A Narrative Analysis of Value Added Tax Changes

I. Brief Introduction

This online appendix presents a narrative analysis of 96 value-added tax rate changes for 35 countries from 1970:Q1-2014:Q4. Given the nature of our study we limit the narrative analysis to those country-quarter observations for which true (as opposed to interpolated) quarterly GDP data is available. It records the magnitude and timing regarding the passage of the tax law and its implementation. Given the main objective of the paper, it crucially describes the economic conditions as well as the nature of the policy of the country at the time the rate change was enacted, and categorizes the tax rate change by the primary motivation for the change. It uses IMF and OECD documents and contemporary news articles to determine the motivation and nature of the value added tax changes. The paper classifies value added tax rate changes into endogenous and exogenous categories based on the categorization of Romer and Romer (2010a, 2010b) with some modifications.[1]

[1] Romer, Christina D. and David H. Romer. 2010a. "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks." American Economic Review 100(June): 763-801.
Romer, Christina D. and David H. Romer. 2010b. "A Narrative Analysis of Postwar Tax Changes." Online appendix to "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks." Available on the American Economic Review website, June.

Narratives of changes in VAT rates (for online publication)

Country: Argentina

1. Tax change of 1995

Legislation was passed to increase VAT from 18 percent to 21 percent on March 16, 1995.[2]
Implementation occurred on April 1, 1995.
Narrative classification: Endogenous – GDP-driven (procyclical).

Background

Argentina's economy stagnated for over a decade and suffered from very high inflation, which averaged 555 percent per year during the 1980s. In 1990, Argentina suffered a banking crisis, which led to the 1991 Convertibility Plan (a currency board system) that pegged the Argentinean peso to the US dollar. After implementation of the plan, real GDP grew by a cumulative 35 percent from 1991-1994. Inflation fell to an average of 4 percent annually and gross fixed investment grew by 22 percent annually in real terms, reaching nearly 20 percent of GDP in 1994.

> During this period, there was a marked shift to more capital intensive production and the economy recorded strong productivity gains. Government policies spearheaded this transformation through fiscal restraint, increased public saving, structural reform and privatization, deregulation of domestic markets, and accelerated integration into the world economy through external trade liberalization. The improvement in policies led to large capital inflows, which supported the economic recovery.[3]

The Mexican banking system was hit by a crisis in December 1994. This severely impacted the Argentine banking system, resulting in an outflow of capital, a decline in deposits, and a credit crunch. Economic growth slowed and became negative by the end of the first quarter of 1995, and unemployment rose sharply from 12.2 percent in October 1994 to 18.6 percent in May 1995.

Since the credibility and sustainability of the Convertibility Plan demanded that sound public finances be maintained, a series of tax measures to restore confidence, strengthen tax collection, and reduce the fiscal deficit were passed in March 1995. One of these measures included a temporary (later legislated permanent) 3 percentage point increase in the VAT rate to 21 percent that was to expire at end-March 1996.

The temporary nature of this VAT increase was due to the desire to reduce the fiscal deficit as a consequence of the economic slowdown and the need to strengthen the fiscal deficit under the Convertibility Plan. We therefore classify this tax change as a procyclical action.

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[2] Long, W. R. (1995, Mar 16). Argentina fighting to reverse capital flight crisis: Deposits have shrunk more than $4 billion since mexico devalued its currency. Los Angeles Times (Pre-1997 Fulltext

[3] SM/95/248, Argentina – Recent Economic Developments, September 20, 1995, IMF Archives, p. 1.

Sources:

IMF Archives. Master Files Room C-525 0493. International Monetary Fund News Brief Number 96/4. IMF Statement on Argentina. August 14, 1995.

IMF Archives. SM/95/248. Master Files Room C-525 0450. Argentina – Recent Economic Developments. September 20, 1995.

IMF Archives. SUR/95/115. Master Files Room C-525 0459. The Acting Chairman's Summing Up at the Conclusion of the 1995 Article IV Consultation with Argentina Executive Board Meeting 95/94. October 5, 1995.

Country: Belgium

1. Tax change of 1992

Legislation was passed to increase VAT from 19 percent to 19.5 percent on March 1, 1992.[4]
Implementation occurred on April 1, 1992.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Background

Belgium's general government deficit peaked at over 13 percent of GNP in 1981. This shaped Belgium's fiscal policy for the rest of the decade, with a focus on first stabilization and then the reduction of the public debt ratio. Success was limited; despite steady reductions in the deficit, the debt ratio continued to rise for most of the 1980s and general government debt net of short-term financial assets reached 124 percent of GNP in 1988. Fiscal adjustment measures and strong economic growth allowed the debt ratio to decline for the first time in 1989. However, after stabilizing in 1990 it rose once again to 124 percent of GNP in 1991 as a result of expenditure slippages especially in social security.[5]

Belgium benefited from a rise in the private savings rate and a revival of private investment, leading to faster growth compared to other European Community countries. The inflation rate was among the lowest of the EC. The current account of the Belgium-Luxembourg Economic Union was in surplus since the mid-1980s, in 1992 reaching a surplus of 2 percent of GNP. Despite a relatively strong output performance, unemployment remained high, as did the budgetary cost of unemployment compensation and employment support measures.

Economic activity slowed in Belgium and throughout the European community in 1991. During 1992, Belgium's growth remained fragile, affected by the general worsening of the international economic environment. Although inflation remained well below the EU average, the slowdown in economic activity led to a rise in unemployment for the first time in ten years. Concurrently, the federal budget deficit rose once again (reversing a five-year tread) to 6.3 percent of GNP as a result of expenditure slippages, especially in social security.[6]

Belgium's policy goals in 1992 focused on developing a convergence plan aimed at satisfying the fiscal criteria for entrance to the European Monetary Union. The 1991 Maastricht agreement required countries proceeding to the third stage of EMU to have general government fiscal deficits that did not exceed 3 percent of GDP as well as debt ratios equal to or lower than 60 percent of GDP (or declining at a satisfactory pace).

[4] SM/92/222 p. 6, Belgium to Align Its VAT, Duty Laws With Rest of EC Wall Street Journal [Brussels] 17 Mar 1992: 2.
[5] SM/92/206, Belgium – Staff Report for the 1992 Article IV Consultation, November 24, 1992, IMF Archives, p. 2.
[6] SM/92/222, Belgium – Recent Economic Developments, December 21, 1992, IMF Archives, p. 1.

On April 1, 1992, VAT rates and brackets were changed due to the adoption of the EC directive on VAT harmonization. The previous five-rate VAT system was replaced by a new standard rate of 19.5 percent and a reduced rate of 6 percent for essential commodities.[7]

In June 1992, Belgium's Ministry of Finance announced a convergence plan to reach the 3 percent deficit ratio required by the Maastricht agreement in 1996, starting from a projected general government deficit of 5.7 percent of GNP in 1992. This plan was part of the 1993 budget, which for the first time, was presented in a multi-year context.

> To achieve [the deficit goal in the convergence plan] the authorities have adopted three norms to guide fiscal policy over the medium term: (1) zero real growth of primary expenditure by the national government; (2) unitary elasticity of fiscal receipts with respect to GNP; and (3) financial equilibrium in the accounts of the social security system. In addition, the plan contains explicit ceilings on nominal expenditures in certain areas...[8]

The package included expenditure cuts of about BF 47 billion for the national government and BF 13 billion for social security, tax increases of 28.5 billion, and nontax receipts of BF 21 billion. Another BF 13 billion in supplementary measures was targeted at achieving the convergence plan deficit objective. The VAT increase from 19 percent to 19.5 percent was part of the long-term plan to satisfy this deficit criterion.

Belgium's 1992 VAT increase was motivated by an interest in harmonizing VAT rates with other members of the European community and reducing public debt and deficits toward the Maastricht treaty limit. As such, we classify it as inherited fiscal debt driven change.

Sources:

"Belgium to Align Its VAT, Duty Laws With Rest of EC." *Wall Street Journal* [Brussels], March 17, 1992, p. 2.

IMF Archives. SM/92/206. Master Files Room C-525 0450. Belgium – Staff Report for the 1992 Article IV Consultation.

IMF Archives. SM/92/222. Master Files Room C-525 0450. Belgium – Recent Economic Developments. December 21, 1992.

IMF Archives. SM/93/253. Master Files Room C-525 0450. Belgium – Recent Economic Developments. December 3, 1993.

[7] SM/93/253, Belgium – Recent Economic Developments, December 3, 1993, IMF Archives, p. 6

[8] SM/92/222, Belgium – Recent Economic Developments, December 21, 1992, IMF Archives, p. 7

2. Tax change of 1994

Legislation was passed to increase VAT from 19.5 percent to 20.5 percent during the week of October 27, 1993.[9]
Implementation occurred on January 1, 1994.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Belgium experienced recessionary conditions in 1993 (GDP growth rate of -1 percent in 1993). The slowdown was led by a sharp contraction in the rate of export growth, particularly in Germany, in 1992. The unfavorable external economic climate brought about a continuous deterioration in domestic business and consumer confidence during 1992, and by March 1993 the Belgian National Bank's (BNB) leading indicator of economic activity had reached its lowest level since 1981.

Although Belgium's fiscal policy had focused on reducing deficits to the 3 percent of GDP required by the Maastricht treaty, the recession's negative effect on tax revenues largely offset the impact of these fiscal measures. The 1993 deficit was expected to remain near 7 percent, the social security deficit continued to widen, the public debt-to-GDP ratio continued to rise, and the interest burden exceeded 11 percent of GDP.

Parliament addressed the rising social security deficit in a November 1993 package that also aimed to restore competitiveness and stimulate employment.

> The plan envisages to restore social security balance through structural expenditure measures (rising from about BF 41 billion in 1994 to BF 76 billion by 1996) and new taxes (rising from about BF 21 billion to BF 31 billion over 1994-96). Among other measures, it is intended to impose a norm of 1.5 percent real growth on health care expenditure, and to reduce family allowances above certain income levels. The additional revenue will largely come from new taxes on incomes deriving from real estate and financial assets (e.g. the withholding tax on interest income will rise from 10.3 percent to 13.4 percent). No further increases are envisaged in direct taxation, but indirect taxes are to be increased (the standard VAT rate will rise from 19.5 percent to 20.5 percent) in order to finance selective reductions in employers' social security contributions.[10]

The VAT hike was part of a fiscal package aimed at reducing a growing public debt and fiscal deficit that resulted from the 1993 recession. As such, we classify this tax change as a procyclical action.

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[9] Belgian premier to meet with unions, employers. (1993, Nov 29). Wall Street Journal Retrieved from http://search.proquest.com/docview/308164255?accountid=8505
[10] SM/93/253, Belgium – Recent Economic Developments, December 3, 1993, IMF Archives, , p. 12.

Sources:

Greiff, Peter R. “Belgium Is Unlikely to Meet Target For Its Budget Deficit This Year.” *Wall Street Journal* [Brussels], January 12, 1994, p. 2.

IMF Archives. SM/93/253. Master Files Room C-525 0450. Belgium – Recent Economic Developments. December 3, 1993.

3. Tax change of 1996

Legislation was passed to increase VAT from 20.5 percent to 21 percent on October 1, 1995.[11]
Implementation occurred on January 1, 1996.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Belgium exited a recessionary state in 1994 with moderate recovery. The recovery slowed in 1995 as foreign demand faltered; GDP growth in 1995 was estimated at 2 percent. Inflation was low, the exchange rate was strong, the current account surplus was one of the highest in the industrial world, and the fiscal deficit was on a downward path. However, low labor force participation rates and high unemployment continued, while the public debt ratio remained very high at about 127 percent of GDP (despite the fiscal consolidation begun in recent years).

General government deficits declined after 1992 despite weak economic conditions. Measures aimed at raising the ratio of revenue to GDP and reforming social security and improved the fiscal situation. Governments at the regional and community levels had also begun fiscal consolidation. The 1996 budget continued the medium-term goals of deficit reduction originally laid out in the 1992 convergence plan with the objective of meeting the Maastricht debt requirements. The 1996 federal budget, based on an economic growth assumption of 2.2 percent, aimed to achieve a general government deficit of 3 percent of GDP. The budget included both a sharp drop in real growth of general government primary expenditure to about 0.5 percent in 1996 and several revenue measures amounting to around 0.9 percent of GDP. The revenue measures included an increase in the normal VAT rate from 20.5 percent to 21 percent, as well as continued suspension of the indexation of income tax brackets, an increase in the tax on diesel car registration, a surcharge on workers' social security contributions, a rise in the withholding tax on interest income from 13.39 to 15 percent, and the sale of mobile phone licenses and buildings.

Belgium's VAT increase in 1996 took place in the context of modest economic growth. The VAT increase aimed to continue medium-term debt and deficit reduction in agreement with the Maastricht limit. As such, we classify it as inherited fiscal debt driven change.

Sources:

Asert, Raf C. "Belgium Put On Austerity Diet." *The Independent*, October 4, 1995, p. 14.

IMF Archives. SM/96/31. Master Files Room C-525 0450. Belgium – Recent Economic Developments. February 6, 1996.

[11] Belgium put on austerity diet. RAF C ASERT Associated Press. The Independent [London (UK)] 04 Oct 1995: 14.

Country: Botswana

1. Tax change of 2010

Legislation was passed to increase VAT from 10 percent to 12 percent on February 1, 2010.[12]
Implementation occurred on April 1, 2010.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Background

Botswana's economy entered the 2008 global financial crisis from a position of considerable strength because of past prudent macroeconomic management. This facilitated a timely easing of fiscal and monetary policies, which helped cushion the impact of the crisis-induced collapse in demand for diamonds.

Although the crisis was a significant setback, Botswana's economy was already rebounding by 2010. Authorities and the IMF anticipated a rebalancing in 2010 as growth accelerated in the diamond sector, while reductions in government spending slowed growth in the nonmining sector. The IMF described the medium-term outlook as favorable provided that the authorities proceed with planned fiscal consolidation. IMF staff projected that "real GDP growth will average about 6 percent over the medium term, as diamond production gradually recovers towards pre-crisis levels and investment in the power sector boosts growth in the nonmining sector."[13]

Botswana's government responded to the global financial crisis with fiscal stimulus, but shifted toward medium-term balance in 2010. At this time, the government faced a large budget deficit, a decline in revenues from the South African Customs Union, and lower mineral revenue from weak demand in the mining sector. The 2010 VAT increase from 10 percent to 12 percent was part of a package to bring the budget back into balance. The increase in VAT rates from 10 percent to 12 percent was part of restoring fiscal balance.

> As recovery gets underway, significant fiscal consolidation will be needed to ensure fiscal and external sustainability. Staff estimates that reducing the nonmineral primary deficit to about 11–12 percent of nonmining GDP would preserve mineral wealth for future generations in real per capita terms and avoid the need for a sharp adjustment in the public finances when diamond production begins to decline sharply towards the middle of the next decade. The bulk of adjustment will need to come from lower public

[12] http://www.mmegi.bw/index.php?sid=4&aid=1610&dir=2010/April/Monday12;
http://trade.botswanatourism.us/trade_enewsletter_feb_10.html
[13] IMF Country Report No. 10/280, Botswana: 2010 Article IV Consultation – Staff Report and Supplement; Public Information Notice on the Executive Board Discussion, September 8, 2010, p. 3.
http://www.imf.org/external/pubs/ft/scr/2010/cr10280.pdf.

> spending...The budget for 2010/11 makes a good start on this process of consolidation. Adjustment is based on significant spending restraint, including a substantial cut in development spending as recent projects approach completion and a public service salary freeze. The VAT rate has also been increased from 10 to 12 percent. The budget is consistent with an improvement in the nonmineral primary deficit to 26.7 percent of nonmineral GDP.[14]

Botswana's VAT increase was intended to return fiscal balance after an increase in deficits. We categorize it as a deficit-driven change.

Sources:

IMF. Country Report No. 10/280. Botswana: 2010 Article IV Consultation – Staff Report and Supplement; Public Information Notice on the Executive Board Discussion. September 8, 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10280.pdf.

Kayawe, Baboki. "VAT Increase Hits Consumers Hard." *The Monitor* 27(53), April 12, 2010.

Mguni, Mbongeni. "Botswana: VAT Increase a "Consumer Penalty"." *Bidpa Chief* February 10, 2010.

[14] Ibid., p. 6.

<u>Country: Canada</u>

1. Tax change of 2006

Legislation was passed to decrease VAT from 7 percent to 6 percent on June 1, 2006.[15]
Implementation occurred on July 1, 2006.
Narrative classification: Exogenous – Long-run growth.

Background

Canada's economy operated close to potential with strong performance during the mid-2000s. Unemployment was at a 31-year low and robust domestic demand offset weakness in net exports from past currency appreciation. As of 2006, the IMF anticipated that Canada's strong performance would continue. Resilient domestic demand and reduced drag from the external sector were expected to generate a recovery in growth of around 2¾ percent by mid-2007, despite the U.S. slowdown, with inflation staying at about 2 percent.

In 2006, the Canadian government lowered the Goods and Services Tax (GST), a type of VAT, as part of broader intentions to lower the tax burden in the context of a strong fiscal position. Tax cuts were promised by the Conservative party during the 2006 election campaign.

> Besides the GST, Mr. Flaherty said the party made a number of promises in regards to tax relief -affecting small business and seniors- that it is looking to introduce in the pending budget. Meanwhile, he said it is his job to end the days of big surprise budget surpluses that have generally emerged after the end of the fiscal year. That, Mr. Flaherty said, led to hidden revenue the former Liberal government would spend for political purposes without the approval of Parliament.[16]

According to the IMF,

> The government's intention to lower the tax burden is appropriate. The modest fiscal space after planned debt reduction would most usefully be used for growth enhancing cuts in personal and (in particular) corporate marginal effective tax rates. We welcome the government's commitment to using interest savings from debt reduction to lower personal income taxes and its objective of achieving the lowest marginal effective tax rate on new investment in the G-7.[17]

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[15] http://www.theglobeandmail.com/news/national/opposition-says-gst-ads-amount-to-conservative-advertising/article1049763/. Part of campaign promise in 2005/06 campaign.

[16] Paul Vieira, "Tories Keep Door Open on Liberal Tax Breaks: Will Keep GST Promise," *National Post*, April 6, 2006, FP.6.

[17] IMF. 2007 Article IV Consultation with Canada – Preliminary Conclusions of the IMF Mission. December 7, 2006. http://www.imf.org/external/np/ms/2006/120706.htm.

However, the IMF favored cuts to income taxes rather than cuts to consumption taxes because marginal income tax rates were high by international standards, suggesting that reductions in this area would provide larger efficiency gains than further cuts to the Goods and Services Tax.

The 2006 GST cut falls into the category of cuts aimed at increasing long-run growth or increasing conformity of the tax code to principles of efficiency. We classify this as long-run growth.

Sources:

Vieira, Paul. “Tories Keep Door Open on Liberal Tax Breaks: Will Keep GST Promise.” *National Post* April 6, 2006: FP.6.

IMF. 2007 Article IV Consultation with Canada – Preliminary Conclusions of the IMF Mission. December 7, 2006. http://www.imf.org/external/np/ms/2006/120706.htm.

2. Tax change of 2008

Legislation was passed to decrease VAT from 6 percent to 5 percent on December 1, 2007.[18]
Implementation occurred on January 1, 2008.
Narrative classification: Exogenous – Long-run growth.

Background

Canada's economy operated close to potential with strong performance during the mid 2000s. Unemployment was near a 33-year low and the economy remained strong despite commodity price gains, currency appreciation, and, more recently, slowing U.S. demand. This was partly due to a commodity boom which strengthened Canada's external position and boosted domestic demand. The growth of domestic demand was partly offset by a sharp appreciation of the real exchange rate and a decline in real net exports. As of 2008, IMF staff viewed the economy as operating above potential. Real GDP grew 2.6 percent in 2007 with unemployment estimated at 6.0 percent.

The Canadian Goods and Services Tax, which had been lowered in 2006 to fulfill campaign promises of the Conservative Government, was lowered again in 2008. At the time, Canada had a fiscal surplus of about 0.4 percent of GDP and had run surpluses for a decade. The emphasis on tax relief was consistent with promoting long-term growth, but the precise nature of the tax cut was inconsistent with economic efficiency. In the IMF's assessment,

> To foster efficiency, the fiscal room should be used to reduce high marginal effective tax rates on capital, saving, and labor (in that order). Instead, the main tax relief measure in the Statement is a one percentage point cut in the federal GST rate to 5 percent…Harmonization of some provincial sales tax bases with the federal GST would further reduce marginal effective tax rates on capital, and justify more explicit incentives than the government's existing commitment to work with provinces.[19]

The 2008 GST cut continued the Conservative's government's commitment to lowering indirect consumption taxes. We classify it as long-run growth driven.

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[18] http://www.cra-arc.gc.ca/nwsrm/rlss/2007/m12/nr071217-eng.html.

[19] IMF, Country Report No. 08/69, Canada: 2008 Article IV Consultation – Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion, February 2008, p. 24, http://www.imf.org/external/pubs/ft/scr/2008/cr0869.pdf

Source:

Galloway, Gloria. "Opposition Says GST Ads Amount to Conservative Advertising." *The Globe and Mail* January 4, 2008, p. A4.

IMF. Country Report No. 08/69. Canada: 2008 Article IV Consultation – Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion. February 2008. http://www.imf.org/external/pubs/ft/scr/2008/cr0869.pdf

IMF. Public Information Notice No. 08/19. IMF Executive Board Concludes 2008 Article IV Consultation with Canada. February 25, 2008. http://www.imf.org/external/np/sec/pn/2008/pn0819.htm

Country: Chile

1. Tax change of 2003

Legislation was passed to increase VAT from 18 percent to 19 percent on July 2, 2003.[20]
Implementation occurred on October 1, 2003.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Brief background material and description of nature of tax rate change

Chile's economy decelerated along with the world economy during 2001-02 but continued to grow due to access to external financing and ability to pursue countercyclical macro policies. Monetary policy was eased in 2002, aiming to keep inflation from dropping below the target band. Automatic fiscal stabilizers were allowed to operate and the authorities met their structural balance target. Successful inflation targeting reduced the inflation rate from 8 percent annually in the mid-1990s to 1 percent in 2003. The IMF's baseline-scenario economic outlook for Chile anticipated that GDP growth would accelerate to 3 ½ percent in 2003 and 4 ½ percent in 2004 as recovery of demand took up slack capacity.[21] Inflation was expected to remain around 3 percent.

Chile made major changes to its macroeconomic policy in the late 1990s and early 2000s. In 1999, the central bank announced its intention to begin inflation targeting in 2001 and switch to a floating exchange rate that same year. In 2000, the new government of President Frei committed to fiscal policy, emphasizing structural budget balance with a target of 1 percent of GDP surplus. At this time, government expenditure was tied to cyclically adjusted revenue and policy proposals that changed either revenue or expenditure, which had to be tied to other offsetting measures.

In early 2002, the Frei administration adopted a "Pro-Growth Agenda". This ambitious plan sought to modernize public administration, increase government transparency reinforce the financial system, as well as increase the transparency of macroeconomic policy. The fiscal policy part of the Pro-Growth Agenda reiterated the structural budget balance with a target of a 1 percent of GDP surplus.

In 2003, the Chilean authorities concluded that in order to achieve the fiscal balance goal in 2003 and 2004, a new source of revenue would be necessary (due in part to declines in tariff revenue). The 2003 VAT increase from 18 percent to 19 percent was part of a package to restore fiscal balance and also included excise tax increases and spending cuts.

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[20]http://infoserv2.ita.doc.gov/ticwebsite/laweb.nsf/504ca249c786e20f85256284006da7ab/1abd7e5e1d5ec3fa85256923006f65ce!OpenDocument

[21] IMF Country Report No. 03/303, Chile: 2003 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Chile, September 2003, p. 4, http://www.imf.org/external/pubs/ft/scr/2003/cr03303.pdf

This tax change falls into the category of tax changes intended to correct budget deficits and was driven by adherence to a budget rule. As such, we classify it as deficit-driven.

Sources:

IMF Country Report No. 03/303. Chile: 2003 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Chile. September 2003. http://www.imf.org/external/pubs/ft/scr/2003/cr03303.pdf

IMF Country Report No. 03/312. Chile: Selected Issues. October 2003. http://www.imf.org/external/pubs/ft/scr/2003/cr03312.pdf

IMF Country Report No. 04/291. Chile: 2004 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Chile. September 2004. http://www.imf.org/external/pubs/ft/scr/2004/cr04291.pdf

Country: Czech Republic

1. Tax change of 2004

Legislation was passed to decrease the VAT from 22 percent to 19 percent on April 1, 2004.[22]
Implementation occurred on May 1, 2004.
Narrative classification: Endogenous – Offsetting (within VAT).

Brief background material and description of nature of tax rate change

The Czech Republic and Slovakia became independent states in January 2003 after the former Czechoslovakia split into two countries. The Czech Republic entered the European Union in 2004 with "moderate growth, low inflation, moderate public and external debt, and one of the highest per capita incomes among the new EU members (63 percent of the EU-15 average on a PPP basis)."[23] GDP grew by 3.1 percent in 2003 and the first quarter of 2004.

Although the Czech Republic's public debt was only 28 percent of GDP with low financing costs, Czech authorities were concerned about its potential to rise rapidly. Government expenditures were rising faster than tax revenue, driving up deficits. The debt could also rise sharply if a large amount of guarantees were called. Additionally, an aging population meant that pension and health care costs would put pressure on the budget in future. The potential for a rapidly growing debt problem was concerning because high deficits could raise interest rates, crowd out private-sector investment, stall plans to adopt the euro in the intended 2009-10 time frame, and make it difficult to ease the country's high tax burden.

To address the country's high tax burden, a three-year adjustment plan was enacted. It set a goal of deficits of 4 percent of GDP by 2006, consistent with the Czech Republic's 2004 Convergence Program, and capped expenditures, while increasing indirect taxes. The 2004 budget was roughly in line with the plan on the tax side, although it violated the expenditure caps. Indirect tax changes in 2004 included an EU-mandated shift of over ¼ the consumption basket of goods and services from the preferential to the standard VAT rate, and a reduction of the standard VAT rate from 22 percent to 19 percent.

The overall goal of Czech policy was to lower deficits in order to prevent the burgeoning of long-run debt. Although the VAT rate was cut, the VAT base was expanded as many goods moved from the preferential to standard rate. We classify this tax change as tax substitution.

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[22] New Czech law cuts VAT to 19 per cent
BBC Monitoring European [London] 22 Apr 2004: 1.

[23] IMF Country Report No. 04/266, Czech Republic: 2004 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Czech Republic, August 2004, p.4

Sources:

IMF Country Report No. 04/266. Czech Republic: 2004 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Czech Republic. August 2004. http://www.imf.org/external/pubs/ft/scr/2004/cr04266.pdf

IMF. Chile – 2003 Article IV Consultation Discussions. Preliminary Conclusions of the Staff Mission. July 2, 2003. http://www.imf.org/external/np/ms/2003/070203.htm

2. Tax change of 2010

Legislation was passed to increase VAT from 19 percent to 20 percent on March 11, 2009.[24]
Implementation occurred on January 1, 2010.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

The Czech Republic was severely affected by the global financial crisis. The GDP growth rate decreased from 5.7 percent in 2007 and 3 percent in 2008, to -4.7 percent in 2009.

> A downturn in the euro area—especially in Germany, the main trading partner—depressed exports and output fell by 4¼ percent in 2009. A drop in FDI and the tightening of domestic banks' lending standards hit the corporate sector, leading to a decline in investment. Private consumption held up, in spite of rising unemployment, reflecting a supportive fiscal policy. The external position remained robust, despite a sharp decline in capital inflows. The drop in exports was offset by a larger fall in imports, improving the trade balance. FDI more than halved and no longer fully financed the current account deficit, but rising inflows of EU funds filled the gap. The initial depreciation of the Czech koruna was subsequently reversed, and the real exchange rate remains in line with fundamentals. Overall, market sentiment vis-à-vis the Czech Republic remains relatively favorable, reflecting limited vulnerabilities.[25]

The Czech economy was expected to grow by about 1 ½ percent of GDP in 2010.

The deficit increased to 6 percent of GDP in 2009 (from 2 percent previously) and the debt-to-GDP ratio rose from 29 percent of GDP in 2007 to an estimated 34.2 percent of GDP at the end of 2009. The deficit increased was caused by a low level of revenue that resulted from the 2007 tax reform (which cut the income tax and social contribution rates) and fiscal stimulus from the 2009 Crisis package. According to the IMF,

> The crisis led to a sharp widening of the overall deficit in 2009, a rapid accumulation of debt, and an increase in interest rate spreads. In the absence of additional adjustment measures, the budget deficit is projected to remain above 5 percent of GDP over the medium term, with the level of public debt doubling to 60 percent of GDP in less than a decade. We estimate that a structural adjustment of at least 0.7 percent per year will be required to achieve a deficit of below 3 percent of GDP in 2013 mandated by ECOFIN. This, however, will not be sufficient to achieve debt sustainability over the long term, in particular given spending pressures of population aging.[26]

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[24] http://www.meridianglobalservices.com/czechvatrateincrease/

[25] IMF. Czech Republic – 2010 Article IV Consultation Concluding Statement. January 25, 2010. http://www.imf.org/external/np/ms/2010/012510.htm

[26] Ibid.

The interim government elected in May 2010 passed a budget aimed at addressing the deficit problems.

The VAT hike was part of a fiscal package that sought to reduce the growing public debt and fiscal deficit, which were the consequences of the 2009 fall in output. As such, we classify this tax change as a procyclical action.

Sources:

IMF. Czech Republic – 2010 Article IV Consultation Concluding Statement. January 25, 2010. http://www.imf.org/external/np/ms/2010/012510.htm

IMF Country Report 10/60. Czech Republic: Staff Report for the 2010 Article IV Consultation. March 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr1060.pdf

3. Tax change of 2013

Legislation was passed to increase the VAT rate from 20 percent to 21 percent on November 14, 2012.[27]
Implementation occurred on January 1, 2013.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Brief background material and description of nature of tax rate change

The Czech Republic was severely affected by the 2008 global financial crisis. Exports drove a post-crisis recovery that lasted from 2010 until the first half of 2011. However, recovery stalled in the fall of 2011 as exports stanged and domestic demand remained weak compared to neighboring countries. IMF officials deemed the economy fundamentally sound due to strong policies and fundamentals, but expected weak economic performance in 2013 with gradual improvement afterward. Economic improvement was expected to rely heavily on the improvement of the Czech Republic's trading partners.

Post-crisis policy changes left the Czech Republic in an improved fiscal position relative to its pre-crisis status. The IMF reported that

> With a budget deficit projected at 2.8 percent of GDP in 2013, the Czech Republic should be able to exit the Excessive Deficit Procedure. The structural consolidation of around 4.5 percent of GDP over 2010-2013 has resulted in a stronger fiscal position than before the crisis.[28]

The standard VAT rate, which had been increased from 19 percent to 20 percent in 2010, was raised again to 21 percent at the start of 2013. Both the 2011 and 2013 VBAT increased suppressed consumer demand and increased inflation.[29]

The 2011 VAT increase was a key component of the decline in budget deficits from 3.2 to 2.5 percent of GDP between 2011 and 2012, and the 2013 VAT increase was also intended to lower deficits and keep them below the EU cap of 3 percent of GDP. The 2013 budget also included other tax increases targeted toward deficit reduction, including changes to individual income taxes, withholding taxes, and excise taxes.[30] The budget was passed in December 2012 and approved by President Vaclav Klaus. After the increase, the basic VAT rate remained near the EU average, although the reduced rate of 15 percent was among the highest.

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[27] Czech premier interviewed on economic issues, reshuffles. (2012, Nov 18). BBC Monitoring European Retrieved from http://search.proquest.com/docview/1164978254?accountid=8505

[28] IMF, Czech Republic – 2013 Article IV Consultation Concluding Statement. May 20, 2013.

[29] IMF Country Report 13/242, Czech Republic: 2013 Article IV Consultation. August 2013, pp. 4-5. http://www.imf.org/external/pubs/ft/scr/2013/cr13242.pdf.

[30] http://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxnewsflash/pages/czech-republic-increased-vat-rates-other-changes-in-2013.aspx

We classify this tax change as driven by deficit reduction concerns. We also include it as external institution-driven change due to the Czech Republic's desire to exit the EU's excessive deficit procedure.

Sources:

"Basic 21 percent VAT Rate is Average Compared with Europe." *Prague Monitor* January 14, 2013. http://praguemonitor.com/2013/01/14/basic-21-vat-rate-average-compared-europe

"Czech parliament overrides Senate veto on tax hikes, passes 2013 budget." *Intellinews-Czech Republic Today*, December 20, 2012.

IMF. Czech Republic – 2013 Article IV Consultation Concluding Statement. May 20, 2013. http://www.imf.org/external/np/sec/pn/2012/pn1252.htm

IMF Country Report 13/242. Czech Republic: 2013 Article IV Consultation. August 2013. http://www.imf.org/external/pubs/ft/scr/2013/cr13242.pdf

KPMG. VAT TaxNewsFlash. "Czech Republic - Increased VAT Rates, Other Changes in 2013." December 22, 2012.

Country: Denmark

1. Tax change of 1992

Legislation was passed to increase VAT from 22 percent to 25 percent on June 25, 1991.[31]
Implementation occurred on January 1, 1992.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

Denmark's economy overheated in mid-1980s and a contractionary fiscal stance was adopted in 1986. The changes were effective at changing private households from net borrowers to net savers. Labor costs decreased, the current account deficit shrank, and interest rates fell. However, the decrease in domestic demand resulted in the weakening of the economy, prompting a period of slow growth and rising unemployment. Real GDP grew an average of 1 percent annually from 1987-1992 and the unemployment rate averaged 9.4 percent between 1988-1992, reaching 11.1 percent in 1992.

Concern about structural unemployment, which authorities estimated to make up 8-9 percent of the labor force, prompted structural reforms. Denmark had an unusually generous unemployment compensation system that guaranteed benefits, at 90 percent wage replacement rates, for up to 8 years (and only 26 weeks of work were needed to qualify).[32] Major labor market reforms were enacted in 1993, but early reforms began in 1992 when the labor-market contribution tax was decreased as a way to encourage employment. The 1992 VAT increase was enacted partly to offset the revenue loss from the cut. "Denmark will raise its value-added tax on goods and services to 25 percent from 22 percent, effective Jan 1, 1992. The increase is intended to compensate for a revenue loss from abolition of the 3 percent labor-market contribution tax on employers."[33]

We classify this change as a tax substitution.

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[31] AP. (1991, Jun 25). Europeans reach accord on sales tax. New York Times Retrieved from http://search.proquest.com/docview/428091057?accountid=8505
By, M. M. (1991, Jun 25). EC's officials reach accord on VAT rate --- minimum is fixed at 15%; overall, pact will lower rates in the community. Wall Street Journal Retrieved from http://search.proquest.com/docview/398201168?accountid=8505

[32] Jorgen Goul Andersen and Jacob J. Pedersen, "Continuity and Change in Danish Active Labour Market Policy: 1990-2005," Paper prepared for international conference on Welfare State Change: Conceptualisation, Measurement and Interpretation, St. Restrup, Denmark, 13-15 January, 2006. http://www.socsci.aau.dk/welfare/conference-2006/papers/Paper-Goul-Jacob.pdf

[33] Richard Holman, "World Wire: Denmark's VAT to Increase," *The Wall Street Journal* (New York), December 23, 1991, p. A6.

Sources:

Andersen, Jorgen Goul and Jacob J. Pedersen. "Continuity and Change in Danish Active Labour Market Policy: 1990-2005." Paper prepared for international conference on Welfare State Change: Conceptualisation, Measurement and Interpretation. St. Restrup, Denmark, January 13-15, 2006. http://www.socsci.aau.dk/welfare/conference-2006/papers/Paper-Goul-Jacob.pdf

IMF Archives. SM/91/79. Master Files Room C-525 0450. Denmark – Staff Report for the 1991 Interim Article IV Consultation. May 2, 1991.

Holman, Richard. "World Wire: Denmark's VAT to Increase." *The Wall Street Journal* (New York) December 23, 1991, p. A6.

Country: Ecuador

1. Tax change of 1999

Legislation was passed to increase VAT from 10 percent to 12 percent on October 26, 1999.[34]
Implementation occurred on November 1, 1999.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

During the late 1990s, Ecuador experienced a severe contraction in GDP, with rising unemployment and inflation. The El Niño weather phenomenon, sharp drop in world oil prices, and turbulent international financial situation compounded problems caused by a large fiscal deficit and crisis in the banking system. Total public debt rose from 64 percent of GDP to 118 percent of GDP between 1997 and 1999. Real GDP fell 8 percent in 1999 and unemployment nearly doubled during the year, ending at 16 percent.

