

Press Release

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***Fiscal Studies* symposium on the economics of VAT cuts**

As the imminent 2009 Budget presents an opportunity to revisit fiscal policy options during the recession, the new issue of *Fiscal Studies* contains a timely symposium on the economics of the likely effects of the temporary VAT cut that is in place until the end of 2009.

The Economics of a Temporary VAT Cut

Authors: Thomas F. Crossley (University of Cambridge and IFS), Hamish Low (University of Cambridge and IFS) and Matthew Wakefield (IFS, UCL and University of Bologna)

This paper analyses the likely implications of the temporary cut in VAT in the UK to 15 per cent, with a return to 17.5 per cent in place for the end of 2009. We distinguish between the income effect of the cut and the (intertemporal) substitution effect. The former is likely to be small because the change in lifetime income is minimal. The second effect is likely to be much more important because the reduction in the price of goods bought in 2009 compared with 2010 gives an incentive to increase consumer spending this year. With an elasticity of intertemporal substitution of about 1, we would expect the cut in VAT to boost consumer spending by about 1.2 per cent over what it would otherwise be. The distributional consequences of the VAT cut are regressive because goods subject to VAT tend to be luxuries. Unlike a cut in interest rates, there is no difference in the distributional consequences for borrowers compared with savers.

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The Economics of a Reduction in VAT

Authors: Ray Barrell (National Institute of Economic and Social Research) and Martin Weale (National Institute of Economic and Social Research)

We explore the effects of a temporary cut in VAT, identifying three possible effects: an income effect as people benefit from a lower cost of living during the period of the reduction, a substitution effect as people bring their consumption forward and an arbitrage effect as people buy non-perishable goods before the end of the period of low VAT for consumption after the VAT rate has been raised. International evidence suggests a clear overall impact on consumption, although the nature of the pattern depends on the way in which the data are analysed. However, the key policy issue is the impact of the VAT change on output and, to examine that, a simulation model of the whole economy is needed. Evidence from the National Institute's Global Economic Model suggests that the impact of the recent VAT reduction is likely to build up during the course of 2009. The reduction in VAT from 17½ per cent to 15 per cent is likely to result in consumption being augmented by less than 1 per cent by the fourth quarter of 2009. However, GDP is likely to be raised by less than half a per cent relative to what would have happened without the VAT increase. After the temporary reduction is over, both consumption and GDP are depressed as a result of the policy.

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Assessing the Temporary VAT Cut Policy in the UK

Author: Richard Blundell (IFS and UCL)

This paper concerns the likely impact of a temporary VAT cut stimulus policy on consumer demand in the UK. It suggests that around 75 per cent of the VAT reduction will be passed on to consumers and that consumers will react by maintaining their expenditure levels and therefore increasing their demand for consumption goods. The uncertainty caused by the downturn makes this a more muted impact than we might have hoped, especially on the demand for durable goods. Nevertheless, it is a substantive impact. In general, the uncertainty caused by the recession will tend to reduce the impact of any stimulus package. It is also argued that synchronising the subsequent rise with the economic upturn is critical.

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Notes to Editors:

1. The new issue, Vol. 30, No. 1, of *Fiscal Studies* is available online today, 17th April 2009, at <http://www3.interscience.wiley.com/journal/117977097/home>. For press copies, contact the press office at IFS, 020 7291 4800.
2. *Fiscal Studies* is a peer-reviewed journal and the articles published do not reflect the views of the editors or of the Institute for Fiscal Studies, which has no corporate views. For information about the articles summarised above, please contact the authors listed.
3. Alongside the symposium: articles not relating to the VAT cut that are also included in the new issue of *Fiscal Studies* are:

The Cyclical Reaction of Fiscal Policies in the Euro Area: The Role of Modelling Choices and Data Vintages

Authors: Roberto Golinielli (Università di Bologna) and Sandro Momigliano (Banca d'Italia)

What is the After-Tax Price of R&D? An Interstate Comparison

Authors: Lolita Paff (Penn State Berks, Pennsylvania State University) and Todd A. Watkins (College of Business & Economics, Lehigh University)

Borrowing to Finance Public Investment? The 'Golden Rule of Public Finance' Reconsidered in an Endogenous Growth Setting

Authors: Alexandru Minea, (Université d'Orléans and Université d'Auvergne) and Patrick Villieu (Université d'Orléans).