infoIEB
Number 32 · April 2020

IEB Institut d'Economia de Barcelona
UNIVERSITAT DE BARCELONA

Coronavirus and public finances: *Let's do whatever it takes*

Order of priorities

We were ill-prepared. We are facing a shock of such magnitude that our healthcare, financial, fiscal, and even our mental, structures are all struggling to overcome the serious challenges posed by COVID-19. It goes without saying that the principal problem that we have to deal with immediately concerns healthcare provision, though this clearly goes hand in hand with the macroeconomic costs caused by the paralysis in production and consumer activity (Baldwin, 2020). Having said that, the recommendations – or perhaps, given the massive uncertainty that reigns (Furman, 2020), the opinions – of economists can be of great use to us now, insofar as governments need to know, and the public wants to learn, what the economic consequences of this shock are going to be.

Truth be told, economists have not sat idly by. As well as the numerous opinions posted on the social platforms, the Spanish blog *nadaesgratis.es* offers a daily series of contributions evaluating various aspects of the pandemic, and VoxEU.org, in addition to its blog, has published a free access book, edited by Richard Baldwin and Beatrice Weder di Mauro, compiling its blog articles, entitled *Mitigating the COVID Economic Crisis: Act Fast and Do Whatever It Takes*. Indeed, this title captures very well the general opinion of economists: when the pandemic is under control, we need to act fast, as far as this is humanly possible, so as to generate (or, at least, not to hinder) a rapid recovery, and to achieve this, we need to get a number of public policies up and running no matter what it takes. Acting fast and introducing an arsenal of policies inevitably means some errors will be made, but "this is not the time to be cautious" (Gourinchas, 2020), or, perhaps, not to be overly so. Coming from an economist, such claims gain particular value.

Public policies and the magnitude of the economic problem

The IEB has also decided to initiate its own series of contributions, of which this is the first, focusing on different aspects of the pandemic. Here, we analyze the specific role to be played by fiscal policy and taxes. Given the magnitude of the shock, it can be estimated that the direct impact on the public budget will not be less than 117,000 million euros, a total that includes, for the time being, healthcare expenditure, the costs derived from the temporary redundancy plans (*expedientes de regulación de empleo temporal* or ERTEs) and securities to guarantee the liquidity of companies. If we compare this figure to the GDP forecast in the absence of the pandemic, it represents an increase in the deficit of 9.25 percentage points (p.p.), which, added to the deficit of 1.8% predicted by the central executive at the beginning of the year, would mean an overall deficit of 11.05% of the GDP forecast in the absence of the pandemic. Note, however, that this figure is a maximum, given that not all the aforementioned securities will necessarily materialize.

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Based on the simulations reported by Boscá, Doménech & Ferri (2020), in 2020, GDP could fall by between 4.1 and 7.9%, yet, if we take into account the potential impact of the aforementioned measures, it may only fall by between 0.6 and 4.5%. Therefore, let's say – with the caution called for by any estimation, in this case, one based on a simulation of a dynamic stochastic general equilibrium model – that GDP could fall by between 7.9 and 0.6%. Putting these estimates in perspective, at the end of March, the research services of the Deutsche Bank forecast a fall in Spanish GDP of between 8.7 and 18.3%, depending on the specifics of the macro scenario. Thus, we are faced by an estimated range that goes from 0.6 to 18.3%, which merely serves to confirm the massive economic uncertainty derived, in turn, from the doubts existing in relation to the duration of the pandemic. Let's suppose that GDP falls by 9.45% (the average of the estimated range); in this case, the 2020 public deficit forecast would be 12.4% rather than 11.05% referred to above, since the deficit-to-GDP ratio would have decreased. In per capita terms, that implies a liability of 2,968 euros per person. And despite its magnitude, this is the cost that most economists believe we will have to be prepared to assume; see, for example, the results of this survey, in particular the responses given to Question 3 regarding the maximum level of public debt economists would be willing to tolerate to support the economic recovery.