The banking crisis began in 1998 and continued into 1999, with the largest banks in the country failing. Bank runs in March 1999 prompted the government to freeze deposits for six months. In addition, the central bank was forced to float the currency and interest rates skyrocketed.

The IMF agreed to a $400 million loan program, contingent on the passage of tax reform. An increase in the VAT rate was named as a structural benchmark and performance criterion for the fourth IMF review of the program. "The tax reform to be submitted by the government to congress in September will include an increase in the rate and a broadening of the base of the VAT, a reduction in the personal exemption under the income tax, a significant reduction in tax revenue earmarking from the present level of 60 percent, and the introduction of a consumption tax on domestic petroleum derivatives."[35]

The government did submit such a package to the congress in October 1999 that aimed to reduce the fiscal deficit to 2 ½ percent of GDP. However, the final version of the package approved by the congress was far less ambitious. It did increase the VAT rate from 10 to 12 percent as well as increase the personal and corporate income tax rates, but these changes were offset by reductions in other taxes.

The increase in VAT was largely driven by an IMF requirement to reduce deficits and bring down debt as a consequence of the severe fall in output. Therefore, we classify it as procyclical.

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[34] Moss, N. (1999, Oct 27). Ecuador set to pass tax reforms. Financial Times Retrieved from http://search.proquest.com/docview/248750138?accountid=8505

[35] IMF, Ecuador Letter of Intent, Supplement to the Memorandum of Economic Policies, and Supplement to the Technical Memorandum of Understanding, August 10, 2000, paragraph 45, http://www.imf.org/external/np/loi/2000/ecu/01/index.htm

Sources:

IMF. Ecuador Letter of Intent, Supplement to the Memorandum of Economic Policies, and Supplement to the Technical Memorandum of Understanding. August 10, 2000. http://www.imf.org/external/np/loi/2000/ecu/01/index.htm

Oyama, David I. “World Watch.” *The Wall Street Journal* November 8, 1999, p. A33.

2. Tax change of 2001

Legislation was passed to increase VAT from 12 percent to 14 percent on May 2, 2001.[36]
Implementation occurred on May 10, 2001.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

After a serious downturn in 1998-1999 coinciding with the Ecuadoran banking crisis, the economy stabilized in 2000 when real GDP growth reached 2 ½ percent. In 2001, the economy strengthened further, with growth of 4 ½ percent in the first quarter. Unemployment fell to 10 percent. Dollarization in January 2000 helped stabilize the economy. Inflation remained high (107 percent annually in July 2000) but was falling. The banking situation stabilized and deposits increased steadily.

Ecuador rescheduled and deferred about US $800 million in foreign debt due in 2000 and relaunched a program of corporate debt restructuring beginning in February 2001.

Major tax reform was put into place in May 2001. The reform was consistent with the IMF program goal of a combined fiscal deficit of about ¼ percent of GDP and a primary surplus of about 6 ¼ percent of GDP for the non-financial public sector.

> The main elements of the tax reform were: a 2 percentage point increase in the rate of the value-added tax; some rationalization of the tax system through the elimination of many "nuisance" taxes; an increase in taxes on motor vehicles; and a reduction in personal income tax through an increase in the income tax thresholds. Taking account of the revenue lost as a result of the elimination of the financial transactions tax and the import tariff surcharge, there would be a net increase in fiscal revenues deriving from policy measures in 2001 of about ½ percentage point of GDP.[37]

The tax reform was necessary to help guarantee receipt of a $200 million loan package from the IMF, World Bank, Latin American Development Bank, and other world policy institutions. News articles from the time also described how the intent of the VAT was to help insulate Ecuador from sensitivity to oil prices. (Oil production is a major industry in Ecuador.)[38]

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[36] Ecuador set to secure IMF deal: [USA edition]
Moss, Nicholas. Financial Times [London (UK)] 04 May 2001: 03.

[37] IMF, Ecuador Letter of Intent, Memorandum of Economic Policies, May 14, 2001, paragraph 6, http://www.imf.org/external/np/loi/2001/ecu/01/index.htm

[38] "Ecuador: Highlights of CRE Satelital Radio Web Site News 1700 GMT 31 May 01," *BBC Monitoring Americas*, June 1, 2001.

Ecuador stabilized after its 1998-1999 crisis but the reforms put into place in 2001 were part of continued efforts to bring about sustainable change. This tax change was driven by a need to reduce deficits and tax changes demanded by external forces—in this case, the demands of world policy institutions and creditors that provided economic support. As such, we classify it as debt sustainability-driven change, furthered by an external institution-driven change.

Sources:

"Ecuador: Highlights of CRE Satelital Radio Web Site News 1700 GMT 31 May 01." *BBC Monitoring Americas.* June 1, 2001.

IMF. Ecuador Letter of Intent. Memorandum of Economic Policies. May 14, 2001. http://www.imf.org/external/np/loi/2001/ecu/01/index.htm

IMF. News Brief No. 01/129. IMF Approves US$95 Million to Ecuador Under Stand-By Arrangement. December 10, 2001. http://www.imf.org/external/np/sec/nb/2001/nb01129.htm

3. Tax change of 2001

Legislation was passed to decrease the VAT rate from 14 percent to 12 percent on August 15, 2001.[39]
Implementation occurred on September 1, 2001.
Narrative classification: Endogenous – GDP-driven (countercyclical).

Brief background material and description of nature of tax rate change

Major tax reform was put into place in May 2001. The reform, which increased the value-added tax from 12 percent to 14 percent, was consistent with the IMF program goal of a combined fiscal deficit of about ¼ percent of GDP and a primary surplus of about 6 ¼ percent of GDP for the NFPS. The tax reform was necessary to help guarantee the receipt of a $200 million loan package from the IMF, World Bank, Latin American Development Bank, and other world policy institutions.

However, opposition leaders rallied against the tax reform and argued that the VAT increase would raise prices. The reform was challenged as unconstitutional and lost in tribunal, resulting in the return of VAT rates to their pre-reform level of 12 percent.

> Ecuadorean President Gustavo Noboa said the country's value-added tax will be reduced to 12 percent from the current IMF-mandated level of 14 percent as of Sept. 1, in accordance with a Constitutional Tribunal ruling. He said the government will trim spending to cover the resulting fiscal gap. The tribunal reviewed claims that a May decision to raise the VAT to 14 percent from 12 percent was unconstitutional since it didn't carry Congress's stamp of approval. The International Monetary Fund had required the increase as a condition for a $300 million credit line, but several lawmakers came out against the proposed rise. Legislators ultimately didn't amass enough votes to reject the increase. The IMF hasn't commented on the latest developments.[40]

The rejection of the tax reform appears to reflect a deep conflict between the Congress and the administration. News articles from the time note that a significant group of Congress members described the IMG demands as blackmail. However, some felt that the IMF and World Bank should be forced to wait for repayment while others denied the seriousness of the mounting debt.[41]

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[39] Moss, N. (2001, Aug 15). Tax ruling deals blow to Ecuador's economic reforms: Rejection of VAT increase has angered the president and may cause IMF to lose patience with the country, says Nicholas Moss. Financial Times Retrieved from http://search.proquest.com/docview/249246397?accountid=8505

[40] Lily H. Li, "World Watch," *The Wall Street Journal*, August 13, 2001, p. A8.

[41] "Vote Against Tax Reform Puts Ecuador on Collision Course with Creditors." *America's Insider* April 5, 2001. http://www.thefreelibrary.com/Vote+against+tax+reform+puts+Ecuador+on+collision+course+with...-a073089548

The primary motivation for the rejection of the recent VAT increase was political (between President and Congress members), resulting in the absence of a consensus regarding restructuring the economy. Consequently, we categorize this tax change as endogenous and countercyclical.

Sources:

Li, Lily H. "World Watch." *The Wall Street Journal* August 13, 2001, p. A8.

"Vote Against Tax Reform Puts Ecuador on Collision Course with Creditors." *America's Insider* April 5, 2001.
http://www.thefreelibrary.com/Vote+against+tax+reform+puts+Ecuador+on+collision+course+with...-a073089548

Country: El Salvador

1. Tax change of 1995

Legislation was passed to increase VAT from 10 percent to 13 percent on June 5, 1995.[42]
Implementation occurred on July 1, 1995.
Narrative classification: Endogenous – Offsetting (spending).

Brief background material and description of nature of tax rate change

In 1995, El Salvador continued an economic stabilization and reform program originally enacted in 1989. It was supported by loans from the World Bank and Inter-American Development Bank, as well as three stand-by arrangements with the IMF. According the IMF, "El Salvador observed the performance criteria under the stand-by arrangement through September 1994 and most of the revised indicative targets for end-December. Real GDP grew by 6 percent, higher than the 5 percent programmed, while inflation declined to under 9 percent."[43]

The new government began a National Reconstruction Plan to repair damaged infrastructure destroyed during the twelve years of armed conflict that ended in 1992 as well as to "[reintroduce] different segments of society into the economic mainstream."[44] Despite this increase in public expenditure, debt reduction remained a top priority because of the macroeconomic goals of inflation reduction, GDP growth of 6-7 percent, and the maintenance of a strong balance of payments. To achieve the necessary revenue in order to fund the spending increase and decrease the deficit, the plan improved tax administration, increased the VAT from 10 to 13 percent, increased cigarette and alcohol taxation and other tax increases, and windfall proceeds from the coffee sector.

This tax change falls primarily into the category of spending driven.

Sources:

IMF Archives. EBS/96/42. Master Files Room C-525 0451. El Salvador – Staff Report for the 1995 Article IV Consultation and Midterm Review Under the Stand-By Arrangement. March 13, 1996.

IMF Archives. BUFF/ED/95/105. Master Files Room C-525 0418. Statement by Mr. Fernandez on El Salvador. Executive Board Meeting 95/69. July 20, 1995.

IMF Press Release No. 95/41. "IMF Approves Stand-By Credit for El Salvador." July 21, 1995. http://www.imf.org/external/np/sec/pr/1995/pr9541.htm

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[42] Compiled by, R. L. (1995, Jun 09). World wire. Wall Street Journal Retrieved from http://search.proquest.com/docview/398446781?accountid=8505

[43] BUFF/ED/95/105, Statement by Mr. Fernandez on El Salvador, Executive Board Meeting 95/69, July 20, 1995, IMF Archives, p. 1.

[44] Ibid.

Country: Finland

1. Tax change of 2010

Legislation was passed to increase VAT from 22 percent to 23 percent on March 27, 2012.[45]
Implementation occurred on July 1, 2010.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Finland was heavily affected by the 2008 financial crisis because of its dependence on exports to other severely affected countries, but remained fundamentally sound. It experienced an 8 percent decrease in GDP in 2009, the worst decrease in the euro region. Negative growth continued into the first quarter of 2010 and unemployment hit 8 percent in mid-2010, with a peak of 8 ¼ percent. "Generous pay raises have supported consumption, but also led to an erosion of external competitiveness, which however remains adequate. A subdued resumption of activity is projected for 2010–11, with growth remaining well below potential."[46]

The Finnish government passed fiscal stimulus to counteract the effects of the global crisis in 2009 and early 2010. This significantly impacted the fiscal balance, which shifted from a surplus of 4 percent of GDP in 2008 to a deficit of 2 ½ percent in 2009. Furthermore, deficits were expected to expand further in 2010, violating the 3 percent deficit limits of the European Union's Stability and Growth Pact.

When recovery began in 2010, deficit reduction became a priority; the 2011 budget announced plans to significantly curtail spending and raise taxes. In fact, the IMF cautioned against such rapid reduction in stimulus: "The authorities contemplate ambitious fiscal tightening in 2011—1½ percent of GDP. With negative output gaps forecast through 2014, staff advised a more measured pace of consolidation unless clear evidence emerges of more robust growth."[47] The government announced plans to raise energy taxes and employee and employer contributions to the employment pension in 2011. The VAT was increased from 22 percent to 23 percent beginning in July 2010.

The VAT hike was aimed at reducing a growing public debt and fiscal deficit that resulted from the 2009 fall in output. As such, we classify this tax change as a procyclical action.

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[45] Next Finnish premier faces economic uncertainties
Ward, Andrew. Financial Times [London (UK)] 21 June 2010: 5.; http://www.eurovat.com/news.ht
[46] IMF Country Report No. 10/273, Finland: 2010 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Finland, September 2010. p. 1, http://www.imf.org/external/pubs/ft/scr/2010/cr10273.pdf
[47] Ibid.

Sources:

IMF Country Report No. 10/273. Finland: 2010 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Finland. September 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10273.pdf

IMF Public Information Notice No. 10/122. IMF Executive Board Concludes 2010 Article IV Consultation with Finland. September 2, 2010. http://www.imf.org/external/np/sec/pn/2010/pn10122.htm

2. Tax change of 2013

Legislation was passed to increase VAT from 23 percent to 24 percent on July 30, 2010.[48]
Implementation occurred on January 1, 2013.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Brief background material and description of nature of tax rate change

The Finnish economy rebounded strongly after the financial crisis but growth weakened again in 2011 due to the European sovereign debt crisis. Finland enjoys strong economic fundamentals and a well-capitalized banking system. However, "deep trade and financial linkages" make it particularly susceptible to declines in the performance of its trading partners.

> The fiscal position improved markedly in 2011 after a sharp deterioration in 2009. As fiscal policy turned to support growth through automatic stabilizers and discretionary budget stimulus, the general government budget position worsened by about 7 percentage points of GDP in 2009 but remained below the Maastricht deficit limit in 2009–10. With some policy tightening and continued economic recovery into 2011, the headline deficit of the general government improved markedly to less than 1 percent of GDP, and gross debt, while continuing to increase, ended 2011 at below 50 percent of GDP. Nonetheless, projected weak growth in 2012 will likely result in a renewed worsening of the headline deficit and population aging remains a challenge for long-term fiscal sustainability.[49]

Rumors of VAT increases of up to 2 percentage points were prevalent throughout 2011, but concerns about the impact on domestic demand resulted in an increase of only 1 percentage point. The Finnish government announced the change in March 2012 and confirmed it would pass the proposal in August 2012.[50]

The VAT increases were intended to address budget deficits arising from declining tax revenues as well as the health care and pension costs associated with its aging population.[51]

> Directors supported the current broadly neutral fiscal stance and the authorities' adjustment plan aimed at addressing long-term fiscal challenges and closing the sustainability gap...Directors observed that fiscal efforts should focus on mitigating the expected rise in health and long-term care costs and further tightening unemployment and disability pipelines to early retirement as well as increasing the statutory minimum and

[48] Next Finnish premier faces economic uncertainties
Ward, Andrew. Financial Times [London (UK)] 21 June 2010: 5.; http://www.eurovat.com/news.htm

[49] IMF. Public Information Notice No. 12/103. IMF Executive Board Concludes 2012 Article IV Consultation with Finland. August 31, 2012. http://www.imf.org/external/np/sec/pn/2012/pn12103.htm

[50] TMF Group. "Finland to Increase VAT by 1 percent in 2013." International VAT and GST Services. March 22, 201. http://www.tmf-vat.com/tmf-in-the-media/finland-to-increase-vat-by-1.html

[51] "Finland Raises VAT from 23 percent to 24 percent in 2013." AdminEuropean News, March 24, 2012.

> maximum retirement age. On the revenue side, they recommended broadening the tax base and a shift from labor taxation to consumption and property-based taxation."[52]

After announcing the VAT changes in March, Prime Minister Jyrki Katainen said the savings measures on both spending and revenue sides were intended to boost the economy and cut debt. Finland wished to slow state borrowing to preserve the country's triple-A credit rating.

We classify this tax change as driven by deficit reduction concerns. We also include it as external institution-driven change due to Finland's desire to exit the EU's excessive deficit procedure.

Sources:

"Finland Raises VAT from 23 percent to 24 percent in 2013." AdminEuropean News, March 24, 2012.

"Finland To Cut Spending, Increase Taxes After Budget Talks." Xinhua General News Service, March 22, 2012.

Huuhtanen, Matti. "Finland to Hike Taxes, Cut Public Spending." Associated Press Financial Wire, March 22, 2012.

IMF. Public Information Notice No. 12/103. IMF Executive Board Concludes 2012 Article IV Consultation with Finland. August 31, 2012. http://www.imf.org/external/np/sec/pn/2012/pn12103.htm

TMF Group. "Finland to Increase VAT by 1 percent in 2013." International VAT and GST Services. March 22, 2012.

[52] IMF. Public Information Notice No. 12/103. IMF Executive Board Concludes 2012 Article IV Consultation with Finland. August 31, 2012. http://www.imf.org/external/np/sec/pn/2012/pn12103.htm

<u>Country: France</u>

1. Tax change of 1982

Legislation was passed to increase VAT from 17.6 percent to 18.6 percent on April 21, 1982.[53]
Implementation occurred on July 1, 1982.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

France entered recession in 1980 due to the second major oil shock, with real GDP stagnating in the second half of 1980 and the first half of 1981. Unemployment, which had spiked sharply in 1975, continued to rise through 1981, ending at 7.6 percent. The economy recovered during the end of 1981 with support from monetary and fiscal policies, including minimum wage and social transfer policies.

Policy concerns at this time focused on supporting the nascent recovery and addressing the unemployment rate. Demographics meant that the size of the labor force in France would continue to grow, with unemployment projections increasing to over 9 percent, unless the economy added a significant number of new jobs. A number of policy changes in 1981 and 1982 were focused on job development, including a reduction of the legal workweek, a reduction in the legal retirement age to encourage work sharing, state subsidies for retirement, incentives for firms to create new jobs, and the expansion of the public sector workforce.

The 1982 budget attempted to stimulate growth, improve efficiency, and increase income redistribution.

> France's Socialist Government has announced tax relief measures for industry that are meant to stimulate private sector investment badly needed to sustain the country's fragile economic revival. Economists said the measures indicated a shift in government priorities, prompted by signs of a slowdown in the revival brought about by the Socialists last year. The new measures include a 10 per cent reduction over the next two years in the professional tax, which is based on a formula incorporating capital equipment costs and payroll size. The Government also undertook not to raise employers' social security contributions before July, 1983, and will not legislate a further reduction in the official working week until 1984, having already cut it from 40 to 39 hours. Prime Minister Pierre Mauroy listed the measures in talks with Yvon Gattaz, leader of the CNPF employers' group, which said excessive taxes are preventing industry from responding to the Socialist Government's expansion program. Mr. Mauroy said the measures, to be financed by savings in government expenditure and changes in value-added tax, were

[53] Echikson, W. (1982, Apr 21). France's socialists put economic pickup ahead of reform plans. The Christian Science Monitor Retrieved from http://search.proquest.com/docview/1038450585?accountid=8505

part of the drive to generate economic revival and he indicated the employers' response would be reviewed later this year.[54]

We classify the 1982 VAT increase as a tax substitution because it offsets other tax cuts and spending increases intended to stimulate economic growth.

Sources:

"France Moves To Spur Some Business Sectors." *The Globe and Mail* April 17, 1982, p. B12.

IMF Archives. SM/82/69. France – Recent Economic Developments. April 13, 1982.

[54] "France Moves To Spur Some Business Sectors," *The Globe and Mail* April 17, 1982, p. B.12.

2. Tax change of 1995

Legislation was passed to increase VAT from 18.6 percent to 20.6 percent on July 19, 1995.[55]
Implementation occurred on August 1, 1995.
Narrative classification: Endogenous – Offsetting (spending).

Background

France experienced deep recession in 1992 and the beginning of 1993 after being hit by the oil shock following the Gulf War, German reunification, and tensions in the European Monetary union. Real GDP declined by 1.5 percent in 1993, but recovery began in the second half of 1993 thanks to an increase in demand for exports and the quick response of consumer confidence. The pace of the recovery quickened in 1994 with increases in private and public investment, with real GDP increasing by 2.9 percent for the year. Additionally, unemployment rose to 12.4 percent in 1994 and did not begin to fall until 1995. Throughout this time, inflation remained low.

French fiscal policy focused on deficit reduction in accordance with the Maastricht Treaty, requiring European Union member states to keep budget deficits below 3 percent of GDP. The French deficit was about 6 percent of GDP in 1994, and the new government formed after the May 1995 election pledged its determination to bring deficits under control.

The economy slowed in the second quarter of 1995 as demand for exports dropped sharply. By mid-1995 the deficit was on track to exceed the budget target by 0.7 percent of GDP. Supplementary measures were passed to raise revenues, including an increase in the standard VAT rate from 18.6 percent to 20.6 percent.

One motive for the 1995 VAT increase was clearly deficit reduction and efforts to comply with Maastricht treaty requirements. However, the VAT increase was put in place partly to pay for a job creation program and was offset by other changes "seen as emergency measures to combat a "calamitous" economic situation."[56] Since these policies were directly intended to affect output, we treat this tax change as tax substitution.

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[55] Kraft, S. (1995, Jul 19). COLUMN ONE down and out in city of light the homeless are emerging in paris and across france, shaking up a society that has long seen a job as part of its birthright. their numbers-and rising militancy-pose headaches for the new president. Los Angeles Times (Pre-1997 Fulltext) Retrieved from http://search.proquest.com/docview/293180198?accountid=8505

[56] Mary Dejevsky, "French Pay Higher Taxes for Jobs Plan," *The Independent* June 23, 1995, p. 13.

Sources:

Dejevsky, Mary. “French Pay Higher Taxes for Jobs Plan.” *The Independent* June 23, 1995, p. 13.

IMF Archives. SM/95/251. Master Files Room C-525 0450. France – Staff Report for the 1995 Article IV Consultation. September 21, 1995.

IMF Archives. SM/95/266. Master Files Room C-525 0450. France – Recent Economic Developments. October 12, 1995.

3. Tax change of 2000

Legislation was passed to decrease VAT from 20.6 percent to 19.6 percent on March 1, 2000.[57]
Implementation occurred on April 1, 2000.
Narrative classification: Endogenous – GDP-driven (procyclical).

Background

In 2000, France was in its third straight year of strong output growth with low inflation. Real GDP growth averaged almost 3 percent annually since 1997. Unemployment fell from 12 ½ percent to 9 ½ percent due to structural labor market reforms and rapid job creation. Economic growth was supported by strong export demand, high levels of consumer and business confidence, and strong investment.

France enjoyed a strong fiscal situation in 2000. Unexpectedly high corporate tax revenues in 1999 resulted in a deficit of only 1.8 percent of GDP instead of the planned 2.2 percent. This resulted in pressure to reduce taxes in 2000. "The decision by Lionel Jospin, the French prime minister, to lower France 's rates of VAT by one percentage point to 19.6 per cent is expected to cost FFr18bn (£1.67bn) this year. The move was the only new element among measures Mr. Jospin announced on Thursday to head off criticism for failing to use higher treasury receipts generated by France's strong economic growth."[58]

Low deficits presented an opportunity for France to lower its tax burden, which was the highest in the euro region. However, the IMF argued that VAT cuts were a poor choice for tax relief: "It is important that tax cuts be designed to maximize the supply side impact, with the reduction in the standard VAT rate and measures alleviating the impact of rising oil prices on households' incomes running counter to this requirement."[59]

This tax reduction was motivated by pressure to lower taxes in the face of fiscal surpluses.

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[57] Jospin's cut in VAT rates to cost L1.7bn this year NEWS DIGEST: [London edition]
Graham, Robert. Financial Times [London (UK)] 18 Mar 2000: 06.

[58] Robert Graham, "News Digest: Jospin's Cut in VAT Rates To Cost L1.7 Bn This Year," *Financial Times,* March 18, 2000, p. 6.

[59] IMF Staff Country Report No. 00/147, France: 2000 Article IV Consultation – Staff Report; Supplement to the Staff Report; and Public Information Notice Following Board Consultation, November 2000, p. 22, http://www.imf.org/external/pubs/ft/scr/2000/cr00147.pdf

Sources:

Graham, Robert. “News Digest: Jospin’s Cut in VAT Rates To Cost L1.7 Bn This Year.” *Financial Times* March 18, 2000, p. 6.

IMF Public Information Notice No. 00/95. IMF Concludes Article IV Consultation with France. November 13, 2000. http://www.imf.org/external/np/sec/pn/2000/pn0095.htm

IMF Staff Country Report No. 00/147. France: 2000 Article IV Consultation – Staff Report; Supplement to the Staff Report; and Public Information Notice Following Board Consultation. November 2000. http://www.imf.org/external/pubs/ft/scr/2000/cr00147.pdf

Country: Germany

1. Tax change of 1993

Legislation was passed to increase VAT rate from 14 percent to 15 percent on February 14, 1992.[60]
Implementation occurred on January 1, 1993.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

German reunification took place in 1990. Transfers to East Germany, including income support and developing a market, cost between 4 and 5 percent of GDP annually between 1990-1992. Reunification costs were largely funded by deficit spending; Germany shifted from nearly balanced budgets before reunification to a deficit of 3 percent of GDP in 1992.

The fiscal stimulus led to overheating of the West German economy. After a post-unification boom, fiscal and monetary policy were tightened to contain inflation and address the growing fiscal imbalance. However, a recession began in the second half of 1992 and was more severe than anticipated. GDP fell by about 4 percent annually over the first three quarters of 1993. The current account shifted from a surplus of 4 ¾ percent of GNP in 1989 to a deficit of 1 ¼ in 1991. Additionally, capacity utilization fell sharply. Slowdown in other European countries and tensions in the European Monetary Union further impacted the German economy.

The combination of fiscal deficits and cyclical factors increased public borrowing to what an IMF staff report described as "an alarmingly high level."[61] Public sector debt rose from 39.5 percent of GNP in 1990 to 42.6 percent of GNP in 1992, and was projected to expand further. General fiscal deficits reached 2.8 percent of GDP in 1992 and were expected to rise above 4 percent of GDP in 1993.

The 1993 VAT increase was intended to address the deficits resulting from reunification in the context of a severe fall of economic activity. EU rate harmonization also motivated the increase.[62] However, even when combined with expenditure cuts passed in March 1993, the IMF cautioned that Germany's fiscal situation was weak.

> The staff estimated that without a considerable new fiscal effort, the deficit of the territorial authorities was likely to remain well above 4 percent of GNP for the foreseeable future, even on relatively neutral assumptions, implying a rapidly rising debt-

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[60] Bonn VAT Rise Gets Green Light after Split in SDP
Gow, David. The Guardian [London (UK)] 15 Feb 1992: 6.

[61] SM/93/136, Staff Report for the 1993 Article IV Consultation," June 30, 1993, IMF Archives, p. 10.

[62] "Anywhere But Germany," *The Wall Street Journal* (Brussels), January 25, 1993, p. 10.

to-GNP ratio. As such, Germany would not be able to satisfy either the fiscal deficit or debt criteria set out by the Maastricht treaty.[63]

The 1993 VAT increase was intended to address the deficits resulting from reunification in the context of a severe fall of economic activity. We classify it as endogenous. We also include it as external institution-driven change due to Germany's desire to exit the EU's excessive deficit procedure.

Sources:

"Anywhere But Germany." *The Wall Street Journal* (Brussels) January 25, 1993, p. 10.

IMF Archives. SM/93/136. Master Files Room C-525 0450. Germany – Staff Report for the 1993 Article IV Consultation. June 30, 1993.

IMF Archives. SM/94/213. Master Files Room C-525 0450. Germany – Economic Developments and Selected Background Issues. August 12, 1994.

[63] SM/93/136, Staff Report for the 1993 Article IV Consultation," June 30, 1993, IMF Archives, p. 11.

2. Tax change of 1998

Legislation was passed to increase VAT from 15 percent to 16 percent on December 1, 1997.[64]
Implementation occurred on April 1, 1998.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Germany suffered from weak labor market performance through the mid-1990s following the 1992 end of the post-reunification boom. Real GDP growth was only 1.2 and 1.3 percent of GDP in 1995 and 1996 respectively. Unemployment peaked at 11.8 percent of the labor force in 1997. The resulting increase in social expenditures and declining tax revenue exacerbated the budget deficits run following reunification, which peaked at 3.4 percent of GDP in 1996.

The economy began a recovery in 1997 due to increased demand for its exports; real GDP growth reached 2 ¼ percent. Economic priorities included reabsorbing the unemployed into the labor force, strengthening the recovery and developing resistance to future shocks, and lowering deficits to the 3 percent of GDP level required by the EU Maastricht treaty. Public debt was near the Maastricht limit with general government debt at 61.5 percent of GDP in 1997 and was projected to remain at near level for the next couple of years.

The VAT increased mainly to reduce inherited debt. We also include it as external institution-driven change due to Germany's desire to exit the EU's excessive deficit procedure.

Sources:

IMF Archives. SM/98/209. Master Files Room C-525 0450. Germany – Selected Issues and Statistical Appendix. August 19, 1998.

IMF Public Information Notice No. 98/72. IMF Concludes Article IV Consultation with Germany. September 18, 1998. http://www.imf.org/external/np/sec/pn/1998/pn9872.htm

"Kohl Faces Tax Rises and Welfare Cuts To Meet Euro Date." *The Times* (London), April 21, 1997, p. 15.

[64] SM/98/203 p. 8

3. Tax change of 2007

Legislation was passed to increase VAT from 16 percent to 19 percent on June 16, 2006.[65]
Implementation occurred on January 1, 2007.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

After several years of slow growth, Germany experienced a gradual upswing. The improvement was due to multiple factors, including a growing world demand for German exports, wage moderation and restructuring in the private sector, reductions in the fiscal deficit, and reforms to entitlement programs The World Cup, tax incentives, and elevated demand for consumer durables in anticipation of the VAT increase provided additional temporary stimulus to demand in 2006. Growth was expected to increase from 0.9 percent in 2005 to 2.5 percent in 2006.

Despite strengthening GDP growth, investment, and employment, Germany's economy struggled due to high-cost entitlement programs and concerns over deficits, which had held above 3 percent of GDP through 2004 and contributed to rising debt-to-GDP ratios projected at 67.5 percent in 2006.

This tax increase was enacted to lower the debt-to-GDP. We also include it as external institution-driven change due to Germany's desire to exit the EU's excessive deficit procedure.

Sources:

IMF Public Information Notice No. 06/141. IMF Executive Board Concludes 2006 Article IV Consultation with Germany. December 14, 2006, http://www.imf.org/external/np/sec/pn/2006/pn06141.htm

IMF Country Report No. 06/438. Germany: 2006 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Germany. December 2006. http://www.imf.org/external/pubs/ft/scr/2006/cr06438.pdf

[65] Germany to hike VAT from 16% to 19%
Eric Culp in Frankfurt. Sunday Business [London (UK)] 18 June 2006: 1.

Country: Greece

1. Tax change of 2005

Legislation was passed to increase VAT from 18 percent to 19 percent on March 29, 2005.[66]
Implementation occurred on April 1, 2005.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

The Greek economy grew strongly for several years, with growth rates above 4 percent. However, it expected to fall to 3.5 percent in 2005.

> Growth has been underpinned by a sharp fall in interest rates due to adoption of the euro and subsequent ECB easing, rapid increases in private-sector credit following financial sector liberalization, procyclical fiscal policy, and, most recently, spending on the Olympics games. In addition, strong capital formation, high labor productivity growth, and significant immigration have all contributed to an expansion of aggregate supply.[67]

However, serious deterioration in the fiscal situation, due to increased spending, slowed growth. The fiscal deficit was expected to reach 6.6 percent of GDP in 2005 and the debt-to-GDP ratio stood at 111 percent. Furthermore, in late 2004, the Greek government made large upward revisions to previous budget deficit statistics, including revising its measure of the 2003 deficit from 1.7 percent of GDP to 4.6 percent of GDP. These major revisions shook confidence in the Greek economy. "The public finances have deteriorated sharply-only in part because of the Olympics-and the high debt-GDP ratio has fallen very little, with recent data revisions revealing that the fiscal position is much worse than earlier thought."[68]

Inflation and labor costs were both high in Greece relative to the rest of the euro zone, making the Greek economy uncompetitive. Although many structural reforms had already been enacted, the annual IMF staff report identified a number of opportunities for further reform of the Greek system.

> Structural reforms need to be extended to improve productivity and competitiveness. On product markets, the unfinished agenda includes improved tax administration, tax

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[66] Greece raises taxes to meet EU budget targets STABILITY PACT: [LONDON 1ST EDITION] Hope, Kerin. Financial Times [London (UK)] 01 Apr 2005: 8.

[67] IMF Country Report No. 06/4, Greece: 2005 Article IV Consultation – Staff Report; Staff Supplement; Public Information Notice; and Statement by the Executive Director for Greece, January 2006, p. 19, http://www.imf.org/external/pubs/ft/scr/2006/cr0604.pdf

[68] IMF Public Information Notice No. 05/19, IMF Board Concludes 2004 Article IV Consultation with Greece, February 9, 2005, http://www.imf.org/external/np/sec/pn/2005/pn0519.htm

> simplification, reduced red tape, modernization of bankruptcy law, liberalization of gas and electricity markets, and privatization. On labor markets, employment protection measures need to be relaxed, and minimum wages should be reduced (implying a change in central bargaining arrangements), at least for sectors under economic stress.[69]

Deficit reduction was a top policy priority: the 2004 deficit of 6.1 percent of GDP was a record for a Eurozone state. The VAT increase was intended to reduce the deficit and ensure debt sustainability.

> Greece today will increase value added tax and excise duty on tobacco and alcohol in an effort to meet budget targets agreed under European Union stability pact rules on excessive deficits. The tax increases, approved on Tuesday under emergency parliamentary procedures, have highlighted concerns about Greece's ability to slash this year's budget deficit to 3.5 per cent of gross domestic product from 6.1 per cent last year. George Alogoskoufis, the finance minister, said in an interview with the *Financial Times* that the deficit reduction was on track, in spite of a sharp fall in overall tax revenues in the first two months of 2005. The tax increases will raise Euros 500m (Dollars 648m, Pounds 343m) this year, with VAT rising from 18 per cent to 19 per cent.[70]

The need to raise VAT as part of an emergency parliamentary procedure as well as the EU's concern about deficits and growing public debt leads us to classify this tax change as debt sustainability-driven and also as external institution-driven.

Sources:

Hope, Kerin. "Greece Raises Taxes To Meet EU Budget Targets." *Financial Times* (London) April 1, 2005, p. 8.

IMF Country Report No. 06/4. Greece: 2005 Article IV Consultation – Staff Report; Staff Supplement; Public Information Notice; and Statement by the Executive Director for Greece. January 2006. http://www.imf.org/external/pubs/ft/scr/2006/cr0604.pdf

IMF Public Information Notice No. 05/19. IMF Board Concludes 2004 Article IV Consultation with Greece. February 9, 2005. http://www.imf.org/external/np/sec/pn/2005/pn0519.htm

[69] Ibid., p. 3

[70] Greece raises taxes to meet EU budget targets STABILITY PACT: [LONDON 1ST EDITION] Hope, Kerin. Financial Times [London (UK)] 01 Apr 2005: 8.

2. Tax change of 2010

Legislation was passed to increase VAT from 19 percent to 21 percent on March 3, 2010.[71]
Implementation occurred on March 15, 2010.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

In 2010, the Greek economy was on the verge of collapse due to heavy public debt and lost market access. The Greek economy was hit hard by the global financial crisis. To make matters worse, in October 2009, the new government reported that fiscal data had been misreported. Deficits for 2008 and 2009 were revised from 5 percent and 3.7 percent of GDP to 7.7 percent and 12.5 percent of GDP respectively. The 2009 debt was revised from 99.6 percent to 115.1 percent of GDP. The large upward revisions and news of misreporting shocked markets. The current account deficit of 11 percent of GDP underscored Greece's continuing competitiveness problems due to inflation and labor costs above the euro average.

In January 2010, the government promised to reduce the deficit-to-GDP ratio to under 3 percent by 2012. However, insufficient budget measures and overly optimistic macroeconomic projections left the markets skeptical and spreads on Greek debt continued to grow. Ongoing consultations with the European Community, IMF, and other institutions led to additional austerity measures, including the VAT increase from 19 percent to 21 percent announced in March.

