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A Temporary VAT Cut as Unconventional Fiscal Policy

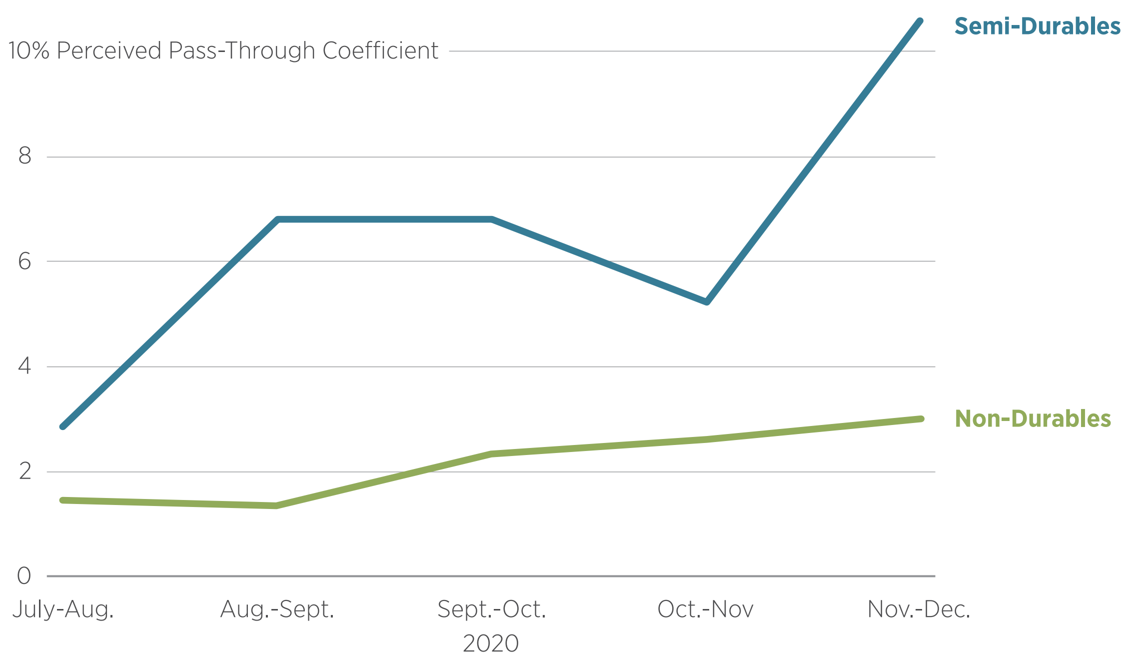
Based on BFI Working Paper 2021-128, "A Temporary VAT Cut as Unconventional Fiscal Policy," by Rüdiger Bachmann, University of Notre Dame; Benjamin Born, Frankfurt School of Finance and Management; Olga Goldfayn-Frank, Deutsche Bundesbank; Georgi Kocharkov, Deutsche Bundesbank; Ralph Luetticke, University College, London; and Michael Weber, Chicago Booth

A temporary reduction in Germany's value added tax in the second half of 2020 led to a 36% increase in durable spending for individuals with a high perceived pass-through, along with an increase in semi- and non-durable spending; in addition, aggregate consumption spending rose by 34 billion Euros.

Monetary policy is often considered the preferred tool to stabilize business cycles because it can be implemented swiftly and because it does not rely on large fiscal multipliers. However, when the effective lower bound (ELB) on nominal interest rates limits the ammunition of conventional monetary policy, alternative policy measures are needed. Enter unconventional fiscal policy, which often uses changes in taxes—in this case, value-added taxes—to influence spending.

Booth's Michael Weber and colleagues previously investigated unconventional fiscal policy in a 2018 paper (See Research Brief). This new paper analyzes the unexpected announcement of the German federal

Figure 1 • Time Path of Spending Response



Note: This Figure shows the spending coefficient for respondents with a high perceived passthrough based on two-months rolling window regressions, both for semi-durables and non-durables in the GfK scanner data. The VAT policy effect is stronger for semi-durables than for non-durables for every point in time and it increases, in particular for semi-durables, toward the expiration date of the VAT cut, i.e., to the point right before the intertemporal price change. See working paper for more details.

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government on June 3rd, 2020, to temporarily cut the value added tax (VAT) rate by 3 percentage points. The law was in effect from July 1, 2020, through December 31, 2020.

Employing survey methods to address empirical challenges pertaining to consumers' awareness of the tax changes and, hence, how those changes affected spending (retrospectively perceived pass-through of the VAT cut), the authors find the following:

- The temporary VAT cut led to a substantial relative increase in durable spending: Households with a high perceived pass-through spent about 36% more than those with low or no perceived pass-through.

- Semi- and non-durable spending was higher for households that perceived a high pass-through relative to other households by about 11% and 2%, respectively. That is, the VAT policy effect is increasing in the durability of the consumption good.

- The VAT policy effect, especially for more durable goods, increases over time and is maximal right before the reversal of the VAT rate. Roughly calculated, the authors' micro estimates translate into an aggregate effect of 21 billion Euros of additional durable spending and of 34 billion Euros of overall consumption spending.

- The combined effect of increased consumption spending and the lower effective VAT tax rate resulted in a revenue shortfall for the fiscal authorities of 7 billion Euros.

- Two groups of consumers (not necessarily overlapping) drive the durable spending response: first, bargain hunters, i.e., households that self-report to shop around, or households that, in a survey experiment, turn out to be particularly price sensitive; second, younger households in a relatively weak financial situation.

- There is no evidence that perceived household credit constraints matter.

- Finally, the stabilization success of the temporary VAT cut is also related to its simplicity. Its effect is not concentrated in households that are particularly financially literate or have long planning horizons for saving and consumption decisions.

This last finding, regarding a VAT cut's simplicity, contrasts with unconventional monetary policy, which often relies on consumer sophistication.

While the authors take no policy stance on monetary vs. fiscal unconventional policies, they do stress the significance of their findings for policymakers: An unexpected temporary VAT cut operates like conventional monetary policy and can be an effective stabilization tool when unconventional monetary policy, like forward guidance, might be less effective.

READ THE WORKING PAPER

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