# COVID-19 ECONOMIC STIMULUS:

## The case for a temporary cut to GST

New Zealand Taxpayers' Union

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TAXPAYERS' UNION

# INTRODUCTION TO GST IN NZ

When New Zealand introduced a compulsory Goods and Services Tax (GST) in 1986, it was set at a flat rate of 10 percent. That 10 percent rate increased to 12.5 percent in 1989, then to 15 percent in 2010. As of 2019, GST made up 30 percent of the government's total tax revenue. This amounts to $25.95 billion per year – roughly $14,180 per New Zealand household.

GST was first introduced in response to inefficiencies in New Zealand's tax system. GST was set to reform "narrow-base" taxes to a single comprehensive "broad base" tax instrument, the original objective being to lower the burden of personal direct taxes and improve overall fairness of the tax system. GST was also intended to reduce tax distortions and the complicated compliance costs associated with previous narrow-base and varied consumption taxes. GST essentially amalgamated different tax types e.g. sales tax, excise duty, service tax as well as luxury tax into one instrument.

GST is designed to collect tax revenue from final consumption of goods and services in New Zealand. While it also applies to all stages of production, where intermediate goods purchased for production are taxed GST is refunded. Given that GST is applied to final consumption in New Zealand, it is also a destination tax, which means that GST is applied to imports but not to exports.

A distinguishing feature of GST in New Zealand is that it is levied at a flat rate, applying evenly to most goods and services, with the only exemptions being rental accommodation and financial services. Therefore, GST is referred to as a broad-base tax.

The major benefit of GST is its comprehensive design. The tax is paid on production inputs. However, these are reclaimable, which means disruption in the production process is minimised and business and export decisions are not distorted.

The main cost effect of GST is to raise the price level. This leads to a reduction in real wage or purchasing power of labour income. A reduction in real wages reduces consumption which, in turn, reduces the size of the overall tax base.