> The Greek government has announced further austerity measures to cut Greece's budget deficit from an estimated 12.7 percent of gross domestic product last year, to 8.7 percent this year. The additional measures are seen as a prelude to a new 10-year bond and a precondition for any European Union financial aid. The new measures include a combined [euro] 4.8 billion, or 2 percent of gross domestic product, of spending cuts and tax increases, with half coming from spending cuts and half from new revenues...Value-added tax: The sales tax on printed products, like newspapers and books, will increase to 5 percent from 4.5 percent, while the tax rate on items like food and medicine will increase to 10 percent from 9 percent. VAT on items like clothing and footwear will increase from 19 percent to 21 percent.[72]

The VAT hike was aimed at reducing a high public debt and fiscal deficit which was severely worsened as a consequence of the 2009 fall in output. As such, we classify this tax change as a procyclical action.

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[71] http://www.tmf-vat.com/tmf-in-the-media/greece-increases-vat-to-21.html; Greece's Cuts and Tax Increases: How Austerity Looks
Wall Street Journal (Online) [New York, N.Y] 03 Mar 2010: /

[72] Alkman Granitsas, "Greece's Cuts and Tax Increases: How Austerity Looks," *The Wall Street Journal* (Online) March 3, 2010.

Sources:

Granitsas, Alman. “Greece’s Cuts and Tax Increases: How Austerity Looks,” *The Wall Street Journal* (Online) March 3, 2010.

IMF. Country Report No. 10/110. Greece: Staff Report on Request for Stand-By Arrangement. May 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10110.pdf

3. Tax change of 2010

Legislation was passed to increase VAT rate from 21 percent to 23 percent on May 2, 2010.[73]
Implementation occurred on July 1, 2010.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

In 2010 the Greek economy was on the verge of collapse due to heavy public debt and lost market access. The Greek economy was hit hard by the global financial crisis To make matters worse, in October 2009, the new government reported that fiscal data had been misreported. Deficits for 2008 and 2009 were revised from 5 percent and 3.7 percent of GDP to 7.7 percent and 12.5 percent of GDP respectively. The 2009 debt was revised from 99.6 percent to 115.1 percent of GDP. The large upward revisions and news of misreporting shocked markets. The current account deficit of 11 percent of GDP underscored Greece's continuing competitiveness problems due to inflation and labor costs above the euro average.

Early austerity measures enacted by the government in January 2010 and again in February and March to reduce deficits to below 3 percent of GDP (as required by the Stability Growth Pact) by 2012 did not calm markets because of insufficient budget measures, overly optimistic macroeconomic assumptions, and uncertainty about financing agreements with euro region countries. Confidence eroded and spreads on Greek debt took off amid fears that Greece would default.

Greece entered a loan agreement with the IMF, European Union, and European Central Bank in May 2010. Greece agreed to severe austerity measures to secure the loan. The top priorities of the agreement were deficit reduction (with the goal of deficits under 3 percent of GDP by 2014) and debt sustainability. Other measures were to focus on improving competitiveness, such as nominal wage and price cuts and reforms to improve price competitiveness. A Financial Stability Fund was to be established to deal with bank solvency pressures.

The VAT increase from 21 percent to 23 percent was part of the package of fiscal reforms toward this goal. The total package contained fiscal measures of 11 percent of GDP for 2010-13 in addition to the 5 percent of GDP in measures already adopted in 2010. Expenditure measures constituted about 5.2 percent of GDP. Revenue measures added another 4 percent of GDP to the package, of which the largest single component was the increase in the standard VAT rate from 21 to 23 percent and the reduced rate from 10 to 11 percent and broadening the VAT base. "George Papandreou, the prime minister, said the austerity measures agreed at an emergency meeting of the cabinet were the "only road to save the country"."[74]

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[73] Greece agrees cuts in Pounds 96bn bail-out [Edition 3]
Fletcher, Richard. The Daily Telegraph [London (UK)] 03 May 2010: 1.

[74] Richard Fletcher, "Greece Agrees Cuts in Pounds 96Bn Bail Out," The Daily Telegraph (London) May 3, 2010, p. 1.

The second 2010 Greek VAT increase was, like the earlier 2010 hike, driven by procyclical action.

Sources:

Fletcher, Richard. "Greece Agrees Cuts in Pounds 96Bn Bail Out." The Daily Telegraph (London) May 3, 2010, p. 1.

IMF. Country Report No. 10/110. Greece: Staff Report on Request for Stand-By Arrangement. May 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10110.pdf

Country: Hungary

1. Tax change of 2006

Legislation was passed to decrease VAT from 25 percent to 20 percent on September 14, 2005.[75]
Implementation occurred on January 1, 2006.
Narrative classification: Endogenous – GDP-driven (procyclical).

Background

Hungary grew quickly between 1997 and 2001 with real GDP growing 4-5 percent annually, employment and investment increasing, inflation falling, and fiscal and current account deficits becoming smaller.

Hungary entered the European Union in 2004. However, in the early 2000s, Hungary's growth fell to the lower end of the former soviet republics that comprised the new European Union members. Real GDP growth recovered to 4.1 percent in 2005, but large fiscal deficits and current account deficits emerged. Due to these growing deficits, the IMF warned, "The authorities' goal of adopting the euro by 2010 has so far not been supported by an active structural reform agenda. Meeting the fiscal Maastricht limits for euro adoption will require substantial effort."[76] Furthermore, the "twin deficits" caused financial markets to start to lose confidence in Hungary as early as September 2005.

Hungary's budget deficit grew in the early 2000s due to rising public sector wages, pensions, and housing subsidy programs. Hungary repeatedly failed to meet deficit targets. Although the government promised fiscal consolidation to take place before the April 2006 election, in mid-2005 the IMF noted that fiscal deficits had spiked in every election year since Hungary became independent.

> Hungary's politics are notoriously emotional, bitter and divisive. With a general election coming up next year, politicians' minds are not on such fusty matters as the country's fiscal deficit. They should be. Currency, bond and equity markets were hit this month by Fitch Ratings' downgrade of Hungary's credit rating and the government's announcement that it planned to nearly double the amount of local currency bonds sold next year. The budget deficit – expected to reach 7.4 per cent of gross domestic product this year – is way above the government's target. Higher government borrowing has contributed to a deteriorating current account deficit, more than 8 percent of GDP, a growing portion of

[75] James Kanter and, S. L. (2005, Sep 15). EU goal of united front on oil prices falters. International Herald Tribune Retrieved from http://search.proquest.com/docview/318694592?accountid=8505
[76] IMF, Country Report No. 05/213, Hungary: 2005 Article IV Consultation – Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion, June 2005, p. 4, http://www.imf.org/external/pubs/ft/scr/2005/cr05213.pdf

> which is financed by volatile portfolio flows... Its politicians, though, have other fish to fry. Voters will not be caught by promises of budget reform, which will hit their pockets. Indeed, the current government recently announced tax cuts and increases in family allowances. A fall in VAT – the largest source of government revenue – from 25 per cent to 20 per cent next month will only aggravate the situation.[77]

Hungary's 2006 VAT cut falls into the category of procyclical driven, due to political economy arguments.

Sources:

"Hungary." *Financial Times* (London) December 19, 2005, p. 20.

IMF. Country Report No. 02/111. Hungary: 2002 Article IV Consultation – Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion. June 2002. http://www.imf.org/external/pubs/ft/scr/2002/cr02111.pdf

IMF. Country Report No. 05/213. Hungary: 2005 Article IV Consultation – Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion. June 2005. http://www.imf.org/external/pubs/ft/scr/2005/cr05213.pdf

IMF. Country Report No. 06/379. Hungary: 2006 Article IV Consultation – Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion. October 2006. http://www.imf.org/external/pubs/ft/scr/2006/cr06379.pdf

IMF. Public Information Notice No. 05/82. IMF Executive Board Concludes 2005 Article IV Consultation with Hungary. June 29, 2005. http://www.imf.org/external/np/sec/pn/2005/pn0582.htm

IMF. Public Information Notice No. 06/118. IMF Executive Board Concludes 2006 Article IV Consultation with Hungary. October 20, 2006. http://www.imf.org/external/np/sec/pn/2006/pn06118.htm

[77] "Hungary," *Financial Times* (London) December 19, 2005, p. 20.

2. Tax change of 2009

Legislation was passed to increase VAT from 20 percent to 25 percent on May 5, 2009.[78]
Implementation occurred on September 1, 2009.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Hungary's economy crumbled after the 2008 global financial crisis. Hungary's real GDP growth had slowed to ½ percent in 2007, down from 4-5 percent earlier in the decade. Hungary faced "twin deficit" problems in the mid-2000s with large fiscal and current account deficits. The fiscal deficit averaged more than 8 percent of GDP between 2002 and 2006 and public debt was estimated at 72 percent of GDP at the end of 2008. Private debt was also high, and gross external debt was around 114 percent of GDP.

Hungary entered a $25 billion loan agreement with the IMF, World Bank, and European Union in November 2008. The conditions for the loan agreement included policies to strengthen fiscal sustainability and bolster the financial sector.

However, Hungary's situation continued to deteriorate as the severity of the global crisis became more apparent. Its real GDP fell by 7.5 percent in annual terms in the second quarter of 2009 and unemployment rose to nearly 10 percent. Reforms that focused even more tightly on improving fiscal sustainability went forward. Fiscal policy focused on tax reform that shifted the tax burden from labor income taxes to taxes on consumption and wealth. The standard VAT rate was raised 5 percentage points back to its pre-2006 level of 25 percent.

> The authorities have also deepened the tax reform, which—by shifting the tax burden from labor to consumption and wealth—should promote growth and thus contribute to fiscal sustainability... In line with staff advice, the authorities plan a more ambitious reduction in the labor tax wedge than envisaged earlier this year, though staff called for a higher income tax credit and less of a decline in the top marginal tax rate to mitigate the regressivity of the reform. Revenue neutrality is expected to be preserved through a broadening of the income tax base, a larger VAT hike, and the introduction of a market-based property tax collected at the central level.[79]

The VAT hike was aimed at reducing a high public debt and fiscal deficit which was severely worsened as a consequence of the 2009 fall in output. As such, we classify this tax change as a procyclical action.

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[78] https://globalvatonline.pwc.com/uk/tls/gvol2/gvol2.nsf/AllByCode/DMCL-7RRFBY?open
[79] IMF, Country Report No. 09/197, Hungary: Second Review Under the Stand-By Arrangement, Request for Waiver of Nonobservance of Performance Criterion, and Request for Modification of Performance Criteria – Staff Report; and Press Release on the Executive Board Discussion, June 2009, p. 9, http://www.imf.org/external/pubs/ft/scr/2009/cr09197.pdf

Sources:

IMF. Country Report No. 09/105. Hungary: First Review Under the Stand-By Agreement and Request for Modification of Performance Criteria – Staff Report; Staff Statement; and Pres Release on the Executive Board Discussion. March 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09105.pdf

IMF. Country Report No. 09/197. Hungary: Second Review Under the Stand-By Arrangement, Request for Waiver of Nonobservance of Performance Criterion, and Request for Modification of Performance Criteria – Staff Report; and Press Release on the Executive Board Discussion. June 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09197.pdf

IMF. Country Report No. 09/304. Hungary: Third Review Under the Stand-By Arrangement, Requests for Extension of the Arrangement, Rephasing of Purchases, and Modification of Performance Criterion. October 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09304.pdf

IMF. Public Information Notice No. 08/124. IMF Executive Board Concludes 2008 Article IV Consultation with Hungary. September 24, 2008. http://www.imf.org/external/np/sec/pn/2008/pn08124.htm

"IMF, EU, and World Bank Line Up $25 Billion for Hungary." *IMF Survey* (online) October 28, 2008. http://www.imf.org/external/pubs/ft/survey/so/2008/car102808b.htm

3. Tax change of 2012

Legislation was passed to increase VAT from 25 percent to 27 percent on March 3, 2011.[80]
Implementation occurred on January 1, 2012.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Hungary's economy recovered briefly in 2008-09 but had slowed again by the end of 2011, with annual growth of 1.25 percent. Domestic demand contracted in 2010 and 2011, leaving exports as the sole source of growth. Consequently, growth prospects for 2012 were poor due to the eurozone crisis.

> Growth prospects for the current year are negatively affected by spillovers from the eurozone crisis and domestic policy missteps. The eurozone crisis is weighing on Hungary's external demand, with exports to Europe decelerating since June. Domestically, private consumption is constrained by tightening credit, rising foreign currency debt service, weak wage growth, high unemployment, and a sharp decline in consumer confidence. Meanwhile, fixed investment, which is particularly important for medium-term growth, is declining sharply with little sign of stabilizing amid a volatile policy environment and ample excess supply.[81]

Hungary enacted a number of policy reforms (the "Szell Kalman plan") during 2011 with the goal of improving medium-term growth. These reforms included structural reforms in expenditures, "support [for] foreign currency mortgage holders, changes to the tax regime and labor market policies, special levies on largely foreign-owned sectors (retail, telecommunication, energy and banking) and the de facto nationalization of the second pillar of the pension system."[82] The 2012 VAT increase was an extension of the Szell Kalman plan and was intended to correct the structural deficit, which had widened by about 3 percent of GDP due to permanent tax cuts passed in 2010-11. The tax hike was authorized by the EU and was accompanied by other new taxes in 2011. It was part of austerity measures to restrain the budget deficit to 2.5 percent of GDP in 2012. IMF staff were supportive of the VAT increase because Hungarian public debt remained high at nearly 80 percent of GDP and Hungary's continued deficits above the EU limit of 3 percent of GDP were straining EU relations.

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[80] Hungary to narrow deficit to 2.5 percent of GDP next year. (2011, Mar 01). Xinhua News Agency - CEIS Retrieved from http://search.proquest.com/docview/854401425?accountid=8505

[81] IMF. Public Information Notice 12/4. IMF Executive Board Concludes Article IV Consultation and Second Post-Program Monitoring Discussions with Hungary. January 25, 2012. http://www.imf.org/external/np/sec/pn/2012/pn1204.htm

[82] Ibid.

In November 2011, Hungary requested assistance from the IMF and the European Commission.[83] Its bonds were downgraded to junk status at the end of November due to its rising public debt and unwillingness to cooperate with the European Commission and IMF conditions for assistance. Hungary had not entered a new IMF or EC assistance program by the end of 2013.

We classify this tax change as driven by public debt and deficit reduction concerns. We also include it as external institution-driven change due to Hungary's desire to exit the EU's excessive deficit procedure.

Sources:

"Hungary Hikes VAT to Highest EU Rate at 27 percent". *EU Business* January 1, 2012. http://www.eubusiness.com/news-eu/hungary-finance-tax.ecm

IMF. Hungary: Staff Report for the 2011 Article IV Consultation and Second Post-Program Monitoring Discussions. January 25, 2012. http://www.imf.org/external/pubs/cat/longres.aspx?sk=25673.0

IMF. Public Information Notice 12/4. IMF Executive Board Concludes Article IV Consultation and Second Post-Program Monitoring Discussions with Hungary. January 25, 2012. http://www.imf.org/external/np/sec/pn/2012/pn1204.htm

IMF. Press Release 11/422. Statement on Hungary. November 21, 2011. http://www.imf.org/external/np/sec/pr/2011/pr11422.htm

Knapp, Emily. "Moody's Downgrades Hungary to Junk." *Wall Street Cheat Sheet* November 25, 2011. http://wallstcheatsheet.com/economy/moodys-downgrades-hungary-to-junk.html

[83] IMF. "Statement on Hungary." Press Release 11/422. November 21, 2011. http://www.imf.org/external/np/sec/pr/2011/pr11422.htm

Country: Ireland

1. Tax change of 2001

Legislation was passed to decrease VAT from 21 percent to 20 percent on December 1, 2000.[84]
Implementation occurred on January 1, 2001.
Narrative classification: Exogenous – Long-run growth.

Brief background material and description of nature of tax rate change

In 2001, Ireland was in the midst of its Celtic tiger period, a decade-and-a-half-long economic expansion. GDP growth averaged 9.7 percent from 1995-2000 and reached around 11.5 percent in 2000. The public debt fell drastically as well, shrinking from 90.5 percent of GDP in 1994 to only 39.3 percent in 2000. Concerns of overheating arose in 1999-2000 when inflation increased to 6 percent and asset prices rose; however, these concerns were alleviated when growth moderated in early 2001.

Rising budget surpluses during this time, including a record surplus of 4.6 percent of GDP in 2000, fed public desire for additional tax cuts. A number of taxes were cut in 2001 in response to these demands. Income tax rates were lowered and VAT was reduced, despite critiques of the pro-cyclical fiscal stance by the European Council. "In last year's Budget the Minister announced a reduction in the standard rate of VAT from 21 percent to 20 percent. At that time, he said the cut "reflected the valid concerns expressed about this country's competitive position in an age of E- Commerce, where differences in VAT rates between different trading partners will influence how successful we are in exploiting this new means of commerce."[85] The IMF recognized the tax reforms (particularly the changes in income taxes) as a welcomed effort to reduce labor supply distortions.[86]

Ireland's 2001 VAT cut was primarily motivated to increase productivity (i.e., long-run growth-driven).

[84] McGreevy unveils a Budget bonanza: [Ulster Edition]
The Belfast News Letter [Belfast] 07 Dec 2000: 37.
[85] Enda, Faughnan, "PRSI Gain By Employers Is a Victory in Part," *Irish Times* (Dublin) December 5, 2001, p. 54.
[86] IMF, Public Information Notice 01/86, IMF Concludes 2001 Article IV Consultation with Ireland, August 13, 2001, http://www.imf.org/external/np/sec/pn/2001/pn0186.htm

Sources:

Coghlan, Dennis. "McCreevy's Virtuoso Display of "Funny Money" Tricks." *Irish Times* (Dublin) December 6, 2001, p. 51.

Faughnan, Enda. "PRSI Gain By Employers Is a Victory in Part." *Irish Times* (Dublin) December 5, 2001, p. 54.

IMF. Country Report No. 01/139. Ireland: 2001 Article IV Consultation – Staff Report and Public Information Notice on the Executive Board Discussion. August 2001. http://www.imf.org/external/pubs/ft/scr/2001/cr01139.pdf

IMF. Public Information Notice 01/86. IMF Concludes 2001 Article IV Consultation with Ireland. August 13, 2001. http://www.imf.org/external/np/sec/pn/2001/pn0186.htm

2. Tax change of 2002

Legislation was passed to increase VAT from 20 percent to 21 percent on December 1, 2001.[87]
Implementation occurred on March 1, 2002.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

In 2002, Ireland was in the midst of its Celtic tiger period, a decade-and-a-half-long economic expansion. However, at the time it appeared that Ireland's growth was slowing. After peaking at 11.5 percent in 2000, real GDP growth fell to 6 percent in 2001 after a mid-year fall in output during the 2001 economic slowdown. The labor market remained tight with unemployment at only 4.2 percent by mid-2002.

Ireland recorded unexpectedly high budget surpluses during the late 1990s with a record surplus of 4.6 percent of GDP in 2000. Public demands prompted income tax cuts and a reduction in the VAT rate from 21 to 20 percent in 2001. The tax cuts, combined with increased spending and the economic slowdown, significantly decreased revenue in 2001 below budgeted levels and a structural deficit emerged for the first time in years. The unexpected nature of the low tax receipts concerned policymakers.

The VAT rate was returned to 21 percent in the 2002 budget. "The standard rate of VAT was jacked back up to 21 per cent with the justification that "we need to maintain revenue from indirect taxes if we are to be serious about reducing the burden of other taxation on effort and enterprise."[88] The IMF also emphasized the deficit as motivation for the VAT increase: "The structural revenue-GDP ratio would also be maintained by various measures, including increases in VAT and excise duties..."[89]

The VAT hike (reversal from the 2001 tax cut) was aimed at reducing the somewhat unexpected fiscal deficit, which occurred as a consequence of the 2001 economic slowdown. As such, we classify this tax change as a procyclical action.

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[87] McCreevy's virtuoso display of 'funny money' tricks ; Blunt, honest Charlie McCreevy has turned into a three-card trick man, writes Denis Coghlan, chief political correspondent: [CITY EDITION]
Irish Times [Dublin] 06 Dec 2001: 51., 2001 lousy year: [Final 1 Edition]
Kerr, Colin. News of the World [London (UK)] 23 Dec 2001: 48.

[88] Dennis Coghlan, "McCreevy's Virtuoso Display of "Funny Money" Tricks.," *Irish Times* (Dublin) December 6, 2001, p. 51.

[89] IMF, Country Report No. 03/242, Ireland: 2003 Article IV Consultation – Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion for Ireland, August 2003, p. 20, http://www.imf.org/external/pubs/ft/scr/2003/cr03242.pdf

Sources:

Coghlan, Dennis. “McCreevy’s Virtuoso Display of “Funny Money” Tricks.” *Irish Times* (Dublin) December 6, 2001, p. 51.

Faughnan, Enda. “PRSI Gain By Employers Is a Victory in Part.” *Irish Times* (Dublin) December 5, 2001, p. 54.

IMF. Country Report No. 02/170. Ireland: 2002 Article IV Consultation – Staff Report and Public Information Notice on the Executive Board Discussion. August 2002. http://www.imf.org/external/pubs/ft/scr/2002/cr02170.pdf

IMF. Country Report No. 03/242. Ireland: 2003 Article IV Consultation – Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion for Ireland. August 2003. http://www.imf.org/external/pubs/ft/scr/2003/cr03242.pdf

3. Tax change of 2008

Legislation was passed to increase VAT from 21 percent to 21.5 percent on October 14, 2008.[90]
Implementation occurred on December 1, 2008.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Ireland's "Celtic Tiger" growth period ended with the onset of the global financial crisis. Real GDP growth fell from 6 percent in 2007 to -3 percent in 2008. Ireland was especially vulnerable to the crisis because of the openness of its economy and the imbalances that developed during its extended boom. Its banks were severely overextended. "Since the start of the decade, and especially from 2005 to 2007, easy credit fostered a property bubble, bank exposures to property lending soared while reliance on wholesale funding intensified, and international competitiveness was compromised as wages climbed rapidly."[91]

Eurozone membership and access to European Central Bank Financing help cushion Ireland's economy mid-crisis, preventing currency pressures and preserving liquidity in the banking sector. The government also acted quickly to minimize the damage caused by the crisis by introducing fiscal and financial reforms.

Ireland's fiscal imbalance developed during the boom years.

> Well before the crisis hit, public finances had developed serious structural weaknesses. The facts are well known. In the boom years, personal income tax rates were lowered and expenditure grew rapidly (at about the highest pace among OECD economies). Buoyant property-related revenues (stamp duties, VAT, and capital-related taxes) masked the growing structural deficit, which reached 12½ percent of GDP in 2008 (Box 3).[92]

The vulnerability of the private sector appeared to raise spreads on Irish sovereign bonds. The spread on Irish bonds over the German Bund reached 250 basis points in January 2009. Although general government debt remained relatively low in 2008, with projected levels of 43.2 percent of GDP, the IMF anticipated that it would stabilize at 80 percent of GDP under current policy, well above the Stability Growth Pact target of 60 percent of GDP.

After the fiscal deficit threatened to reach 15 percent of GDP in 2008, tax increases and spending cuts, each totaling about 1 percent of GDP, were announced with the 2009 budget. The VAT increase was among the tax hikes, although the bulk of the tax increase came from a levy on

[90] http://blog.cadamedia.ie/2008/10/new-vat-rates-budget-2008-announced/
[91] IMF, Country Report No. 09/195, Ireland: 2009 Article IV Consultation – Staff Report; and Public Information Notice on the Executive Board Discussion, June 2009, p. 3, http://www.imf.org/external/pubs/ft/scr/2009/cr09195.pdf
[92] Ibid., p. 21.

personal incomes. "The Minister has announced an increase in the standard rate of VAT from 21 percent to 21.5 percent with effect from 1 December 2008. It is estimated that this will raise revenue of EUR 227 million in a full year. Obviously, the Minister is attempting to balance the need for increased revenue without impacting negatively on consumer confidence, hence the minimum increase possible."[93]

We classify this tax change as procyclical driven since the government increased the VAT tax rate aiming at counteract the increase in fiscal deficit that emerged as a consequence to the crisis.

Sources:

IMF. Country Report No. 09/195. Ireland: 2009 Article IV Consultation – Staff Report; and Public Information Notice on the Executive Board Discussion. June 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09195.pdf

IMF. Public Information Notice No. 10/86. IMF Executive Board Concludes 2010 Article IV Consultation with Ireland. July 14, 2010. http://www.imf.org/external/np/sec/pn/2010/pn1086.htm

"Indirect Taxes." *Sunday Business Post* (Cork) October 19, 2008.

[93] "Indirect Taxes," *Sunday Business Post* (Cork) October 19, 2008.

4. Tax change of 2010

Legislation was passed to decrease VAT from 21.5 percent to 21 percent on September 1, 2009.[94]
Implementation occurred on January 1, 2010.
Narrative classification: Endogenous – GDP-driven (countercyclical).

Brief background material and description of nature of tax rate change

Ireland suffered severe recession in 2008 and 2009 after the global financial crisis hit and its "Celtic Tiger" boom ended. Real GDP grew by 6 percent in 2007 but plummeted to -3 percent in 2008 and -7.1 percent in 2009. The economy began to stabilize in late 2009 and growth was expected to resume in 2010. However, Ireland expected high and persistent unemployment to continue as it underwent structural changes. According to the IMF, "The Irish economy may be in a regime with the relatively-modest potential growth and the high unemployment reinforcing each other."[95]

Ireland's fiscal situation worsened dramatically during the crisis. After recording a surplus of 0.06 percent of GDP in 2007, the deficit soared to 14.3 percent of GDP in 2009. The public debt also skyrocketed from only 24.9 percent of GDP to 64.0 percent between 2007 and 2009.

Despite high deficits and rising debt, Ireland reduced the VAT from 21.5 percent to 21 percent in 2010, reversing the 2009 VAT increase.

> The move, combined with a range of excise cuts on alcohol, is designed to stem the flow of people who have been travelling from the Republic to Northern Ireland to take advantage of lower prices on a range of goods....When he announced the cuts last month, Mr Lenihan pointed out that currency differences on both sides of the Border played a key role in price difference.[96]

The cut was intended to support Irish businesses and promote Irish consumption.

> Chambers Ireland chief executive Ian Talbot said: "The reduced VAT rates, coupled with the changed excise rates on the sale of alcohol, will stimulate spending and generate

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[94] Pearce, A. (2009, Sep 26). VAT will reach 20pc; let's take the hit now lifting the rate of valued added tax is inevitable, but perhaps biting the bullet now is better than doing it in dribs and drabs. The Daily Telegraph Retrieved from http://search.proquest.com/docview/321695753?accountid=8505

[95] IMF, Country Report No. 10/209, Ireland: 2010 Article IV Consultation – Staff Reprt; and Public Information Notice on the Executive Board Discussion, July 2010, p. 8, http://www.imf.org/external/pubs/ft/scr/2010/cr10209.pdf

[96] Barry O'Halloran, "Business Group Welcomes 0.5 percent Cut in VAT Rates," *Irish Times* (Dublin), January 2, 2010, p. 18.

> much needed revenue streams for the Exchequer, while also helping to stem the flow of job losses, particularly in the retail sector."[97]

This VAT change falls into the category of countercyclical actions.

Sources:

IMF. Country Report No. 10/209. Ireland: 2010 Article IV Consultation – Staff Report; and Public Information Notice on the Executive Board Discussion. July 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10209.pdf

IMF. Public Information Notice No. 10/86. IMF Executive Board Concludes 2010 Article IV Consultation with Ireland. July 14, 2010. http://www.imf.org/external/np/sec/pn/2010/pn1086.htm

Madden, Caroline. "VAT Cut in Bid To Stem Cross-Border Shopping." *Irish Times* (Dublin) December 10, 2009, p. 8.

McElroy, Naomi. "Lower VAT Will Boost Economy." *The Daily Mirror* (London) January 2, 2010, p. 16.

O'Halloran, Barry."Business Group Welcomes 0.5 percent Cut in VAT Rates." *Irish Times* (Dublin) January 2, 2010, p. 18.

[97] Naomi McElroy, "Lower VAT Will Boost Economy," *The Daily Mirror* (London), January 2, 2010, p. 16.

5. Tax change of 2012

Legislation was passed to increase VAT from 21 percent to 23 percent on December 6, 2011.[98]
Implementation occurred on January 1, 2012.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Ireland entered an Extended Fund Facility arrangement with the IMF in December 2010 and also received aid from other EU countries and institutions after its "Celtic Tiger" boom ended catastrophically during the global financial crisis. Ireland enacted widespread policy reforms after entering the IMF agreement. It implemented comprehensive financial sector reforms in March 2011 that began with the reorganization of domestic banks and the strengthening of their capital base. Ireland also passed major fiscal policy changes to gradually bring the budget in line with the EU's requirement of deficits below 3 percent of GDP.

> The authorities are also continuing to implement a sizeable fiscal adjustment, with the budget on track for the 2011 fiscal targets. The recently announced 2012 budget includes €3.8 billion (2.7 percent of GDP) in spending and revenue measures, to reach a deficit target of 8.6 percent of GDP, and the authorities' Medium-Term Fiscal Framework sets out the path to bring the deficit below 3 percent of GDP in 2015. These actions are helping to restore confidence as part of the government's strategy to put the economy on a path of sustainable growth, sound public finances, and job creation.[99]

The Irish economy showed signs of recovery in 2011, with growth of 2¼ percent in the second quarter and annual growth expected at 1.1 percent. The growth was largely export-driven and was expected to decline to around 1 percent of GDP in 2012 due to weakening demand from trading partners.

The 2012 Irish budget stuck to a deficit target of 8.6 percent, despite a deteriorating economic outlook, in order to signal commitment to reform. The 2012 VAT increase had originally been planned for 2013-14 and was brought forward to raise 2012 revenue.

> For revenue-raising, in 2012 the authorities have decided to rely primarily on indirect taxes by raising the standard VAT rate from 21 percent (the EU median) to 23 percent (75th percentile); bringing forward the increase that was originally programmed for 2013–14. This will be accompanied by a further strengthening and reform of direct taxes, by introducing an interim uniform charge on principal residences (to help finance local

[98] Bardon, S. (2011, Dec 06). WAR ON THE POOR. The Daily Mirror Retrieved from http://search.proquest.com/docview/908592581?accountid=8505

[99] IMF. Press Release No. 11/471. IMF Completes Fourth Review Under the Extended Arrangement with Ireland and Approves €3.9 Billion Disbursement. December 15, 2011. http://www.imf.org/external/np/sec/pr/2011/pr11471.htm

> governments), and harmonizing capital income tax rates at 30 percent. These measures will lend greater stability to Ireland's tax revenues over time.[100]

This tax change falls into the category of debt-driven change, and changes driven by external institutions (due to IMF program participation and the need to eventually bring deficits within the 3 percent EU limits).

Sources:

IMF. Country Report No. 11/356. Ireland: Fourth Review Under the Extended Arrangement and Request for Rephrasing of the Arrangement - Staff Report; Letter of Intent; Memorandum of Economic and Financial Policies; Technical Memorandum of Understanding; Letter of Intent and Memorandum of Understanding on Specific Economic Policy Conditionality (College of Commissioners); Staff Supplement; Press Release on the Executive Board Discussion. December 20, 2011. http://www.imf.org/external/pubs/ft/scr/2011/cr11356.pdf
IMF. Press Release No. 11/471. IMF Completes Fourth Review Under the Extended Arrangement with Ireland and Approves €3.9 Billion Disbursement. December 15, 2011. http://www.imf.org/external/np/sec/pr/2011/pr11471.htm

[100] IMF. Country Report No. 11/356. Ireland: Fourth Review Under the Extended Arrangement and Request for Rephasing of the Arrangement - Staff Report; Letter of Intent; Memorandum of Economic and Financial Policies; Technical Memorandum of Understanding; Letter of Intent and Memorandum of Understanding on Specific Economic Policy Conditionality (College of Commissioners); Staff Supplement; Press Release on the Executive Board Discussion. December 20, 2011, p. 16. http://www.imf.org/external/pubs/ft/scr/2011/cr11356.pdf

Country: Italy

1. Tax change of 1981

Legislation was passed to increase VAT from 14 percent to 15 percent On July 1, 1980.
Implementation occurred on January 1, 1981.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Brief background material and description of nature of tax rate change

Italy entered stand-by arrangements with the IMF in 1974 and again in 1977. After stabilization, the period from 1978-1980 was characterized by rising real demand and output, which increased at cumulative rates of 14.7 percent and 11.4 percent respectively. Italy's real GDP grew by 3.9 percent in 1980, but the economy began to overheat as the rising domestic demand started to crowd out exports, the current account deficit significantly increased, and inflation increased to 21 percent.

> The Italian authorities are keenly aware of the fact that, in the absence of prompt and decisive action to attack some of the fundamental weaknesses that continue to beset the economy, any future easing of monetary policy to accommodate a recovery of domestic demand would lead to a rapid reversal of any hard-won progress on the inflation and balance of payments fronts. The weaknesses that have emerged in the 1970s, particularly in the areas of wage determination and the public finances, have resulted in an increasing preemption of real and financial resources by private and public consumption at the expense of investment and ultimately of the potential growth of output and employment.[101]

Italy's public finances were weak during this period, partly because of the separation between the taxing authorities in the central administration and the local authorities that govern rising levels of spending. As a result, the deficit nearly quadrupled as a percentage of GDP in the early 1970s. Efforts to contain the deficit resulted in a decrease of the overall public deficit from 15.5 percent of GDP in 1978 in 1978 to 11.6 percent of GDP in 1980. However, this decrease was driven mainly by tax increases rather than expenditure cuts. The increase in the tax burden brought the deficit closer to average European levels, but the burden on labor income was quite high.

A package of fiscal measures was issued in July 1980 in order to reduce the fiscal deficit to original forecasted levels by increasing revenues and reducing expenditures. The package included the restructuring of VAT rates and an increase in the average rate. However, Parliament did not confirm the package within the required 60 days, making Legislations inoperative. The

[101] SM/81/112, Italy – Staff Report for the 1981 Article IV Consultation, May 14, 1981, p. 9.

majority of the package was reinstated at the end of October 1980 with some adjustments to the rates for VAT and other indirect taxes. These VAT changes went into effect in 1981.

The 1981 tax change was deficit-driven.

Sources:

IMF Archives. SM/81/112. Working Set Room C-120 01. Italy – Staff Report for the 1981 Article IV Consultation. May 14, 1981.

IMF Archives. SM/82/178. Italy – Recent Economic Developments. August 27, 1982.

OECD. Economic Surveys: Italy. June 1981. http://www.oecd-ilibrary.org/docserver/download/fulltext/1081191e.pdf?expires=1341357435&id=id&accname=oid006114&checksum=E899CA9832C73DF05F8CB62FBF1161F8

2. Tax change of 1982

Legislation was passed to increase VAT from 15 percent to 18 percent on July 1, 1982.[102]
Implementation occurred on August 5, 1982.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Brief background material and description of nature of tax rate change

In the 1970s, Italy's economic policy cycled between phases of expansion and contraction in response to changes in the external accounts. Italy suffered an exchange rate crisis in 1976 after the world recession in 1974-75, rapid financial policy changes, and uncertainty about the 1976 election. A stabilization program in 1976-77 involved major tax increases and credit tightening. The period from 1978-1980 was characterized by rising real demand and output, which increased at cumulative rates of 14.7 percent and 11.4 percent respectively. Italy's real GDP grew by 3.9 percent in 1980, but the economy began to overheat and the rising domestic demand started to crowd out exports, the current account changed from surplus of 1 ½ percent of GDP in 1979 to a deficit of 2 ½ percent of GDP in 1980, and inflation increased to 21 percent.

> During the course of 1981, in response to the deterioration in the external position and with a view to moderating the rate of inflation, monetary policy was progressively tightened. At the beginning of the year, the credit ceilings on commercial bank lending were renewed and the exemptions previously accorded to lending in foreign currency were eliminated. Subsequently, against the background of a considerable expansion in the public sector's borrowing requirement interest rates were raised to levels that became significantly positive in real terms... The tighter stance of monetary policy in 1981 was achieved despite a boost to public sector spending which rose as a proportion of GDP from 47 percent in 1980 to over 50 per cent in 1981. In part, the rise in public sector spending reflected cyclical factors associated with the reduced level of economic activity which also adversely affected revenue performance. However, the major part of the increase in spending stemmed from discretionary factors including further improvements in social benefits and generous wage settlements for public sector employees. As a result the cash deficit of the state sector rose by the equivalent of over 2 percentage points to 13 per cent of GDP in 1981...while that of the overall public sector (defined to include the general government plus some public enterprises) reached an estimated 13 ½ percent of GDP.[103]

Facing a similar deficit of around 14 percent of GDP in 1982, in July 1982 the government announced a package of emergency measures aimed at reducing the budget deficit in July 1982.
The Italian system allowed a few of these reforms to be enacted by decree (including VAT increases), but required parliamentary approval to remain in effect beyond a 60-day period. The parliamentary approval was granted in October 1982. "Premier Giovanni Spadolini's coalition

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102 OECD docs again

103 SM/82/167, Italy – Staff Report for the 1982 Article IV Consultation, August 9, 1982, IMF Archives, p. 1-2.

government in Italy won a parliamentary vote of confidence on tax measures decreed three months ago as part of an austerity program....The approved decree increases Italy's value added tax, a form of sales tax, by varying amounts on a range of products and services."[104]

Italy's 1982 VAT increase change was falls into the category of deficit-driven VAT changes.

