

Two Notes on the Pre-Budget Report

1) The VAT cut

Many commentators have suggested that this will have a limited impact, and that the money could have been better used elsewhere. Sometimes the same commentator would remark that a cut in interest rates would have a much larger impact. This misses a very simple point: for most consumers, the relevant interest rate when deciding when to buy goods is a post-tax rate. By cutting VAT by 2.5%, the government has reduced this post-tax interest rate by 2.5% for one year. If we believe that changes in interest rates have a significant impact on consumer behaviour, then this represents a powerful incentive to buy now rather than later.

We make exactly the same point in a more straightforward way by saying that any VAT rated goods will, *ceteris paribus*, be 2.5% cheaper in December 2009 than in January 2010. This is a powerful incentive to bring purchases forward. No doubt we will see a spike in consumption in the last months of 2009, followed by a partially offsetting dip in early 2010. But if modern macroeconomic theory means anything then consumption should be of the order of a per cent higher in 2009 overall than it would have been otherwise.

This is an example of a much more general point that I never tire of repeating (see for example Wren-Lewis, S (2000), *The Limits to Discretionary Fiscal Stabilisation Policy*, *Oxford Review of Economic Policy*, 16,92-105, which includes the experiment of a VAT cut). Most tax changes have an impact on the pattern of consumer's incomes, but they also have an impact on relative prices. Following the theory of Ricardian Equivalence, we are rightly cautious in believing that these income effects will have much of an impact on spending, and instead will be largely saved. (An important exception is if tax cuts or benefit increases go to those who are credit constrained, which given the financial climate at the moment might be a relatively large group.) But relative price effects can remain quite powerful. It is a hangover from very simple post-war Keynesian analysis that we focus on income effects rather than relative price effects.

2) What do we do about debt?

The fiscal rules that bound the government between 1997 and 2008 embodied a debt target of 40% of GDP. The projections in the pre-budget report involve debt rising over the next few years to nearly 60% of GDP. The government is absolutely right not to try and do anything about this in the short term, because counteracting the recession has to be the priority. But once a recovery is underway, a critical issue will be what to do about this higher level of debt.

Tax smoothing would suggest a very simple answer – nothing. It is less costly to suffer a small but permanent increase in taxes to pay the interest on the higher debt, than to raise taxes in the short term by more in order to bring debt back down. (See Kirsanova, T, Leith, C and Wren-Lewis, S (2007), *Optimal Debt Policy, and an Institutional Proposal to help in its Implementation*, *European Economy Economic Papers No 275*, April for more on this.) There may be a number of reasons why we may not want to follow this result too literally. But the work I have been involved with, and other results in the literature, suggest that any plan to return debt to a lower than 60% level should be slow and gradual. In this respect, a deep recession is like a major war. It makes sense

to pay for a war by borrowing, but there is no reason why this borrowing has to be paid back immediately the war is over.

The pre-budget report does not explicitly address the issue of how fast debt should be reduced once the recession is over, but there is a commitment to a steady reduction. The same point can be made about the Conservative Party's proposals. There are two big differences between the government and the opposition. The first is that the Conservatives appear not to believe in counter cyclical fiscal action, or at least not from this starting point of a structural deficit. On this I believe they are wrong. The second is that the Conservatives would set up an Office of Budget Responsibility – a Fiscal Council – to validate the fiscal consolidation process and perhaps guide them as to how quickly it should proceed. This should give that party, if it wins the next election, a degree of credibility in its medium term fiscal planning, credibility which may have disappeared from the current government.

Simon Wren-Lewis

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