

AN ANALYSIS OF THE MACROECONOMIC AND REDISTRIBUTIVE EFFECTS OF THE SAFEGUARD CLAUSES ON VAT

The 2019 Budget Law modified the VAT increases envisaged under the safeguard clauses. Were they to be activated, in 2020 the ordinary rate would rise from 22 to 25.2 per cent, and the lower rate from 10 to 13 per cent; the 4 per cent rate applied to the goods and services accounting for the largest share in the consumption basket of poorest households would remain unchanged. Official assessments suggest that this increase would generate €22.7 billion in additional revenue next year.

The potential impact on demand and economic activity, as well as the redistributive effects of an eventual increase in VAT envisaged under the clauses for 2020, are examined using the quarterly econometric model¹ and the Bank of Italy microsimulation model (BIMic)² for taxes and social benefits. The extent of these effects depends on the pass-through to sales prices of the increase in the rates. In particular, they could be limited if the pass-through were also limited, as was the case when the ordinary rate was last raised in 2013, when there was a strong contraction in demand. The redistributive effects are also analysed in connection with those determined by the recent introduction of the new minimum income scheme (*Reddito di cittadinanza* or RdC).

Macroeconomic effects – The average multipliers of the econometric model estimated based on the historical data (ordinary pass-through) entail a pass-through of the increase in the VAT rates of around 80 per cent over two years. Nevertheless, if demand conditions are especially weak, firms could absorb this increase for a longer period of time, leading to a more lasting reduction in their profit margins.

In the case of an ordinary pass-through, consumer inflation would be around 1 percentage point higher in 2020 and 0.5 points higher in 2021 compared with the baseline scenario (see the table). GDP growth would be 0.3 points lower in both

The macroeconomic effects of the VAT increase
(rates of change; deviations from the baseline scenario)

	Ordinary pass-through		Lower pass-through	
	2020	2021	2020	2021
Harmonized index of consumer prices (HICP)	1.1	0.4	0.6	0.2
Gross domestic product	-0.3	-0.3	-0.1	-0.2
Household consumption	-0.6	-0.6	-0.3	-0.3

¹ For a description of the general characteristics and main equations of the quarterly model of the Italian economy, see: G. Bulligan, F. Busetti, M. Caivano, P. Cova, D. Fantino, A. Locarno and L. Rodano, 'The Bank of Italy econometric model: an update of the main equations and model elasticities', Banca d'Italia, Temi di Discussione (Working Papers), 1130, 2017.

² For a description of the model, see N. Curci, M. Savegnago and M. Cioffi, 'BIMic: the Bank of Italy microsimulation model for the Italian tax and benefit system', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 394, 2017.

years. The effects appear mostly attributable to the fall in real disposable income and consumption of households, which after two years would be lower by 1.2 percentage points overall compared with the baseline scenario.

The impact would be roughly halved if the pass-through were more gradual, like the effect of the 1 point increase in the ordinary VAT rate on 1 October 2013. Based on our assessments back then, the effect on the HICP was around 0.1 percentage points after six months, compared with the 0.5 points expected under the hypothesis of a total pass-through (Chapter 8, 'Demand, Supply and Prices', *Annual Report for 2013, 2014*). Indications of a limited impact on prices had also emerged from the quarterly survey on inflation and growth expectations conducted by the Bank of Italy and *Il Sole 24 Ore* in December of the same year: 61 per cent of the firms interviewed declared they had not transferred, even in part, the increase in the rate to their sales prices. In all scenarios the simulations do not take account of eventual changes in consumer confidence, which are difficult to quantify.

Redistributive effects – The redistributive analysis hypothesizes the full pass-through of the VAT increase to the prices of goods and no change in consumer choices; it takes account of only the direct effects of the change in rates, while it does not consider the indirect effects, including those stemming from the reaction of wages, income and employment to the higher taxes.

Under these hypotheses the increase in VAT would lead in the short term to greater inequality in the distribution of net equivalent household incomes:³ the Gini index would rise to 32.4 per cent, with an increase of 0.2 percentage points compared with the baseline scenario. In particular, for the households belonging to the bottom decile of the distribution, net income would fall by around 1.5 per cent, while for those belonging to the top decile, the decline would amount to 0.7 per cent.

