



## Credit where credit's due – the VAT cut is working

The VAT cut boosts retail spend by £2.1 billion in first three months of operation – the Chancellor should extend it to July 2010

Prior to the Pre-Budget Report in November, cebr called for a temporary reduction in the rate of Value Added Tax (VAT) of 5 per cent in order to encourage consumer spending and help limit the recession in 2009. Alistair Darling delivered half of what we suggested with a 2.5 per cent cut, citing restrictive EU legislation that precluded a bolder move. The cut of 2.5 per cent was set upon by critics. Opponents argued that it was too small to make a difference, it was overshadowed by the heavy retail discounting underway in any case, or that encouraging saving not consumption was required to rebalance the United Kingdom economy.

Now that we have retail figures from the Office for National Statistics for the first quarter of the cuts duration; it is time to take a view on whether the cut has helped the beleaguered retail sector so far. **The figures are clear; the VAT cut is working.** There was an immediate boost to the volume of retail sales after the cut was introduced on 1<sup>st</sup> December 2008. As shown in the chart overleaf, annual growth in retail sales accelerated from 1.6 per cent in November 2008 to 2.6 per cent in December\*. Sales growth accelerated further in January to 3.2 per cent, and registered a marginal decline in February to 3.0 per cent.

In our retail sector forecasts prior to November's VAT cut, we expected to see retail sales continue to decline as the recession intensified, with growth reaching 0 per cent by February 2009. This is in-line with the fall seen at the beginning of the 1990 recession. Assuming that reality would have followed our forecast in the absence of the policy measure, **the VAT cut has boosted retailers' turnover by £2.1 billion over the first three months of its operation.** The current plan is to reverse the cut in January 2010 – **this threatens to cause a consumer downturn and choke the fragile economic recovery.** **The Chancellor should extend the duration of the cut to July 2010 when the economy will be stronger.**

