

Institute for Fiscal Studies



Value Added Tax

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What's coming up...

- The temporary cut in VAT
- Prospects for using VAT for additional economic stimulus
- Raising additional revenue by:
 - Increasing standard rate of VAT
 - Broadening the VAT base

The temporary VAT cut...

- Standard rate of VAT cut from 17.5% to 15% from Dec 1st 2008 to Dec 31st 2009
 - Government estimates the cost to be £12.4 billion
 - This is about £440 per household
- Standard rate of VAT applies to about 55% of total consumer expenditure
- If fully (or near fully) passed on, average consumer prices would fall by about 1.2%

... is not getting rave reviews...



“The VAT cut has been an unbelievable and expensive failure. This government, that lectured us about prudence, has spent £12.5bn of our money, and wasted it.”

“Temporarily cutting VAT, a measure that was adopted in Great Britain, does not seem to me to be a good idea – 2% less is not perceived by consumers as a real incentive to spend.”



... but we view it more positively

- Temporary VAT cut has, potentially, two impacts:
 - Income effect – lower prices mean with unchanged purchasing you have more money left in your pocket
 - Substitution effect – lower prices today relative to tomorrow may want you to bring forward spending
- Changes in relative prices a bit like cut in interest rate (1%+)
 - Unlike cut in interest rates doesn't hurt savers
- Temporary cut in Income Tax has only an income effect

How will people respond?

Unconstrained consumers

- If not subject to credit constraints substitution effect is key
 - Income effect small as base spending on lifetime ability-to spend
 - But prices are 1.2% lower in 2009 than 2010 and thereafter
- Studies: 1.2% fall in prices this year relative to next boosts purchases by 0.6-1.2%. We think towards top end:
 - VAT is largely payable on ‘luxuries’
 - VAT is focussed more on ‘durable goods’ (e.g. TVs, fridges)
- Purchase 1.2% more things 1.2% more cheaply leaving amount they spend unchanged

How will people respond? Credit-constrained consumers

- For those subject to credit constraints the substitution effect cannot operate – only an income effect
 - The 1.2% fall in prices means their money goes 1.2% further
 - As they would like to consume more they spend these savings
- Normally few people constrained – more important group now?
- Luckily response of similar magnitude

Overall impact of VAT cut

- If there is full (or close to full) pass through expect people to purchase 1.2% more things 1.2% more cheaply
- As less of this (unchanged) expenditure is paid in VAT, retailers keep more of it
- Suppose pass through actually only 2/3:
 - Prices fall by 0.8% and purchases increase by 0.8%
 - £4.1 billion retained by firms (bolster margins)
- Cannot compare shopper numbers or purchases with last year
- Compare purchases now with *what they would have been now* without the policy

Could VAT be used for further stimulus?

- Is unlikely to be as effective
- If extend the tax cut consumers may believe 15% rate is permanent
 - But then no incentive to bring consumption forward
- Instead increase VAT to 18.5% from the beginning of 2011?
 - Makes 2010 purchases cheaper relative to 2011
 - People may save now to pay for future tax rise
 - But credit constrained households can't respond
- So not much room for using VAT as additional stimulus