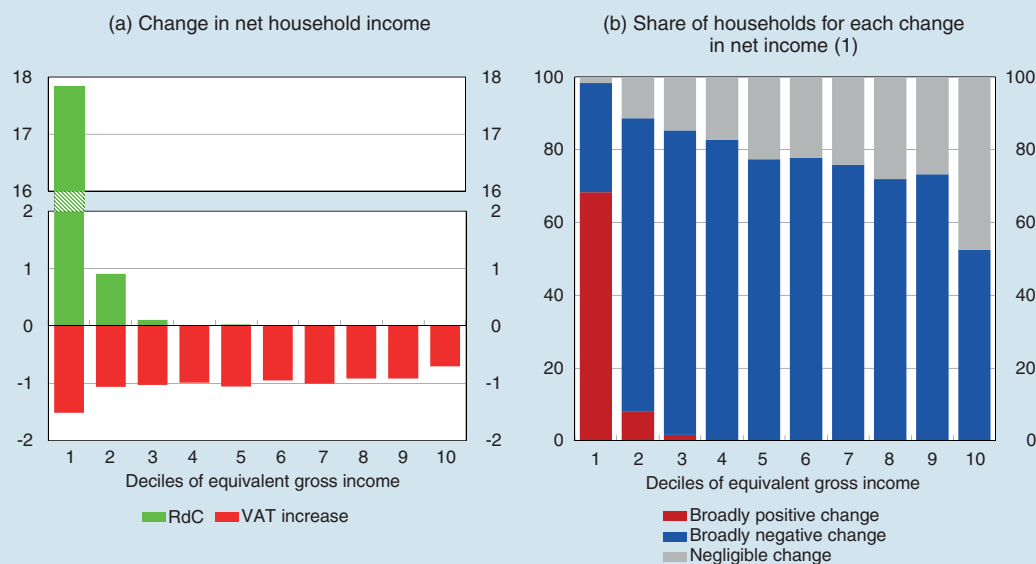
It is worth recalling, however, that compared to what occurred with past VAT increases, in 2020 the lowest-income households can benefit from the new minimum income scheme (RdC) introduced last April (see the box: 'An analysis of the redistributive effects of recent anti-poverty measures', Chapter 5). According to our estimates⁴ this measure would lead to a relatively large maximum potential reduction in the Gini index of 1.1 percentage points. In fact, the benefits of the new minimum income scheme are concentrated in the most vulnerable segment of the population, while the VAT increase affects all taxpayers.

The combined effect of an increase in VAT and the new minimum income scheme (RdC) would lead on average to a significant increase in net income for the

³ Net income in the BIMic model is calculated based on personal income from work and capital, to which social security benefits and other monetary transfers are added, and the main taxes (IRPEF, tax on financial assets, property taxes, and VAT) are subtracted. To take account of the different composition of households, the net household income is given by the sum of net incomes of the various members and equalized using the modified OECD scale of equivalence.

⁴ These assume that all those eligible adhere to the scheme.

**Combined short-term effect of the increase in VAT
and the new minimum income scheme (RdC)**
(per cent)



Source: Based on the BIMic microsimulation model.

(1) A broadly positive (negative) change in net income corresponds to an increase (reduction) of more than 1.0 per cent. The change is considered negligible if in absolute value terms it is below 1.0 per cent.

first decile of the distribution of gross income⁵ (see panel (a) of the figure); this effect would disappear for the second decile and would turn negative thereafter. There are, moreover, households in the bottom decile of the income distribution which, since they would not be eligible for the new minimum income scheme, would be disadvantaged by the increase in VAT (see panel (b) of the figure).

⁵ Gross income is calculated as the sum of income from work and capital, social security benefits and other monetary transfers (including payments received under the old minimum income scheme (*Reddito di inclusione* or ReI) but not the new scheme (RdC). To take account of the different composition of the households the equivalence is obtained by applying the modified OECD scale of equivalence.