Sources:

Fleming, David. "Italy Sets Talks To Pick Premier On Resignation." *The Wall Street Journal* (New York) August 9, 1982, p. 16.

IMF Archives. SM/77/77. Italy – Staff Report for the 1977 Article VIII Consultation. April 12, 1977.

IMF Archives. SM/79/140. Italy – Staff Report for the 1979 Article IV Consultation. May 31, 1979.

IMF Archives. SM/82/167. Italy – Staff Report for the 1982 Article IV Consultation. August 9, 1982.

IMF Archives. SM/82/178 Supplement 1. Italy – Recent Economic Developments. September 21, 1982.

"Italian Premier Wins Confidence Vote on Taxes." *The Wall Street Journal* (New York) October 28, 1982, p. 34.

[104] "Italian Premier Wins Confidence Vote on Taxes." Wall Street Journal, Oct 28, 1982.

3. Tax change of 1988

Legislation was passed to increase VAT from 18 percent to 19 percent on May 1, 1988.[105]
Implementation occurred on August 1, 1988.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Italy's economy grew quickly from 1984-87, outpacing the average growth of its trading partners. Disinflation ended during the second half of 1987 as industries operated near full capacity and several labor contracts were renewed. However, persistent unemployment (concentrated among women, the young, and in the South) increased through 1987, reflecting structural problems.

Public spending growth outpaced revenue growth in Italy during the 1970s and 1980s. Italy's tax ratio, which increased significantly, especially after 1979, was comparable to other industrialized countries at 36 percent. Italy relied more heavily on labor income taxes than did other industrialized countries that had higher shares of indirect taxes. The tax system had a large number of taxes and many rate brackets. At this time, Italy also suffered from high levels of tax evasion.

Italy's public debt was nearly 100 percent of GDP by 1988, and the real interest rate on the debt was near, and sometimes above, the GDP growth rate. Public debt management focused the reduction of de facto indexation of the debt by encouraging the market for fixed coupon bonds.[106] This resulted in raising interest rates on those bonds and declining average maturity of debt.

In May 1988, the government introduced a fiscal adjustment plan designed to stabilize the debt-to-GDP ratio by 1992. The plan set a new target for state-sector borrowing for 1988. Several revenue streams were brought forward and new taxes were announced.

> On May 30, 1988 the proportion of advance payments on personal income tax and local income tax paid by individuals was increased from 92 percent to 95 percent; the periodic payment of VAT by taxpayers with gross annual revenues over Lit 480 million was anticipated by 13 days; the tax on electricity and the registration fees for companies and corporations were increased. On the same occasion, additional expenditure reduction measures totaling Lit 3 trillion were announced. On July 30, 1988 the basic VAT rate was increased from 18 percent to 19 percent, together with the tax on oil and diesel oil and with the local tax on electricity consumption. According to the Bank of Italy, the combined additional revenue effect of the fiscal measures included in the Finance Bill in the May and July decrees is estimated at Lit 10.4 trillion in 1988 and Lit 6.3 trillion in

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105 SM/89/66 p. 41-42

106 SM/89/53, Italy – Staff Report for the 1988 Article IV Consultation, March 13, 1989, IMF Archives, p. 5.

> 1989. The effect on consumer prices was estimated to involve an increase of 1/2 percentage point, most of which due to the VAT rate increase.[107]

Italy's 1988 VAT increase change was motivated by debt sustainability concerns.

Sources:

IMF Archives. SM/89/53. Master Files Room C-130 0401. Italy – Staff Report for the 1988 Article IV Consultation. March 13, 1989.

IMF Archives. SM/89/66. Master Files Room C-130 0401. Italy – Recent Economic Developments. April 12, 1989.

IMF Archives. SM/89/66 Supplement 1. Master Files Room C-130 0401. Italy – Recent Economic Developments. April 13, 1989.

[107] SM/89/66, Italy – Recent Economic Developments, April 12, 1989, IMF Archives, p. 42.

4. Tax change of 1997

Legislation was passed to increase VAT from 19 percent to 20 percent on September 1, 1997.[108]
Implementation occurred on October 1, 1997.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Italy experienced a downturn that began in the second quarter of 1992 and ended in the first quarter of 1994. Growth slowed down severely in 1996 and turned negative at the end of the year. The 1996 slowdown occurred due to declining exports, weak investment performance, and weak private consumption. Growth resumed in the second quarter of 1997 as private consumption increased. However, job creation remained very poor and, as in the rest of Europe, overall unemployment remained high.

Italy's primary fiscal goal in 1997 was ensuring entry into the European Monetary Union as one of the founding members. Italy's fiscal situation had improved significantly from the 1980s, when it suffered chronic large budget deficits. The primary balance first recorded a surplus in 1991 and the surplus was estimated at 6.7 percent of GDP in 1997. The debt-to-GDP ratio was still high at 122 ½ percent of GDP, but was declining at record rates.

Despite earlier plans to reach the Maastricht deficit criterion of 3 percent of GDP in 1998, the Italian government decided to increase the pace of fiscal consolidation in late 1996. Fiscal retrenchment measures in the 1997 budget were increased to 3.2 percent of GDP and Italy's lira rejoined the European Exchange Rate Mechanism at the end of 1996. The 1997 measures relied on revenue increases. The 1998 budget continued toward the goal of fiscal consolidation with additional revenue measures coming from an increase in VAT and in social security contributions of self-employed. Expenditure measures in the 1998 budget came from changes to healthcare and pensions, lower transfers to state-owned enterprises, and containment of public sector wages.

> The Italian government last night unveiled a budget to promote "growth and jobs" in 1998, claiming that its proposals would head off a serious clash over welfare reform later this year with its leftwing allies. After three months of negotiations with trade unionists and far-left politicians over the budget plans, Romano Prodi's government announced it would introduce fiscal tightening worth L25,000bn (£8.9bn)in 1998 – thereby keeping the country on course to join a single European currency the following year. However, one of the big surprises of the budget was a decision to raise value added tax by more

[108] James Blitz, "Prodi Budget Aims To Avert Welfare Clash," Financial Times (London, UK), September 29, 1997, p. 2.

> than expected, raising L5,500bn and adding 0.6 of a percentage point to Italy's inflation rate, currently estimated to be running at 1.4 per cent.[109]

Italy's 1997 VAT increase change falls primarily into the category of debt-driven VAT changes. We also classify it as an external institution-driven change (in this case, the Maastricht treaty requirements for EMU membership).

Sources:

Blitz, James. "Prodi Budget Aims To Avert Welfare Clash." *Financial Times* (London, UK) September 29, 1997, p. 2.

IMF Archives. SM/97/85. Master Files Room C-525 0450. Italy – Recent Economic Developments and Selected Issues. March 24, 1997.

IMF Archives. SM/98/50. Master Files Room C-525 0450. Italy – Staff Report for the 1997 Article IV Consultation. February 20, 1998.

[109] James Blitz, "Prodi Budget Aims To Avert Welfare Clash," *Financial Times* (London, UK), September 29, 1997, p. 2.

5. Tax change of 2011

Legislation was passed to increase VAT rate from 20 percent to 21 percent on November 14, 2010.[110]
Implementation occurred on November 17, 2011.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Italy experienced a weak recovery from the global financial crisis in 2010, with annual growth of 1.3 percent. The growth was driven by exports: other economic indicators were poor and included rising inflation, a growing current account deficit despite export growth, rising unemployment, and weak domestic demand. Italy's weak performance was consistent with its poor growth during the 2000s. Italy's public debt was near 120 percent of GDP in 2011.

However, the European sovereign debt crisis hit Italy in June and July 2011, while the EU considered a second Greek bailout package.

> The cost of insuring Italian debt against default jumped to a record high on Monday, while the spread of Italy's 10-year bond yield over German debt widened to a euro-era high of three percentage points. The yield jumped 0.44 percentage point - the kind of sharp rise seen in Greece's bonds when the crisis there erupted last year - to above 5.7 per cent, an area which some bankers say may start putting heavy pressure on Italy's finances.
>
> The bond sell-off has fanned fears that Italy, with the eurozone's highest sovereign debt relative to its economy after Greece, could be dragged into crisis. If that happened, the zone's bailout fund, the European Financial Stability Facility, would be too small to finance a multi-year bailout of Italy.
>
> After talking by telephone to Italian Prime Minister Silvio Berlusconi, German Chancellor Angela Merkel said on Monday that Rome needed to demonstrate it was undertaking budget reforms necessary to restore confidence, and that she was confident it would do so.[111]

Italy's government quickly drafted a 4-year, 40-billion euro austerity package in an effort to stall the crisis. Despite this effort, market pressure on Italian bonds continued. The European Central Bank bought up Italian bonds in August to knock down borrowing costs under the condition that Italy enact further austerity measures. The government announced amendments to the austerity package in early September, which included a 1 percentage point increase in VAT from 20 percent to 21 percent. The VAT increase went into effect in November 2011.

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110 Italy: Government approves 2011 austerity budget. (2010, Oct 14). McClatchy - Tribune Business News Retrieved from http://search.proquest.com/docview/758266733?accountid=8505

111 Julien Toyer and Dan Flynn. "Europeans Clash Over Greek Debt Crisis; Is Italy Next? Euro Sinks In Value as World Fears Greece Will Default." *The Gazette* (Montreal). July 12, 2011, p. B10.

While Italy has been struggling on the fiscal front for several decades, these weaknesses have increased it significance since the financial crisis in 2009 and, again in 2011 (together with other European countries such as Greece, Portugal, and Spain). We classify it as debt driven fiscal tax hike.

Sources:

Collins, Sarah. “Economic Policy: EU Welcomes Italian Austerity Pledge.” *Europolitics* September 8, 2011.

IMF. Country Report No. 11/176. Italy: Selected Issues. July 2011. http://www.imf.org/external/pubs/ft/scr/2011/cr11176.pdf

MacKenzie, James and Deepa Babington. “Italian Consensus Helps Calm Markets; Austerity Plan Cuts 40 Billion Euros.” *The Gazette* (Montreal). July 14, 2011, p. B5.

Sisto, Alberto. “Italy Boosts Its VAT to Reassure Europe; Budget Bill Promised; General Strike Protests Against Austerity Moves.” *The Gazette* (Montreal). September 7, 2011, p. B10.

Toyer, Julien and Dan Flynn. “Europeans Clash Over Greek Debt Crisis; Is Italy Next? Euro Sinks In Value as World Fears Greece Will Default.” *The Gazette* (Montreal). July 12, 2011, p. B10.

6. Tax change of 2013

Legislation was passed to increase VAT from 21 percent to 22 percent.[112]
Implementation occurred on October 1, 2013.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Italy fell into recession in mid-2011, when discussion of a second Greek bailout package increased fears that Italy would also experience a debt crisis, turning markets against Italian bonds. Italy quickly passed a package of austerity measures. Sovereign yields fell considerably after August 2012, but the combined effect of the European debt crisis and the austerity measures, as well as weak economic fundamentals and slow growth predating the global financial crisis, resulted in a lasting recession.

> Italy's economy has been in recession for almost two years. GDP contracted by 2.4 percent in 2012, and at a similar annualized rate in the first half of 2013. The contraction was led by a sharp fall in domestic demand, reflecting tight credit conditions, fiscal adjustment, and depressed confidence. The unemployment rate is at post-war highs of 12 percent, with youth unemployment nearing 40 percent. Weak demand has also contributed to the narrowing of external imbalances. The current account deficit has declined from 3½ percent of GDP in 2010 to near zero in the first half of 2013, reflecting mainly a collapse in imports and steady exports.[113]

The 2011-2012 austerity measures resulted in significant improvements to Italy's budget deficits, which fell from 4.4 percent of GDP in 2010 to 3 percent of GDP in 2012, and allowed Italy to exit the EU's Excessive Deficit Procedure. Public debt, however, continued to rise from about 120 percent of GDP in 2011 to forecasted levels of over 130 percent of GDP in 2013.

The VAT had originally been scheduled to rise to 22 percent in July 2013, but the increase was delayed until October and was expected to be canceled altogether.[114] The VAT delay was agreed to as part of the formation of a new coalition government. The VAT increase had been intended to help bring deficits below the 3 percent cutoff, but IMF staff reports encouraged Italy to find spending reductions in the budget rather than increase the VAT because of Italy's already high tax burden.[115]

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[112] Italy: New italian cabinet to ponder policy on tuscan retreat. (2013, May 07). McClatchy - Tribune Business News Retrieved from http://search.proquest.com/docview/1348900895?accountid=8505

[113] IMF. Press Release 13/362. IMF Executive Board Concludes 2013 Article IV Consultation with Italy. September 27, 2013. http://www.imf.org/external/np/sec/pr/2013/pr13362.htm

[114] Gavin Jones, "Italy To Delay VAT Sales Tax Hike-Ministry Official." *Reuters* June 23, 2013. http://uk.reuters.com/article/2013/06/23/uk-italy-economy-tax-idUKBRE95M04T20130623

[115] IMF. Country Report No. 13/298. Italy: 2013 Article IV Consultation. http://www.imf.org/external/pubs/ft/scr/2013/cr13298.pdf

Even in mid to late September, it was expected that the VAT increase would be further delayed or canceled. But conflict in the coalition government resulted in it going forward as scheduled. At the end of September, Prime Minister Enrico Letta delayed discussion of an economic package intended to delay the VAT increase and claimed that, instead, he wanted a vote of confidence in the coalition government.[116] Consequently, a decree that would have delayed the VAT increase until January 2013 was not passed.[117]

Italy's 2013 VAT hike falls into the category of debt-driven tax changes.

Sources:

IMF. Country Report No. 13/298. Italy: 2013 Article IV Consultation. http://www.imf.org/external/pubs/ft/scr/2013/cr13298.pdf

IMF. Press Release 13/362. IMF Executive Board Concludes 2013 Article IV Consultation with Italy. September 27, 2013. http://www.imf.org/external/np/sec/pr/2013/pr13362.htm

Jones, Gavin. "Italy To Delay VAT Sales Tax Hike-Ministry Official." *Reuters* June 23, 2013. http://uk.reuters.com/article/2013/06/23/uk-italy-economy-tax-idUKBRE95M04T20130623

Kington, Tom. "Italian Prime Minister Enrico Letta Calls for Vote of Confidence after Silvio Berlusconi Brings Down Coalition; Italian Prime Minister Enrico Letta Called a Parliamentary Vote of Confidence in His Teetering Left-Right Government on Wednesday Amid a Tug-of-War Over Silvio Berlusconi's Legal Woes." *The Telegraph* September 29, 2013.

Vasarri, Chiari and Lorenzo Totaro. "Italy Halts Budget Decisions as Letta Seeks To Gauge Support." *Bloomberg News* September 28, 2013.http://www.bloomberg.com/news/2013-09-27/italy-mulls-delay-of-vat-increase-to-january-as-cabinet-teeters.html

[116] Tom Kington, "Italian Prime Minister Enrico Letta Calls for Vote of Confidence after Silvio Berlusconi Brings Down Coalition; Italian Prime Minister Enrico Letta Called a Parliamentary Vote of Confidence in His Teetering Left-Right Government on Wednesday Amid a Tug-of-War Over Silvio Berlusconi's Legal Woes." *The Telegraph* September 29, 2013.

[117] Chiara Vasarri and Lorenzo Totaro, "Italy Halts Budget Decisions as Letta Seeks To Gauge Support." *Bloomberg News* September 28, 2013.

Country: Japan

1. Tax change of 1997

Legislation was passed to increase VAT from 3 percent to 5 percent on March 1, 1997.[118]
Implementation occurred on April 1, 1997.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Japan's asset price bubble collapsed in 1990. Subsequently, GDP growth averaged only 1½ percent annually for eight years as domestic demand stalled. Consumer demand was depressed by the fall in stock and real estate prices, and firms decreased cut investment due to over-accumulation of capital during the bubble. In addition, exports declined due to the appreciation of the yen during 1994-95.

Japan attempted to stimulate the economy repeatedly during the early 1990s through fiscal stimulus and monetary policy. Furthermore, interest rates were cut nearly to zero. In 1996, the economy appeared to rebound and GDP grew at 3.5 percent for the year.

Central government deficits had increased to 4.2 percent of GDP by 1996, due to fiscal stimulus spending. Consequently, policy focus shifted toward deficit reduction and consequently a return to a stable fiscal position; the 1997 budget planned to reduce the structural deficit to 2 percent of GDP. Revenue measures included ending temporary income tax cuts introduced in 1995, increasing the VAT by 2 percentage points to 5 percent, and increasing medical insurance copayments. Expenditure measures primarily consisted of large decreases in public investment relative to the amounts stipulated in the 1995 stimulus. Finally, the VAT increase had originally been enacted in 1994, but was postponed until the 1997 budget.[119]

> Nomura Research Institute predicted that the tax increases and government moves to cut the budget deficit could depress demand by 10 trillion yen ($80.95 billion) in the fiscal year that begins tomorrow....After several years of trying to jumpstart a slow economy with fiscal spending, the government now faces accumulated debts of $3.9 trillion. The new consumption tax will bring in an estimated $29.3 billion in additional revenue, while the tax cut repeal will add $11.4 billion.[120]

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[118] Sapsford, J. (1997, Mar 19). Japan's hashimoto orders new reforms to bolster sluggish real-estate market. Wall Street Journal Retrieved from http://search.proquest.com/docview/398620356?accountid=8505

[119] Bruce Bartlett, "Economic Miseries of VAT Tax Creep," *Washington Times* (Washington, DC), January 13, 1997, p. A13.

[120] "Japan's consumption tax increases to 5 percent from 3 percent," *Wall Street Journal* (New York), March 13, 1997, p. A11.

The turnaround in fiscal policy appeared to squash the recovery. Recession began during the second quarter of 1997.

Japan's 1997 VAT increase falls into the category of debt-driven tax changes.

Sources:

Bartlett, Bruce. "Economic Miseries of VAT Tax Creep." *Washington Times* (Washington, DC) January 13, 1997, p. A13.

IMF. Public Information Notice No. 97/19. IMF Concludes Article IV Consultation with Japan. August 13, 1997. http://www.imf.org/external/np/sec/pn/1997/pn9719.htm

IMF Archives. SM/98/191. Master Files Room C-525 0450. Japan – Selected Issues. July 22, 1998.

"Japan's consumption tax increases to 5 percent from 3 percent," *Wall Street Journal* (New York), March 13, 1997, p. A11.

Country: Latvia

1. Tax change of 2009

Legislation was passed to increase the VAT from 18 percent to 21 percent on November 1, 2008.[121]
Implementation occurred on January 1, 2009.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Latvia grew very rapidly for several years prior to 2007. Capital inflows and expansionary macroeconomic policies fueled growth, but also led to an unsustainable levels of credit and a real estate bubble. Latvia was hit harder than many other countries during the global financial crisis of 2008 as the real estate bubble burst and domestic demand collapsed. As a result, Latvia entered a stand-by arrangement with the IMF at the end of 2008, but the downturn worsened beyond expectations. Real GDP fell by 18 percent year-on-year in the first quarter of 2009.

Although public debt remained low, there were significant solvency concerns surrounded private-sector debt, which contributed to a net external debt of 70 percent of GDP. Additionally, there was some risk that the government would have to shoulder some of those liabilities. "Latvia faces intense liquidity pressures and needs to take steps to address concerns over external debt sustainability."

> Markets have grown increasingly concerned over the sustainability of the [exchange rate] peg, and the likelihood that contingent financial sector liabilities will have to be absorbed by the government. All three ratings agencies have recently downgraded Latvia, with Fitch and S&P currently assigning it their lowest investment grade ratings, both with a negative outlook. Latvia's Eurobond spread has increased to around 600 basis points, while its CDS spread has flirted with the 1,000 basis point level... Liquidity demands from non-resident depositors have aggravated these developments.[122]

Latvia entered a stand-by arrangement with the IMF in December 2008. "In November 2008, with deposit withdrawals putting pressure on international reserves and the fiscal position

[121] http://www.imf.org/external/np/sec/pn/2010/pn10104.htm
[122] IMF, Country Report No. 09/3, Republic of Latvia: Request for Stand-By Arrangement – Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia, January 2009, p. 7, http://www.imf.org/external/pubs/ft/scr/2009/cr0903.pdf

deteriorating due to a steep drop in revenue as well as mounting banking costs, Latvia approached the Fund and European Commission for emergency financial support."[123]

Latvia hoped to adopt the euro as soon as possible, which required deficits below 3 percent of GDP. However, the 2009 budget deficit was projected to reach double digits. Reducing the size of the deficit was a top policy priority both to preserve Latvia's goal of euro adoption and to ensure access to loans from international lenders. Several tax changes were considered and an increase in the VAT was decided upon.

> The 2009 budget passed in November targeted a 1 percent of GDP fiscal deficit, but was based on overly optimistic assumptions. Both the 2008 deficit (now expected to be 3 percent of GDP, compared to the budget balance assumed earlier) and the 2009 growth projection (now projected at -5 percent, compared to -1 percent earlier) are now much worse. With indirect tax revenues plummeting...and corporate income tax revenues set to collapse as profits fall, left unchanged, the 2009 budget would have resulted in a 12 percent 15 of GDP fiscal deficit... On December 11 Parliament adopted a revised budget with 7 percent of GDP in measures, to target a 4.9 percent of GDP deficit. Roughly ⅓ of the adjustment comes from revenue measures (increases in VAT and excises), and ⅔ from cutting expenditure...[124]

The VAT hike was part of a fiscal package aimed at reducing a growing public debt and high fiscal deficit as a consequence of the 2008/2009 fall in output. As such, we classify this tax change as a procyclical action.

[123] IMF, Public Information Notice No. 10/104, "IMF Executive Board Concludes 2010 Article IV Consultation and Third Review Under the Stand-By Arrangement with the Republic of Latvia," August 12, 2010, http://www.imf.org/external/np/sec/pn/2010/pn10104.htm

[124] Ibid, p. 14-15.

Sources:

Fridrihsone, Madara. “Latvian National Budget Imperfect But Should Be Passed.” *BBC Monitoring European* from *Diena* (Riga), December 1, 2009, p. 12.

IMF. Country Report No. 09/3. Republic of Latvia: Request for Stand-By Arrangement – Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Latvia. January 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr0903.pdf

IMF. Country Report No. 09/125. Republic of Latvia: Stand-By Arrangement – Interim Review Under the Emergency Financing Mechanism. April 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09125.pdf

IMF. Country Report No. 09/297. Republic of Latvia: First Review and Financing Assurances Review Under the Stand-By Arrangement, Requests for Waivers of Nonobservance of Performance Criteria, and Rephasing of Purchases Under the Arrangement. October 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09297.pdf

IMF. Public Information Notice No. 10/104. IMF Executive Board Concludes 2010 Article IV Consultation and Third Review of the Stand-By Arrangement with the Republic of Latvia. August 12, 2010. http://www.imf.org/external/np/sec/pn/2010/pn10104.htm

“Latvian Premier Comments On Crisis, Relations with International Lenders.” *BBC Monitoring European* from *Diena Bizness* (Riga) April 2, 2009.

2. Tax change of 2011

Legislation was passed to increase VAT from 21 percent to 22 percent on December 20, 2010.[125]
Implementation occurred on January 1, 2011.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Brief background material and description of nature of tax rate change

Latvia grew very rapidly for several years prior to 2007. Capital inflows and expansionary macroeconomic policies fueled growth, but also led to unsustainable levels of credit and a real estate bubble. Latvia was hit harder than many other countries during the global financial crisis of 2008 as the real estate bubble burst and domestic demand collapsed. Real GDP fell by 18 percent in 2009.

Latvia received large loan packages from international lenders, including an IMF stand-by arrangement that ran from December 2008 through December 2011. After receiving the loans, Latvia strengthened its policies, causing competitiveness to return, inflation to remain in the low single digits, and the fulfillment of its 2010 deficit target. By mid-2010, growth was expected to resume, causing Latvia to remain committed to its goals of euro adoption and reduction of deficits to 3 percent of GDP by 2011. However, Latvia fell behind, and changed its euro adoption goal to 2012 and reduction of deficits to 3 percent of GDP to 2014.

The 2011 budget aimed to reduce its deficit to 4.5 percent of GDP. Revenue measures constituted 1.8 percent of GDP and included increases in the standard and reduced VAT rate, while cuts in expenditure and net lending contributed another 0.8 percent of GDP. The government also announced it would not cut taxes or raise spending in 2011.

We classify Latvia’s 2011 VAT increase as, primarily, deficit-driven and, secondarily, external institution-driven due to Latvia’s goal of euro adoption and need to reduce deficits to 3 percent of GDP.

125 Latvia passes 2011 austerity budget with more cuts promised
Collier, Mike. McClatchy - Tribune Business News [Washington] 20 Dec 2010

Sources:

IMF. Country Report No. 10/65. Republic of Latvia: Second Review and Financing Assurances Review Under the Stand-By Arrangement, Request for Extension of the Arrangement, and Rephasing of Purchases Under the Arrangement and Request for Waiver of Nonobservance and Applicability of Performance Criteria. March 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr1065.pdf

IMF. Country Report No. 10/356. Republic of Latvia 2010 Article IV Consultation. December 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10356.pdf

IMF. Latvia: Letter of Intent, and Technical Memorandum of Understanding. May 9, 2011. http://www.imf.org/external/np/loi/2011/lva/050911.pdf

IMF. Public Information Notice. IMF Executive Board Concludes 2010 Article IV Consultation and Third Review of the Stand-By Arrangement with the Republic of Latvia. August 12, 2010. http://www.imf.org/external/np/sec/pn/2010/pn10104.htm

3. Tax change of 2012

Legislation was passed to decrease VAT from 22 percent to 21 percent on May 10, 2012.[126]
Implementation occurred on July 1, 2012.
Narrative classification: Exogenous – Long-run growth.

Brief background material and description of nature of tax rate change

Both an increase in domestic demand and export growth allowed Latvia to enjoy a strong recovery from the global financial crisis beginning in 2010, with GDP growth reaching 5.5 percent in 2011. As of mid-2012, GDP growth of 3.5 percent was expected for the year despite weaker external conditions.

Fiscally, Latvia exited a stand-by arrangement with the IMF and agreement with the EU in strong shape.

> Latvia successfully completed its EU-IMF-supported program in December 2011. As part of the program, Latvia implemented fiscal consolidation measures of more than 15 percent of GDP. As a result, the general government deficit has declined from nearly 10 percent of GDP in 2009 to 3.5 percent of GDP in 2011. This year, strong revenue growth is expected to reduce the fiscal deficit to around 2 percent of GDP, while general government debt is expected to stabilize around 40 percent of GDP. Although the Latvian parliament approved a one percentage point cut in VAT effective July and cuts in personal income tax rates for 2013–15, the approval of the Fiscal Compact is evidence of the authorities' continued commitment to budget discipline.[127]

The July 2012 VAT cut was approved by the Latvian Parliament on May 24. It was primarily intended to improve competitiveness with other Baltic state. For example, Lithuania's VAT was at 21 percent and Estonia's was at 20 percent. Labor income taxes were cut as well.

> The purpose of the bill is to reduce the VAT rate in Latvia to bring it closer to the tax rates charged in the neighboring countries in order to boost Latvia's regional competitiveness and offset the inflationary pressure created by global price hikes. Also, reducing the tax burden might lessen the impact of inflation, encourage consumption and have positive effects on business growth, the Finance Ministry said.[128]

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[126] Latvia's ruling coalition agrees on plans for reduction of VAT, personal income tax. (2012, May 10). Baltic News Service.Latvian Daily News Retrieved from http://search.proquest.com/docview/1082083418?accountid=8505

[127] IMF. Public Information Notice 12/76. IMF Executive Board Concludes First Post-Program Monitoring Discussions with the Republic of Latvia. July 16, 2012. http://www.imf.org/external/np/sec/pn/2012/pn1276.htm

[128] "Latvian Parliament Approves VAT Reduction in Final Reading." *Baltic News Service* May 24, 2012.

IMF directors were very pleased with Latvian fiscal consolidation and adoption of the Fiscal Compact, but their July 2012 reports to Latvia did stress the need to maintain commitment to low deficits in the face of these tax cuts. By November, however, the 2012 budget deficit was predicted to fall to 2 percent of GDP and Latvia's 2013 budget was on track to be well within deficit limits as well.

We classify this tax change as long-run growth-driven.

Sources:

IMF. Public Information Notice 12/76. IMF Executive Board Concludes First Post-Program Monitoring Discussions with the Republic of Latvia. July 16, 2012. http://www.imf.org/external/np/sec/pn/2012/pn1276.htm

IMF. Republic of Latvia: 2012 Article IV and Second Post-Program Monitoring Discussions Concluding Statement of the IMF Mission. November 26, 2012. http://www.imf.org/external/np/ms/2012/112612.htm

"Latvian Parliament Approves VAT Reduction in Final Reading." *Baltic News Service* May 24, 2012.

Country: Lithuania

1. Tax change of 2009

Legislation was passed to increase VAT from 18 percent to 19 percent on December 1, 2008.[129]
Implementation occurred on January 1, 2009.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Lithuania's economy grew rapidly during the 2000s, also known as the "Baltic Tiger" period. Lithuania entered the European Union in 2004, which resulted in a subsequent surge of capital inflows as well as an asset and consumption boom. Rising wages and loose fiscal policy also increased demand, and external indebtedness grew.

Lithuania was hit harder than many other countries during the global financial crisis of 2008 when the asset bubble burst and domestic demand collapsed. Domestic demand experienced the largest decline since Lithuania became independent in 1990. Real GDP fell by 14.8 percent in 2009 and 20 percent from peak to trough. Lithuania experienced rapid adjustment in 2009 as capital flows reversed. The domestic crash was exacerbated by the global crisis.

The crash severely affected government finances, although the deficit situation was not as dire as in neighboring Latvia, where the deficit as a percentage of GDP was in the double digits in 2009. The cyclically adjusted deficit had risen to 6½ percent of GDP by the end of 2008, a near threefold increase from 2006, and the public debt doubled to 33 percent of GDP by mid-2009. Lithuania acted quickly to tighten fiscal policy and contain the deficits; the 2009-10 budgets contained measures worth 10 percent of GDP toward deficit reduction.

The VAT increase that went into effect in the first quarter of 2009 was part of the new government's crisis management plan approved at the end of 2008. It was intended to protect the revenue base and prevent deterioration of the deficit because Lithuania's rapid action was necessary to ensure debt sustainability. According to an IMF staff assessment, "Allowing the deficit to widen would compromise fiscal sustainability and the euro adoption strategy. Without a change in policies, the debt burden would rise rapidly to over 90 percent of GDP by end-2014."[130]

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[129] Bikas, Egidijus, and Darius Saikevi?ius. "The Reform of Value-Added Tax in Lithuania: Productivity and Collection Efficiency." N.d. *Vilnius Gediminas Technical University Press*. Web. 9 Feb. 2016. http://leidykla.vgtu.lt/conferences/BUS_AND_MANA_2010/Finance_Engineering/015-021_Bikas_Saikevicius.pdf.
[130] IMF, Country Report No. 09/322, Republic of Lithuania: Staff Report for the 2009 Article IV Consultation, December 2009, p. 13, http://www.imf.org/external/pubs/ft/scr/2009/cr09322.pdf

The VAT hike was part of a fiscal package aimed at reducing a growing public debt and high fiscal deficit as a consequence of the 2008/2009 fall in output. As such, we classify this tax change as a procyclical action.

Sources:

IMF. Country Report No. 09/322. Republic of Lithuania: Staff Report for the 2009 Article IV Consultation. December 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09322.pdf

IMF. Public Information Notice No. 10/80. IMF Executive Board Concludes 2010 Article IV Consultation with the Republic of Lithuania. July 8, 2010. http://www.imf.org/external/np/sec/pn/2010/pn1080.htm

"Lithuania's New Cabinet Sworn In." *Xinhua News Agency – CEIS* (Woodside) December 9, 2008.

"Lithuanian Daily Examines How Cabinet's Plans To Affect Business, Print Media." *BBC Monitoring European* (London) from *Lietuvos Rytas* (Vilnius) December 8, 2010, p. 2.

"Lithuanian Daily Says Government's Actions Impede Economic Recovery." *BBC Monitoring European* (London) from *Lietuvos Rytas* (Vilnius) July 3, 2009.

2. Tax change of 2009

Legislation was passed to increase VAT from 19 percent to 21 percent on June 1, 2009.[131]
Implementation occurred on September 1, 2009.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Lithuania's economy grew rapidly during the 2000s, also known as the "Baltic Tiger" period. It entered the European Union in 2004 and the subsequent surge of capital inflows boosted growth, but also resulted in an asset and consumption boom. Rising wages and loose fiscal policy also increased demand, and external indebtedness grew.

Lithuania was hit harder than many other countries during the global financial crisis of 2008 as the asset bubble burst and domestic demand collapsed. Domestic demand experienced the largest decline since Lithuania became independent in 1990. Real GDP fell by 14.8 percent in 2009 and 20 percent from peak to trough. Lithuania experienced rapid adjustment in 2009 as capital flows reversed. The domestic crash was exacerbated by the global crisis. Quarterly GDP was 12 percent lower in the first quarter of 2009 than at peak in the second quarter of 2009. Real GDP was forecasted to decline by 16 percent in 2009 and another 3¾ percent in 2010, when the Ignalina nuclear plant was scheduled to close.

The crash severely affected government finances, although the situation was not as dire as in neighboring Latvia, where the deficit as a percentage of GDP was in the double digits in 2009. The cyclically adjusted deficit had risen to 6 ½ percent of GDP by the end of 2008, a near threefold increase from 2006, and the public debt doubled to 33 percent of GDP by mid-2009. Lithuania acted quickly to tighten fiscal policy and contain the deficits. The 2009-10 budgets contained measures worth 10 percent of GDP toward deficit reduction.

A crisis management plan passed in December 2008 raised the VAT from 18 percent to 19 percent in the first quarter of 2009. The government passed a supplementary budget in June 2009 to rein in the deficit further and begin structural fiscal reforms. "The package strikes a balance between structural measures that realign high public sector costs (a grade-differentiated pay cut for all public workers and reduction in overly generous maternity benefits) and measures to raise revenue (increase in VAT rate from 19 to 21 percent)."[132] The motivation to lower the deficit and maintain debt sustainability was heightened by Lithuanian plans to qualify for euro adoption by 2013, which necessitated meeting the Maastricht requirement of deficits below 3 percent of GDP by 2011.

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131 http://www.imf.org/external/pubs/ft/scr/2009/cr09322.pdf p. 14

132 IMF, Country Report No. 09/322, Republic of Lithuania: Staff Report for the 2009 Article IV Consultation, December 2009, p. 14. http://www.imf.org/external/pubs/ft/scr/2009/cr09322.pdf

> Staff agreed that additional sizeable fiscal consolidation would still be needed in 2010–11 to safeguard debt sustainability and underpin the euro-adoption. In 2010, even including the impact of the June 2009 supplementary budget measures, the fiscal deficit could rise to 11.2 percent of GDP (½ percent greater net of pillar II transfer cuts) due to the continued fall in GDP, with the Ministry of Finance's working estimates of the fiscal deficit broadly in the same range. This implies additional fiscal consolidation of about 7 percent of GDP in 2010/11 is needed to achieve the authorities' deficit target of 3 percent of GDP in 2011, the target date set recently under the EU excessive deficit procedure. This would stabilize the debt burden at a more sustainable 40 percent of GDP...and secure compliance with the Maastricht debt criterion. However even with the adjustment, the anticipated 2010 deficit may still require significant financing.[133]

The VAT hike was part of a fiscal package aimed at reducing a growing public debt and high fiscal deficit as a consequence of the 2008/2009 fall in output. As such, we classify this tax change as a procyclical action.

