European Parliament

Taxation in times of high inflation

A sustained period of high inflation will impact the total sum of a country's tax receipts and the overall composition of its tax revenue. In particular, an overall rise in consumer prices will automatically push up value added tax (VAT) receipts. In response to the current rise in prices, notably for energy, the European Commission has issued guidance to clarify the options available to Member States under EU tax law to support struggling households and businesses.

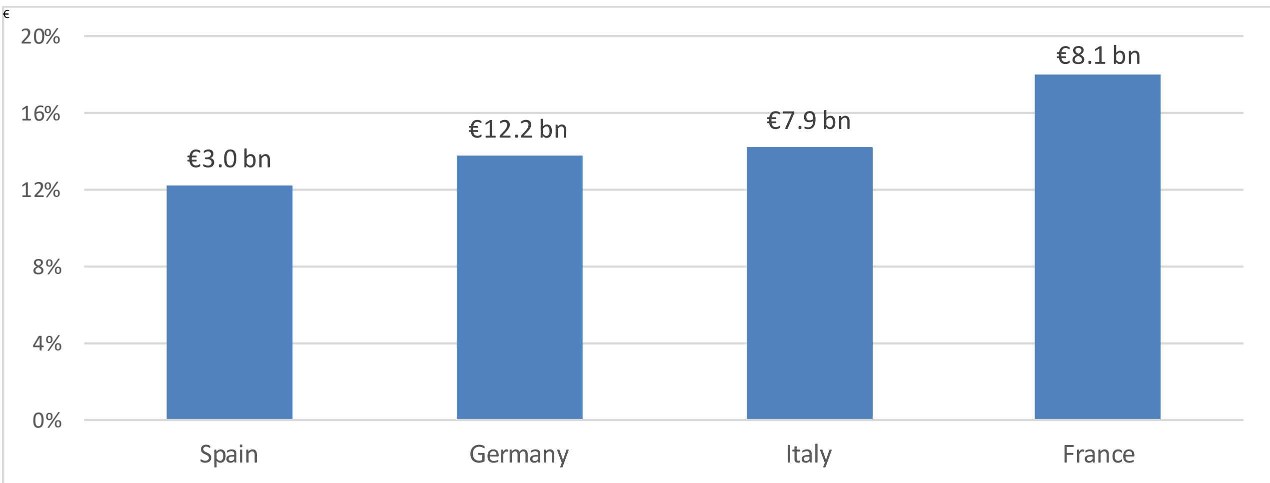
Impact of inflation on tax revenue

There are different ways that high inflation can impact both the amount and composition of tax revenue collected, for instance depending on whether the inflationary sources are more demand- or supply-driven. By way of example, today's inflation crisis in the EU was driven at first by the rise in gas prices. As a first-round effect, Member States are expected to have raised more revenue through the auctioning of carbon permits through the emissions trading system (ETS), as utilities moved from gas to (more CO_2-intensive) coal-based electricity, raising the overall ETS carbon price.

A general fiscal phenomenon in periods of high inflation is 'bracket creep', whereby inflation pushes workers' wage income into higher tax brackets on account of the progressivity of the tax system in most EU Member States. Without there being an inflation adjustment of the brackets themselves, this would result in additional tax revenue collected by the state, even though there is no real increase in citizens' disposable income. Moreover, the increased wages would automatically bring in higher social security contributions on top. Bracket creep is reported to affect those in the lower- and middle-income brackets particularly negatively. Most Member States do not **adjust tax brackets for inflation automatically**; however, the current crisis has pressured countries to take measures regardless: for instance, Austria will (partly) stop the 'bracket creep' from 2023 onwards by updating tax brackets for the two lowest income scales each year.