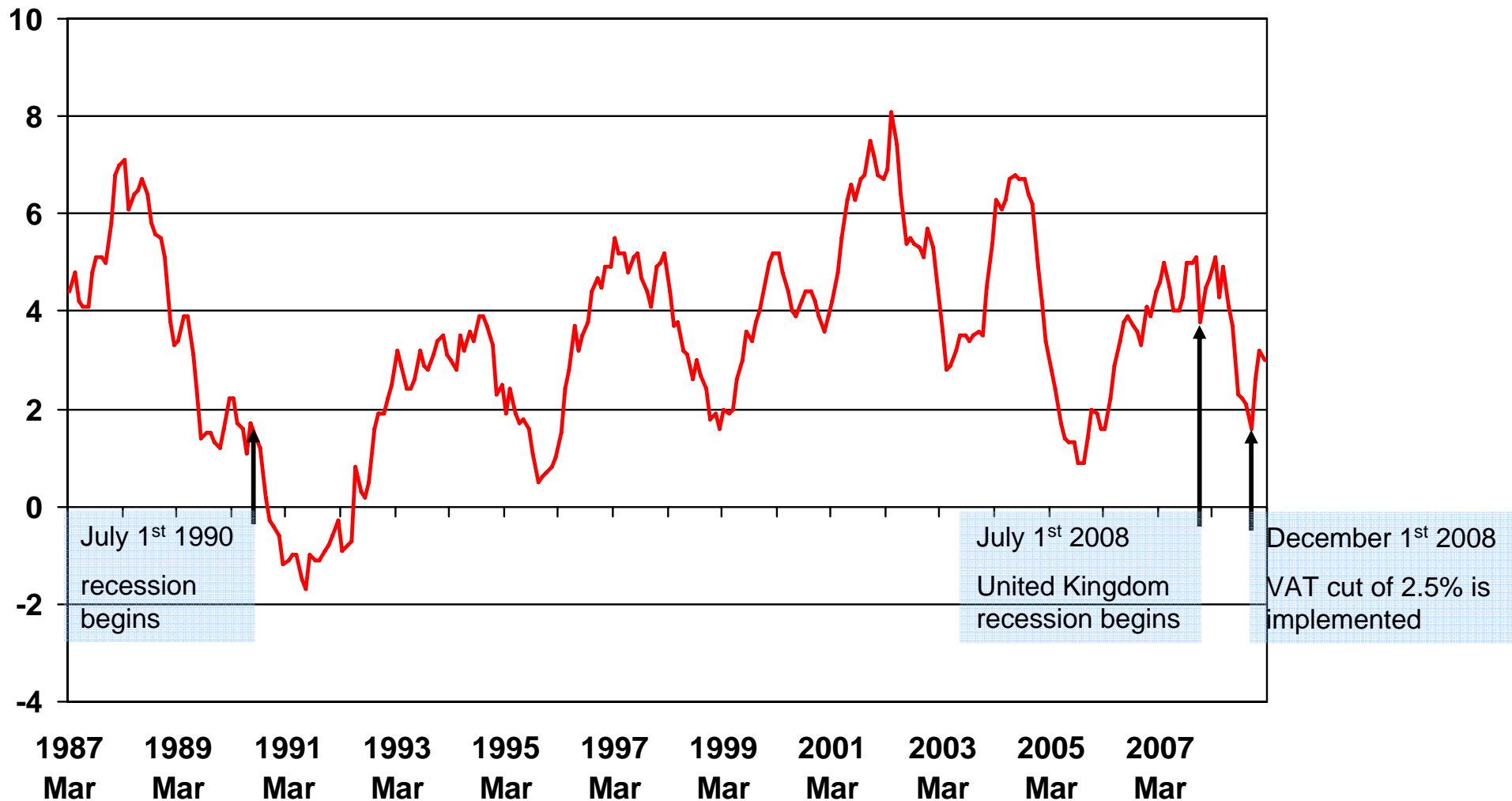
The rise in retail growth is even more remarkable given the economic context over this period. Following the intensification of the credit crunch in October and the bank bail-out package the United Kingdom economy was in freefall. Indicators of business and consumer confidence declined markedly, interbank lending spreads rose to new record levels and lending volumes fell to a trickle. We now know that the UK economy recorded its worst quarter since 1980, with a contraction of 1.6 per cent. Despite all of this, retail sales not only continued to grow, but growth accelerated.

\*Retail figures are expressed as the year-on-year change in the three month moving average of sales volume. This measure is considered the most representative by the Office for National Statistics due to the volatility of the retail sales index series



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UK retail sales volume, annual percentage change on a three month moving average basis





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The data also shows that **the acceleration in retail sales volume was not achieved through fire sales and fierce discounting on the high street**. Annual growth in the value of retail sales (which also measures price changes) remained steady at around 2 per cent between November 2008 and February 2009. In short, prices are around 1 per cent lower than last year (in part due to the VAT cut) but due to the robust growth in volumes the retail sector has seen an increase in turnover, despite the challenging environment.

In summary, we consider that the temporary Value Added Tax cut was the best stimulus option available to the government and has helped lessen the impact of the recession. The key element to the cut was its immediate implementation, it therefore provided help to the economy and gave monetary policy and financial stability measures time to kick in. There has been a clear and immediate impact on retail sales since its introduction. We estimate that retail sales over the December-February period were £2.1 billion higher than would otherwise have been the case.

How does this figure compare with the cost of the measure? In the Pre-Budget Report the Treasury estimated that the VAT cut would reduce tax revenues by £12.5 billion. Our estimate at the time was that this overstated the cost because of the Treasury's overoptimistic growth forecasts. A more realistic figure on the Treasury's method would have been £11bn. However, this does not take account of the impact of higher corporation tax, lower social expenditure, higher income tax and higher national insurance receipts than would otherwise have been the case. When these are taken into account our estimate of the annual net cost to public finances is £4-5 billion. Our calculations suggest that retail sales for the year are likely to be £8-9 billion higher than would have been the case without the VAT cut. **The VAT cut therefore appears to be good value for the taxpayer.**

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