Sources:

IMF. Country Report No. 09/322. Republic of Lithuania: Staff Report for the 2009 Article IV Consultation. December 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09322.pdf

IMF. Public Information Notice No. 10/80. IMF Executive Board Concludes 2010 Article IV Consultation with the Republic of Lithuania. http://www.imf.org/external/np/sec/pn/2010/pn1080.htm

[133] IMF, Country Report No. 09/322, Republic of Lithuania: Staff Report for the 2009 Article IV Consultation, December 2009, p. 14. http://www.imf.org/external/pubs/ft/scr/2009/cr09322.pdf

Country: Mexico

1. Tax change of 1991

Legislation was passed to decrease VAT from 15 percent to 10 percent on November 1, 1991.[134]
Implementation occurred on November 21, 1991.
Narrative classification: Endogenous – Offsetting (within VAT).

Brief background material and description of nature of tax rate change

Economic development in Mexico was described as "broadly satisfactory" by the IMF in 1992. Mexico began a series of fiscal and policy reforms aimed at fostering growth, lowering inflation, and improving the balance of payments in 1988. These reforms included tightened fiscal and credit policies and a wage-price pact that limited the adjustment of the exchange rate in addition to adjusting public sector wages. Other reforms included broadening the income tax base and lowering rates in 1989, reducing external debt payments through a financial package with commercial banks, and structural reforms. The fiscal situation strengthened with rising surpluses and low public borrowing requirements. Real GDP growth rates rose from around 1.5 percent annually before the reforms to about 4 percent during 1990-1991, and inflation fell from 52 percent annually in 1988 to 19 percent in 1991. However, the current account deficit grew to 4.7 percent of GDP and GDP growth began to slow at the beginning of 1992.

In November 1991, Mexico extended the wage-price pact through 1993. The exchange rate of the peso to the US dollar was limited to a band, the minimum wage was increased, and the VAT was reduced from 15 to 10 percent. The VAT was also simplified via reductions in the number of categories and brackets and broadening of the base, which partially offset revenue losses from the lower rate. The VAT reduction was justified using arguments for greater tax equity and reduction in the regressivity of the tax system.

This tax change simplified the tax code and improved equity. It took place in the context of moderate growth and during a time when Mexico was making many reforms to fiscal policy in order to increase long-run stability. Although the VAT rate was cut, the VAT base was expanded as many goods moved from the preferential to standard rate. We classify this tax change as tax substitution.

[134] EBS/92/221 p. 2

Sources:

IMF Archives. EBM/92/64. Master Files Room C-525 0404. Minutes of Executive Board Meeting 92/64. May 20, 1992.

IMF Archives. EBS/92/221. Master Files Room C-525 0451. Mexico – Staff Report for the 1992 Article IV Consultation and Review Under the Fourth Year of the Extended Arrangement. December 24, 1992.

2. Tax change of 1995

Legislation was passed to increase VAT from 10 percent to 15 percent on March 10 1995.[135]
Implementation occurred on March 27, 1995.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Mexico enacted a number of fiscal and structural reforms in the late 1980s and early 1990s that improved the fiscal balance, reduced the size of the state sector, and lowered inflation. Monetary policy was characterized by tight currency controls that limited the movement of the currency within a band that was depreciated by a predetermined amount. Mexico was admitted to the OECD in May 1994.

The rising current account deficit, a large budget deficit run up by the outgoing administration in anticipation of the 1994 presidential election, and the uncertain political environment in Mexico (due to the Zapatista uprising and the election) combined to put severe pressure on the currency controls. The peso was allowed to float suddenly in December 1994, which sparked a severe financial crisis that hit the Mexican banking system. The resulting rising interest rates, rising inflation, and falling economic activity prevented borrowers from making full payments and harmed banks' positions.

The Mexican government responded with programs to help banks and borrowers a well as the creation of reforms in bank regulation and regulatory enforcement. The US and international lenders also provided aid packages.

The government sought to halve the current account deficit to 4 percent of GDP, lower inflation, and tighten the fiscal position to help stabilize financial markets. The main tool was a policy on wages and prices formulated between the government, the Bank of Mexico, and the labor and business sectors. The policy raised wages and lowered effective income tax rates for some groups, but increased VAT to generate revenue.

> Mexicans, already reeling over a series of high-level murder and corruption scandals, are braced for a hard year of austerity and possible social unrest, after the government announced the toughest economic measures in the country's modern history. Using a live nationwide television broadcast to get the message across, the Finance Minister, Guillermo Ortiz, unveiled a shock therapy package including a 35 per cent rise in petrol prices, a 20 per cent rise in electricity, a boost in VAT from 10 to 15 per cent and wage restrictions that will cut workers' purchasing power by more than a third this year. The

[135] DePALMA, A. (1995, Mar 10). MEXICO INITIATES AN ECONOMIC PLAN OF EXTENDED PAIN. New York Times Retrieved from http://search.proquest.com/docview/430089773?accountid=8505

> aim was to stabilize the peso, which has fallen to less than half its value of three months ago, and halt a mass outflow of the Mexican currency.[136]

Mexico's 1995 VAT increase was intended to quickly address the Mexican financial crisis.

> The program's specific objectives for 1995 are: (i) the reduction in the external current account deficit from 8 percent of GDP in 1994 to 4 percent of GDP in 1995, and to 3-3 1/2 percent of GDP in 1996; and (ii) a lowering of the annualized rate of inflation to around 9 percent in the fourth quarter of 1995, from more than 30 percent in the first quarter of the year...To achieve these goals, the program is centered on a policy of wage, price, and credit restraint supported by an improvement in the fiscal position. The revised 1995 budget for the nonfinancial public sector provides for a fiscal surplus of 0.5 percent of GDP (compared with a balanced position in 1994), and a primary surplus (the overall balance excluding interest obligations) of 3.4 percent for the year as a whole, compared with a primary surplus of 2.6 percent of GDP in 1994. The contribution of the public sector to the adjustment process is to be particularly large in the first half of 1995. Moreover, the authorities stand ready to strengthen the public finances through additional measures if necessary.[137]

The VAT hike was part of a fiscal package aimed at reducing the high fiscal deficit as a consequence of the Tequila crisis. As such, we classify this tax change as a procyclical action.

Sources:

Davison, Phil. "Austerity Policy Spells Tough Year for Mexico." *The Independent* (London) March 11, 1995, p. 13.

IMF. Press Release No. 95/10. IMF Approves US$17.8 Billion Stand-By Credit for Mexico. February 1, 1995. http://www.imf.org/external/np/sec/pr/1995/pr9510.htm

IMF Archives. SM/96/195. Master Files Room C-525 0450. Mexico – Recent Economic Developments. July 23, 1996.

Torres, Craig. "Mexico's Opposition Parties Challenge Zedillo's Economic Plans and Cut VAT." *The Wall Street Journal* (New York) December 8, 1997, p. A20.

[136] Phil Davison, "Austerity Policy Spells Tough Year for Mexico," *The Independent* (London), March 11, 1995, p. 13.

[137] IMF, Press Release No. 95/10, IMF Approves US$17.8 Billion Stand-By Credit for Mexico, February 1, 1995, http://www.imf.org/external/np/sec/pr/1995/pr9510.htm

3. Tax change of 2010

Legislation was passed to increase VAT from 15 percent to 16 percent on September 1, 2009.[138]
Implementation occurred on January 1, 2010.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Mexico was hit hard by the global financial crisis largely due to its close ties to the US economy. It was also severely impacted by H1N1 flu outbreak in 2009, which effectively shut down the entire economy for two weeks in May. The financial crisis plunged into its worst recession since its 1994-95 crisis, with the economy expected to contract 7.3 percent in 2009. Fortunately, its policy framework was strong: the flexible exchange rate, inflation targeting framework, and fiscal rules functioned well to stabilize the economy in the midst of the crisis. In addition, the strong policy fundamentals were a large contributing factor to the IMF's willingness to extend its first-ever precautionary Flexible Credit Line. The economy was still in recession at the end of 2009, but was beginning to show signs of improvement. The exchange rate and stock market both improved substantially.

Mexico passed significant fiscal stimulus in May 2009, just after the flu outbreak. The stimulus plan included both tax incentives and financial support. Later that year, the IMF noted that "[stimulus] spending will be cut somewhat to adhere to the balanced budget target in the face of larger than expected declines in non-oil revenues."[139]

The 2010 budget eased the balanced budget target under the exceptional circumstances clause in the budget rules to allow for short-term deficits while returning to the balance by 2012. It was intended to slowly withdraw stimulus, while simultaneously improving the medium-term position by "(i) a stronger than previously expected tax reform package expected to yield 1.7 percent of GDP, (ii) expenditure restraint and a re-prioritization of spending to further increase the anti-poverty focus."[140] Gross public debt was forecast to peak at 48 percent of GDP in 2010 before declining. Overall, the IMF assessed Mexico as having "sustainable public debt and sound public finances."[141]

Mexico enacted significant tax reforms in late 2009 as part of the 2010 budget package. These reforms were introduced in September 2009.

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[138] Buchanan, R. (2009). Cautious reaction to mexico's 2010 budget. FT.Com, Retrieved from http://search.proquest.com/docview/229267957?accountid=8505

[139] IMF. Mexico: Review Under the Flexible Credit Line Arrangement - Staff Report and Press Release on the Executive Board Discussion. October 16 2009, p. 5. http://www.imf.org/external/pubs/ft/scr/2009/cr09302.pdf

[140] Ibid.

[141] Ibid, p. 8.

> The 2010 tax reform bill provides that Mexico's primary taxes: the Income Tax, the Flat Tax ("IETU"), the Value-Added Tax ("VAT"), the Excise Tax and the Tax on Cash Deposits ("IDE") would remain in effect. In addition to these taxes, a new consumption tax would be introduced. The purpose of this tax would be to fight poverty, and it will have similar basis to the current Mexican VAT.[142]

The version of tax reform passed by Congress replaced the new consumption tax, with a 1 percentage point increase in VAT, raising the VAT rate to 16 percent effective in January 2010.

The VAT hike was part of a fiscal package aimed at reducing a high fiscal deficit as a consequence of the 2009 fall in output. As such, we classify this tax change as a procyclical action.

Sources:

IMF. Mexico: Review Under the Flexible Credit Line Arrangement - Staff Report and Press Release on the Executive Board Discussion. October 16 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09302.pdf

IMF. Press Release No. 09/362. IMF Executive Board Completes Review of Mexico's Performance Under the Flexible Credit Line. October 16, 2009.

"Mexican Finance Minister Unveils Fiscal Stimulus Plan to Counter Flu Outbreak." *BBC Monitoring Latin America* May 7, 2009.

"Mexico Lawmakers Adopt Tax Plan, Raise VAT, Income Tax." Reuters November 1, 2009. http://www.reuters.com/article/2009/11/01/mexico-economy-idUSN0139604320091101

Rodgriguez, Adriana and Jose Luis Olvera. "Mexico: 2010 Mexican Tax Reform Bill." *Latin American Business Report*. PricewaterhouseCoopers. September 2009 pp. 26-28. http://www.pwc.com/mx/es/prensa/archivo/062010-4-Mexican-Tax-Reform-Bill-la.pdf

[142] Adriana Rodgriguez and Jose Luis Olvera. "Mexico: 2010 Mexican Tax Reform Bill." *Latin American Business Report*. PricewaterhouseCoopers. September 2009 pp. 26-28. http://www.pwc.com/mx/es/prensa/archivo/062010-4-Mexican-Tax-Reform-Bill-la.pdf

Country: Netherlands

1. Tax change of 1989

Legislation was passed to decrease VAT from 20 percent to 18.5 percent on September 20, 1988.[143]
Implementation occurred on January 1, 1989.
Narrative classification: Exogenous – Long-run growth.

Brief background material and description of nature of tax rate change

The Netherlands' growth gained momentum after 1982 reforms to the labor market, including wage moderation, reduction in public employment, and encouragement of private-sector employment. By 1988 real GDP was 2.8 percent, the investment ratio was strong, the current account was in surplus, and inflation was among the lowest in the European Community.

The key weaknesses of the Dutch economy were a large fiscal deficit, high unemployment, and low labor force participation. According to the IMF, "These problems are related. Strong social concerns about the effects of changing the distribution of income to be more in accord with market forces have made it difficult to sharpen the incentive system in the labor markets, while triggering large compensatory income redistributions and social support payments via the public finances."[144] In 1988, the unemployment rate was still 9.3 percent, despite steady declines.

Deficit reduction and the reduction of the debt-to-GDP ratio were among the priorities of the 1989 budget, which made modest cuts to state spending while also enacting supply side policies. Tax cuts in the corporate and tax and VAT were intended to boost demand and increase corporate profitability. The VAT cut was partly directed at boosting demand and partly intended to comply with the European Community's directive on VAT harmonization.

> A major element of the 1989 budget is two tax cuts aimed at encouraging corporate profitability, investment and job creation, and at the same time to underpin consumer buying power in the Netherlands as part of the government's longstanding incomes-maintenance program. The Dutch corporate income tax rate was cut from a flat 42 percent rate to one that taxes the first 250,000 guilders of business earnings at a 40 percent rate and levies a 35 percent tax on profits above that. To offset a rising tax burden on individuals due in part to income tax bracket creep, the cabinet also cut the top rate of the Netherlands relatively high value-added tax to 18.5 percent from 20 percent....Mr.

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[143] Verbeek, Felix, Hoegen Dijkhof, and Utrecht Van Brakel. "Some 1989 Dutch Tax Developments." *International Business Lawyer* 17: 235-36. *HEINONLINE*. Web. 9 Feb. 2016.
http://heinonline.org/HOL/Page?handle=hein.journals/ibl17&div=72&g_sent=1&collection=journals.
[144] SM/90/34, Kingdom of the Netherlands – Netherlands – Recent Economic Developments, February 7, 1990, IMF Archives, p. 1.

> Ruding noted that these tax reductions were taken to bring Dutch VAT and corporate rates more in line with those in other European countries in advance of the fiscal and market harmonization of the European Community in 1992.[145]

The 1989 VAT cut was touted as a tool to encourage job creation and address the Netherlands' persistent low labor force participation rates, high unemployment, and modest economic growth. We classify this tax change as, primarily, long-run growth driven and, secondarily, as an external institution-driven change.

Sources:

"Dutch Budget for 1989 Trims Spending Broadly, Cuts Corporate and VAT Taxes." *The Wall Street Journal* (New York) September 21, 1988, p. 1.

IMF Archives. SM/90/21. Master Files Room C-525 0401. Kingdom of the Netherlands – Netherlands – Staff Report for the 1989 Article IV Consultation. January 23, 1990.

IMF Archives. SM/90/34. Master Files Room C-525 0401. Kingdom of the Netherlands – Netherlands – Recent Economic Developments. February 7, 1990.

[145] "Dutch Budget for 1989 Trims Spending Broadly, Cuts Corporate and VAT Taxes," *The Wall Street Journal* (New York), September 21, 1988, p. 1.

2. Tax change of 1992

Legislation was passed to decrease VAT from 18.5 percent to 17.5 percent on September 1, 1992.[146]
Implementation occurred on October 1, 1992.
Narrative classification: Exogenous – Long-run growth.

Brief background material and description of nature of tax rate change

The Netherlands grew strongly during the first quarter of 1992, but stagnated for the rest of the year. Exports decreased significantly due to stalled recoveries among the Netherlands' major trading partners and a decline in German demand. Domestic demand was also depressed, as business investment declined and the growth in household consumption tapered off. Unemployment began to rise at the end of 1992, and the steady rise in labor force participation seen over the past several years began to level off. Wage cost pressures rose in 1991 and continued into 1982; despite these wage cost pressures weakening competitiveness, the current account surplus appeared stable at around 3 percent of GDP.

The Netherlands' policy focus during much of the 1980s was structural reform intended to increase labor force participation and decrease unemployment. Employment rose and unemployment rates declined steadily throughout much of the decade. Deficit and debt reduction was the top fiscal priority at this time; deficits fell steadily throughout the late 1980s and early 1990s. The 1992 deficit was estimated at 4.3 percent of national net income (NNI), down from 7.8 percent in 1987. The debt-to-GDP ratio was nearly 80 percent, well above the European Monetary Union's criterion of 60 percent of GDP.

> The original budget for 1993 aimed to lower the central government deficit to 3.75 percent of NNI. To this end, it included a set of new measures to restrain overall spending, while at the same time shifting somewhat its composition from consumer subsidies and other current spending to investment, education and environmental protection. The budget also announced measures, in addition to the reduction in the VAT, intended to reduce disincentives to work and encourage wage restraint.

The language used to describe the Netherlands' 1992 VAT cut frames it as a long-term structural reform to improve the functioning of the labor market. We categorize it as long-run growth-driven.

Sources:
IMF Archives. SM/93/27. Master Files Room C-525 0450. Kingdom of the Netherlands – Netherlands – Staff Report for the 1992 Article IV Consultation. February 1, 1993.

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[146] Slowing of Dutch Inflation May Not Continue Next Year
Wall Street Journal [Brussels] 11 Sep 1992: PAGE 2.

3. Tax change of 2001

Legislation was passed to increase VAT from 17.5 percent to 19 percent on May 5, 2000.[147]
Implementation occurred on January 1, 2001.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

The Netherlands economy grew quickly in 2000, with real GDP increasing at a rate of 3.5 percent, causing the year 2000 to be the fifth year in a row of rapid growth. The Netherlands economy enjoyed a strong external sector and relatively low interest rates. Product and labor markets were tight and wage pressure was increasing.

After major structural reform following years of high unemployment and low labor force participation in the 1970s and 1980s, the Netherlands had one of the lowest unemployment rates in the industrialized world in 2000 at 2.4 percent. The size of the public sector shrank steadily during the 1980s and 1990s, with high fiscal deficits giving way to a surplus of 2.2 percent of GDP in 2000. The debt-to-GDP ratio fell from nearly 80 percent in the mid-1990s to an anticipated 52 percent in 2001.

The Netherlands enacted a long-planned major tax reform in 2001 that shifted away from direct taxation toward indirect taxation. The goals of the reform were to shift toward a more stable tax base and improve incentives to work. The changes included reductions in marginal income tax rates, increases in the VAT, some eco-taxes, and changes in investment taxation

> The Dutch government yesterday unveiled proposals to increase value-added tax while cutting the direct burden on labor, in long- awaited fiscal reforms aimed at stimulating jobs growth and adjusting to a rapidly ageing society. The tax proposals are likely to form an important part of the governing coalition's platform in elections next year. A white paper endorsed by the cabinet sets out the most thorough overhaul since the 1950s of a tax system often criticized as burdensome. It was published three months behind schedule, as the coalition of social democrats, reformists and free marketeers sought consensus on the issue ahead of the general election next May. Reductions in income tax are to be financed by "broadening, shifting and greening the tax base," said Gerrit Zalm, finance minister.[148]

We classify the Netherlands' VAT as tax substitution.

[147] FUNDAMENTAL TAX REFORM IN THE NETHERLANDS
Sijbren Cnossen and Lans Bovenberg; http://arno.unimaas.nl/show.cgi?fid=564
[148] Gordon Cramb, "Dutch Unveil Plan To Raise VAT," *Financial Times* (London), December 12, 1997, p. 2.

Sources:

Cramb, Gordon. “Dutch Unveil Plan To Raise VAT.” *Financial Times* (London) December 12, 1997, p. 2.

IMF. Country Report No. 01/94. Kingdom of the Netherlands – Netherlands: 2001 Article IV Consultation – Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion. July 2001. http://www.imf.org/external/pubs/ft/scr/2001/cr0194.pdf

IMF. Public Information Notice No. 01/61. IMF Concludes Article IV Consultation with the Kingdom of the Netherlands – Netherlands. http://www.imf.org/external/np/sec/pn/2001/pn0161.htm

4. Tax change of 2012

Legislation was passed to increase VAT rate from 19 percent to 21 percent on April 26, 2012.[149]
Implementation occurred on October 1, 2012.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

The Netherlands is one of the euro area economies that enjoys a AAA credit rating thanks to a long-standing track record of responsible fiscal policies. However, its private sector is in far worse shape than other AAA-rated European economies due to the highest household debt levels in the euro area, weak domestic demand, a declining real estate market, and a banking sector highly exposed to real estate.

The Dutch had been among the countries heavily involved in drafting eurozone budget rules for other EU countries with weaker fiscal positions. In spring 2012, however, it became apparent that the Dutch budget did not meet many of the EU requirements.

> On current policy, a mild recession would leave the country nursing a budget deficit of 4.5 percent of gross domestic product next year, 2 percentage points higher than previously projected and 50 percent above the eurozone ceiling of 3 percent - risking the wrath of Brussels and the imposition of automatic penalties the Dutch had been keen to devise for others.
> What's more, without a fresh round of austerity, the Dutch would still be above the eurozone deficit limit by 2015. National debt levels are also running in the wrong direction, from 65.4 percent of GDP last year to 75.8 percent in 2015, well above the 60 percent eurozone threshold.[150]

The Dutch minority government fell after initial efforts to put together an austerity package. A five-party coalition caretaker government approved an austerity package in April 2012 to meet the EU deficit requirement of 3 percent per year and to preserve the Dutch AAA credit rating. At the time the package was proposed, however, the Dutch central planning agencies and ministers of finance could not guarantee that the austerity package, including the VAT hikes, would be enough to bring the deficit within target levels.[151] The VAT increase was approved by the Senate in July 2012.

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[149] Dutch parties reach deal on austerity budget; agreement will cut deficit to 3% target. (2012, Apr 27). The Ottawa CitizenRetrieved from http://search.proquest.com/docview/1010197708?accountid=8505
[150] Ian Traynor, "Euro Crisis: Debt, Deficit, and Going Dutch: How Holland Lost the Moral High Ground. After Backing a Tough EU Fiscal Pact, Dutch Find Their Economy Is Falling Behind." *The Guardian* March 12, 2012, p. 27.
[151] Peter Cluskey, "Dutch Austerity Package "Too Vague"." *The Irish Times* May 4, 2012, p. 11.

There were no further plans for fiscal consolidation in 2013, which the IMF felt was appropriate given the Netherlands' strong fiscal fundamentals.

We classify this tax change as, primarily, debt-driven and, secondarily, as an external institution-driven change.

Sources:

Cluskey, Peter. "Dutch Austerity Package "Too Vague"." *The Irish Times* May 4, 2012, p. 11.

IMF. Public Information Notice 13/48. IMF Executive Board Concludes 2013 Article IV Consultation with the Kingdom of the Netherlands - Netherlands. May 10, 2013. http://www.imf.org/external/np/sec/pn/2013/pn1348.htm

IMF. The Netherlands - 2013 Article IV Consultation: Concluding Statement of the IMF Mission. March 19, 2013. http://www.imf.org/external/np/ms/2013/031913.htm

Traynor, Ian. "Euro Crisis: Debt, Deficit, and Going Dutch: How Holland Lost the Moral High Ground. After Backing a Tough EU Fiscal Pact, Dutch Find Their Economy Is Falling Behind." *The Guardian* March 12, 2012, p. 27.

"VAT rate will increase from 19 percent to 21 percent with effect from 1 October 2012." VMW Taxand News. July 12, 2012. http://www.vmwtaxand.nl/7/7/5/46/46/en/overgangsregeling+btw-verhoging.html&art=320

Country: New Zealand

1. Tax change of 1989

Legislation was passed to increase VAT from 10 percent to 12.5 percent on March 1, 1989.[152]
Implementation occurred on July 1, 1989.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

New Zealand's stock market was hit hard by the Black Monday crash in 1987. The stock market collapse, combined with New Zealand's stringent financial policies, resulted in a recession beginning in the final quarter of 1987. Real GDP fell by 1 percent in 1988 as private consumption slowed and business investment fell. The recession and industrial restructuring resulted in rising unemployment; the unemployment rate rose from 4 percent at the end of 1987 to 7 ½ percent in the first quarter of 1989. Inflation had fallen from 20 percent in mid-1986 to 4 percent at the beginning of 1989. However, recovery began in early 1989.

The Labor government in office in 1989 took office in 1984 after the previous government ran large budget deficits (near 9 percent of GDP). The public debt peaked at 80 percent of GDP in 1986/87 and deficits were reduced to 1.5 percent of GDP in 1988/89. The government implemented large-scale tax reform in 1986 which broadened the base, lowered income tax rates, and replaced many indirect taxes with the goods and services tax (GST), a type of VAT. Expenditure was cut, and many commercial government functions were transformed into state-owned enterprises with plans for subsequent privatization. In July 1988, a budget passed that continued plans for fiscal consolidation; asset sales were used to reduce external debt, taxes were lowered, and expenditure cuts were passed. Specifically, the tax reform reduced the number of income tax brackets into two and lowered the rates, resulting in some of the lowest income tax rates in the OECD. Although the 1988/89 deficit was only 1.5 percent of GDP, lower than the anticipated 2.2 percent of GDP, the strong performance was deceptive. Measures brought forward revenue and delayed expenditure, so that the structural deficit was significantly larger. The 1989 budget sought to correct this problem, with the ultimate goal of deficit reduction through the trimming of the public debt-to-GDP ratio by a large margin. In 1988 the debt-to-GDP ratio stood at 66 percent.

> The financial balance in 1988/89 was better than the budget target, but it masked a significant underlying weakening of the fiscal position. The outcome was positively influenced by the measures which had brought revenue forward and postponed expenditures. Furthermore, the full impact of the tax cuts that became effective in October 1988 would not be felt until 1989/90. Taking account of these factors, in the

[152] Defence spending cut back as New Zealand fights deficit: [3* Edition]
Barber, David. The Vancouver Sun [Vancouver, B.C] 22 Mar 1989: F6.,

> absence of new measures, the deficit for 1989/90 was expected to widen to over 4 percent of GDP. Against this background, on March 21, 1989, the authorities announced a package of measures totaling $NZ 1.5 billion, with the aim of reducing the prospective deficit by about $NZ 2 billion, to around 1 percent of GDP, by the July (1989/90) Budget presentation. The measures were expected to raise revenue by $NZ 800 million and lower spending by $NZ 700 million. The most significant measure was to increase the GST from 10 percent to 12.5 percent, to take effect on July 1.[153]

The 1989 New Zealand VAT increase falls into the category of debt and deficit-driven tax increases.

Sources:

Barber, David. "Defence Spending Cut Back as New Zealand Fights Deficit." *The Vancouver Sun* (Vancouver, Canada) March 22, 1989, p. F6.

Freeman, Alan. "Tax Cut Helped Sell GST in New Zealand, Ex-Minister Says." *The Globe and Mail* (Toronto, Canada) October 11, 1989, p. A3.

IMF Archives. EBM/88/89. Master Files Room C-130 0404. Minutes of Executive Board Meeting 88/89. June 24, 1988.

IMF Archives. SM/90/108. Master Files Room C-525 0450. New Zealand – Recent Economic Developments. June 8, 1990.

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[153] SM/90/108, New Zealand – Recent Economic Developments, June 8, 1990 p. 26.

2. Tax change of 2010

Legislation was passed to increase VAT rate from 12.5 percent to 15 percent on May 1, 2010.[154]
Implementation occurred on October 1, 2010.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

New Zealand weathered the global financial crisis better than many countries and emerged from recession in mid-2009, even though GDP declined 1.6 percent for the year and unemployment was at 6.2 percent. The strong fiscal position, resulting in a budget surplus of 3.1 percent of GDP in 2008 and a debt-to-GDP ratio of only 5.6 percent of GDP, allowed the government to deliver significant fiscal stimulus. The mild impact of the crisis was also due to strong Asian demand for New Zealand exports, the relatively strong Australian economy, and a flexible exchange rate. In addition, New Zealand did not experience a banking crisis.

However, the recovery stalled in mid-2010 due to soft domestic demand. The economy slowed further after the Canterbury earthquake in September 2010 hit Christchurch, the second-largest city, causing considerable damage and depressing confidence.

New Zealand passed tax reform in 2010 that lowered income taxes and increased the goods and services tax (GST), which is similar to a VAT. This was part of a long-term strategy to switch away from income taxes toward consumption taxes, and additional switches were planned for the future. The government made the shift because consumption taxes, which do not tax saving, are better for long-run growth.

> Personal tax cuts plus compensation for GST mean the vast bulk of people are better off, even if they spend all of their income. GST does not tax savings. Therefore an across the board reduction in personal income taxes, together with an increase in GST, encourages people to save, or pay off their mortgage, rather than consume. New Zealand relies heavily on personal income and corporate taxes, which are harmful for economic growth. Shifting the tax mix away from these taxes, and on to GST, is less distorting and better for the economy. GST is a very difficult tax to avoid, no matter how people arrange their financial affairs.[155]

We classify this VAT increase as tax substitution.

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[154] NEW ZEALAND GOVERNMENT: Fact sheet - GST and compensation
Anonymous. M2 Presswire [Coventry] 21 May 2010., GST rise biggest concern ahead of 2010 Budget
JAMIESON, Debbie. The Southland Times [Invercargill, New Zealand] 19 May 2010: 5.
[155] New Zealand Government, Fact Sheet – GST and Compensation, May 21, 2010, http://www.national.org.nz/taxcuts/oct1/fact_sheet_gst_and_compensation.pdf

Sources:

Armstrong, Graham. “Expert: 15 percent GST and Cut Income Tax.” *Sunday Star-Times* (Wellington, New Zealand) August 2, 2009, p. A2.

IMF. Country Report No. 11/102. New Zealand: 2011 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for New Zealand. April 22, 2011. http://www.imf.org/external/pubs/ft/scr/2011/cr11102.pdf

IMF. Public Information Notice No. 10/64. IMF Executive Board Concludes 2010 Article IV Consultation with New Zealand. May 26, 2010. http://www.imf.org/external/np/sec/pn/2010/pn1064.htm

IMF. Public Information Notice No. 11/52. IMF Executive Board Concludes 2011 Article IV Consultation with New Zealand. May 9, 2011. http://www.imf.org/external/np/sec/pn/2011/pn1152.htm

New Zealand Government. Fact Sheet – GST and Compensation. May 21, 2010. http://www.national.org.nz/taxcuts/oct1/fact_sheet_gst_and_compensation.pdf

Country: Norway

1. Tax change of 1993

Legislation was passed to increase VAT from 20 percent to 22 percent on December 1, 1992.[156]
Implementation occurred on January 1, 1993.
Narrative classification: Endogenous – Offsetting (other tax).

Background

Norway benefits from large oil and natural gas reserves that generate large amounts of government revenue through petroleum taxes as well as interest and dividends from the government's stake in the petroleum sector. Norway's government actively managed the economy in the 1990s and used fiscal policy as the primary tool to stabilize the domestic economy and monetary policy to stabilize the exchange rate.

Starting in 1989, decreasing unemployment was the primary goal of fiscal policy, causing the government to pursue expansionary fiscal policies. However, weak domestic private demand and a major banking crisis in 1991 resulted in weak growth in 1991 and 1992. Real GDP grew at only 1.6 percent of GDP in 1991, but recovered to 3.4 percent of GDP in 1992. Total domestic demand declined every year from 1988-91, with a cumulative fall of 8 percent. Steady increases in oil and gas production supported growth despite weakness in other sectors. In addition, demand increased in 1992 due to government spending and petroleum investment.

Norway's financial balance was in surplus for a number of years prior to 1992, although the surplus fell to 0.1 percent of GDP in 1991. Rising expenditures and decreasing tax revenue accounted for the decline.

Overall, the 1993 budget was designed to curtail the rising deficit. The budget attempted to change the composition of expenditures by reducing transfers to households and local government, and shifting toward spending to support employment. The budget was broadly revenue-neutral on the tax side, but altered taxes by lowering employers' social security contributions by 2.4 percentage points and simultaneously raising the VAT by 2 percentage points to 22 percent. The goal of the decrease in taxes on labor was to increase Norway's competitiveness.

Norway's 1993 tax change was generally revenue-neutral but shifted from payroll taxes on labor income to consumption taxes. This change falls into the category of tax substitution.

[156] SM/93/103 p. 7 & p. 9

Sources:

IMF Archives. SM/93/118. Norway – Recent Economic Developments. June 3, 1993.

IMF Archives. SM/95/17. Master Files – Room C-525 0450. Norway – Recent Economic Developments. January 26, 1995.

IMF Archives. SM/97/36. Master Files – Room C-525 0450. Norway – Recent Economic Developments. February 10, 1997.

"Norway Central Bank Says Country Shows Signs of a Rebound." *The Wall Street Journal* (New York) September 17, 1993, p. A7C.

2. Tax change of 1995

Legislation was passed to increase VAT from 22 percent to 23 percent on November 28, 1994.[157]
Implementation occurred on January 1, 1995.
Narrative classification: Endogenous – GDP-driven (countercyclical).

Background

Norway grew strongly in the mid-1990s with annual real GDP growth of 5.5 percent in 1994 and 3.6 in 1995. Mainland GDP growth, which excludes petroleum and shipping activities, grew at over 3 percent in both years. Inflation was at a 30-year low and unemployment was declining as labor force participation rose. The current account remained in surplus and net external debt was very low.

Norway benefits from large oil and natural gas reserves that generate large amounts of government revenue through petroleum taxes as well as interest and dividends from the government's stake in the petroleum sector. Oil and gas production expanded rapidly in the 1970s and 1980s, and the economy suffered boom and bust cycles due to oil-related shocks. Norway's Solidarity Alternative policy, begun in 1993, sought to preserve the country's competitiveness in non-oil sectors and reinvested a large portion of the country's oil revenues in the State Petroleum Fund to protect the economy from entering a downturn when oil output declined. Fiscal policy targeted demand management.

Norway sought to encourage growth and employment through expansionary fiscal policy in the late 1990s and early 1990s, but cut expenditure while maintaining revenue after the economy began to recover in 1993. However, deficits grew and "in 1993, the authorities acknowledged that fiscal expansion had been pushed to the limits and that fiscal consolidation over the medium-term was warranted, not least to preserve room for maneuver in fiscal policy in future downturns in the economy."[158] The 1995 budget originally targeted an overall state budget deficit of 2.6 percent of GDP, but the government planned to revisit the budget after the November 28, 1994, referendum on EU membership regardless of the outcome.

EU membership was rejected at the polls, causing the Norwegian government to revise the budget following the referendum. The VAT increase was described as "part of a budget meant to restore confidence in Norway's economy after the country voted against European Union membership," although the VAT increase had been under discussion prior to the referendum.[159] The government intended the tax increase "to demonstrate their commitment to sound economic policies."[160]

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[157] Compiled by, R. L. (1994, Sep 28). World wire. Wall Street Journal Retrieved from http://search.proquest.com/docview/398530308?accountid=8505

[158] SM/95/17, Norway – Recent Economic Developments, January 26, 1995, IMF Archives, p. 9-10.

[159] "Financial Brief: Norwegian Inflation," *The Wall Street Journal* (Brussels), December 14, 1994, p. 1.

[160] SM/95/17, Norway – Recent Economic Developments, January 26, 1995, IMF Archives, p. 12-13.

Norway's 1995 VAT increase is consistent with Norway's continued efforts to use fiscal policy to manage demand. It was intended to restrain demand stemming from strong economic growth and high petroleum revenue and demonstrate fiscal responsibility following the rejection of EU membership. This tax increase thus falls into the category of countercyclical action.

Sources:

"Financial Brief: Norwegian Inflation." *The Wall Street Journal* (Brussels) December 14, 1994, p. 1.

Holman, Richard L. "World Wire." *The Wall Street Journal* (New York) September 28, 1994, p. A15.

IMF. Press Information Notice No. 98/14. IMF Concludes Article IV Consultation with Norway. March 9, 1998. http://www.imf.org/external/np/sec/pn/1998/pn9814.htm

IMF Archives. SM/95/17. Master Files – Room C-525 0450. Norway – Recent Economic Developments. January 26, 1995.

IMF Archives. SM/97/36. Master Files – Room C-525 0450. Norway – Recent Economic Developments. February 10, 1997.

3. Tax change of 2001

Legislation was passed to increase VAT from 23 percent to 24 percent on November 19, 2000.
Implementation occurred on January 1, 2001.
Narrative classification: Endogenous – Offsetting (spending).

Brief background material and description of nature of tax rate change

In 2000, Norway was one of the richest countries in the world. It enjoyed large revenues from the petroleum sector and prudently invested much of the revenue in the State Petroleum Fund, which was used to protect the economy from oil price and output shocks. Overall GDP grew at 3 percent in 2000 and mainland GDP (excluding the oil sector) grew at 1.9 percent. Unemployment was low at 3.3 percent with high labor force participation, resulting in persistently tight labor markets. The current account surplus was over 14 percent of GDP. Simultaneously high oil prices, high output, and a strong US dollar drove up oil revenues and natural gas exports hit record levels. The fiscal balance was strong, with a surplus of over 10 percent of GDP in 2000.

