



RiR 2018:25

Reduced VAT on food

– price effect, distribution profile and cost effectiveness

Summary and recommendations

In the spring of 1995, the Swedish Government proposed a number of measures to further stabilize the economy and reduce expenditures in the public sector. Among other things, it was suggested that the benefit levels of the social security system should be reduced. To counteract the negative distribution policy effects of reduced benefit levels, the Government proposed that the VAT rate on food should also be reduced, from 21% to 12%. A guiding idea behind the proposal was that reduced VAT on food would result in lower food prices, and would thus particularly benefit families with children and low-income households, because these use a relatively high proportion of their household budget on food purchases.

The value added tax rate on food was to be reduced starting on January 1, 1996. The reduction was noted in the media and in the spring of 1995, the Government established a price commission responsible for monitoring how the prices evolved. Since then, the VAT rate for food has remained at the reduced level of 12 percent.

Because the VAT rate for food after the reduction varies from the standard rate of VAT, a so-called tax expenditure arises. Tax expenditures are support that is included on the revenue side of the budget. In the same way as ordinary expenditures, these are charged against the financial savings in the public sector. The tax expenditure for the reduced VAT on food is estimated at nearly 30 billion SEK for the 2018 income year.

The purpose and objective of the audit

The fiscal policy guidelines adopted by the Riksdag indicate that the primary purpose of fiscal policy is to yield taxes, but that the tax system can have other purposes. When possible, support based on the revenue side of the budget should be avoided, and should at least be examined in the same way as regular expenses in the course of the annual budget process.

The Swedish National Audit Office has recently noted that tax expenditures are not recorded in as great detail in the budget as support on the expenditure side of the budget. The audit is further justified by the fact that the total tax expenditure for reduced VAT on food is a large amount. It has been just over 20 years since the VAT on food was reduced, and yet no evaluation of the price effects of the reduction have been published. There is therefore a risk that the price impact has been overstated.

The purpose of the audit is to examine the effectiveness of the reduced VAT on food by evaluating its effects on pricing and distribution. The review is based on an overall audit issue.

- Is reduced VAT on food a cost effective measure by which to enhance the purchasing power of families with children and low-income households?

“Cost effectiveness” refers to a relationship between the cost of the reduced VAT and its success in achieving its objective, that is, how well it enhances the purchasing power of families with children and low-income households. In order to assess the cost effectiveness of the measure, the reduced VAT on food is compared with other measures to strengthen the purchasing power of families with children and low-income households.

The results of the audit

We have audited the cost effectiveness of the reduced value added tax in a two-step process. In the first step, the measure's distribution effects were examined, partly through an estimate of how the reduced VAT rate impacted food prices in the short term, and partly through an examination of how purchasing power gain is currently distributed between different households.

In the second step, we have evaluated the cost effectiveness of the measure by auditing it in relation to other measures to distribute purchasing power to families with children and low-income households. We also followed up the Value Added Tax Rate Inquiry's study of how the households' cost shares for food evolved over time.

In the short term, the reduced VAT on food had a full impact on food prices

In order for the reduced VAT on food to be at all successful in strengthening household purchasing power, the VAT reduction must have resulted in the reduction in food prices, or

must at least have prevented them from increasing at the same rate as they would otherwise have done. It is through reduced food prices that households strengthen their purchasing power.

To investigate the price impact of the VAT reduction, the Swedish National Audit Office used a method that involves a natural experiment in which both producer prices in the food chain and Danish food prices constitute control groups.

The estimates indicate that in the short term, food prices were reduced to such an extent that it is reasonable to assume that the full VAT reduction was converted to reduced prices. On the other hand, we cannot assess how the effects will look in the longer term. However, based on the estimation results, we assume a full price impact when we examine the distribution effects. At the same time, the fact that it is difficult to assess the long-term effects of the tax measures – because too many factors may have affected the prices – means that the Government is faced with specific challenges with respect to how it will ensure that the measures help to achieve the objectives of the expenditure areas in the long term.

Reduced VAT on food has a positive distribution profile

In our audit, we demonstrate that the reduced VAT on food has a positive distribution profile, that is to say, that it enhances the purchasing power of the target groups relative to other households. This applies as long as the purchasing power gain is measured in terms of a percentage change in the households' equivalent disposable income. When purchasing power gain is calculated in SEK, the distribution profile changes.

The cost effectiveness of the reduced VAT on food is low

The reduced VAT on food is a boon to everyone who consumes food, regardless of whether or not they have children and whether they are low or high-income earners. The fact that groups other than the target group can take advantage of this support means that the measure's success rate decreases. Low accuracy reduces the cost effectiveness of the measure because it means that the measure's total cost increases relative to its achievement of its objective.

In order to assess the cost effectiveness of the reduced VAT on food, we have created a simulation in which we compared the measure with other possible measures to strengthen the purchasing power of low-income households and families with children. The goal of the simulation was to employ other measures to compensate the target groups for the weakened purchasing power that would result from the abolition of the reduced VAT on food. A comparison of the costs of the different measures by which to achieve equivalent purchasing power gain for the target groups is the basis for the assessment of the cost effectiveness of the reduced VAT.

However, there is no directly comparable support that can be offered to the target groups, and it has been necessary to simulate a combination of support aimed at both families with children and low-income households. We have also been working with two different definitions of low-income households. In the simulations conducted by the Swedish National Audit Office, the child allowance, the large family supplement, and the study allowance were increased, as were the national standard for financial assistance and the housing supplement for, e.g., pensioners, including the special housing supplement.

The simulations are illustrative examples, and seek to assess the cost effectiveness of the reduced VAT. They should not be seen as suggestions for other measures. In the selection of simulated measures, we were able to use other support – on the expenditure or revenue side of the budget. It should also be noted that the simulated measures have their limitations and issues that must be taken into account. However, the Swedish National Audit Office only audits the reduced VAT on food from a cost effectiveness perspective, and it is up to the Riksdag to make an overall assessment of the measure in relation to other measures.

The illustrative example indicates that the cost effectiveness of the reduced VAT on food is low compared to that of the simulated measures. The cost of the simulated actions is estimated at 13.4 billion SEK, which is about half of our estimate of the tax expenditure (27.3 billion SEK) that the reduced VAT on food entails. However, we must emphasize that in our simulation, it was not possible to fully compensate the low-income household group when they were defined as households in income deciles 1 to 4. Households in the first decile were somewhat overcompensated, while households in deciles 2 to 4 were compensated to a relatively decreasing degree. The estimated figure of 13.4 billion SEK is thus on the low side when this definition of low-income households is used.

In light of the fact that the cost of the simulated measures amounts to about half of the cost of the reduced VAT on food, the illustrative example shows that the reduced VAT is not a cost-effective way to enhance the purchasing power of families with children and low-income households. The funds that the State would save by removing the reduced VAT on food would enable it to finance additional fiscal measures in order to fully compensate households in deciles 2-4.

Our simulations also demonstrate that the definition of low-income households plays a role in the results. If the simulation is analysed by defining low-income households as households at risk of poverty, it appears that the simulated measures manage to compensate the group fully. This means that the simulated measures strengthen the purchasing power of families with children and low-income households in the same way as the reduced VAT on food, but that spending for the simulated measures costs roughly half as much as the reduced VAT on food.

Recommendation

In light of the findings of our audit, which point to the low cost effectiveness of the reduced VAT on food, it is the recommendation of the Swedish National Audit Office that the Government:

- Take the initiative to investigate the reduced VAT on food and determine whether its motive is still to support families with children and for low-income households, and in such case, to consider other ways to support these households.