I. The build-up to European VAT increases

Over the past 10 years, European economies were feeling the pain of losing manufacturing output to emerging markets. These new interlopers were offering more business-friendly tax regimes, making production costs appear high in the EU. Typically, this meant low corporate tax rates and light employment surcharges – often neatly packaged in simplified flat-rate tax systems. This tax mix was typically supported by the adoption of VAT (or its close relation, GST) systems to spread the burden on to the consumer. Many tax theorists opined that this was a healthy and moti-

vating widening of the tax burden; European governments feared it was yet another way encourage their national companies to relocate jobs abroad.

What became clear by the early 2000's was that European states would have to follow suit to remain competitive in the now global job market. It was clear that business taxes had to fall, and that the consumer had to meet the bill. As a result, in the past five years it has become an article of faith amongst tax analysts, government officials and corporate executives that EU VAT was on the upward march.

Leading this movement, the global financial organisations spread the gospel of indirect tax increases. It seemed the International Monetary Fund was dictating to countries that consumer taxes must be increased to pay for cuts in corporate taxes.

CFO's and FD's around the region went on red-alert. Surveys and seminars poured forth on managing the new VAT changes and associated risks. VAT was voted the biggest worry for the world's finance departments.

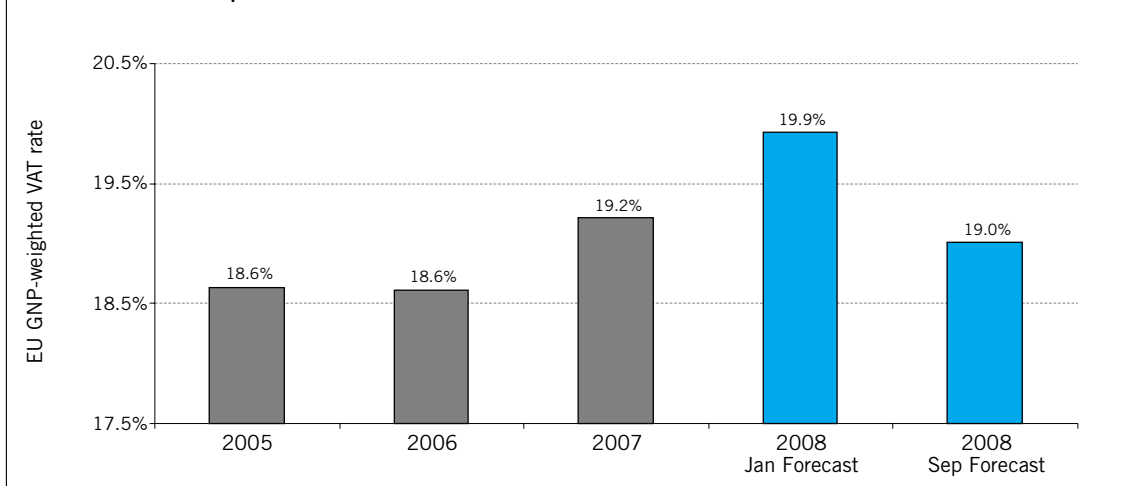
The first major significant rise came from a surprising source.

## II. Germany leads the way

Never a fiscal reform leader, Germany may have seemed an unusual place to start the revolution. However, it was probably because of the apparent sclerotic fiscal regime, holding its industry that forced it to take the lead.

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**EU VAT Tracker (September 2008)**



Swept to power in 2005 promising economic stimulus reform, Angela Merkel's CDU party needed to shake up German business. Faced with its industrial heartland seeping away to Eastern Europe and beyond, drastic measures were on the cards. Exorbitant labour levies, amongst the highest in Europe, had to be slashed.

At the end of 2006, a three percent increase in VAT to 19 percent was announced. This catapulted Germany from below the average VAT rate of 18.6 percent up alongside countries such as the Greece, the Netherlands and Romania. In return, labour charges were slashed.

It seemed a big gamble for a country which was only just coming out of recession. Historically, the introduction of VAT regimes or big increases usually resulted in hefty increases in inflation. Many campaigned against the increase, warning that it would choke off the new found economic growth.

At first, it seemed that the warnings had been prescient. In addition to the direct impact on prices, it quickly became clear that key economic indicators, such as new motor vehicle registrations, had fallen off alarmingly. However by mid-2007, the economy had shrugged off the VAT rise and regained its confidence.

The Germans received huge plaudits from all corners for its achievement: redressing the fiscal imbalances to help guarantee the attractiveness of Germany for foreign business investment. Others were ready to follow.

### III. Form an orderly queue for VAT rises

Buoyed by the German VAT success, many other countries, in dire need of a solution to their loss of global competitiveness, were eager to follow.

Greece made the earliest soundings. For a country that had squeezed hard to bring itself into the Euro, a VAT increase seemed an obvious route to help solve the lingering government deficit. It also presented a politically palatable sales message given the need to cut taxes elsewhere. Soundings were made; the opposition dealt with; Greece went full steam ahead with a planned increase for the start of 2008.