This percentage, however, is set to increase further because we need to take into account the negative impact on tax revenue foreseen prior to the pandemic. Everybody, tourists included, have stopped consuming; companies and freelancers have stopped earning; workers' wages, even with the ERTEs, have fallen. In short, while we have no estimates of these impacts, one thing we do know is that the increase in the public deficit will be even greater. Admittedly, in the case of VAT, given that it is a proportional tax, an estimate could be made, among others, on the consumption being foregone by tourists. However, here again, given the massive uncertainty (for example, we have no way of knowing what the summer season will be like), and aware of the great importance of the direct fiscal impact, we believe that carrying out more calculations contributes very little.

In the next section, we propose or, rather, we identify tax measures that should contribute either to minimizing the impact on the public deficit or to promoting macroeconomic stabilization; basically, such stabilization should seek to ensure the liquidity of the economy to avoid its collapse in the short term, with the consequent negative effects this will represent in the long term. But we need to act fast, so that when we come out of this difficult period of hibernation, the economic structures are in place to return to normal operations.

Before doing so, however, it is worth highlighting a number of further important questions:

- Based on our simple calculations, public debt looks set to increase by, at least, 12.4 p.p. This means that the public debt-to-GDP ratio will easily reach 110% in 2020, approximately. However, this figure is by no means exceptional inasmuch as the current shock, whose duration remains unknown, is similar to that caused by a war (Eichengreen, El-Ganainy, Esteves & Mitchener, 2019; Draghi, 2020).

- As such, we are faced with a high level of public debt in what are undoubtedly exceptional economic circumstances. Moreover, the situation has come about at a time of very low real interest rates that are not expected to change in the medium term, though this should not call into question their sustainability (Krugman, 2020).

- As the shock is symmetric – that is, one that affects all countries to some degree – the risk premium is not expected to increase in the specific case, here, of Spain, or in that of other countries, such as Italy, saddled with very high levels of public debt. In this sense, the non-application by ECOFIN of the excessive deficit procedure insofar as the situation can be attributed to the pandemic, and the setting up of the so-called Pandemic Emergency Purchase Program (PEPP), whose objective is for the European Central Bank to generate a credit line of up to 750,000 million euros to buy debt issued by both the public and private sectors, are steps in the right direction, pending determination of whether they are sufficient or whether it will be necessary to activate other types of financial measure (see, for example, Bénassy-Quéré et al., 2020; Galí, 2020; and Garicano, 2020). As long as the support of the EU institutions is maintained, and the exceptional nature of the times requires that this be so (Blanchard, 2020), the lower the fiscal costs will be and the greater the guarantee of the sustainability of our public debt (Alesina & Giavazzi, 2020).

Finally, there is, unfortunately, no guarantee that a health crisis will not recur in the medium term, for example, in the autumn-winter of 2020. This means that, by then, the countries, or supranational entities, will have to have adjusted their health, tax and financial structures to be able to face this type of contingency with greater guarantees. And this means that, in addition to the fiscal efforts that will have to be made in response to the shock, other measures will have to be taken to maintain a minimum 'protective shield'. By then, we will be well warned. In the next section, however, we deal only with extraordinary proposals for the short term, to address the needs of what are exceptional times. Now, as we pointed out earlier, for the time being, this crisis is generating severe problems of liquidity for private agents, a matter regarding which, as we shall show, the tax system can influence in order to avoid problems of solvency.

> This means that the public debt-to-GDP ratio will reach approximately 110% in 2020. However, this figure is by no means exceptional inasmuch as the current shock, whose duration remains unknown, is not dissimilar to that caused by a war.

What role should the tax system play?