The overall 2001 budget was fiscally neutral; spending increased by about 2 ½ percent in real terms with increases in education and health care. Taxes were increased to ensure budget neutrality, a top priority. The VAT was raised from 23 percent to 24 percent, and a tax on dividend income was introduced. The 2001 VAT increase was one of several tax increases used to offset increased spending on health and education to maintain a neutral budget.

This tax change falls into the category of tax increases to offset increase in fiscal spending.

Sources:

IMF. Country Report No. 01/33. Norway: 2000 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of Norway. February 2001.
http://www.imf.org/external/pubs/ft/scr/2001/cr0133.pdf

IMF. Public Information Notice No. 01/10. IMF Concludes Article IV Consultation with Norway. February 5, 2001. http://www.imf.org/external/np/sec/pn/2001/pn0110.htm

4. Tax change of 2005

Legislation was passed to increase VAT from 24 percent to 25 percent on October 6, 2004.[161]
Implementation occurred on January 1, 2005.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

At the beginning of the 2000s, Norway was one of the richest countries in the world. It enjoyed large revenues from the petroleum sector, prudently investing much of the revenue in the State Petroleum Fund, which was used to protect the economy from oil price and output shocks. In 2001, it adopted inflation targets and fiscal guidelines to preserve petroleum revenue for future generations by investing it abroad in financial assets in the Government Petroleum Fund.

Real mainland GDP grew by 3.5 percent in 2004, with total GDP (including the petroleum sector) growing by 2.9 percent. Unemployment remained low at 4.5 percent and inflation remained low and stable. The general government surplus was nearly 15 percent of GDP.

Norway passed a tax reform package as part of the 2005 budget. The reform lowered labor taxes, exempted companies from taxation of dividends and capital gains on shares, reduced the wealth tax, and raised the standard and reduced VAT rates to 25 percent and 7 percent respectively. The reforms were expected to reduce revenue by 0.3 percent of GDP for 2005.

The tax reform was based on the recommendations of an advisory committee and was designed to reduce tax arbitrage between labor and capital income, improve fairness of labor income taxation, and stimulate labor supply.

The 2005 Norwegian VAT increase falls into the category of tax substitution.

Sources:

IMF. Country Report No. 05/196. Norway: 2005 Article IV Consultation – Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Norway. June 2005.
http://www.imf.org/external/pubs/ft/scr/2005/cr05196.pdf

IMF. Public Information Notice No. 05/75. IMF Executive Board Concludes 2005 Article IV Consultation with Norway. June 13, 2005.
http://www.imf.org/external/np/sec/pn/2005/pn0575.htm

Norwegian Government. Press Release No. 80/2004. Fiscal Budget 2005 – A Good Basis for Continued Growth. October 6, 2004. http://www.regjeringen.no/nb/dokumentarkiv/Regjeringen-Bondevik-II/fin/Nyheter-og-pressemeldinger/2004/fiscal_budget_2005_-a_good_basis.html?id=253449

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[161] Norwegian Government: Fiscal Budget 2005 - A Good Basis for Continued Growth
M2 Presswire [Coventry] 06 Oct 2004: 1.

Country: Poland

1. Tax change of 2011

Legislation was passed to increase VAT from 22 percent to 23 percent on November 17, 2010.[162]
Implementation occurred on January 1, 2011.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Poland was less affected by the global financial crisis than other European countries, avoiding recession in 2009. Its limited dependence on exports, strong domestic economy, and well-capitalized banking system helped protect it from turbulence. By the end of 2010, Poland was experiencing steady recovery driven by domestic demand. Real GDP grew at 3.8 percent and employment, wage growth, and inventory accumulation picked up during the second half of the year. In addition, the current account deficit grew to 3.4 percent of GDP.

Poland used fiscal stimulus in 2008 and 2009 to protect the economy from the financial crisis. Consequently, Poland's fiscal situation mirrored that of many European countries following the global financial crisis as deficits rose. The fiscal deficit for 2010 was large, at 7.9 percent of GDP, and the public debt-to-GDP ratio rose from 44.8 percent of GDP in 2007 to an estimated 52.8 percent of GDP in 2010. The increase in the deficit in 2010 was largely due to lagged effects of corporate income tax revenues as firms continued to deduct losses suffered during the crisis.

In reaction to the financial crisis, the 2011 budget sought to reduce the fiscal deficit. Poland's Public Finance Act set thresholds for the public debt at 50 percent, 55 percent, and 60 percent of GDP, triggering mandatory fiscal adjustments.

> With government debt not far from an important threshold under the Public Finance Act, the authorities specified additional corrective actions triggered by the debt threshold. Substantial fiscal consolidation is under way... Consolidation measures amounting to 1½–1¾ percent of GDP each year are being implemented in 2011–12, notably tightened eligibility for early retirement, a ceiling of CPI+1 on the growth of discretionary expenditure (which includes a wage bill freeze in 2011), a VAT increase of 1 percentage point, and increases in excise taxes.[163]

Poland's 2011 VAT increase falls into the category of debt-driven tax increases.

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[162] http://www.eurovat.com/news.htm; http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Alerts/dttl_tax_globalindirecttaxnews_nov10.pdf
[163] IMF, Country Report No. 11/166, Republic of Poland – Staff Report for the 2011 Article IV Consultation, July 2011, p. 8, http://www.imf.org/external/pubs/ft/scr/2011/cr11166.pdf

Sources:

IMF. Country Report No. 11/166. Republic of Poland – Staff Report for the 2011 Article IV Consultation. July 2011. http://www.imf.org/external/pubs/ft/scr/2011/cr11166.pdf

IMF. Poland – Concluding Statement of the 2010 Article IV Consultation. March 15, 2010. http://www.imf.org/external/np/ms/2010/031510.htm

IMF. Public Information Notice No. 11/86. IMF Executive Board Concludes 2011 Article IV Consultation with the Republic of Poland. July 8, 2011. http://www.imf.org/external/np/sec/pn/2011/pn1186.htm

Country: Portugal

1. Tax change of 1995

Legislation was passed to increase VAT from 16 percent to 17 percent on October 1, 1994.[164]
Implementation occurred on January 1, 1995.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

Portugal entered the European Union in 1986. At first it experienced rising GDP per capita and decreasing inflation. The downturn in the early 1990s, however, hit Portugal more severely than other countries, prompting a relatively weaker recovery. Portugal's downturn and recovery lagged the rest of Europe, a pattern typical for the Portuguese economy. Real GDP grew by 1 percent in 1994 after falling by 1.2 percent in 1993. Domestic demand was sluggish and grew at only 1.4 percent in 1994 relative to 2.5 percent in the European Union due to the low growth of private consumption. However, unemployment rose to 6.8 percent in 1994.

Problems with tax administration and enforcement, combined with the recession, resulted in rising deficits. The deficit nearly doubled in 1993 to 7 percent of GDP and remained at 5.8 percent of GDP in 1994. The debt-to-GDP ratio, which had fallen to 61.4 percent of GDP in 1992, grew to 69.6 percent in 1994.

The 1995 budget did not attempt to reduce the overall deficit and, in fact, planned for a larger primary deficit and higher debt-to-GDP ratio than in 1994. An IMF staff report described the budget as "singularly unambitious" and expressed disappointment that Portugal had not addressed the rising deficits.

The major policy changes were reforms to improve tax administration and an increase in standard VAT rates from 16 percent to 17 percent, as part of continued EU VAT harmonization and a shift from direct to indirect taxation. (The higher VAT rate was eliminated.) Direct taxes on personal and corporate taxes were reduced and employers' social security contributions were cut. Finally, the new higher VAT revenues were earmarked for the social security system.

Portugal's 1995 VAT increase was a tax substitution change.

[164] World Wire, Compiled by Richard L. Holman. Wall Street Journal [New York, N.Y] 18 Oct 1994: A14.
http://www.britannica.com/EBchecked/topic/471447/Portugal-in-1994

Sources:

"Bigger Bite: Slew of Tax Increases In Europe Threatens To Squeeze Consumer." *The Wall Street Journal* (Brussels) January 1, 1995, p. 1.

IMF. Press Information Notice No. 97/35. IMF Concludes Article IV Consultation with Portugal. November 7, 1997. http://www.imf.org/external/np/sec/pn/1997/pn9735.htm

IMF Archives. SM/95/244. Master Files Room C-525 0450. Portugal – Staff Report for the 1995 Article IV Consultation. September 28, 1995.

IMF Archives. SM/95/269. Master Files Room C-525 0450. Portugal – Recent Economic Developments. October 13, 1995.

2. Tax change of 2002

Legislation was passed to increase VAT from 17 percent to 19 percent on May 5, 2002.[165]
Implementation occurred on June 5, 2002.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Portugal's economy grew strongly during the second half of the 1990s, causing living standards converged toward the European Union average. Output and employment grew at such a rate that unemployment fell to one of the lowest levels in the euro area.

However, private sector bank debt relative to GDP grew to the second-highest level in the euro area and the current account deficit widened to 9 percent of GDP in 2000. GDP growth slowed significantly, falling from 3.2 percent in 2000 to 1.6 percent in 2001. Demand for exports stalled at the end of 2001 and the slowdown continued in 2002, with GDP growth falling to 0.5 percent. Private sector indebtedness continued to rise and banks were significantly less capitalized than in other countries in the euro zone. Inflation was above 1 ½ percentage points above the regional average. Competitiveness was eroding as wage growth outpaced the euro average, without increases in productivity.

The 2001 deficit rose to 4.2 percent of GDP, well above targeted levels, as expenditures were above budgeted levels while revenue fell below the targets. The public debt-to-GDP ratio was 55.5 percent of GDP at the end of 2001. The 2002 budget sought to lower the deficit to 1.8 percent of GDP and Portugal's Stability Program remained committed to a balanced structural budget by 2004. However, the 2002 budget was drawn up based on estimates that the 2001 deficit would only reach 2.2 percent of GDP.

The unexpectedly high deficit in 2001 forced the government to pass emergency measures to correct the deficit. "The structural deficit reduction was the largest recorded during the past decade. This reflected sizable adjustment measures introduced by the newly elected government, which took office in April 2002, including an increase in the standard VAT rate, a freezing of some capital expenditures, and one-off revenue measures of about 1.5 percent of GDP, related to asset sales and revenues from a tax amnesty."[166]

> Less than a month after taking office in April, Jose Manuel Durao Barroso, Portugal's new center-right prime minister, was announcing to the nation that he would have to break two of his central campaign promises. A "fiscal shock" designed to stimulate

[165] Portugal's 'iron lady' applies fiscal medicine FINANCE MINISTER DRASTIC MEASURES NEEDED TO CUT THE BUDGET DEFICIT, SAYS MANUELA FERREIRA LEITE: [London edition]
Wise, Peter. Financial Times [London (UK)] 09 May 2002: 08.
[166] IMF, Public Information Notice No. 03/48, IMF Concludes 2002 Article IV Consultation with Portugal, April 9, 2003, http://www.imf.org/external/np/sec/pn/2003/pn0348.htm

> economic growth and investment by lowering the highest rate of income tax and cutting corporate tax from 30 to 20 per cent would be postponed. The standard rate of value added tax (VAT), which he had undertaken not to increase, would be raised from 17 to 19 per cent....The prime minister contends he has been forced into reversing his campaign pledges by the calamitous state in which the Socialists left the country's public finances. The new government, he said, had discovered the problems to be "far beyond our worst expectations".[167]

This tax change falls into the category of debt-driven tax increases.

Sources:

"Curbing Expenditure Is a Delicate Balancing Act: Heavy Reliance on Exports Brings a Chill Wind When Global Markets Take a Turn Downwards." *Financial Times* (London) June 3, 2002, p. 1.

IMF. Public Information Notice No. 00/99. IMF Concludes Article IV Consultation with Portugal. November 20, 2000. http://www.imf.org/external/np/sec/pn/2000/pn0099.htm

IMF. Public Information Notice No. 02/48. IMF Concludes 2001 Article IV Consultation with Portugal. April 26, 2002. IMF. Public Information Notice No. 03/48. IMF Concludes 2002 Article IV Consultation with Portugal. April 9, 2003. http://www.imf.org/external/np/sec/pn/2003/pn0348.htm

IMF. Public Information Notice No. 03/48. IMF Concludes 2002 Article IV Consultation with Portugal. April 9, 2003. http://www.imf.org/external/np/sec/pn/2003/pn0348.htm

[167] "Curbing Expenditure Is a Delicate Balancing Act: Heavy Reliance on Exports Brings a Chill Wind When Global Markets Take a Turn Downwards," *Financial Times* (London), June 3, 2002, p. 1.

3. Tax change of 2005

Legislation was passed to increase VAT from 19 percent to 21 percent on June 1, 2005.[168]
Implementation occurred on July 1, 2005.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Portugal's economy grew strongly during the second half of the 1990s, allowing living standards to converge toward the European Union average. Output and employment grew and unemployment fell to one of the lowest levels in the euro area. However, rising private sector indebtedness, low bank capitalization, and declining competitiveness resulted in a slowdown beginning in 2001 and a crippling recession between 2002 and 2004.

> Portugal has yet to emerge from the downturn that followed the bursting of the euro adoption bubble. A gradual domestic demand-driven recovery started in 2004, but activity weakened during the second half of last year amid ongoing concerns about competitiveness. Preliminary data show year-on-year GDP growth of 0.3 percent in the first half of 2005. Private consumption has proven resilient, reflecting low interest rates and lengthening tenors on bank lending, while investment and export growth remained weak. Meanwhile, the unemployment rate reached a seven-year high of 7.5 percent in the first quarter of 2005, before moderating slightly to 7.2 percent in the second quarter. Due in part to weak demand, inflation fell to just over 2 percent in the first half of 2005. Poor productivity growth has weakened external competitiveness. As a result, export shares shrank and the current account deficit (excluding capital transfers) widened to 7.2 percent of GDP last year.[169]

Despite expectations of real GDP growth of only ½ percent in 2005 and 1 ¼ percent in 2006, Portugal's fiscal strategy focused on lowering the budget deficit, which had risen to 6.1 percent of GDP. The chief measures were a VAT rate increase and freeze on public sector wages. The government, reluctant to cut other spending, defended the increase in the VAT rate from 19 to 21 percent by arguing it had to raise taxes due to European Community pressure for quick improvement on the deficit front. However, the IMF and the European Union's Economic and Financial Committee criticized the tax increase. Although the EU had issued censures and imposed fines to pressure Portugal to bring down deficits, the VAT increase without spending cuts caused concern.

> The government claims that it has to raise taxes because the European Commission calls for quick progress on the deficit front, and cutting spending alone would take too long to

[168] FT.com site : Portugal introduces emergency plan to cut deficit
Peter Wise in Lisbon. FT.com (May 25, 2005): 1.
[169] IMF, Public Information Notice No. 05/147, "IMF Executive Board Concludes 2005 Article IV Consulation with Portugal," October 19, 2005, http://www.imf.org/external/np/sec/pn/2005/pn05147.htm

> bring the public finances under control. Nothing could be further from the economic truth. The tax increases will only cool down the economy and the effects will be just the opposite of the government's expectations, both on economic growth and the deficit. This is exactly why the EU's Economic and Financial Committee (EFC) has criticized the Portuguese tax increase, and one of the main reasons why rating agencies such as Fitch and Standard & Poor's have downgraded the outlook for Portuguese public debt.[170]

Portugal's 2005 VAT increase falls into the category of VAT increases intended to address an inherited debt. We also classify it as external institution-driven.

Sources:

Cohen, Adam. "Leading the News: Portugal's Economy Offers a Cautionary Tale; Fiscal Austerity Took a Toll on Growth; When To Cut Taxes?" *The Wall Street Journal* (Brussels) March 7, 2008, p. 3.

Frasquilho, Miguel. "The Socratic Method." *The Wall Street Journal* (Brussels) July 21, 2005, p. 9.

IMF. Country Report No. 05/375. Portugal: 2005 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Portugal. October 2005.
http://www.imf.org/external/pubs/ft/scr/2005/cr05375.pdf

IMF. Public Information Notice No. 05/147. IMF Executive Board Concludes 2005 Article IV Consultation with Portugal. October 19, 2005.
http://www.imf.org/external/np/sec/pn/2005/pn05147.htm

[170] Miguel Frasquilho, "The Socratic Method," *The Wall Street Journal* (Brussels), July 21, 2005, p. 9.

4. Tax change of 2008

Legislation was passed to decrease VAT from 21 percent to 20 percent on March 1, 2008.[171]
Implementation occurred on July 1, 2008.
Narrative classification: Endogenous – GDP-driven (countercyclical).

Brief background material and description of nature of tax rate change

Portugal experienced a crippling recession from 2002-2004, after the bursting of the euro adoption bubble. Growth resumed in 2004, but real GDP grew by only 0.5 percent in 2005 and 1.3 percent in 2006. By 2007, strong demand for exports accelerated the rate of corporate investment and kickstarted a more robust recovery. The current account deficit fell slightly to 8 ½ percent of GDP in 2007. Unemployment continued to rise to 8 percent despite moderate job creation due to a growing labor force.

Portugal ran high deficits in the mid-2000s and faced pressure from the European Union to reduce deficits to the 3 percent of GDP required by the Stability Growth Pact. It did so successfully and the deficit fell to 2.5 percent of GDP in 2007 from 6.1 percent in 2004. Although Portugal was heavily criticized by the European Community for failing to restrain spending in the 2005 budget, subsequent budgets achieved fiscal consolidation, primarily through expenditure reduction. Improved tax administration also resulted in increased revenue over performance relative to expectations. Social security reforms improved the long-term budget outlook.

The 2008 budget continued the pattern of fiscal consolidation, with the target deficit at 2.2 percent of GDP. However, concerns that the economy was weakening prompted a cut in VAT to stimulate the economy as well cushion the effects of commodity prices. "Economists expect Portuguese growth to continue, and possibly even accelerate, in the third quarter thanks to a one-percentage point cut in VAT in July to 20 percent that many businesses and consumers were thought to be waiting for before making big purchases."[172] Past deficit reduction also opened the door for the VAT cut.

> "This momentous reduction in the deficit to a 30-year low, achieved through tough spending cuts, structural reforms and a sharp increase in tax revenue, will "restore Portugal's credibility in international markets and strengthen confidence in the economy", he says. As a consequence, he has announced a cut in value added tax from 21 to 20 per cent from July, attenuating the 2 percentage point increase that Jose Socrates, the prime minister, announced immediately on taking office in March 2005 – breaking an election

[171] http://search.proquest.com/news/docview/248337676/22F7D7FC12FB4310PQ/13?accountid=8505
[172] Andrew Eatwell, "Portugal Again Out To Buck Trend Set By the Iberian Powerhouse," *El Pais* (Madrid), September 15, 2008, p. 7.

> pledge not to increase taxes – as an emergency measure to help cope with the deficit crisis.[173]

This VAT cut falls into the category of countercyclical actions.

Sources:

Eatwell, Andrew. "Portugal Again Out To Buck Trend Set By the Iberian Powerhouse." *El Pais* (Madrid) September 15, 2008, p. 7.

IMF. Country Report No. 08/323. Portugal: 2008 Article IV Consultation-Staff Report; Staff Statement, Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Portugal. October 2008. http://www.imf.org/external/pubs/ft/scr/2008/cr08323.pdf

IMF. Public Information Notice No. 99/98. IMF Executive Board Concludes Article IV Consultation with Portugal. October 22, 1999. http://www.imf.org/external/np/sec/pn/1999/pn9998.htm

IMF. Public Information Notice No. 07/126. IMF Executive Board Concludes 2007 Article IV Consultation with Portugal. October 11, 2007. http://www.imf.org/external/np/sec/pn/2007/pn07126.htm

IMF. Public Information Notice No. 08/128. IMF Executive Board Concludes 2008 Article IV Consultation with Portugal. http://www.imf.org/external/np/sec/pn/2008/pn08128.htm

Wise, Peter. "Tough Cuts To Strengthen Confidence." *Financial Times* (London) April 8, 2008, p. 2.

[173] Peter Wise, "Tough Cuts To Strengthen Confidence," *Financial Times* (London), April 8, 2008, p. 2.

5. Tax change of 2010

Legislation was passed to increase VAT from 20 percent to 21 percent on May 1, 2010.[174]
Implementation occurred on July 1, 2010.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Portugal's economy was hit hard by the 2008 global financial crisis; exports and investment both fell sharply, real GDP fell by 2.5 percent in 2009, and unemployment increased to nearly 10 percent. Although Portugal grew well in the mid-2000s, a number of underlying problems reemerged after the financial crisis. Portugal entered the European Union in 1986 and adopted the euro in 2002. Subsequently, interest rates fell, prompting a growing current account deficit and lowering savings. In result, the financial and corporate sectors became highly indebted, causing high wage growth and low labor productivity to reduce competitiveness. Growth was further inhibited by protection for the non-tradable sector, which drove up costs and impeded growth in the tradable sectors. Unfortunately, this problem was furthered by the existence of poor institutions.

Portugal's fiscal situation was severely affected by the crisis. In order to combat the crisis, Portugal used fiscal stimulus of about 1¼ percent of GDP over the 2008-09 period, causing revenue to fall significantly. Deficits, which had fallen below 3 percent of GDP in the mid-2000s, grew to more than 10 percent of GDP in 2009. The public debt ballooned to 83 percent of GDP in 2009 and continued to grow, finishing in 2010 at 93 percent of GDP.

The OECD, EU, and other international organizations pressured Portugal to emphasis deficit reduction in 2010. Investors were largely concerned about Portugal's high debt levels, fearing that the country could undergo a financial crisis similar to that in Greece. . In May 2010, Portugal passed deficit reduction measures, including a 1 percent increase in VAT and wage reductions for top government employees.

Portugal's 2010 VAT hike aimed at reducing a high fiscal deficit and debt as a consequence of the 2009 fall in output and EU Stability Pact. As such, we classify this tax change as a procyclical action.

[174] Lejeune, Ine. "The EU VAT Experience: What Are The Lessons?" *Tax Analysts*. N.p., n.d. Web. 9 Feb. 2016. http://tax.org/www/freefiles.nsf/Files/LEJEUNE-21.pdf/$file/LEJEUNE-21.pdf.

Sources:

IMF. Country Report No. 11/127. Portugal: Request for a Three-Year Arrangement Under the Extended Fund Facility. June 2011. http://www.imf.org/external/pubs/ft/scr/2011/cr11127.pdf

IMF. Public Information Notice No. 10/08. IMF Executive Board Concludes 2009 Article IV Consultation with Portugal. January 20, 2010. http://www.imf.org/external/np/sec/pn/2010/pn1008.htm

Lewis, Jeffrey T. and Jonathan House. "World News: Portugal Approves Tax Increases, Salary Cuts-Lisbon Takes a Cue from Spain in Launching Additional Measures Designed to Prevent a Financial Crisis Like Greece's." *The Wall Street Journal* (New York) May 14, 2010, p. A8.

6. Tax change of 2011

Legislation was passed to increase VAT from 21 percent to 23 percent on October 1, 2010.[175]
Implementation occurred on January 1, 2011.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Portugal's economy was hit hard by the 2008 global financial crisis; exports and investment both fell sharply, real GDP fell by 2.5 percent in 2009, and unemployment increased to nearly 10 percent. Although Portugal grew well in the mid-2000s, a number of underlying problems reemerged after the financial crisis. Portugal entered the European Union in 1986 and adopted the euro in 2002. Subsequently, interest rates fell, prompting a growing current account deficit and lowering savings. In result, the financial and corporate sectors became highly indebted, causing high wage growth and low labor productivity to reduce competitiveness. Growth was further inhibited by protection for the non-tradable sector, which drove up costs and impeded growth in the tradable sectors. Unfortunately, this problem was furthered by the existence of poor institutions.

The OECD, European Union, and IMF all pressured Portugal to emphasize deficit reduction mainly because the international community was concerned that Portugal could suffer a Greece-style collapse. The 2010 budget included some deficit reduction measures, but additional changes were made later that year in May. Revision included an increase and additional measures passed in May 2010 raised the VAT from 20 percent to 21 percent and reduced some public sector wages. In September and October, however, the Socialist government of Prime Minister Jose Socrates struggled to pass a budget that would contain the deficit due to resistance from the Social Democrat party, who refused to vote for additional tax increases. The uncertainty had driven Portugal's borrowing costs to record highs in September.

The 2011 budget was passed at the end of October and increased indirect taxes. The VAT rate was increased from 21 percent to 23 percent and the personal and corporate income tax rates were also increased. These higher rates were set to expire in 2013.

Portugal's 2011 VAT increase falls primarily into the category of tax increases driven by debt sustainability concerns. We also classify it as external institution-driven.

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[175] Lejeune, Ine. "The EU VAT Experience: What Are The Lessons?" *Tax Analysts*. N.p., n.d. Web. 9 Feb. 2016. http://tax.org/www/freefiles.nsf/Files/LEJEUNE-21.pdf/$file/LEJEUNE-21.pdf.

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IMF. Public Information Notice No. 10/08. IMF Executive Board Concludes 2009 Article IV Consultation with Portugal. January 20, 2010. http://www.imf.org/external/np/sec/pn/2010/pn1008.htm

Minder, Raphael. "Portugal Ends Long Standoff Over Budget." *The New York Times* (New York) October 31, 2010, p. 14

Minder, Raphael. "O.E.C.D. Urges Portugal To Tame Deficit." *International Herald Tribune* (Paris) September 28, 2010, p. 18.

Tarvainen, Sinikka and Emilio Rappold. "Portugal Struggles to Restore Confidence in Its Economy." *McClatchy – Tribune Business News* (Washington) October 12, 2010.

Country: Romania

1. Tax change of 2000

Legislation was passed to decrease VAT from 22 percent to 19 percent on December 29, 1999.[176]
Implementation occurred on January 1, 2000.
Narrative classification: Endogenous – Offsetting (within VAT).

Brief background material and description of nature of tax rate change

Romania transitioned to a market economy after the 1989 fall of the Iron Curtain. However, it was slower to adopt reforms than other former Soviet-block countries and its period of growth in the mid-1990s relied on distortionary policies that included subsidies to inefficient firms, price controls, rapidly increasing foreign debt, and fiscal deficits. After elections in 1996 changed the party in power, major reforms started 1997 with the liberalization of price and exchange systems, the ending of subsidies through the national bank, and the tightening of fiscal policy. The reform effort stalled soon afterward as efforts to privatize state-owned enterprises were limited. Monetary policy was relaxed and the currency was allowed to appreciate in real terms, lowering inflation significantly to 41 percent, but also driving up the current account deficit to 7.2 percent of GDP in 1998. A severe recession developed in 1997 and continued with real GDP declining by 6.1 percent, 5.4 percent, and 3.2 percent in 1997, 1998, and 1999 respectively. Crisis appeared imminent in early 1999, when markets became concerned that Romania would default on US $0.8 billion in bonds.

The government responded to the impending crisis with decisive action. Romania entered an IMF loan standby program and implemented significant policy changes, including deficit reduction, tight monetary policy, and the closure of a large insolvent state bank. Crisis was averted and the market confidence was restored. Although output continued to decline, the current account deficit declined to a sustainable level of 3.8 percent of GDP and recovery was expected in 2000.

Romania pursued major tax reform in the 2000. Changes included unifying VAT rates (so that the top VAT rate fell from 22 percent to 19 percent, but goods formerly taxed at the preferred 12 percent rate saw VAT increases), cutting the income tax rate from 38 to 25 percent, and widening the tax base through eliminating exemptions.

This tax change reformed the tax system to reduce distortions and simplify administration. It falls into the category of tax substitution.

[176] Romania: fiscal reform cuts income tax, VAT, simplifies excise duties. BBC Monitoring European - Political [London] 30 Dec 1999: 1.

Sources:

IMF. Public Information Notice No. 00/106. IMF Concludes Article IV Consultation with Romania. December 12, 2000. http://www.imf.org/external/np/sec/pn/2000/pn00106.htm

IMF. Country Report No. 00/159. Romania: 2000 Article IV Consultation – Staff Report; Statement by Staff Representative; and Public Information Notice Following Consultation. December 2000. http://www.imf.org/external/pubs/ft/scr/2000/cr00159.pdf

2. Tax change of 2010

Legislation was passed to increase VAT from 19 percent to 24 percent on June 1, 2010.[177]
Implementation occurred on July 1, 2010.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Romania grew quickly in the mid-2000s with real GDP growth rates of 6.3 and 7.3 percent in 2007 and 2008, respectively. However, the country was highly susceptible to the global financial crisis.

> Before the current crisis, the Romanian economy was characterized by high growth rates, associated with the build-up of external and internal imbalances. Large capital inflows stimulated domestic demand, while labor constraints and rising public sector wages generated wage inflation. Fiscal policy was pro-cyclical, exacerbating the overheating of the economy despite tight monetary policy to counteract price pressures. The rapid development of the banking system came with vulnerabilities to outside liquidity shocks and foreign exchange risks. The global economic and financial crisis hit Romania hard in late 2008 and 2009. Capital inflows dried up, exports plunged, and country risk indicators skyrocketed. As a result of the sharp contraction in domestic demand, GDP plummeted and the current account deficit fell markedly. Although banks generally entered the crisis well capitalized, they faced rising NPLs, a dried up interbank market and limited access to external sources of funds. The country's large fiscal deficit constrained the fiscal policy response to the crisis.[178]

The fiscal deficit rose to 7.4 percent of GDP in 2009 and gross public debt (direct debt only) jumped from 19.5 percent of GDP to 28.2 percent of GDP between the end of 2008 and the end of 2009. Romania received financing from the IMF, European Union, and World Bank in early 2009 with the understanding that it would pursue deficit reduction, financial sector reform, and monetary policy targeting inflation reduction. Real GDP continued to decline by 7.1 percent, but other indicators suggested that the economy was stabilizing: exchange rates declined, the financial sector stabilized, and borrowing costs declined.

Romania's parliament approved a package of expenditure cuts that were agreed on by IMF staff for the 2010 budget. The package then went before the Constitutional Court.

> The Court accepted the legality of the 25 percent cut in public sector wages and the cuts of 15 percent in most social transfers, but rejected the constitutionality of the 15 percent reduction in pensions. This decision created a gap of 0.7 percent of GDP to achieve the

[177] Romanian gov't hikes VAT to keep IMF loan on track
Anonymous. Xinhua News Agency - CEIS [Woodside] 26 June 2010.
[178] http://www.imf.org/external/np/sec/pn/2010/pn1097.htm

agreed 6.8 percent of GDP deficit target. The authorities responded quickly to implement compensatory measures. On June 26, the Cabinet approved an emergency decree to increase in the standard VAT rate from 19 percent to 24 percent, effective immediately (revised prior action), and on June 29 parliament reapproved legislation to implement the wage cuts accepted by the Court... The VAT increase is expected to yield RON 3.6 billion (0.7 percent of GDP) for the remainder of 2010 at current revenue yields, effectively closing the gap created by the rejection of the pension cuts.[179]

Contemporary news reports tell a similar story.

> Romanian Prime Minister Emil Boc said that the government plans to raise value-added tax (VAT) to 24 percent in an effort to curb the country's deficit, adding that the 5 percent rise was an attempt to guarantee a $20 billion International Monetary Fund (IMF) loan, AP reported. The move comes after Romania's top court ruled out plans to cut pensions, prompting the IMF to delay key talks. But critics say the VAT rise will hit consumer spending in the European Union country. The austerity plan negotiated by the government with the IMF aims to cut the national deficit from 7.2 percent of output to 6.8 percent. Finance Minister Sebastian Vladescu said the increase, which will be implemented in July, will bring in between $1 billion and $1.15 billion extra revenue in 2010.[180]

Romania's 2010 VAT hike aimed at reducing a high fiscal deficit and growing debt as a consequence of the 2009 fall in output. As such, we classify this tax change as a procyclical action.

Sources:

IMF. Country Report No. 10/227. Romania – Staff Report for the 2010 Article IV Consultation, Fourth Review Under the Stand-By Agreement, and Requests for Modification and Waiver of Nonobservance of Performance Criteria – Staff Report; Staff Supplement; Public Information Notice and Press Release on the Executive Board Discussion; Statement by the Executive Director for Romania. July 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10227.pdf

IMF. Public Information Notice No. 10/97. IMF Executive Board Concludes 2010 Article IV Consultation and Fourth Review of the Stand-By Agreement with Romania. July 23, 2010. http://www.imf.org/external/np/sec/pn/2010/pn1097.htm

"Romania To Raise VAT By 5 percent." MENAFN.com (New York) June 27, 2010.

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179 IMF, Country Report No. 10/227, Romania – Staff Report for the 2010 Article IV Consultation, Fourth Review Under the Stand-By Agreement, and Requests for Modification and Waiver of Nonobservance of Performance Criteria – Staff Report; Staff Supplement; Public Information Notice and Press Release on the Executive Board Discussion; Statement by the Executive Director for Romania, Supplementary Letter p. 1, July 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10227.pdf

180 "Romania To Raise VAT By 5 percent." MENAFN.com (New York) June 27, 2010.

Country: Slovak Republic

1. Tax change of 2003

Legislation was passed to decrease VAT from 23 percent to 20 percent on November 14, 2002.[181]
Implementation occurred on January 1, 2003.
Narrative classification: Exogenous – Long-run growth.

Brief background material and description of nature of tax rate change

The Slovak Republic enacted major structural reforms in the late 1990s, including the privatization of many state-owned enterprises, narrowing the scope of quasi-fiscal activities, improving fiscal transparency, and reforming the financial sector. These reforms, combined with successful macroeconomic policy, led to strong growth, inflation reduction, and substantial foreign direct investment (which reached a record 17 percent of GDP in 2002 when the state gas monopoly was sold). In result, real GDP grew by 3.8 percent in 2001 and 4.6 percent in 2002. Despite these successes, unemployment remained very high at 18.6 percent in 2002. The current account and fiscal deficits were also relatively large, with the current account deficit narrowing slightly to 8 percent of GDP in 2002 and the fiscal deficit exceeding 7 percent of GDP on an ESA95 basis.

After elections in 2002, the government of Prime Minister Mikulus Dzurinda pursued fiscal reform focusing on taxes, pensions, and the benefits system. The tax reform aimed to make taxes simpler and more transparent. It introduced a flat 20 percent income tax and reduced the standard VAT to 20 percent. Policymakers planned to cut corporate taxation significantly in the long run. The reform was scheduled to continue in 2004, unifying VAT rates at 19 percent.

> The tax reform appropriately aims to provide better incentives to work and save. The reform features a more transparent and simpler tax law, a shift in the tax burden from direct to indirect taxes, and a flat income tax rate. The measures sought are likely to improve economic performance. Removal of exemptions, deductions, and exclusions should lead to fewer distortions in income and consumption taxation, and help finance lower rates of direct taxation. The uniform rate of VAT should improve administration and compliance, while leading to a more neutral taxation of goods and services. Lower direct taxation should encourage both the legalization of firms operating in the grey economy, and foreign and domestic investment. We welcome the sequencing of

[181] Slovak parliament approves new VAT rates for 2003
BBC Monitoring European - Political [London] 14 Nov 2002: 1.

introduction of the tax legislation, with the more politically difficult items, particularly unification of the VAT, already passed by the parliament.[182]

The Slovak Republic's 2003 VAT decrease fits into the category of long-run growth-driven changes.

Sources:

IMF. Concluding Statement. IMF Staff Visit to the Slovak Republic, October 7-15, 2003. http://www.imf.org/external/np/ms/2003/101503.htm

IMF. Country Report No. 03/234. Slovak Republic: 2003 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Slovak Republic. August 233. http://www.imf.org/external/pubs/ft/scr/2003/cr03234.pdf

IMF. Public Information Notice No. 05/24. IMF Executive Board Concludes 2004 Article IV Consultation with the Slovak Republic. http://www.imf.org/external/np/sec/pn/2005/pn0524.htm

"Slovak Government To Motivate Jobless To Actively Seek Employment." *BBC Monitoring European – Political* (London) November 2002, p. 1.

[182] IMF, Concluding Statement, IMF Staff Visit to the Slovak Republic, October 7-15, 2003, http://www.imf.org/external/np/ms/2003/101503.htm

2. Tax change of 2004

Legislation was passed to decrease VAT from 20 percent to 19 percent on May 28, 2003.[183]
Implementation occurred on January 1, 2004.
Narrative classification: Endogenous – Offsetting (within VAT).

