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

Proportion of expenditure

-3.0% -2.5% -2.0% -1.5% -1.0% -0.5% 0.0% 0.5%

Income decile group

Poorest 2 3 4 5 6 7 8 9 Richest

VAT increase
Across board NI
Above UEL NI
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 3/10ths 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

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

Proportion of expenditure

Income decile group

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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