Ensure the financial sufficiency of the public sector

As we have just mentioned, it is not our goal here to propose an exhaustive series of specific measures that can guarantee the future sustainability of our public finances, there will be more than enough time for this later and, clearly, this is not our priority at the moment. Rather, what we offer is a list of exceptional measures for exceptional times:

- A key factor impacting a country's tax compliance is the extent of the "tax morale" of its citizens, that is, a society's set of values in relation to paying its taxes: the higher society's tax morale, the greater its compliance and, therefore, the smaller the losses in tax revenue due to fraud (Luttmer and Singhal, 2014). This is probably a good time for a society to create a social norm of compliance and to highlight, in line with a report submitted by a committee to the legislature in the State of Vermont in 1852, that taxes are the price we pay for a civilized society. Without taxes, we would not have the public health system today that allows us to fight this terrible pandemic! In 1942, a successful advertising campaign in the United States, *The New Spirit*, used Donald Duck to encourage patriotic Americans to file and pay their income taxes faithfully in order to help the war effort. Despite the current paralysis in production, a higher degree of tax awareness – created by means of government advertising campaigns combined with suitable tax compliance measures, which we describe below – could generate returns in the short term, but, in this specific case, probably in the long term too.

- The crisis is having a highly negative impact on most economic activities, which have had to watch their income go up in smoke almost overnight; yet, some companies in certain sectors have actually benefited and turned an extraordinary profit, that is, above and beyond what might be considered normal. It is perhaps time, as has been done at other exceptional times, such as the Second World War, to introduce, exceptionally, some progressivity in corporate tax so as to levy a charge on these windfall profits (Saez & Zucman, 2020).

- Finally, to the extent that public debt is financed, in part, by quantitative monetary expansion policies such as the ECB's aforementioned PEPP, some of the public deficit could be financed from the seigniorage or inflation tax. If used, this would become more relevant, the higher the resulting inflation.

Generate liquidity for private agents

At the time of writing, numerous Spanish professional tax associations and institutes – most notably the REAF, the AEDAF and the General Council of Lawyers – have declared themselves in favor of a broad moratorium on compliance with the tax liabilities corresponding to 2019, including income tax and corporate tax, as well as those corresponding to the current year, such as tax withholdings and VAT. However, the Spanish government is opposed to such a moratorium as it needs, according to the Minister of the Economy, revenue because "public spending does not disappear". The tax deferral measures adopted so far (Royal Decree-Law 7/2020) generally apply to SMEs, with no guarantee being required if debts are less than 30,000 euros, with deferment being permitted for six months and no default interest being accrued during the first three. It has also been announced that the Social Security Treasury will grant moratoriums to businesses and the self-employed, albeit conditional on the fulfillment of certain requirements yet to be made public.

Extraordinary circumstances undoubtedly require extraordinary measures to guarantee the liquidity of private agents, but we should not forget that better designed taxes would permit a much quicker adaptation to the prevailing circumstances, thus reducing the need for new measures at times of great stress. As we show below, these are not new problems that we are becoming aware of for the first time, but analyzing them in the current situation highlights the importance of a good design for the smooth operation of the tax system:

- The time period that elapses for most taxes between their accrual becoming effective – that is, when the obligation to pay arises – and the fulfillment of this liability gives rise to a certain complexity that can be difficult for taxpayers to comprehend. For example, a successful restaurant owner, a physical or legal person, will see how this June he will have to pay a part of his 2019 personal income tax, despite the fact that he has no current income and may not have sufficient liquidity. This, however, will not be the situation for most workers, even though their salary may also have fallen significantly in 2020, because in this case any withholdings at source are calculated by adjusting much better the amount withheld with the final amount to be paid. If, however, the restaurant is owned by a company, now, in the month of April, it will have to a make a payment on account of its 2020 company tax, but calculated according to its results back in 2018. Actually, it is possible for the restaurant to ask for the calculation to be made on the basis of the company's results for the first quarter of 2020, but for this to happen it should have made an express request to the tax authorities back in February of this same year.

As we can see, the current crisis highlights something that was already well known, but which was not always sufficiently appreciated, namely, the importance of adjusting to the full the calculation of partial payments on account with the final balancing payment, as well as the frequency with which these payments are made. The technology currently available to us means that this is something that can be easily improved, so that, implicitly, the time lapse between the accrual becoming effective and the payment of the tax liability loses importance.