Brief background material and description of nature of tax rate change

The Slovak Republic enacted major structural reforms in the late 1990s, including the privatization of many state-owned enterprises, narrowing the scope of quasi-fiscal activities, improving fiscal transparency, and reforming the financial sector. These reforms, combined with successful macroeconomic policy, led to strong growth, inflation reduction, and substantial foreign direct investment (which reached a record 17 percent of GDP in 2002 when the state gas monopoly was sold). Real GDP grew by 3.8 percent in 2001 and 4.6 percent in 2002. Despite these successes, unemployment remained very high, at 18.6 percent in 2002. The current account and fiscal deficits were also relatively large, with the current account deficit narrowing slightly to 8 percent of GDP in 2002 and the fiscal deficit exceeding 7 percent of GDP on an ESA95 basis.

After elections in 2002, the government of Prime Minister Mikulus Dzurinda pursued fiscal reform focusing on taxes, pensions, and the benefits system. The Slovak Republic's 2004 VAT decrease from 20 percent to 19 percent was scheduled as part of the continuation of tax reform begun in 2003. The tax reform aimed to make taxes simpler and more transparent and to shift the burden from direct to indirect taxes. It introduced a flat 20 percent income tax and raised the standard VAT to 20 percent in 2003 and then unifying VAT rates at 19 percent in 2004.

VAT unification allowed the Slovak Republic to begin preparing documents for adopting the euro, which it hoped to do in 2006. Prime Minister Mikulas Dzurinda told reporters, "It is true that we have agreed on a single rate [income and VAT] tax, we agreed on the rate itself [19 per cent], we agreed on a single VAT. We can thus prepare the necessary legislation, draft laws, to be approved by the government of the Slovak Republic and then by parliament."[184]

The Slovak Republic's 2004 VAT increase was a continuation of a tax reform that unifies the 14 percent (reduced) and 20 percent (standard) vat rates into a uniform 19 percent rate. As such, we classify this change as substitution-driven.

[183] Slovak cabinet approves 19-per-cent VAT
BBC Monitoring European - Political [London] 28 May 2003: 1.
[184] "Slovak Coalition Determined To Meet Maastricht Criteria," *BBC Monitoring European – Political* (London), May 27, 2003, p. 1.

Sources:

IMF. Concluding Statement. IMF Staff Visit to the Slovak Republic, October 7-15, 2003. http://www.imf.org/external/np/ms/2003/101503.htm

IMF. Country Report No. 03/234. Slovak Republic: 2003 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Slovak Republic. August 233. http://www.imf.org/external/pubs/ft/scr/2003/cr03234.pdf

IMF. Public Information Notice No. 05/24. IMF Executive Board Concludes 2004 Article IV Consultation with the Slovak Republic. http://www.imf.org/external/np/sec/pn/2005/pn0524.htm

"Slovak Coalition Determined To Meet Maastricht Criteria." *BBC Monitoring European – Political* (London) May 27, 2003, p. 1.

3. Tax change of 2011

Legislation was passed to increase VAT from 19 percent to 20 percent on December 1, 2010.[185]
Implementation occurred on January 1, 2011.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Brief background material and description of nature of tax rate change

The Slovak economy grew strongly from 2004-2008. The effects of the global financial crisis did not hit Slovakia until much later than it hit other countries due to solid fundamentals and a well-capitalized financial sector. The Slovak Republic successfully adopted the euro at the beginning of 2009, but the decline of the euro hampered output in the first quarter. Recession hit in 2009 because of the economy's high degree of dependence on its trading partners, but the recovery was strong relative to most of Slovakia's neighbors due to strong exports. IMF staff anticipated that Slovakia's 2011 growth would exceed 3½ percent of GDP and would be among the highest in the European Union. However, unemployment remained high at 14.4 percent in 2010.

Slovakia, like most countries, experienced rising deficits and government debt during the global financial crisis. General government deficits widened to 7.9 percent and 7.8 percent of GDP in 2009 and 2010 respectively due to declining tax revenue. Expenditure continued to grow at the pre-crisis pace despite a targeted stimulus package because the cost of the stimulus was offset by decreases in other spending. The general government debt rose from 29.6 percent of GDP in 2007 to a projected 44.4 percent of GDP in 2011.

The 2011 budget included significant fiscal consolidation measures intended to shrink the general government deficit to 5 percent of GDP. The 2011 VAT increase, which raised the rate to 20 percent, was the primary change. Excise taxes were also increased. Spending cuts were made in the public wage bill, subsidies, and investment. The focus was deficit reduction.

The Slovak Republic's 2011 VAT increase falls into the category of deficit-driven tax increases.

Sources:

IMF. Country Report No. 11/122. Slovak Republic: 2011 Article IV Consultation – Staff Report; Informational Annex; and Public Information Notice on the Executive Board Discussion. June 2011. http://www.imf.org/external/pubs/ft/scr/2011/cr11122.pdf

IMF. Public Information Notice No. 11/68. IMF Executive Board Concludes 2011 Article IV Consultation with Slovak Republic. May 31, 2011. http://www.imf.org/external/np/sec/pn/2011/pn1168.htm

"Report Details Main Points of Slovak State Budget for 2011." *BBC Monitoring European* (London) December 12, 2010.

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[185] Report details main points of Slovak state budget for 2011
Anonymous. BBC Monitoring European [London] 12 Dec 2010.

Country: Slovenia

1. Tax change of 2002

Legislation was passed to increase VAT from 19 percent to 20 percent on October 1, 2001.[186]
Implementation occurred on January 1, 2002.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Brief background material and description of nature of tax rate change

Modern Slovenia formed in 1991 after the breakup of Yugoslavia. Slovenia was one of the most successful transition economies during the 1990s. Slovenia approached structural reforms at a moderate pace, practiced tight monetary policy, and kept inflation low. Fiscal deficits were low and government debt was held at about 25 percent of GDP. Slovenia enjoyed strong competitiveness and had the highest investment rating and highest per capita income among transition countries in 2001.

Slovenia's growth slowed in 2001 when domestic demand plummeted and external demand fell as well. The growth rate of real GDP fell from 4.5 percent to 3 percent.

Slovenia introduced a value-added tax in 1999 to meet one of the conditions for integration into the EU. The rate was set at 19 percent initially. Slovenia planned reforms to the tax system for 2003; changes were expected to result in losses in revenue from direct taxes, which were to be offset by a 1 percentage-point increase in the VAT.

This VAT increase had originally been planned for 2003 but was brought forward to 2002 to help Slovenia's medium-term deficit reduction goal. The government's medium-term fiscal objective was to eliminate the fiscal deficit by 2005, primarily through expenditure reduction. The 2002 budget targeted a general government deficit of 1.1 percent of GDP.

We classify Slovenia's 2002 VAT increase as primarily deficit-driven.

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[186] http://europa.eu/legislation_summaries/enlargement/2004_and_2007_enlargement/slovenia/e10110_en.htm

Sources:

Aris, Ben. “Slovakia, Slovenia Unlikely to See Economic Gain without Pain.” *McClatchy – Tribune Business News* (Washington]) March 21, 2004, p. 1.

IMF. Country Report No. 02/77. Republic of Slovenia: 2002 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Slovenia. April 2002. http://www.imf.org/external/pubs/ft/scr/2002/cr0277.pdf

IMF. Public Information Notice No. 02/39. IMF Concludes 2001 Article IV Consultation with the Republic of Slovenia. April 4, 2002. http://www.imf.org/external/np/sec/pn/2002/pn0239.htm

Country: South Africa

1. Tax change of 1993

Legislation was passed to increase VAT from 10 percent to 14 percent on March 1, 1993.[187]
Implementation occurred in April 1993.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

South Africa was in the process of ending apartheid in the early 1990s. It was also experiencing its most severe recession since the 1930s.

> By the fourth quarter of 1992, when the current depression appeared to have bottomed out, real GDP had shrunk for three successive years, real income per capita was 15 percent lower than in the early 1980s, and an estimated 45 percent of the labor force was unable to find employment in the formal sector. The 1989-93 recession took place in the context of a long-term secular decline in growth: from 5-6 percent a year on average during the 1960s and 3-3 percent percent a year during the 1970s to 1 percent percent a year in the 1980s... Growth during the 1980s was not enough to absorb a labor force growing at 2.7 percent per year or to raise real per capita income.[188]

The 1989-93 recession was caused by political unrest, uncertainty about future policy, and consequent declines in gross fixed investment, trade and financial sanctions, and worsening terms of trade. As a result, South Africa pursued inward-looking policies including protective trade barriers. A severe drought in 1992 reduced agricultural production by a quarter.

South Africa's public finances deteriorated significantly during the recession, with deficits rising from 2 percent of GDP in 1989/90 to 8.5 percent of GDP in 1992/93. Government debt was 45 percent of GDP in 1992, although foreign debt constituted less than 2 percent of GDP.

South Africa introduced a VAT in 1991 as a replacement for its general sales tax (GST), with the VAT consisting of a lower rate than the tax it replaced. The change resulted in large unanticipated declines in revenue, accounting for about ⅓ of the total increase in the deficit. Expenditure increased by about 4 percent of GDP, including 1 percent for increased debt payments and 1 percent for drought relief in 1992. The rest of the expenditure increases expanded social services to address the "social backlog" in services for black South Africans.

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[187] Go, Delfin, et al. "An Analysis of South Africa's Value Added Tax." N.d. *The World Bank*. Web. 9 Feb. 2016. http://web.worldbank.org/archive/website01010/WEB/IMAGES/WPS3671_.PDF
[188] SM/93/255 p. 1

The March 1993 budget attempted to reverse the decline in the fiscal position. The chief revenue measure was an increase in the VAT rate from 10 percent to 14 percent, although this was partly offset by cuts in corporate income taxes. Other revenue increases were achieved by not indexing income tax brackets and by a new tax on dividends.

The VAT hike was aimed at reducing the fiscal deficit as a consequence of the 1991/1992 fall in output. As such, we classify this tax change as a procyclical action.

Sources:

IMF Archives. SM/93/255. Master Files Room C-525 0450. South Africa – Selected Economic Issues. December 10, 1993.

IMF Archives. SM/95/9. Master Files Room C-525 0450. South Africa – Selected Economic Issues. January 20, 1995.

IMF Archives. SM/95/113. Master Files Room C-525 0450. South Africa – Background Material for the WTO. May 17, 1995.

Country: Spain

1. Tax change of 1995

Legislation was passed to increase VAT from 15 percent to 16 percent on September 1, 1994.[189]
Implementation occurred on January 1, 1995.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

Spain's real GDP grew at an annual rate of 4.8 percent in the late in 1980s after extensive trade liberalization and entry into the European Union in 1986. However, unemployment remained high, at above 16 percent, while inflation rose. Monetary policy was tightened, but inflation continued to increase. The currency appreciated and domestic demand weakened in 1990-1991.

The weakening economy resulted in Spain's great susceptibility to the European Exchange Rate Mechanism (ERM) crisis that hit in September 1992 when the United Kingdom withdrew the pound sterling from the ERM. In result, Spain entered recession, with real GDP falling 1.1 percent in 1993 and unemployment reaching 23 percent.

Demand for exports increased significantly in mid-1993 and the recession ended in 1994, with real GDP increasing by 2.2 percent for the year. However, unemployment continued to rise. The falling value of the currency and growing demand from the rest of Europe supported the recovery.

Deficits grew from 2.8 percent to 7.5 percent of GDP between 1989 and 1993, due to both the recession and Spain's lax expenditures policy. In July 1994 the Spanish government submitted a Convergence Plan to the European Council that set out targets for deficit reduction with the goal of achieving the Maastricht Treaty deficit limit of 3 percent of GDP by 1997. Most of the reduction was to come from expenditure reduction, including a number of labor market reforms including limits on public sector wage increases, and reforms to unemployment compensation. Revenue measures included a 1 percentage point increase in the VAT rate, partly offset by a reduction in contribution rates to social security. The VAT revenues were earmarked for the social security system.

Spain's 1995 VAT increase falls into the category of tax substitution (reducing social security taxes).

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[189] By, C. V. (1994, Sep 30). Spain's draft budget aims to pare deficit without sacrificing its social spending. Wall Street Journal Retrieved from http://search.proquest.com/docview/308149819?accountid=8505

Sources:

IMF Archives. SM/93/262. Master Files Room C-525 0450. Spain – Staff Report for the 1993 Article IV Consultation. December 27, 1993.

IMF Archives. SM/96/72. Master Files Room C-525 0450. Spain – Staff Report for the 1996 Article IV Consultation. March 27, 1996.

IMF Archives. SM/96/77. Master Files Room C-525 0450. Spain – Recent Economic Developments. April 3, 1996.

2. Tax change of 2010

Legislation was passed to increase VAT from 16 percent to 18 percent on September 26, 2009.[190]
Implementation occurred on July 1, 2010.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Spain grew rapidly from the mid-1990s until its real-estate boom burst in 2007. The end of the housing boom, which was largely supported by cheap credit, combined with the global financial crisis, pushed Spain into recession. Real GDP growth slowed from 4 percent in 2006 to 0.9 percent in 2008 and output fell by 3.4 percent in 2009. Unemployment increased to 20 percent, partly due to wage and working-hour rigidities. After running surpluses in the mid-2000s, the general government deficit reached 11.2 percent in 2009.

Growth began to pick up in the first quarter of 2010 as exports started to recover. However, unemployment remained extremely high at 21 percent and inflation was accelerating. The IMF and other international organizations called for major labor market reforms as well as deficit reduction.

Spain implemented major fiscal, financial, and labor market reforms in 2010. The government targeted the return of deficits to 3 percent of GDP by 2013. The fiscal reforms in the 2010 Budget and Stability Program increased VAT and income tax rates, cut transfers and subsidies, reduced public investment, and restricted public hiring. An additional fiscal package made additional changes including cutting public sector wages and was seen as an important signal of Spain's commitment to the adjustment. Financial reforms included a new savings bank law.

Spain's 2010 VAT increase, like most of the tax increases passed immediately following the global financial crisis, is a procyclical one.

[190] Spanish Budget Calls for Higher Taxes, JASON SINCLAIR and JONATHAN HOUSE, Wall St Journal, September 26, 2009, http://online.wsj.com/article/SB125397414808443645.html

Sources:

IMF. Country Report No. 10/254. Spain: 2010 Article IV Consultation – Staff Statement; Staff Supplement; Staff Report; Statement by the Executive Director for Spain; and Public Information Notice on the Executive Board Discussion. July 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10254.pdf

IMF. Country Report No. 11/215. Spain – Staff Report for the 2011 Article IV Consultation; Public Information Notice; Statement by the Staff Representative; and Statement by the Executive Director for Spain. July 2011. http://www.imf.org/external/pubs/ft/scr/2011/cr11215.pdf

IMF. Public Information Notice No. 10/106. IMF Executive Board Concludes 2010 Article IV Consultation with Spain. July 30, 2010. http://www.imf.org/external/np/sec/pn/2010/pn10106.htm

"Salgado Sees Only Half of Tax Hike Being Passed On." *El Pais* (Madrid) March 10, 2010, p. 7.

3. Tax change of 2012

Legislation was passed to increase the VAT rate from 18 percent to 21 percent on April 27, 2012.[191]
Implementation occurred on September 1, 2012.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

In 2012, Spain continued to suffer from a recession as well as its debt crisis. It experienced a double-dip recession, with unemployment reaching 24 percent (and over 50 percent among young workers). GDP was expected to continue to contract due to the need for more austerity measures to combat government deficits, public debt, and the market reaction to Spanish bonds.

The Spanish government was making strong efforts to enact and implement reforms. Reforms to the banking sector and support from the EU community helped improve the financial situation. Significant fiscal measures were passed in December 2011, with further reforms in the 2012 budget. However, the fiscal deficit turned out to be larger than expected in 2011. To make matters worse, the Spanish government was slow to release updates about the budget situation, ultimately weakening the government's credibility. Labor reform was introduced in February 2012.

On July 10, 2012, the EU granted Spain another year to bring its deficits below the 3 percent of GDP limit before imposing penalties. In addition, the EU loosened the deficit targets for 2012-2014. The deficit path set was 6.3 percent of GDP in 2012, falling to 2.8 percent of GDP in 2014. The next day, the Spanish prime minister announced a new fiscal package of measures intended to meet those deficit targets; the VAT increase from 18 percent to 21 percent was part of this package. Other measures included increases to other indirect taxes, the elimination of the mortgage income tax deduction, the elimination of a December extra payment to civil servants, and a reduction in employment and Social Security contributions. The IMF estimated that this package would bring deficits close to target levels but further adjustments would be necessary.

Despite the actions of the Spanish government to stabilize the economy, there was strong concern that the situation could deteriorate significantly.

> ...market confidence remains weak. Spain has suffered a sharp reversal of private external financing flows in the second half of 2011 and early 2012. After an LTRO-induced respite, market tensions re-emerged in the spring. Yields and spreads on Spanish government bonds remain high and banks unable to tap private unsecured financing.

[191] Spain raising VAT, cutting spending in 2013 budget. (2012, May 03). BBC Monitoring European Retrieved from http://search.proquest.com/docview/1010725418?accountid=8505

Public debt was also rising rapidly, from 68.5 percent of GDP in 2011 to a predicted 89.6 percent of GDP in 2012. By mid-July, the debt crisis had returned.

The VAT hike was aimed at reducing the fiscal debt and deficit as a consequence of the early 2012 fall in output. As such, we classify this tax change as a procyclical action.

Source:

Evans-Pritchard, Ambrose. "Spanish Debt Crisis Returns as Germany Nears Bailout Fatigue; Spanish Borrowing Costs Have Surged to Euro-Era Highs Despite Draconian Fiscal Cuts and Backing from the German Parliament for the Country's (EURO)100bn (£78bn) Bank Rescue Package." *The Telegraph* July 19, 2012.

IMF. 2012 Article IV Consultation with Spain: Concluding Statement of the IMF Mission. June 14, 2012. http://www.imf.org/external/np/ms/2012/061512.htm

IMF. Country Report No. 12/202. Spain: 2012 Article IV Consultation. July 2012. http://www.imf.org/external/pubs/ft/scr/2012/cr12202.pdf

IMF. Public Information Notice No. 12/87. IMF Executive Board Concludes 2012 Article IV Consultation with Spain. July 27, 2012. http://www.imf.org/external/np/sec/pn/2012/pn1287.htm

Country: Sweden

1. Tax change of 1980

Legislation was passed to increase VAT from 20.63 percent to 23.46 percent on September 6, 1980.[192]
Implementation occurred on September 8, 1980.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Background

Sweden's economy slowed in the second half of the 1970s after the oil price shocks. Rigid labor markets and rapid wage growth, declining competitiveness in the steel and shipyard industries, and low levels of investment weakened key industries. The Swedish economy exited the recession following the 1976 oil price shocks in 1977 and real GDP grew at a rate of 3.4 percent in 1979. Growth continued through the first quarter of 1980.

Labor markets were very tight and unemployment was at only 2.1 percent in 1979. Major strikes in April and May 1980, among both public and private sector workers, caused an output loss amounting to 0.5 percent of GDP. The subsequent wage agreement increased domestic demand and raised concerns about a twin deficit problem as the fiscal and current account deficits expanded rapidly. The oil price shocks of the mid-1970s, rising competition from Japan and other countries, and declining demand for exports pushed up the current account deficit to 2.5 percent of GDP in 1979 and 4.3 percent of GDP in 1980. After running a general government surplus during the mid-1970s, the fiscal deficit grew quickly after 1976 because of commitments to expand social insurance and other social programs. By 1979, the fiscal deficit had reached 5.6 percent of GDP. These spending commitments, which were made in the 1960s and early 1970s, could not be met sustainably after the productivity slowdown in the mid-1970s. In particular, the pension scheme introduced in 1960 obligated the government to raise the real value of pensions annually at a rate of 3-4 percent.

The Swedish government introduced measures in September and October 1980 aimed at curtailing government expenditure, particularly in the areas of social benefits, transfers to local authorities, and industrial policy. The government also enacted revenue measures including increases in the VAT rate and other indirect taxes.

> Parliament decided today by a one vote margin to give Sweden the highest value-added tax in Europe. The tax will rise on Monday to 23.46 percent from 20.63, overtaking Denmark's VAT, as the value-added tax is known, of 22 percent as the highest in Europe…The 173-to-172 vote during a special session was a key victory for the three-

[192] Swedes to pay europe's highest value-added tax. (1980, Sep 07). New York Times (1923-Current File) Retrieved from http://search.proquest.com/docview/121028616?accountid=8505

> party center-right government's program to limit consumption and reduce the balance-of-payments deficit, which is expected to be $4.8 billion this year.[193]

Sweden's 1980 VAT increase responds to a deficit-driven motivation.

Sources:

IMF Archives. SM/81/211. Sweden – Recent Economic Developments. November 6, 1981.

"Swedes To Pay Europe's Highest Value-Added Tax." *The New York Times* (New York) September 7, 1980, p. 8.

[193] "Swedes To Pay Europe's Highest Value-Added Tax," *The New York Times* (New York), September 7, 1980, p. 8.

2. Tax change of 1981

Legislation was passed to decrease VAT from 23.46 percent to 21.51 percent on September 15, 1981.[194]
Implementation occurred on November 16, 1981.
Narrative classification: Exogenous – Long-run growth.

Brief background material and description of nature of tax rate change

Sweden's rate of real GDP growth slowed significantly from 3.4 percent of GDP, in 1979, to only 1.4 percent, in 1980. Major strikes in April and May 1980, in both the public and private sectors, netted large wage increase agreements and prompted the Swedish government to pass a package of expenditure cuts and tax increases in late 1980 to address rapidly growing fiscal and current account deficits.

Output held constant in 1981 with GDP growth forecast at 0.2 percent for the year as of November. A wage agreement in February 1981 helped improve competitiveness.

The government continued the strategy begun in 1980 that cut expenditure to help bring about necessary adjustments to the price shocks and productivity declines of the 1970s as well as reduce the current account and fiscal deficits. The Swedish government passed several measures in September 1981 to improve competitiveness and address the current account deficit. It devalued the currency by 10 percent and decreased the VAT to offset the impact of the devaluation on prices, which the government wished to hold constant.

> Sweden's devaluation of the krona last week, accompanied by measures to dampen inflation and stimulate industrial output, is the Government's final effort to stop a deterioration in the country's economic performance that began during the early 1970s. If this package does not work, the Swedish voters at the next general election in September, 1982, will certainly return the ruling Liberal alliance to the political wilderness from which it emerged six years ago when it broke 44 years of Social Democratic rule....The Government has opted for devaluation as the medicine likely to work most quickly. It has also taken the unusual course of combining devaluation with a cut in the value-added tax. In economic theory, devaluation would usually be accompanied by a rising VAT to hold back consumption. The cut in VAT is seen as compensation to wage earners for the loss in purchasing power caused by devaluation and is intended to stop the price index from rising to levels that would trigger new wage demands. Government economists see the cut in VAT as giving the Government the leverage to effect cuts in public spending that it

[194] Reuters. (1981, Sep 15). STOCKHOLM DEVALUES CROWN TO AID ECONOMY. New York Times Retrieved from http://search.proquest.com/docview/424187845?accountid=8505

would otherwise not have dared to make for fear that it would be accused of creating unemployment.[195]

Some news sources also cited the VAT as intended to spur output.[196] At the same time, the government announced a major employment program providing more public-sector construction jobs.

The VAT cut was set at about 3 percentage points at the time of the currency devaluation in September 1981. However, in October the government and the conservative opposition reached a compromise agreement that the VAT would only fall by 2 percentage points to 21.5 percent.[197] The 21.5 percent rate went into effect on November 16.

We categorize the 1981 Swedish VAT decrease as a long-term growth action.

Sources:

IMF Archives. IMF Archives. SM/81/211. Sweden – Recent Economic Developments. November 6, 1981.

OECD. Economy Surveys. Sweden. July 1982. http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-surveys-sweden-1982_eco_surveys-swe-1982-en

"Sweden Turns To Devaluation To Halt Economic Decline." *The Globe and Mail* (Toronto, Ont) September 21, 1981, p. 7.

"Stockholm Devalues Crown To Aid Economy." *New York Times* (New York) September 15, 1981, p. D19.

[195] "Sweden Turns To Devaluation To Halt Economic Decline," *The Globe and Mail* (Toronto, Ont), September 21, 1981, p. 7.

[196] "Stockholm Devalues Crown To Aid Economy," *New York Times* (New York), September 15, 1981, p. D19.

[197] OECD, Economy Surveys: Sweden, July 1982, p. 56, http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-surveys-sweden-1982_eco_surveys-swe-1982-en. http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-surveys-sweden-1982_eco_surveys-swe-1982-en

3. Tax change of 1983

Legislation was passed to increase VAT from 21.51 percent to 23.46 percent on December 16, 1982.[198]
Implementation occurred on January 1, 1983.
Narrative classification: Endogenous – Offsetting (spending).

Brief background material and description of nature of tax rate change

In the early 1980s Sweden suffered from a twin deficit problem comprised of a large current account deficit and fiscal deficit. These problems developed after the oil price shocks in the mid-1970s. Rising wages and loss of competitiveness in key industries, combined with labor market rigidities and subsidies for deteriorating industries resulted in slow adjustment.

> By the early 1980s, the two deficits had become entrenched, making the return to overall economic equilibrium more difficult. As a share of GDP gross investment fell from around 24 per cent in the mid-1970s to about 18 percent in 1982. Gross savings fell even more, or by about 10 percentage points. Accordingly, the economy had to resort increasingly to foreign financing, and in 1982 the deficit on the external current account was equivalent to 3.7 percent of GDP, compared with near balance in the mid-1970s. This deterioration of the financial balance of the economy originated principally in a poor savings performance of the public sector.

A new government took office in late 1982 after general elections in September. The government devalued the currency for the second time in two years. It also pursued a crisis program aimed to "increase production and raise full employment."[199] The program raised the VAT to 23.46 percent in 1983 to cover the cost of restoring benefits cut by the previous government. The VAT hike was passed in December and went into effect in 1983. Payroll taxes, inheritance taxes, and other taxes were also increased. The new government set out an agenda for structural reform to reduce the growth rate of public expenditure and control the fiscal deficit. Constraining wage settlements was crucial, and the government combined calls for wage restraint with imposition of special taxes on corporate profits and dividends and introduced a wage earners' fund to help win union cooperation.

We categorize the 1983 Swedish VAT increase as tax substitution since it was raised to cover the cost of restoring benefits cut by the previous government.

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[198] AROUND THE WORLD palme wins vote on tax. (1982, Dec 17). The Globe and Mail Retrieved from http://search.proquest.com/docview/386504267?accountid=8505
[199] OECD, Economic Surveys: Sweden. February 1984. http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-surveys-sweden-1984_eco_surveys-swe-1984-en

Sources:

Apple, R. W. Jr. “Social Democrats Favored in Sweden.” *The New York Times* (New York) September 19, 1982, p. A17.

Feder, Barnaby J. “Swedes Rankled By Taxes.” *The New York Times* (New York) April 25, 1983, p. D6.

IMF Archives. SM/84/179. Master Files Room C-120 01. Sweden – Recent Economic Developments. July 23, 1984.

OECD. Economic Surveys. Sweden. February 1984. http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-surveys-sweden-1984_eco_surveys-swe-1984-en

4. Tax change of 1990

Legislation was passed to increase VAT from 23.46 percent to 25 percent on November 1, 1989.[200]
Implementation occurred on July 1, 1990.
Narrative classification: Endogenous – GDP-driven (countercyclical).

Background

Sweden's economy suffered from a large current account deficit and fiscal deficit during the second part of the 1970s and early 1980s. Coupled with other reforms, competitiveness improved after two large currency devaluations in 1981 and 1982. Sweden grew steadily in 1985-86, but the economy began to overheat in 1987. Rapid demand growth and a resumption of high wage increase agreements led to an increase in the current account deficit from ¾ percent in 1987 to 2 ¾ percent in 1989.

Unemployment was at 1.4 percent in 1989, with labor markets for skilled labor particularly tight. Wage settlements in the financial sector and among local government employees increased wages 12-20 percent, harming competitiveness. GDP growth slowed from 3 percent in 1987 to 2 percent in 1989. In addition, inflation rose to 6 ½ percent in 1989 and continued to rise in 1990.

The government took action to slow the growth of domestic demand. In April, the government legislated a temporary increase in VAT rates from 23.5 to 25 effective July-December 1990. (The temporary increase was made permanent later that year). Other changes included the end of a price and rent freeze passed in March 1990 and postponement of promised increases in benefits.

We classify the 1990 Swedish VAT increase as a countercyclical action.

Sources:
IMF Archives. SM/90/151. Master Files Room C-525 0450. Sweden – Recent Economic Developments. August 2, 1990.

[200] By, S. D. (1989, Nov 06). Sweden close to starting tax overhaul, but plan may fall short of early hopes. Wall Street Journal Retrieved from http://search.proquest.com/docview/398125452?accountid=8505

Country: Switzerland

1. Tax change of 1999

Legislation was passed to increase VAT rate from 6.5 percent to 7.5 percent on June 1, 1998.[201]
Implementation occurred on January 1, 1999.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Background

Switzerland experienced a long period of economic stagnation between 1991-1996, with average growth rates of only 1 percent of GDP. Unemployment grew from ½ percent to 5 ¼ percent between 1990 and 1997. Policy changes, beginning in 1995 with the relaxation of monetary policy and the later currency depreciation and fiscal stimulus, helped bring about a recovery in 1997. Growth slowed again in 1998 as demand for exports fell due to effects from the Asian crisis. Exports accounted for about 40 percent of Swiss GDP, and the IMF anticipated that growth would slow further as the effects of the crisis continued.

Switzerland ran a budget surplus for much of the 1980s, but in 1997 the deficit reached 2 ¼ percent of GDP and remained at almost 2 percent of GDP in 1998. While low by international standards, the rapid deficit growth alarmed the Swiss electorate. In June 1998, voters approved a constitutional amendment requiring the federal government to balance the budget by 2001. Annual deficit ceilings were imposed and an additional, more stringent constitutional amendment was planned for 2001.

The VAT rate was increased by one percentage point to 7.5 percent, effective January 1, 1999, to address the deficit in the state pension program. Further VAT increases were anticipated to address deficits in the social security system.

Switzerland's 1999 VAT increase falls into the category of deficit-driven VAT increases.

Sources:

IMF. Country Report No. 00/23. Switzerland: Staff Report for the 1999 Article IV Consultation. February 2000. http://www.imf.org/external/pubs/ft/scr/2000/cr0023.pdf

IMF. Public Information Notice No. 99/14. IMF Concludes Article IV Consulation with Switzerland. March 1, 1999. http://www.imf.org/external/np/sec/pn/1999/pn9914.htm

Williams, Frances. "International Climate Could Halt Tentative Recovery:" *Financial Times* (London) October 13, 1998, p. 2.

[201] http://www.oberson.ch/images/articles/VATMonitor1999.pdf

2. Tax change of 2001

Legislation was passed to increase VAT from 7.5 percent to 7.6 percent on September 1, 1999.[202]
Implementation occurred on January 1, 2001.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Background

Switzerland experienced a long period of economic stagnation between 1991-1996. Recovery began in early 1997, but was subdued by weak export demand following the Asian crisis. A surge in export demand in 2000 combined with strong domestic demand to generate strong economic performance with GDP growth rising to 4 percent in early 2000 before moderating to 3 ½ percent for the year. The current account surplus was nearly 13 percent of GDP.

Concerns about overheating prompted adjustments in monetary policy to head off inflation, which remained below 2 percent in 2000. Switzerland adopted a new monetary policy framework that focused on medium-term price stability, while the old framework used monetary targets.

Switzerland's fiscal policy was dominated by a constitutional requirement to balance the budget in order to prevent further increases in the debt-to-GDP ratio. After running surpluses during the 1980s, deficits grew rapidly during the economic stagnation of the early 1990s, reaching 2.4 percent during 1997. Local governments also ran large deficits. In 1998, voters approved a constitutional amendment requiring balanced budgets by 2001 and annual deficit ceilings as a percentage of GDP. Subsequent changes allowed the budget to vary with the economic cycle, although balance was still required on average.

The general government deficit had fallen to 0.4 percent of GDP in 1999 and a surplus of 1.8 percent of GDP was recorded in 2000. However, much of the decrease was due to one-time revenue windfalls, including the interest withholding tax and stamp duties on securities transactions.

The 2001 budget did not include major initiatives. The most significant change was new exemptions on stamp duties on security transactions. The VAT was increased by 0.1 percentage points, to 7.6 percent, and the revenue was allocated to the traffic fund.[203]

Switzerland's 2001 VAT increase falls into the category of inherited fiscal deficit-driven VAT increases.

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[202] http://uk.practicallaw.com/5-101-1316?q=&qp=&qo=&qe=

[203] Frank Bodmer and Alain Geier, "Estimates for the Structural Deficit in Switzerland, 2002 to 2007," *OECD Journal on Budgeting* 4(2), p. 89. http://www.oecd.org/dataoecd/0/5/44477987.pdf

Sources:

Bodmer, Frank and Alain Geier. "Estimates for the Structural Deficit in Switzerland, 2002 to 2007." *OECD Journal on Budgeting* 4(2): 77- 100. http://www.oecd.org/dataoecd/0/5/44477987.pdf

IMF. Switzerland – Article IV Consultation. Concluding Statement. January 29, 2001. http://www.imf.org/external/np/ms/2001/012901.htm

IMF. Country Report No. 01/74. Switzerland: 2001 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of Switzerland. May 2001. http://www.imf.org/external/pubs/ft/scr/2001/cr0174.pdf

IMF. Country Report No. 01/75. Switzerland: Selected Issues. May 2001. http://www.imf.org/external/pubs/ft/scr/2001/cr0175.pdf

IMF. Public Information Notice No. 01/49. IMF Concludes Article IV Consultation with Switzerland. May 21, 2001. http://www.imf.org/external/np/sec/pn/2001/pn0149.htm

3. Tax change of 2011

Legislation was passed to increase VAT from 7.6 percent to 8 percent on April 21, 2010.[204]
Implementation occurred on January 1, 2011.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Background

Switzerland grew rapidly from 2004-2007. Recession began in the second half of 2008 with the onset of the global financial crisis, causing real GDP to fall by 1.9 percent in 2009. A strong recovery began and GDP growth rebounded to 2.6 percent.

> Domestic demand was underpinned by sound balance sheets, low interest rates, and a rebound in employment and immigration. Exports increased more strongly than expected, on the back of robust external demand and in spite of a 10-percent appreciation in the real effective exchange rate. Trade and current account surpluses have continued to expand. Capacity utilization, particularly in construction, is now above its long-term average while the unemployment rate has gradually declined. Despite the surge in oil prices and declining slack in the economy, inflationary pressures, so far, remain muted. House prices have accelerated but there is so far no evidence of a widespread misalignment.
>
> Monetary policy has supported a swift exit from the recession....Fiscal policy provided limited stimulus [of about ¾ of a percent in 2009 and 2010] during the crisis given small automatic stabilizers, a moderate package of policy measures, and conservative application of the debt brake fiscal rule. Thus, overall fiscal balances were little affected by the downturn.[205]

Switzerland’s public finances are constrained by many rules, including a constitutional requirement to balance the budget (although it allows for changes over the economic cycle). Despite the economic downturn associated with the global financial crisis, both the federal government balance and the general government balance remained in surplus throughout the 2007-2010 period with a general surplus of 0.2 percent of GDP in 2010. In addition, the debt-to-GDP ratio hovered around 55 percent of GDP throughout the period.

Despite the general government surplus, Switzerland struggled to maintain balance in social entitlement programs as its population aged. Voters in 2010 chose to increase the VAT rate from 7.6 percent to 8 percent in 2011 in order to address deficits in the disability insurance program. “Regarding disability insurance, the temporary increase in VAT will cover its deficit for the next six years.”[206]

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[204] http://www.admin.ch/ch/e/rs/641_20/a25.html#fn1

[205] IMF., Public Information Notice No. 11/62, IMF Executive Board Concludes 2011 Article IV Consultation with Switzerland, May 26,2011, http://www.imf.org/external/np/sec/pn/2011/pn1162.htm

[206] IMF, Country Report No. 10/140, Switzerland: 2010 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; Statement by the Executive Director for Switzerland, and Informational Annex, May 2010, p. 33, http://www.imf.org/external/pubs/ft/scr/2010/cr10140.pdf

Switzerland's 2011 VAT increase falls into the category of deficit-driven VAT increases and was enacted to address an inherited budget deficit in the disability insurance program.

Source:

Blackaby, Anna. "Leaders Urged: Don't Rule Out a Rise in VAT." *Birmingham Post* (Birmingham, UK) April 15, 2010, p. 8.

