“The only constant in life is change” … So, should VAT become progressive?

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Pedro Monteiro, PhD | University Professor and VAT Public Consultant

This note describes the proposal for a progressive VAT put forward by De La Feria and Swistak and critically evaluates some of its merits and shortcomings.

1. Main features of a proposal for a progressive VAT

De La Feria and Swistak have suggested the implementation of a progressive VAT (P-VAT) based on some key general features, such as a single tax rate, no merit exemptions, and, on applying, a compensation to be paid in real time to low-income individuals or households at the moment they acquire goods or services.

Some other (non-core) characteristics involve determining whether the P-VAT should:

› target strictly individuals or solely households (or both);
› benefit all citizens, not merely those on low income;
› apply up to a pre-specified consumption threshold; and
› allow different compensation amounts (in accordance with individualized levels of low-income thresholds).

The main (adapted) features of the proposal are as follows:

<table>
<thead>
<tr>
<th>Core Features</th>
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<td><strong>Tax Base</strong></td>
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<td>Broad-base tax: one rate, no merit exemptions.</td>
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### Optional Features

<table>
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<th>Compensation Mechanism</th>
<th>Objective scope</th>
<th>Payment Method</th>
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<td><strong>Unit of targeting assessment</strong>: by individual or household.</td>
<td><strong>Scope</strong>: compensation to low-income individuals or one standard/universal payment if targeting of low-income individuals is not possible.</td>
<td><strong>To be made through an integrated and personalized tax system (e.g. income tax deductions of VAT paid) and centralized bank transfers, if possible; or through digital wallet/ money and mobile devices, should it not be possible to integrate the banking system.</strong></td>
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<td><strong>Scope</strong>: given to individuals on low incomes or to all citizens if targeting of low-income individuals is not possible.</td>
<td><strong>How much I</strong>: if a targeted compensation is possible, then a threshold level could be determined (e.g. only the first brackets of low income or up to other levels of wealth); if targeting is not possible, the attribution of a universal subsidy should be pondered.</td>
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<td><strong>How much II</strong>: if a targeted compensation is possible, then a reimbursement of all paid VAT should be pondered or VAT up to an income ceiling, based on average consumption.</td>
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<td><strong>How much III</strong>: if a targeted compensation is possible, then it might be advisable to consider the existence of an identical compensation for everyone below a specified threshold or different compensation levels for those in dissimilar income brackets (e.g. full compensation for lower ceilings, partial compensation for upper income levels).</td>
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De La Feria and Swistak go on to claim that, in order to achieve true progressivity, households below a given threshold should be able to receive a VAT compensation in full, regardless of what they consume.

Other scenarios, such as the adoption of a universal subsidy or a negative VAT (i.e. where all consumers, regardless of their income levels or what they effectively buy, receive a subsidy equal to the threshold amount), are to be merely perceived as “targeted social programs”.

2. Analysis of the P-VAT proposal

The proposal suggests that the P-VAT would be able to tackle the inherent regressivity commonly associated with VAT without the need for adopting zero or reduced rates and exemptions.

Nonetheless, the authors are extremely straightforward when assessing regressivity by stating – and concurring - that consumption taxes tend to be rather proportional and/or progressive (and not regressive), should you measure them as a proportion of expenditure. It is only when one assesses the impact of VAT as a measure of disposable income that one may come to the conclusion that VAT is regressive. The reason for this is that a single-year, income-based analysis is oblivious to “savings behaviour” (i.e. it cannot be automatically assumed that an increase in consumption made in a specific time-period corresponds to an increase of income, given that present levels of consumption might be “funded” by previous savings).

This hurdle becomes rather insurmountable if we consider the fact that it is extremely difficult to determine each specific individual’s propensity to save. In reality, in order to effectively measure regressivity, it would be necessary to analyse individualized savings patterns for multiple periods of time (preferably, a lifetime). Only then, would it be possible to assess an equitable correlation between income and tax revenue.

Apart from this, it should be stated that VAT’s regressivity is very much associated with a rather subjective concept, the so-called income’s marginal utility theory, by which it is suggested that, as individuals’ wealth surges, each additional monetary unit is less satisfying, since it will be used to fulfil less urgent/relevant needs. Contrariwise, low-income individuals would put a higher value on their last monetary unit, given that the entirety or a large portion of their income is to be used in the satisfaction of urgent/basic needs.

Subjectivity is grounded on the fact that, in real/pragmatic terms, it is quite difficult to quantify the precise value that individuals assign to each of their monetary units.

For instance, Warren Buffet – perhaps the most successful trade investor of all time – opts to eat breakfast in a MacDonald’s drive-thru every single day.

Furthermore, it is known that consumption taxes tend to be ineffective when determining an individual’s “ability to pay”. In reality, analysing acts of consumption (as an external factor that would implicitly allow a correct assessment of an individualized income) seems to be inadequate, because:

- acts of consumption reflect different tastes and decisions (Keen and Slemrod);
- individuals are capable of irrational consumption acts (e.g. purchasing goods that are beyond their means of subsistence); and
- individuals are, likewise, willing to use external financing (i.e. loans) in order to afford such acquisitions.
Conversely, individuals are also quite efficient at changing patterns of consumption so as to avoid taxation, thus concealing a specified ability to pay.

Moreover, a P-VAT could deprive states of liquidity (i.e. since the amount of P-VAT charged by providers will only be paid to the tax administration at a date subsequent to the moment of acquisition and, given that such P-VAT will immediately be transferred to the bank account of the acquirer, who benefits from the compensation, the state would have to assure the existence of means that have not yet been accounted for). To overcome this difficulty, it would be necessary to associate the proposal with a “split-payment” mechanism, whereby the P-VAT charged would immediately be transferred to the government treasury, provided that payments by card (immediate debit or credit) would become mandatory.

Nevertheless, the proposal represents, beyond a shadow of a doubt, a strong commitment to trying to solve an old conundrum: can VAT become more equitable?

This question might be difficult to answer, but it is the right one. After all, changing in order to better ourselves and the world surrounding us is undoubtedly a big part of our nature.