Even France, in the middle of an intense national election campaign, seemed capable of forcing through a VAT hike in mid-2007. Leaks were made by the

centre-right UMP party of the would-be-President, Nicolas Sarkozy, for a – wait for it – five percent VAT rise. Initial denials were half-hearted. When it became clear that such a policy might not cost the UMP party the election, the VAT increase seemed to become inevitable. Throughout the summer of 2007, the debate was about how much the rise would be, not whether it would come.

Dutch courage took a grip by the end of 2007 when the Netherlands authorities actually came out and declared a one percent VAT increase to 20 percent from the start of 2009. This was backed up by immediate rises in other indirect taxes, such as insurance premium tax, which rose by 0.5 percent to 7.5 percent with immediate effect.

The mould was set for the VAT increase formula. Some of the major economies had shown their cards. Rumours swirled around other countries, such as Hungary and Bulgaria.

### IV. The Jersey launch

For the nearest thing to a scientific trial of the efficacy and side effects of VAT to solving direct tax objectives, Jersey's experience in 2008 is probably the purest example.

In 2007, Jersey, as an offshore finance centre reduced its company income tax rate. This was a clear message to the seekers of offshore homes that Jersey was the place to be.

To make up for the cut in direct tax revenues, Jersey introduced GST at three percent from March 2008. Jersey is not part of the EU for VAT, and so had not implemented the EU VAT Directives.

The results held some interesting lessons for its EU neighbours harbouring thoughts of VAT increases to subsidise corporation tax reductions. Firstly, the GST implementation went smoothly, with the expected proportionate lift in inflation. However, by April inflation had risen by seven percent, which begs the question: was the introduction of GST used as an excuse for a wider increase in prices by retailers? It mirrored the inflationary experiences of the introduction of the Euro in 2000, and the UK's decimalisation.

There is now a push to exempt a number of essential goods from GST to offset some of these side effects.

## V. Inflation's back

The scene had been set: everyone was braced for similar VAT rises across the EU. However, the old enemy, inflation, re-emerged to spoil the campaign.

The explosive rises in food, oil and commodity prices burst upon the world economies as 2007 rolled on. Oil rocketed towards US\$150 per barrel; grain and basic food ingredients price rises which had plagued the developing world for two years now spilled into European supermarkets. Inflation quickly picked up momentum to climb way in excess of central bank limits. Central banks quickly responded with interest rate increases in an attempt to cool off the economies.

The surprise re-emergence of inflation meant VAT increases now came off the agenda.

## VI. Dutch discourage

European countries quickly went from "consultation" to procrastination to retreat. France had smothered talk of its five percent VAT increase by the end of 2007. Greece was forced to admit that it would not look to VAT increases to fund its deficit.

The most dramatic climb down came from the Netherlands, where the scheduled one percent increase was shelved in August 2008.

On top of these retreats, came the surprise Portuguese VAT rate cut from 21 percent to 20 percent in July 2008. This was seen as a populist sop from a government facing re-election, and worried about its slowing economy.

So, by mid-2008, inflation looked to have conquered the EU's fiscal strategy. It would not be unreasonable to conclude that many countries had missed this opportunity to rebalance the tax mix in the good times. Now, faced with rising prices and slowing economies, this strategy seemed off-limits for the time being.

## VII. European shivers spread to international VAT

Europe invented VAT. Whilst the French were the first to implement it after the Second World War, few people realise that it was actually dreamt up by a German economist in the 19th century. Since then, it has been Europe's biggest invisible export. There are now some 170-180 countries with a VAT/GST system. The only major economy which has yet to adopt VAT is the USA – suggestions to introduce it tend to cost presidential candidates their chances of winning elections.

However, by the end of 2008, worldwide tax authorities were also feeling nervous about replicating plans to move to indirect tax for relief. The most prominent example was the UAE, which promised GST by 2009. This move was planned as the Gulf States sought to diversify away from oil tariffs. However, the introduction now looks certain to be delayed until 2010 due to inflationary pressures. Japan has also pulled back from a five percent increase in its consumption tax. The OECD recently called for Australia to raise its GST from 10 percent.

## VIII. Fiscal deficit realities force EU VAT increases?

Bringing the story up-to-date, what had seemed like a measured economic slow down is now rapidly escalating into full-blown recession across Europe and beyond. Credit markets freezing over, magnified by the equity markets' turmoil, has now created a new pressure on EU tax ministries: spiralling government deficits.

Whilst some European economies, such as Germany, appear in reasonable shape for the dip, many others did not prepare during the good times; notably France and the United Kingdom. With colossal fiscal borrowing mounting as part of the bank bail out plans, all European governments will be squeezed to meet spending requirements.

Can you increase tax in a recession? Surely consumers cannot withstand a further blow to confidence. Many say no, but history tells it differently: in the United Kingdom, the last two VAT increases came in difficult economic circumstances.

## IX. EU VAT hikes are back

On October 15, 2008, the Minister of Finance of Ireland announced a 0.5 percent increase in its standard VAT rate. This was part of a package of tax rate increases to meet a growing black hole in government finances.

Ireland was one of the first economies to go into recession in this economic cycle. Its VAT increase may now re-launch the trend for the rest of Europe – albeit in more difficult circumstances. European consumers are unlikely to resort to the tactics of Iranian market shoppers, whose violent revolts in the local bazaars led to the withdrawal of a new three percent VAT charge in early October 2008. However, politicians will be wary.

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