IMF. Country Report No. 10/140. Switzerland: 2010 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; Statement by the Executive Director for Switzerland, and Informational Annex. May 2010. http://www.imf.org/external/pubs/ft/scr/2010/cr10140.pdf

IMF. Country Report No. 11/115. Switzerland: 2011 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Switzerland. May 2011. http://www.imf.org/external/pubs/ft/scr/2011/cr11115.pdf

IMF. Public Information Notice No. 11/62. IMF Executive Board Concludes 2011 Article IV Consultation with Switzerland. May 26,2011. http://www.imf.org/external/np/sec/pn/2011/pn1162.htm

Country: Thailand

1. Tax change of 1997

Legislation was passed to increase VAT from 7 percent to 10 percent on August 5, 1997.[207]
Implementation occurred on August 16, 1997.
Narrative classification: Endogenous – GDP-driven (procyclical).

Background

Thailand grew rapidly for a decade before the onset of the Asian financial crisis in the summer of 1997. Real GDP growth rates exceeded 8 percent in 1994 and 1995 before slowdowns in export demand and export growth reduced the GDP growth rate to 6.4 percent in 1996.

However, large capital inflows facilitated by the pegged exchange rate and open capital account resulted in rising credit and short-term external debt. The current account deficit rose to 8 percent of GDP in 1995 and 7.9 percent in 1996. The subsequent sharp drop in export demand, combined with weaknesses in the financial system and the bursting of a property sector bubble, prompted a collapse. The Bank of Thailand attempted to address speculative attacks on the currency, but the authorities abandoned the exchange rate peg on July 2, 1997. This increased the burden from foreign debt.

The IMF and the Thai government agreed to an economic adjustment program in August 1997 and Thailand received access to more than U.S. $17 billion in financing. The program called for comprehensive restructuring of the financial sector and other reforms. The key program objectives were a recovery of output growth, inflation reduction, a decline in the current account deficit to 3-4 percent of GDP, and restoration of foreign exchange reserves.

The VAT rate increase from 7 to 10 percent was part of a set of changes designed to help correct the current account imbalance that contributed to the crisis. It contributed to the goal of converting 1997's fiscal deficit of 1.6 percent of GDP to a surplus of 1 percent of GDP.

Thailand's 1997 VAT increase falls primarily into the category of procyclical changes due to the collapse in output associated with the Asian financial crisis.

Sources:

[207] Sherer, P. M. (1997, Aug 05). Thailand, IMF moving closer to agreement. Wall Street Journal. Retrieved from http://search.proquest.com/docview/398690397?accountid=8505

IMF. Press Information Notice No. 98/44. IMF Concludes Article IV Consultation with Thailand. June 25, 1998. http://www.imf.org/external/np/sec/pn/1998/pn9844.htm

IMF. Thailand. Letter of Intent. August 14, 1997. http://www.imf.org/external/np/loi/081497.htm

"Thailand Shelves VAT Increase." *The Wall Street Journal Asia* (Hong Kong) February 5, 2003, p. A3.

"Thailand'' IMF Solution." *The Wall Street Journal* (Brussels) August 13, 1997, p. 8.

2. Tax change of 1999

Legislation passed to reduce the VAT from 10 percent to 7 percent on March 3, 1999.[208]
Implementation occurred on April 1, 1999.
Narrative classification: Endogenous – GDP-driven (countercyclical).

Background

Thailand's economy collapsed in the summer of 1997. Strong growth in the mid-1990s led to large capital inflows that increased use of short-term credit and worsened the current account deficit to 7.9 percent of GDP in 1996. Low levels of reserves and attacks on the currency in 1997 forced the government to abandon its exchange rate peg and increase the country's large amount of foreign-denominated short-term debt. Regional contagion worsened the crisis; GDP fell by 10.8 percent in 1998.

Thailand and the IMF agreed to an economic adjustment program and loan agreement in August 1997. As a result, Thailand began to rapidly introduce policy reforms as well as the financial system after a new government took over in November 1997. The reform efforts were successful at improving financial stability; bank recapitalization and privatization moved at a steady pace. The exchange rate was stable, inflation was low, and the current account deficit began to decline. GDP growth remained low, however, because of weak domestic demand, global effects of high oil prices, and the slow pace of nonperforming loan resolution.

Thai authorities attempted to revive domestic demand with a fiscal stimulus package passed on March 30. The government borrowed $1.45 billion from the IMF, World Bank, and Japanese government with plans to use the funds to create jobs and spur demand. It cut the value-added tax from 10 percent to its pre-crisis level of 7 percent, including income tax cuts. The IMF supported the stimulus package. "The package is "an important step in facilitating economic recovery," said Reza Moghadam, the IMF representative in Thailand. "The spending component of the package will strengthen the social safety net for those hurt most by the crisis, while achieving the maximum impact on domestic demand."[209] The VAT cut was legislated as a temporary cut to stay in place for two years, although it was extended later.

Thailand's 1999 VAT cut falls into the category of GDP-driven, countercyclical tax changes.

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[208] By, P. U. (1999, Mar 31). Thailand unveils details of stimulus plan --- package totals $3.5 billion, including tax cuts, spending to lift demand. Asian Wall Street Journal Retrieved from http://search.proquest.com/docview/315534136?accountid=8505

[209] Pichayaporn Utumporn, "Thailand Unveils Details of Stimulus Plan – Package Totals $3.5 Billion, Including Tax Cuts, Spending to Lift Demand," *Asian Wall Street Journal* (Hong Kong), March 31, 1999, p. 3.

Sources:

IMF. News Brief No. 99/16. IMF Completes Review and Approves Credit Disbursement for Thailand. April 7, 1999. http://www.imf.org/external/np/sec/nb/1999/nb9916.htm

IMF. Public Information Notice No. 00/110. IMF Concludes Post-Program Monitoring Discussion on Thailand. December 20, 2000. http://www.imf.org/external/np/sec/pn/2000/pn00110.htm

"Thailand: Tax Relief Spurs Huge Jump in Auto Sales." *The Vancouver Sun* (Vancouver, BC) June 16, 1999, p. D3.

Utumporn, Pichayaporn. "Thailand Unveils Details of Stimulus Plan – Package Totals $3.5 Billion, Including Tax Cuts, Spending to Lift Demand." *Asian Wall Street Journal* (Hong Kong) March 31, 1999, p. 3.

Country: United Kingdom

1. Tax change of 1979

Legislation was passed to increase VAT from 8 percent to 15 percent on June 12, 1979.[210]
Implementation occurred on June 18, 1979.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

The United Kingdom experienced a severe recession in 1975, partly due to a worldwide recession and partly due to declines in domestic industrial firms' liquidity and profitability. After two years of financial and economic recovery, real GDP growth in the United Kingdom slowed from 4 percent to 2 percent in 1979.

Elections in May 1979 replaced the Labour government of James Callaghan with the conservative Thatcher government. The Thatcher government took office during a time where there were concerns about inflation, which fell to 8 percent in 1978 but was accelerating again. The emergence of the United Kingdom as an oil producer also helped improve the country's external balance. The Thatcher government's priorities included inflation control, generating supply-side output, and employment growth.

Thatcher's government enacted major tax reform in 1979. Economic policy shifted away from short-term countercyclical measures and toward medium-term pro-growth policies. Tax policy shifted away from personal income taxation, with large cuts, especially to rates at the upper end of the income distribution, and toward VAT and indirect taxation.

> In 1979, [the United Kingdom's VAT] had a zero rate, a basic rate of 12.5 per cent charged on "luxury" items, and a reduced rate of 8 per cent on most other goods and services. When the Conservatives came to power that year, Geoffrey Howe, the Chancellor, increased both of these to a single rate of 15 per cent, to partially offset the impact of large cuts to basic and higher rates of Income Tax. This was portrayed as a deliberate move aimed at shifting the burden of taxation from earnings to consumption.[211]

The 1979 higher VATs was intended to substitute for income tax.

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[210] State holdings in industry to be sold Bold U.K. budget trims taxes,
raises prices
The Globe and Mail [Toronto, Ont] 13 June 1979: .2.
[211] Lindsay McIntosh, "Oh, VAT on Earth Does All of This Mean?" *The Scotsman* (Edinburgh), November 24, 2008, p. 18.

Sources:

IMF Archives. SM/76/153. United Kingdom – Staff Report for the 1976 Article VIII Consultation. July 7, 1976.

IMF Archives. SM/79/216. United Kingdom – Recent Economic Developments. August 15, 1979.

IMF Archives. SM/81/30. United Kingdom – Recent Economic Developments. February 5, 1981.

McIntosh, Lindsay. "Oh, VAT on Earth Does All of This Mean?" *The Scotsman* (Edinburgh) November 24, 2008, p. 18.

2. Tax change of 1991

Legislation was passed to increase VAT from 15 percent to 17.5 percent on March 19, 1991.[212]
Implementation occurred on April 1, 1991.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

The United Kingdom experienced a strong upswing in growth from 1982 until mid-1990.

> For most of the period, domestic demand grew in excess of the estimated rate of potential output growth (2 percent-3 percent), but the existence of a sizable gap in the labor market permitted output to respond in an environment of relatively stable inflation. However, in 1988 with the economy approaching capacity, the strong growth of domestic demand resulted in a sharp acceleration of prices and a marked deterioration of the external balance...[213]

Due to concerns about rising inflation, monetary policy was tightened and the United Kingdom entered a period of economic slowdown in 1989 and 1990. Domestic demand, however, continued to grow so that inflationary pressure and the external imbalance increased. By mid-1990, a severe downturn appeared possible.

The conservative Thatcher government controlled the United Kingdom throughout this period. Thatcher served as prime minister from 1979 until November 1990. The Thatcher government argued that overprovision of public services was rampant in the United Kingdom because of the weak connection between local spending and local tax collection. This weak connection was due to a complex system of allocating transfers from the central government to local governments, and to the difference between who paid taxes and who benefitted from services. Only the head of household was liable for the property tax, leaving many adults with no tax liability. In addition, local authorities could tax local businesses who could not participate in the election of the local council. To address these problems, in 1990 the United Kingdom replaced the property tax with a head tax known as the Community Charge, centralized the local taxation of businesses, and overhauled the method by which the central government allocated funds to local authorities. A principal objective of the reforms was to "contain local expenditures at affordable levels."[214]

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[212] The Guardian (London)
March 20, 1991
VAT buys Pounds 140 poll tax cut: Lamont keeps June election option, Pounds 1bn incentive for firms, Kinnock derides 'climbdown', Higher mortgage relief ends
BYLINE: By MICHAEL WHITE
[213] SM/91/18, United Kingdom – Recent Economic Developments, January 30, 1991, IMF Archives, p. 2.
[214] Ibid., p. 19.

The Community Charge was intensely unpopular due to its regressivity and was widely avoided and defaulted. In 1991, the VAT was increased from 15 to 17.5 percent in a revenue-neutral change to replace ⅓ of the unpopular Community Charge. "The government [announced] it was reducing the poll tax by 140 pounds (about $250) per person for the current year. That reduction was made possible by a permanent increase in the national sales tax, known here as the value-added tax or VAT, from 15 percent to 17.5 percent. There was nary a whimper of protest. So unpopular had the poll tax become that the steep increase in the VAT, which applies to everything except basic necessities, won relatively easy public acceptance – even though it seems likely to put a damper on consumer spending and thereby prolong the country's deep economic slump."[215]

The VAT increase in 1991 was intended to substitute for the so-called Community Charge.

Sources:
IMF Archives. SM/91/18. Master Files Room C-525 0450. United Kingdom – Recent Economic Developments. January 30, 1991.
IMF Archives. SM/92/17. Master Files Room C-525 0450. United Kingdom – Staff Report for the 1991 Article IV Consultation. January 28, 1992.
Eichel, Larry. "Conservatives in Britain Ax Hated Poll Tax." *Philadelphia Inquirer* (Philadelphia, PA) April 24, 1991, p. 12.

[215] Larry Eichel, "Conservatives in Britain Ax Hated Poll Tax," *Philadelphia Inquirer* (Philadelphia, PA), April 24, 1991, p. 12.

3. Tax change of 2008

Legislation was passed to decrease VAT from 17.5 percent to 15 percent on November 1, 2008.[216]
Implementation occurred on December 1, 2008.
Narrative classification: Endogenous – GDP-driven (countercyclical).

Brief background material and description of nature of tax rate change

The United Kingdom was hit hard by the 2008 global financial crisis. The UK financial sector was heavily impacted, and its exposure to the crisis was heightened by high household indebtedness and interdependence on other countries. Housing prices declined over 20 percent from peak value, and real GDP growth slowed from 2.6 percent in 2007 to 0.7 percent in 2008. In mid-July, GDP growth was projected at -4.2 percent in 2009.[217] Unemployment increased and inflation fell despite significant currency depreciation.

The British government responded to the crisis with significant fiscal and monetary stimulus.

> The measures included expansion of the Bank of England's liquidity facilities, significant public capital injections in several large banks, an Asset Protection Scheme to limit losses on troubled bank assets, and guarantees for banks' debt...The Bank of England reduced interest rates to a historic low of 0.5 percent by March 2009 and began purchasing assets, financed by an expansion of base money (quantitative easing).[218]

On the fiscal side, a stimulus package of approximately 2 percent of GDP was enacted. One primary measure was the 2008 VAT tax reduction. It was legislated as a temporary tax reduction to expire in January 2010. VAT rate cuts were chosen in favor of income tax rate cuts to speed implementation, although larger personal income tax allowances were also passed, as was advancing of planned capital expenditure. Despite the size of the fiscal stimulus, the IMF notes that it is small relative to the effect of automatic stabilizers and the loss of asset price-related revenue.

These policies were generally viewed as successful at containing the crisis, and growth was expected to resume in 2010. In fact, growth resumed in late 2009. However, concern about the strength of the recovery persisted due to uncertainty and the magnitude of the shock.

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[216] VAT rate cut will only help big spenders, says foster. (2008, Nov 27). The Bath Chronicle Retrieved from http://search.proquest.com/docview/424163215?accountid=8505
[217] IMF, Public Information Notice No. 09/84, IMF Executive Board Concludes 2009 Article IV Consultation with the United Kingdom, July 16, 2009, http://www.imf.org/external/np/sec/pn/2009/pn0984.htm
[218] Ibid.

The 2009 VAT tax decrease was intended to stimulate the British economy in the wake of severe economic slowdown following the global financial crisis. As such, it was directly intended as countercyclical policy to stimulate output.

Sources:

Atkins, Ralph, Benoit Bertrand, Ben Hall, and Jim Pickard. “UK Acts Alone To Cut VAT as Part of Pound(s)20bn Fiscal Stimulus Package.” *Financial Times* (London) November 25, 2008, p. 1.

IMF. Country Report No. 09/212. United Kingdom: 2009 Article IV Consultation – Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom. July 2009. http://www.imf.org/external/pubs/ft/scr/2009/cr09212.pdf

IMF. Public Information Notice No. 09/84. IMF Executive Board Concludes 2009 Article IV Consultation with the United Kingdom. July 16, 2009. http://www.imf.org/external/np/sec/pn/2009/pn0984.htm

4. Tax change of 2010

Legislation was passed to increase VAT from 15 percent to 17.5 percent on October 1, 2009.[219]
Implementation occurred on January 1, 2010.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

The United Kingdom experienced a deep recession after the 2008 global financial crisis. The year 2009 was associated with a fall in output of about 4 percent and a sudden increase in primary deficit of 6 percent. The turnaround began with a classic turn in the inventory cycle and continued with a recovery in final private demand. The Bank of England responded to the crisis with intensive monetary stimulation, and the British government passed fiscal stimulus policies that begin phasing out in 2010. Concern remained over the strength of the recovery in 2010 because net exports remained relatively low despite sterling depreciation, because the pace of global recovery appeared to have slackened, and growing concerns about fiscal debt and deficit. Inflation also was higher than expected.

One fiscal stimulus policy that expired in 2010 was the temporary reduction of the VAT to 15 percent. Upon the expiration of the temporary cut, the VAT rate returned to 17.5 percent. Although the return to the higher rate had been legislated in the 2009 tax cut, the rate resumption was accompanied by much discussion, including both arguments for increasing the rate beyond 17.5 percent to reduce the growing fiscal deficit. As reported by the *Guardian*, "Alistair Darling wanted to impose a VAT rise above 17.5 percent in his pre-budget report to raise extra revenue but was persuaded by Gordon Brown to opt for an increase in national insurance instead, government sources disclosed yesterday. Cabinet sources said the discussion at the top of the government was over whether to opt for a VAT rise or a 0.5 percent hike in national insurance to raise the funds necessary to protect frontline services, and start to plug the deficit."[220]

The 2010 VAT hike responded to need to increase revenues as a consequence of the fall in output associated with the global financial crisis.

[219] http://www.eurovat.com/news.htm; Passing the budget buck is shameless politicking
Jamieson, Bill. The Scotsman [Edinburgh (UK)] 20 Nov 2009: 29.
[220] "No 10 Blocked Darling Plan for VAT Hike: Brown Feared that Increase Beyond 17.5 percent Would Put Recovery at Risk," *The Guardian* (London), December 11, 2009, p. 1.

Sources:
Elliot, Larry. “Conservative Conference: If I Were Chancellor ...: All Osborne Has To Do Now Is Come Up with Another Pounds 70bn.” *The Guardian* (London) October 8, 2009, p. 14. IMF.
IMF. Country Report No. 10/338. United Kingdom: 2010 Article IV Consultation – Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom. http://www.imf.org/external/pubs/ft/scr/2010/cr10338.pdf
“No 10 Blocked Darling Plan for VAT Hike: Brown Feared that Increase Beyond 17.5 percent Would Put Recovery at Risk,” *The Guardian* (London), December 11, 2009, p. 1.

5. Tax change of 2011

Legislation was passed to increase VAT from 17.5 percent to 20 percent on June 23, 2010.[221]
Implementation occurred on January 4, 2011.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

The United Kingdom experienced six quarters of deep recession after the 2008 global financial crisis. The Bank of England engaged in unprecedented levels of monetary stimulus after the crisis, including moving the policy rate to near zero and purchasing £200 billion in asset (mostly of longer-term government bonds). This helped depress bond yields and boost asset prices, thereby supporting market confidence, household net wealth, and corporate credit supply.

The British economy began to grow late in 2009 with a turn in the inventory cycle. Subsequently, corporate investment increased, the labor market stabilized, and private demand began to rebound. The British authorities anticipated GDP growth of 1.7 percent in 2010 and 2.0 percent in 2011.

As in much of Europe and the US, the financial crisis severely affected the United Kingdom's fiscal balance, resulting in large deficits. The overall deficit in fiscal year 2009/10 was 11 percent of GDP (among the highest deficit-to-GDP ratios in the world) and the net debt-to-GDP ratio had risen from 36.5 percent of GDP in 2007 to an estimated 61.2 percent of GDP in 2010.

> To ensure confidence in public finances and avoid adverse market reactions, the government has set itself a fiscal mandate of balancing the cyclically adjusted current budget (by the end of a rolling five-year horizon) and putting the net debt-to-GDP ratio on a declining path by 2015/16, and it has announced plans to achieve these goals one year early. The adjustment is frontloaded and relies mainly on spending restraint, with support from an increase in the VAT rate and other tax measures.[222]

News coverage of the VAT increase emphasized the purpose of deficit reduction: "The UK's weighty deficit is set to shed much-needed pounds in 2011 thanks to an estimated pounds 12bn boost to revenue. The relief will come courtesy of the Government's much-publicized New Year's resolution to increase the VAT rate to 20 percent from January 4."[223] The other tax measures included higher capital gains taxes and a new bank levy on wholesale liabilities.

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[221] http://www.imf.org/external/pubs/ft/scr/2010/cr10338.pdf p. 26; Time's running out for low rates Malsbury, Melanie. Journal [Newcastle-upon-Tyne (UK)] 16 Dec 2010: 26.; http://www.eurovat.com/news.htm
[222] IMF, Public Information Notice No. 10/147, IMF Executive Board Concludes 2010 Article IV Consultation with the United Kingdom, November 9, 2010, http://www.imf.org/external/np/sec/pn/2010/pn10147.htm
[223] Melanie Malsbury, "Time's Running Out for Low Rates," *Journal* (Newcastle-upon-Tyne, UK), December 15, 2010, p. 26.

Spending cuts were spread evenly across the 5 years. The spending measures were spread across the 5-year horizon.

The 2011 United Kingdom VAT increase occurred in the context of gradual recovery from the global financial crisis when the country was suffering from one of the highest deficit-to-GDP ratios in the world. The IMF and news articles agree that the purpose of the tax change was debt reduction.

Sources:

IMF. Country Report No. 11/220. United Kingdom: 2011 Article IV Consulation – Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the United Kingdom. July 2011. http://www.imf.org/external/pubs/ft/scr/2011/cr11220.pdf

IMF. Public Information Notice No. 10/147. IMF Executive Board Concludes 2010 Article IV Consultation with the United Kingdom. November 9, 2010. http://www.imf.org/external/np/sec/pn/2010/pn10147.htm

Malsbury, Melanie. "Time's Running Out for Low Rates." *Journal* (Newcastle-upon-Tyne, UK) December 15, 2010, p. 26.

Country: Uruguay

1. Tax change of 1984

Legislation was passed to increase VAT from 18 percent to 20 percent on June 26, 1984.
Implementation occurred on June 26, 1984.
Narrative classification: Endogenous – GDP-driven (procyclical).

Brief background material and description of nature of tax rate change

Uruguay entered an extended recession after real GDP stagnated in 1981 and fell almost 9 percent in 1982. Unemployment rose to 13 percent, the public sector balance switched from a surplus to a deficit of 10 percent of GDP, and the balance of payments moved from surplus to deficit of nearly 14 percent of GDP.

In November 1982 the government developed an adjustment plan consisting of pursuit of a flexible exchange rate policy, an intensification of the effort to improve efficiency in the economy, a liberalization of wage policy, a major reduction in the borrowing needs of the nonfinancial public sector, a deceleration of central bank credit growth, and a marked slowdown in net official recourse to external financing. The goals of the program were a major improvement in the balance of payments and a return to relative price stability, once corrective price adjustments had worked their way through the economy. Also, it was expected that, once adjustment had taken hold, the program would lay the basis for a gradual recovery of economic activity.[224]

Both revenue increases and expenditure cuts, including limits on government wage increases, were passed to improve Uruguay's fiscal stance. "Although the deficit of the public sector was reduced in 1983 and credit policy was tightened, sizable imbalances remained and the inflation outcome was disappointing. Nevertheless, a sharp real depreciation of the peso occurred and the balance of payments response to the program was very strong. The results in terms of output and employment were modest."[225]

Uruguay entered a stand-by arrangement with the IMF in early 1983. Much of Uruguay's public and private external debt was rescheduled. At the end of 1993, total external debt was 58.5 percent of GDP and public-sector external debt was 46.2 percent of GDP.

The economy continued in recession in 1983 and 1984, and fiscal deficits were large. The value added tax comprised the largest single government revenue source, yielding 40 percent of tax revenue in 1984. Poor revenue performance during the early 1980s was a major factor contributing to weak public finances. "To reverse the decline in the ratio of the VAT to GDP

[224] SM/84/78, Uruguay – Recent Economic Developments, April 13, 1984, IMF Archives, p. 2.
[225] Ibid., p. 4.

since the early 1980s, the authorities increased the basic rate from 18 to 20 percent in 1984 and reduced the collection lag from four to three months in 1985; these measures yielded an increase in VAT collections of about l/2 percent of GDP in 1985-86."[226]

The 1984 VAT increase was intended to address the Uruguayan fiscal deficit that occurred as a consequence of the 1982-1984 fall in output of more than 14 percent. We treat this tax change as falling into the category of procyclical changes.

Sources:

IMF Archives. SM/84/78. Master Files Room C-120 01. Uruguay – Recent Economic Developments. April 13, 1984.

IMF Archives. SM/85/83. Master Files Room C-120 01. Uruguay – Staff Report for the 1985 Article IV Consultation. March 11, 1985.

IMF Archives. SM/87/112. Master Files Room C-130 01. Uruguay – Recent Economic Developments. May 21, 1987.

[226] SM/87/112, Uruguay – Recent Economic Developments, May 21, 1987, IMF Archives, p. 18-19.

2. Tax change of 1987

Legislation was passed to increase VAT from 20 percent to 21 percent on October 21, 1987. Implementation occurred that same day.
Narrative classification: Exogenous – Inherited fiscal deficit-driven.

Brief background material and description of nature of tax rate change

Economic activity in Uruguay stagnated during the early 1980s after a serious decline in 1981; inflation was approximately 100 percent annually as of the first half of 1985. Uruguay's balance of payments was in deficit despite improvements in the current account balance. The combined deficit of the nonfinancial public sector and the central bank exceeded 9 ½ percent of GDP.

Faced with this low-growth, high-deficit, high-inflation environment, the new administration that took office in March 1985 announced an adjustment program and received support through a standby arrangement from the IMF. Revenue measures adopted in June 1985 helped narrow the deficit, and declining international oil prices and falling interest rates abroad also benefited the fiscal outlook. By 1986, the fiscal deficit had fallen to 5 percent of GDP. The economy also recovered from a four-year recession and real GDP grew by more than 6 percent in 1986. Strong exports propelled the manufacturing sector to a 12 percent expansion, and urban unemployment fell from 12 ¾ percent in 1985 to 10 percent at the end of 1986.

Major social security reform was passed in 1987. The World Bank helped draft the reform.

> The core of the proposal was a reform of the disability, old age and survivors fund (IVS), which accounted for a significant proportion of the deficit of the social security system. The legislation eventually approved in October 1987 included the capping of individual pensions at minimum wages, but omitted three important features of the original draft, namely: (a) an increase in the retirement age to 65 for men and 60 for women; (b) a formula for adjusting benefits annually based, at the discretion of the Government, on either the average increase in wages or in the cost of living; and (c) an increase in payroll contributions. The approved legislation linked annual increases in social security benefits to past increases in average wages, insuring a rise in real benefits in periods of declining inflation. In lieu of the increase in payroll contributions contemplated in the original draft, Legislation included a 1 percentage point rise in the base VAT rate to 21 percent, and a 20 percent increase in the tax on new automobile sales.[227]

The 1987 VAT increase was directly related to the reform of the social security system. The increased VAT was partly designed to bring the system into better actuarial balance, and, as such, was deficit-driven.

Sources:

[227] SM/89/183, Uruguay – Recent Economic Developments, August 28, 1989, IMF Archives, p. 26-27.

IMF Archives. SM/87/112. Master Files Room C-130 01. Uruguay – Recent Economic Developments. May 21, 1987.

IMF Archives. SM/88/86. Master Files Room C-130 0401. Uruguay – Staff Report for the 1988 Article IV Consultation Under the Procedures for Enhanced Surveillance. April 20, 1988.

IMF Archives. SM/89/183. Master Files Room C-130 0401. Uruguay – Recent Economic Developments. August 28, 1989.

3. Tax change of 1990

Legislation was passed to increase VAT from 21 percent to 22 percent on March 31, 1990.
Implementation occurred in April 1990.
Narrative classification: Exogenous – Inherited fiscal debt-driven.

Brief background material and description of nature of tax rate change

Uruguay undertook a broad economic adjustment program under the administration that took power in 1985. This program reduced public sector deficits from 9 ¼ percent of GDP in 1984 to 4 ¼ percent of GDP in 1987, and annual inflation declined from 83 percent to 57 percent during the same period. Subsequently, however, deficits grew and inflation increased so that by 1989 the fiscal deficit was 7 ½ percent of GDP and inflation was nearly 90 percent. "The deficit was financed by domestic bank credit and by short-term external borrowing, contributing to a deterioration in the country's external debt profile."[228] The combined effect of a weakening fiscal situation and external factors such as the Latin American debt crisis and instability in neighboring countries resulted in stagnating economic growth. Real GDP in 1990 was only slightly above its value in 1980. One bright spot was the balance of payments, which remained in surplus due to strong exports and the public sector's use of short-term borrowing.

A new administration took power in 1990 and enacted new policies to lower the fiscal deficit and control inflation. A comprehensive fiscal package approved in March 1990 included "increases in agricultural income taxes and in several excise taxes; an increase in tax payments by public enterprises, including special levies; the creation of a tax on real estate transfers; a one-year, 1 percentage point rise in the maximum value-added tax rate (later extended [...]); and a temporary surcharge on certain imports."[229] The government also worked to improve tax administration, curb tax evasion, and increase revenue collections, although the IMF described the results as ineffective. As a result of these changes, the combined public sector deficit fell to 3.6 percent of GDP in 1990, although the target had been 3.1 percent of GDP. The IMF attributed the underperformance on the deficit front partly to poor performances by state enterprises.

This tax increase occurred in the context of stagnating growth, high fiscal deficit, deterioration in the country's external debt profile, and inflation. This tax change occurred at the beginning of a new political administration. We classify it as debt-driven.

Sources:

[228] SM/91/168, Uruguay – Staff Report for the 1991 Article IV Consultation, August 20, 1991, p. 2.
[229] SM/91/183, Uruguay – Recent Economic Developments, September 5, 1991, p. 18.

IMF Archives. SM/91/168. Master Files Room C-525 0450. Uruguay – Staff Report for the 1991 Article IV Consultation. August 20, 1991.

IMF Archives. SM/91/183. Master Files Room C-525 0450. Uruguay – Recent Economic Developments. September 5, 1991.

IMF Archives. SM/92/226. Master Files Room C-525 0450. Uruguay – Recent Economic Developments. December 22, 1992.

4. Tax change of 1995

Legislation was passed to increase VAT from 22 percent to 23 percent on April 25, 1995.
Implementation occurred in May 1995.
Narrative classification: Endogenous – Offsetting (other tax).

Brief background material and description of nature of tax rate change

Uruguay experienced improving macroeconomic conditions during 1990-1994, with real GDP growth averaging 4 ¾ percent per year. Inflation slowed from about 130 percent to 44 percent annually, although the IMF standby arrangement had targeted a reduction to 30 percent by 1993. The economy opened up and the administration took measures to reduce government intervention in the economy. Unemployment fell to 7.6 percent in 1993 but rose to 9.1 percent at the end of 1994 due to increased labor force participation. The public finances improved as well; the public sector deficit fell from 8 percent of GDP in 1989 to 3 ¼ percent in 1994 and public sector external debt was projected at 24.9 percent of GDP, down from 46.5 percent of GDP in 1989.

The new administration that took control in 1995, led by President Julio Maria Sanguinetti, made further deficit reduction a primary fiscal goal with the intention of lowering it to 1 percent of GDP in 1995-96. According to the IMF,

> The new Administration aims to improve growth performance in the medium-term by lowering inflation to industrial country levels and removing structural impediments to growth, while maintaining balance of payments viability. In the near term, the authorities are implementing a program based on a substantial reduction in the public sector deficit, together with monetary and wage restraint, to bring down inflation to 30 percent during 1995/96 (i.e., the year ending in March 1996), consistent with the maintenance of the current exchange rate policy.[230]

The reduction in the deficit was to be achieved by both reducing growth in expenditure and increasing taxes. The spending measures included reduced public sector hiring, limits on discretionary spending, and reducing capital expenditures, and limiting public-sector wage adjustments. On the tax side, the VAT was increased from 22 percent to 23 percent, and the lower rate was raised from 12 to 14 percent. The VAT base was also expanded by reducing VAT exemptions. Public enterprise tariffs were increased by 33 percent on average and the personal tax on wages and pensions was also increased.[231] The VAT increases were partially offset by reduced employer contribution rates to social security and increase in the family allowance. As such, we classify it as tax substitution.

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[230] SM/95/126, Uruguay – Staff Report for the 1995 Article IV Consultation, May 30, 1995, p. 5.

[231] EBS/96/115, Uruguay – Staff Report for the 1996 Article IV Consultation and First Review Under the Stand-By Arrangement, July 8, 1996, p. 2.

Sources:

IMF Archives. SM/95/126. Master Files Room C-525. Uruguay – Staff Report for the 1995 Article IV Consultation. May 30, 1995.

IMF Archives. EBS/96/115. Master Files Room C-525 0451. Uruguay – Staff Report for the 1996 Article IV Consultation and First Review Under the Stand-By Arrangement. July 8, 1996.

5. Tax change of 2007

Legislation was passed to decrease VAT from 23 percent to 22 percent on January 18, 2007.[232]
Implementation occurred the same day.
Narrative classification: Exogenous – Long-run growth.

Brief background material and description of nature of tax rate change

Uruguay suffered prolonged recession beginning in 1999, and in 2002 the economy contracted by 11 percent.[233] A major banking crisis in July 2002 forced the government to freeze banking operations. Growth resumed slowly in 2003 and the economy continued to expand in 2007. According to the IMF,

> "Growth has exceeded expectations supported by strong macroeconomic policies and renewed market confidence, and economic vulnerabilities have been sharply reduced. Nevertheless, a recent increase of inflation and the ongoing implementation of the structural reform agenda remain key challenges. Real GDP grew by 7 percent in 2006, continuing the strong performance following the crisis in 2002. The growth momentum remains solid this year, led by foreign investment and consumption, and supported by an accommodative monetary policy stance. Inflation has increased, fueled by pass-through from oil and other commodity prices and strong domestic activity. Twelve-month inflation through July 2007 was 8 percent, above the upper limit of the central bank's target range (6.5 percent)."[234]

The financial system was stable in 2007, with a "well-capitalized banking system, low non-performing-loan ratios, high liquidity levels, and improved profitability. In addition, nonresident deposits—a key vulnerability at the time of the crisis—are much lower than in 2002, and stress tests confirm the increased resilience of the financial system."[235]

Uruguay's fiscal performance was also strong. The public debt declined to a projected 62 percent of GDP in 2007 from a high of 110 percent of GDP in 2003. In July 2007, "landmark" tax reform went into effect. This reform restructured the tax system to increase progressivity and improve efficiency. According to Llambi, Laens, and Perera, "The explicit goals of the 2007 Tax Reform are: i) to promote greater equity in the tax structure, relating the tax burden to the taxpaying capacity of each agent; ii) to promote greater efficiency of the tax scheme; and iii) to

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232 http://www.escapeartist.com/Special_Reports/Uruguays-New-Tax-Rules/;
http://www.us.kpmg.com/microsite/tax/ies/2007_flash_alerts/fa07-048.pdf "Uruguay's Tax Reform Law 18.083 takes effect beginning July 1, 2007 (the new Law was published in the Diario Oficiall on January 18, 2007). (For prior coverage, see Flash International Executive Alert 2007-007 (January 8, 2007).)"

233 IMF, Public Information Notice No. 03/91, IMF Concludes 2003 Article IV Consultation with Uruguay, August 4, 2003, http://www.imf.org/external/np/sec/pn/2003/pn0391.htm

234 IMF, Public Information Notice No. 07/111, IMF Executive Board Concludes 2007 Article IV Consultation with Uruguay, September 10, 2007, http://www.imf.org/external/np/sec/pn/2007/pn07111.htm

235 Ibid.

stimulate investment and employment."[236] Uruguay replaced the pre-reform direct income tax on labor and pensions with a personal income tax, harmonized the social security employer contribution rate, altered the direct tax on firms, and modified the VAT rate and VAT tax base. The general VAT rate was reduced from 23 percent to 22 percent and the minimum rate was reduced from 14 percent to 10 percent.

This major tax reform restructured the Uruguayan tax system to improve efficiency and promote long-run growth.

Sources:

IMF. Public Information Notice No. 07/111. IMF Executive Board Concludes 2007 Article IV Consultation with Uruguay. September 10, 2007. http://www.imf.org/external/np/sec/pn/2007/pn07111.htm

IMF. Public Information Notice No. 03/91. IMF Concludes 2003 Article IV Consultation with Uruguay. August 4, 2003. http://www.imf.org/external/np/sec/pn/2003/pn0391.htm

Llambi, Cecilia, Silvia Laens, Marcelo Perera, and Mery Ferrando. "Assessing the Impact of the 2007 Tax Reform on Poverty and Inequality in Uruguay." Centro de Invetigaciones Economicas. Final Report MPIA 11061. http://www.cinve.org.uy/descargas/Llambi_Laens_Perera.pdf

[236] Cecilia Llambi, Silvia Laens, Marcelo Perera, and Mery Ferrando, "Assessing the Impact of the 2007 Tax Reform on Poverty and Inequality in Uruguay," Centro de Invetigaciones Economicas, Final Report MPIA 11061, p. 8. http://www.cinve.org.uy/descargas/Llambi_Laens_Perera.pdf