Economic literature frequently points to the role of VAT in times of high inflation. With VAT being charged on nominal prices, any overall increase in consumer prices should **push up overall VAT receipts mechanically**, with VAT usually already one of the largest contributors to public finances. Figure 1 shows the additional VAT revenue received in the first half (H 1) of 2022 (compared with the first half of 2021) in the four largest EU Member States. While a share of the increase in revenue is partly due to the impact of pandemic-era lockdowns on consumption, the sharp climb in VAT receipts remains striking, with VAT payments increasing, for instance, by 12 % in Spain and 18 % in France.

Figure 1 – Increase in VAT revenue (%), H1 2022 against H1 2021, additional VAT revenue raised (billion €)



Data source: Bundesministerium der Finanzen (Germany), Dipartimento delle Finanze (Italy), Ministre de l'Économie, des Finances et de la Souveraineté industrielle et numérique (France), Agencia Tributaria (Spain). H1 = January to June.

EU guidance on tax cuts

Following the rise in energy prices in 2021-2022, Member States started implementing a series of unilateral fiscal measures to support citizens and businesses. In advance of wider measures taken at EU level, in April 2022, European Commissioner for Economy Paolo Gentiloni sent a letter to EU ministers of finance to clarify the tax rules already applicable under EU law, and in particular the EU's VAT rules (VAT Directive) and the excise duty framework (Energy Taxation Directive, ETD).

- New rules on the setting of **VAT rates** had been put in place in April 2022. While motor fuels should always be taxed at the standard VAT rate (at least 15 %), Member States are allowed to set a reduced VAT rate (at least 5 %) on natural gas, electricity and district heating, and several Member States have used this option in recent months. Moreover, other products have also recently been subject to rate reductions, with the objective of supporting households and speeding up the energy transition: Belgium has reduced VAT on solar panels, heat pumps and solar water heaters from 21 % to 6 %; Poland has decreased VAT on basic foodstuffs from 5 % to 0 %; Luxemburg will for one year reduce its standard VAT rate from 17 % to 16 % in 2023; and Bulgaria reduced the VAT rate on bread from 20 % to 0 % until 1 July 2023.

While acknowledging the easy and fast-track nature of VAT rate adjustments, Commissioner Gentiloni did raise concerns about the effectiveness of such measures, and referred to the 'bad track record' of VAT cuts in generating lower prices for customers. Empirical academic evidence seems to support a general trend of 'under-shifting' when VAT rates are lowered on products; the overall price of a product is reduced, but by a smaller extent than the decrease in VAT. By contrast, when VAT rates are raised, the pass-through to customers is more pronounced.

- In terms of **energy taxes**, the ETD sets minimum excise duty rates on energy products used as motor and heating fuels, and electricity. Annex I to the ETD lists the required minimum rate per energy product. For instance, in terms of electricity, the ETD's required minimum rate is **€1 per megawatt-hour (MWh) for non-business use (i.e. households)**, and **€0.5 per MWh for business use.** However, the ETD also provides some flexibility for Member States: for instance, respecting the minimum rate, Member States can differentiate tax rates **based on quantitative consumption levels** (often offering lower tax rates for energy-intensive companies). In July 2021, as part of the 'fit for 55' package, the European Commission tabled a proposal to update the energy taxation framework. It aims to bring the framework more into line with the objectives of the European Green Deal by (gradually) increasing the minimum rates on polluting fuels, and removing the option to differentiate tax levels according to consumption levels. No agreement has yet been found in the Council, and further technical discussions are ongoing on a wide range of issues.

The European Commission (and the Organisation for Economic Co-operation and Development, OECD) have warned countries against taking overly **broad-based fiscal measures**; instead, they have encouraged countries to opt for **targeted lump-sum payments** to consumers rather than tax cuts, so as to maintain the incentive for consumers to save energy. A recent study estimates that a €0.2 tax cut per litre of petrol and diesel (either through VAT or excise reductions) could push up the EU's demand for Russian petrol and diesel once again, and lead to €8 million in additional revenue gain for the Russian economy per day. By contrast, an equivalent direct fiscal transfer to citizens could limit any increase in demand for Russian fuel, and curb the profit gain for the Russian economy to less than a quarter of a million euros per day.

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