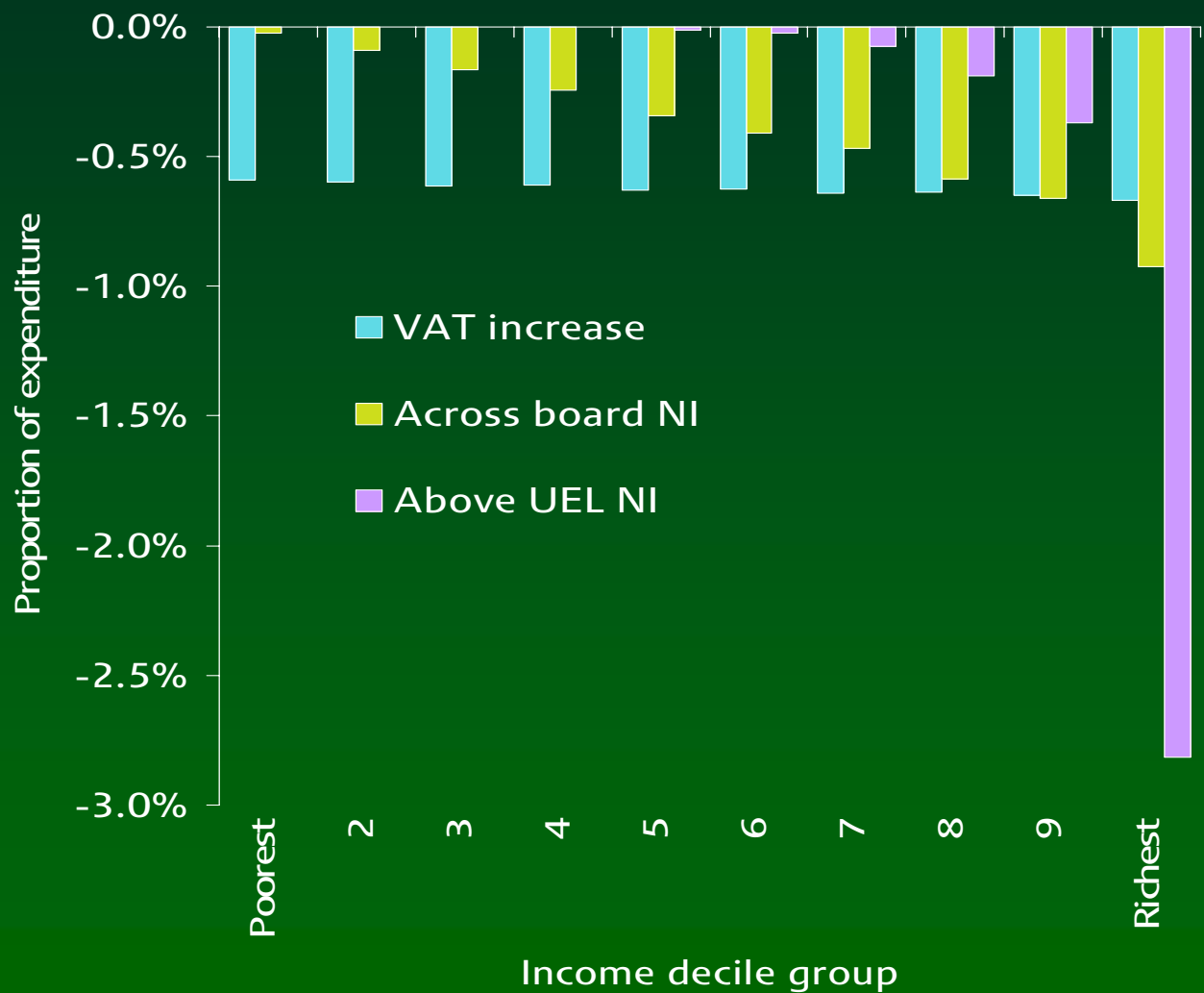
Could VAT be used to raise additional revenue?

- Gemma said future tax rises likely to be needed
- Government considered increasing VAT from 17.5% to 18.5% before the PBR
- Are increases in VAT and/or reforms of the system back on the agenda?
- We consider two reforms:
 - Increasing the standard rate of VAT by 1%
 - Broadening the range of goods on which VAT is charged

Increasing the rate of VAT

- Increasing the standard rate of VAT from 17.5% to 18.5% raises £5 billion in 2011-12
- Increasing all rates of National Insurance by 0.5% raises a similar amount
- As does increasing the rate of employees' NI paid above the UEL from 1.5% to 6%
- Here we show the distributional impact of these various policies

