



Darling's VAT cut has worked – expect a tough Spring for retailers as 0.7 per cent is knocked off consumer spending when it is reversed

With customers rushing to get their remaining Christmas shopping done, retailers sound cautiously optimistic that retail volumes and values have held up. John Lewis, a bell weather for the high street, reported sales growth of 15.2 per cent in the first two December weeks, compared to flat growth over the same period one year ago. A remarkable finish to a year which began with speculation of depression-like scenarios for the economy. Private consumption in particular was surprisingly resilient. Retail sales volumes were up by 2.7 per cent year-on-year in October, which is even more remarkable given the 1.9 per cent decline in the eurozone.

What has triggered this resilience? The main factor undeniably is lower mortgage costs. However, the often criticised VAT cut has also had a significant impact on households' finances. Lowering the standard VAT rate by 250 basis points is the equivalent of an additional £300 disposable income for each household in 2009 – if most firms passed on the cut, that is. The latest consumer price data suggest they actually did so. The Office for National Statistics calculated that prices excluding the impact of indirect taxes – of which VAT is the largest chunk – were on average 1.2 percentage points higher than those including VAT and other indirect taxes.¹⁾ This is broadly consistent with our estimate that the VAT cut increased disposable income by 1.2 per cent – a noticeable boost to household finances.

While some of it will have been saved (or used to pay down debt) as the rising savings ratio suggest, **we calculate that the VAT cut boosted consumer spending by some £6.8 billion.** Given this increase, **the VAT reduction boosted gross domestic product by some 0.5 per cent in 2009.** Not quite the 1.0 per cent boost the Chancellor was hoping for, but a welcome and timely support for the ailing economy. Add to this knock-on-effects from higher profitability – of those companies not passing on the cut – higher employment, improved confidence and lower business failures and the impact is likely to have been even higher.

But was the VAT cut too expensive? Those who argue that the VAT cut has not worked also like to point out that it was too expensive. Yet, regardless whether passed on or used to boost margins, only a *working* VAT reduction results in any cost for the Treasury. We calculate that the *gross* cost for Her Majesty's Revenue and Customs will be around £10.7 billion. Now take the additional tax revenues from increased consumer spending and higher economic activity and **the net cost of the VAT reduction to the Treasury is likely to be only around £4.3 billion.** Given other important aspects such as ease and speed of implementation as well as its temporary nature, the VAT cut was the right measure at the right time.

However, that it where the good news ends. **The downside of a working VAT cut is that reversing it in January has the potential of stalling an emerging recovery.** Indeed, when cebr called for the cut last year (7 November 2008, *The UK problems are getting worse, not better – an immediate 5% cut in VAT is required*) we argued that it should stay in place until July 2010 anticipating that domestic demand would be yet too weak to cope with a reversal at the turn of the year. Annual consumer price inflation is likely to spike above three per cent at the beginning of 2010 consequently knocking around 0.7 per cent off consumer spending. Against this backdrop we forecast that consumer spending will decline by another 0.2 per cent in 2010. Additionally, while some companies may decide not to pass the increase on, shrinking margins at a time of falling profitability will be the result.

All told, reversing the cut in January is likely to wipe out most of the benefits it was meant to create in the first place – expect a tough Spring for retailers and other industries dependent on consumer spending.

1) The latest consumer price data show that CPI consumer price inflation was 1.2 percentage points lower in 2009 than annual inflation excluding indirect taxes (CPIY) as measured by Office for National Statistics.

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