- VAT, the legal provisions for which are based on the criteria established under the 1977 Community Directive, works on the accrual basis, according to which the essential concern for the purposes of the tax is not when it is collected or when it is paid, but when the taxable transaction is effected. In fact, it was not until the Great Recession that community regulations allowed the introduction of a special regime based on a cash accounting scheme. However, its application today is almost testimonial, which means at the time of writing there will be companies that will have to account for VAT on sales made during the first quarter for which they have yet to receive payment. Is it impossible to make the VAT cash accounting scheme – with the necessary refinements to avoid abuse –the general criterion for the levying of this tax? In terms of tax equity, is it reasonable that it should be the companies who, at least in the first instance, have to deal with the failure of their customers to pay on time? This did not seem just to us before the current crisis (Durán Cabré, 2013); it does not seem just to us now.

And this means that it is possibly a good time to appreciate the true importance of taxes. Among other reasons because as well as the fiscal efforts that will have to be made to address the shock, additional efforts will have to be made to maintain a minimum 'protective shield' for the most immediate future. By then, we will be well warned.

- As a direct result of the Great Recession, various restrictions were introduced in corporate tax regulations aimed at mitigating the fall in tax revenue, especially that of companies with the highest turnover. Thus, for example, the amount that could be offset from negative tax bases out of future profits was limited, this limit becoming more restrictive as the company's turnover grew. Likewise, the amount of deductible financial expenses was also limited. These measures, which by their nature are justified in terms of the objective of generating tax revenue, are more debatable from the point of view of the economic capacity of the taxpayers. Does it make any sense to maintain these measures when companies have to pay corporate tax next July?

- Corporate tax treats profits and losses asymmetrically: the former are taxed; for the latter, no "charge" is made. However, the losses may be offset against future profits, albeit with certain restrictions as noted in the previous point. However, in the last reform, which came into force in 2016, a certain "backward" compensation was introduced for the benefit of small firms, by means of the so-called equalization reserve that allows taxation of a part of the profits to be deferred for up to a maximum of five years. Correcting this asymmetry and allowing backward compensation for losses, with retroactive effect on 2019 settlements to be presented in July this year, would be a measure that would undoubtedly help companies with problems of liquidity.

- In the Spanish system there are certain taxes whose design is clearly obsolete, and whose continuing existence can only be explained by the importance inertia has acquired in the tax field and the total absence of interest on the part of those in government to undertake a far-reaching reform of the tax system. Among others, obvious examples include the determination of income according to the personal income tax 'modules', the simplified VAT regime and the calculation of the business tax (or *IAE*) (Esteller Moré and Durán Cabré, 2013). The calculation of tax bases using variables that often have little to do with the reality of each company (for example, the number of tables in a restaurant regardless of whether they are occupied or empty), as though in the 21st century it was not possible to easily determine a company's actual turnover however small it might be, means that in many cases the company has to be taxed according to a hypothetical result often far removed from its true economic capacity. It is true that the regulations can be changed and the amounts of the modules modified, yet, by definition, they will never coincide with the reality of each activity.

- In a decentralized country such as Spain, where the spending of its regions, the Autonomous Communities (ACs), represents more than a third of total public spending (and with the anticipated increase in healthcare spending, its weight will be even greater), it is essential to have a good financing system that, among other concerns, enables it to fulfill the public sector' stabilization function. The most important source of tax revenues for the ACs is personal income tax, of which they receive approximately half of the amount paid by their residents. The ACs fix their own tax rate; but, nevertheless, this rate is not taken into account when determining the amounts to be withheld, which means the period between the accrual of the tax and its payment, as discussed above, is extended (Esteller, 2008). But, what's more, the resources from the funding system that are finally made available, both for assigned taxes and for equalization grants, are calculated with a two-year delay. Meanwhile, it operates a system of payments on account calculated according to income forecasts that do not usually correspond to reality, as was clearly seen at the start of the Great Recession, and which delayed the adoption of appropriate corrective measures (*Comisión de expertos para la revisión del modelo de financiación autonómica*, 2017; Durán Cabré y Esteller Moré, 2020).

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