Comparing losses from NI reforms and potential VAT increase



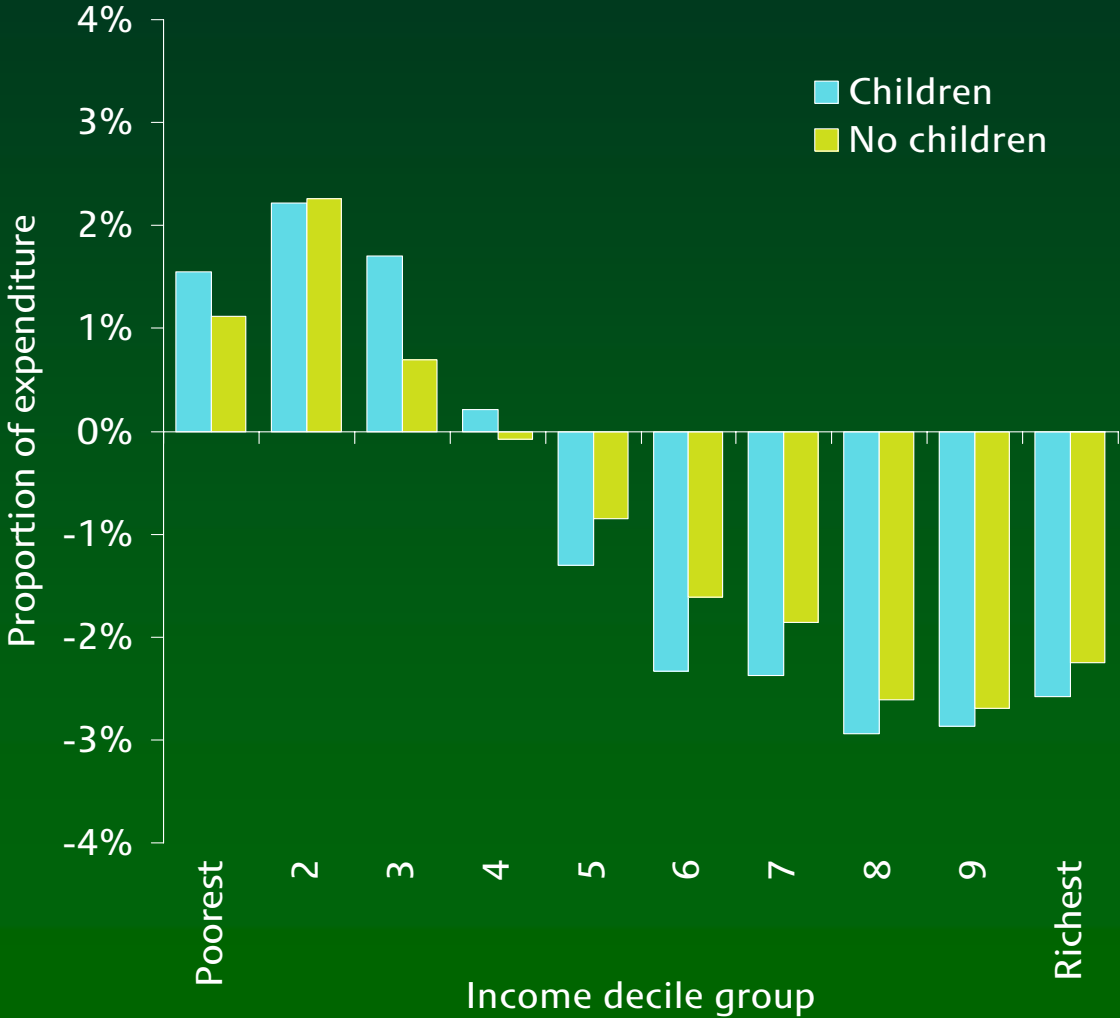
Broadening the VAT base

- Rather than increase standard rate raise revenue by getting rid of zero and reduced rates of VAT
- Some justification for special treatment of some goods:
 - Offset disincentives of income tax by taxing complements to work less than complements to leisure
 - Lower rates of tax on goods with special merit or that benefit others (and vice versa)
- Current VAT not in accordance
- Redistribution not a very good reason despite poorer households spending more on these goods
- Alternative policies better: universal benefits or tax credits

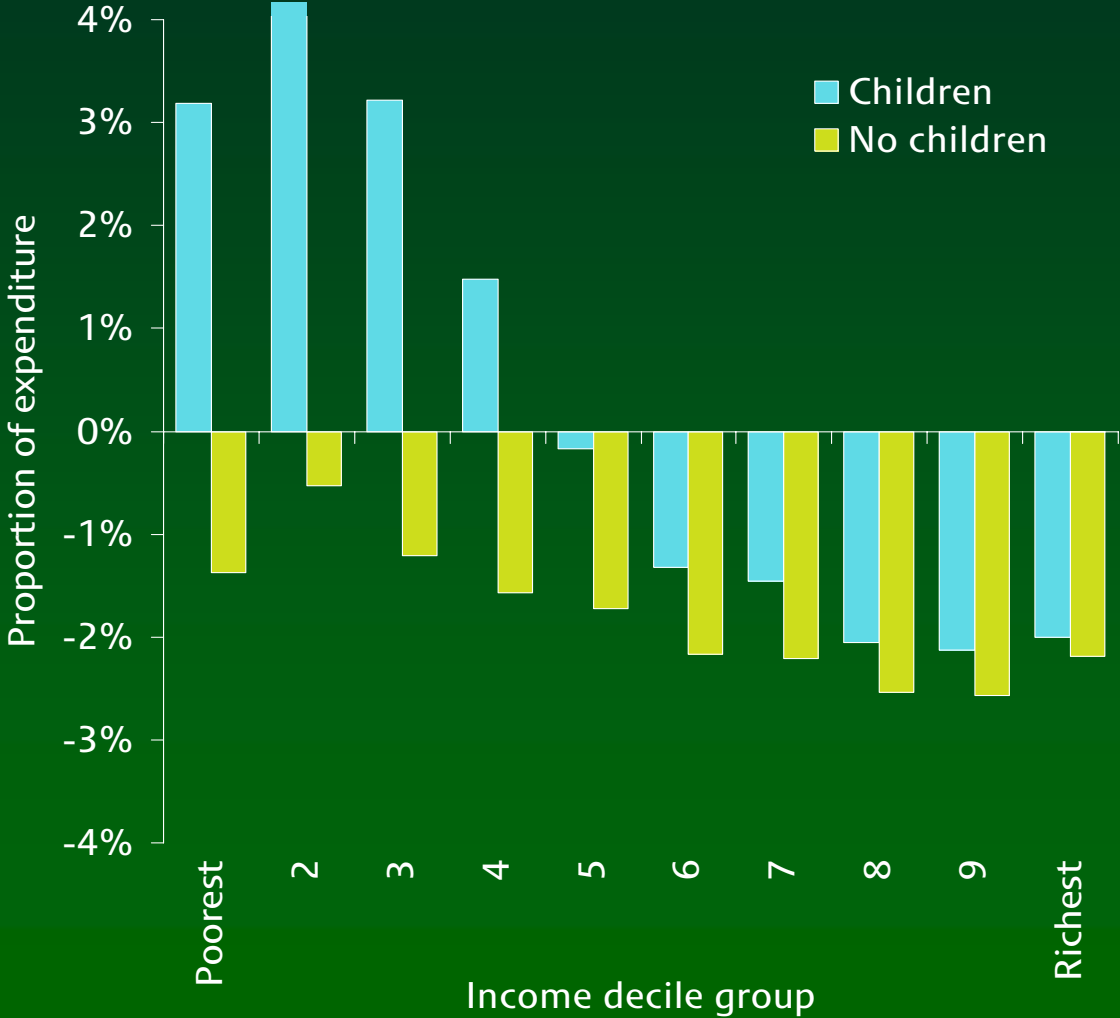
Broadening the VAT base

- Impose VAT on all zero and reduced rated goods except new houses and a few smaller categories
- This raises £24.4 billion of which £14.4 billion will be spent on compensating poorer households
- Net amount raised is £10 billion = 2% on VAT
- Compensation packages:
 - Package 1: Protect poorest 3/10^{ths} of households by increasing most means-tested benefits by 16.5%
 - Package 2: Focus on cutting child poverty by increasing child benefit and child tax credit with some increase in means-tested benefits, the state pension and ESA

Losses from applying a uniform rate of VAT of 17.5%: Compensation Package 1



Losses from applying a uniform rate of VAT of 17.5%: Compensation Package 2



Summary

- The temporary cut in VAT
 - If fully passed on would see prices fall by 1.2%
 - Will lead to 1.2% more things purchased
 - Comparing spending now with last year is *not* a valid comparison.
- Not much scope to use VAT for further stimulus
- Raising revenues by increasing the standard rate of VAT is less progressive than further NI increases
 - but poorer households can be compensated
- Raising additional revenue by broadening the VAT base would reduce distortions to purchase decisions and poorer households could be *more than* compensated