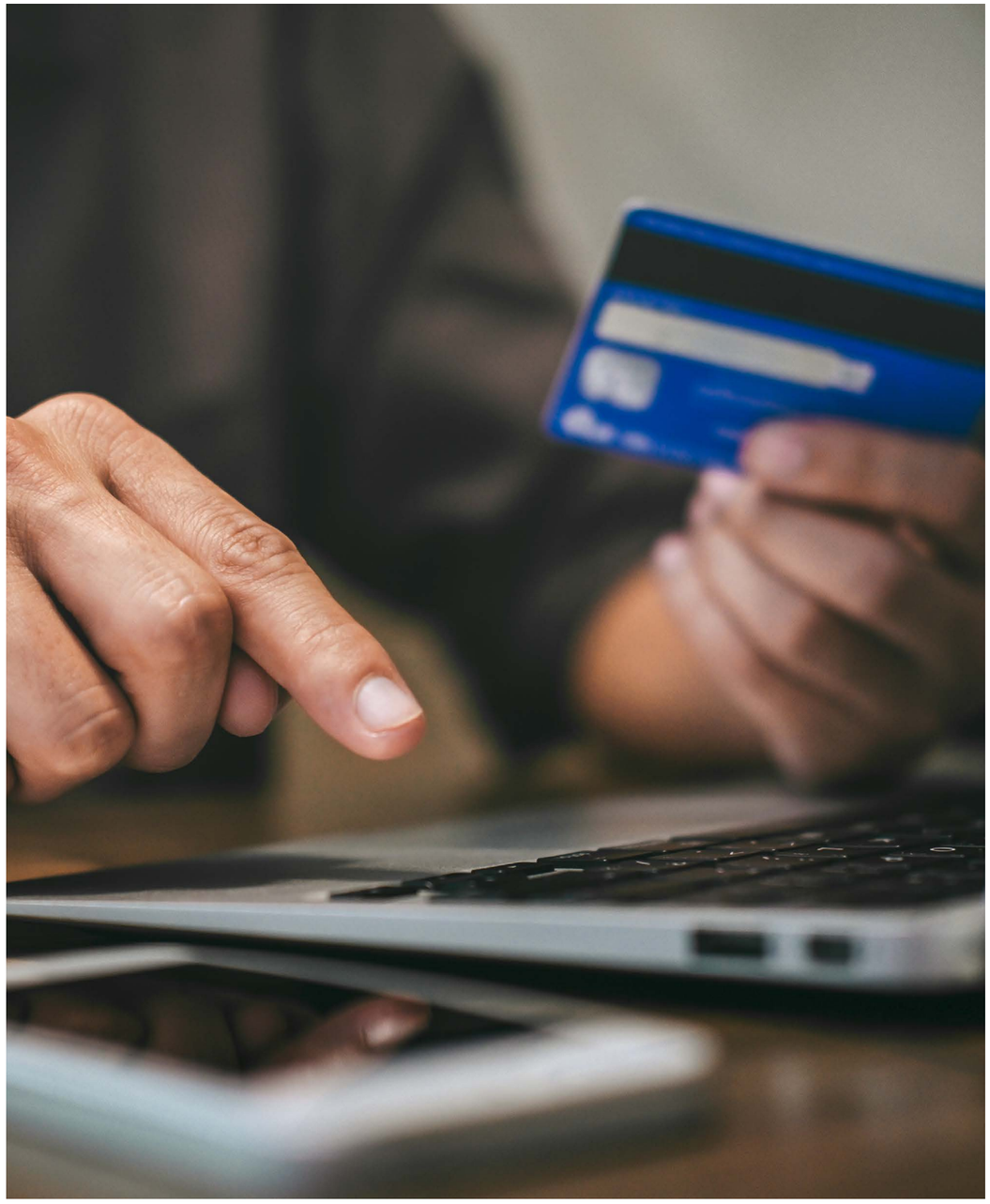
**Our proposal**

We propose a temporary reduction of GST to 10 percent.

The COVID-19 pandemic has seen sharp contractions in the New Zealand and global economy, leading policymakers to consider ways to increase consumer spending.

Traditionally, the goal of incentivising consumer spending has been the domain of monetary policy, where the Reserve Bank would reduce the Official Cash Rate (OCR) to encourage individuals to borrow and spend. However, this practice is now proving to be ineffective, as the OCR is now at a historic low, with speculation that it may be cut to below zero. At such low rates, further reductions to the OCR are likely to have little effect on increases in borrowing or spending.

This is where fiscal policy, such cutting GST, complements monetary policy objectives. The Government is already implementing demand side economic interventions by increasing spending and transfers to households and businesses to bolster the economy, most significantly via the income relief payment and the wage subsidy. Our proposal complements these programmes.



# BENEFITS OF A GST REDUCTION: THE UK CASE STUDY

A GST reduction would have two important effects. Firstly, the reduced rate would leave consumers with more money in their pockets to spend. This is known in microeconomics as the income effect.

Secondly, the temporary reduction in GST would mean consumers would anticipate a price increase in the future. Lower prices today relative to tomorrow would then give consumers the incentive to bring forward purchases and consumption from the future to today. This second effect is known as the substitution effect.

Given the application of the substitution effect over time, we would expect to see an increase in purchases of non-perishables and other durables which would be consumed later.

There are two important questions to consider when looking at the efficacy of a GST reduction; the extent to which the tax cut is passed on to the consumer and whether the resultant price decrease is large enough for consumers to notice/react.

**The United Kingdom's post-GFC VAT cut**

During the 2008 financial crisis, the United Kingdom was hit harder than most nations in the European Union because the United Kingdom's financial institutions were disproportionately inter-connected to financial institutions in the United States at the centre of the crisis. The Government also lifted barriers to capital flows to and from the rest of the world. The strong presence of financial institutions in London, and the City's role as a global financial centre, meant that it became the global magnet for capital flows for risky investments. Due to this, the United Kingdom was especially vulnerable when risks failed. Once banks found they were making losses, the problem spread quickly to other institutions. This financial crisis led to an economic crisis. The United Kingdom suffered a severe economic downturn, with thousands of businesses shutting down and millions losing their jobs.

The United Kingdom's fall in GDP was greater than any other in that country since the Great Depression of the 1930s. At the start of 2013, GDP in the UK was over three percent below its 2008 peak. Poor economic growth was the major problem during the 2008 recession.

One of the fiscal measures the UK government took to spur the economy was to temporarily reduce its Value-Added Tax (VAT, equivalent to GST) from 17.5 percent to 15 percent from December 2008 to December 2009. This affected 55 percent of all gross taxable consumer expenditure.

The main purpose was to induce consumers to spend now, largely to stimulate spending in an economy during a deflationary spiral.

At a time when demand was collapsing, retailers struggled to maintain sales, which led to prices decreases across the economy. Researchers at the Institute for Fiscal Studies anticipated that if the VAT cut was significant in terms of passing through to the consumer, the effects of the VAT reduction would be seen through changes in expected inflation.

The researchers used two sources of data on inflation expectations. The first source was the quarterly surveys commissioned by the Bank of England on households' inflationary expectations. The second was differentials in the yields of real and nominal government bonds.

Both data points implied that inflation expectations rose after the VAT cut was implemented.

The second factor was whether the cut in prices was large enough for consumers to notice. The Nationwide Consumer Confidence Index conducted a survey where five major questions about the present economic situation and future expectations on economic conditions were put to 1000 adults. Data from this index suggests that the number of people reporting that it was a good time to buy a major appliance rose sharply during the time of the VAT cut, despite questions about the present situation showing less optimism, as would be normal when an economy is heading toward a recession.

**Did it work?**

The immediate effects of the VAT reduction were to lower the price of applicable goods, on average, by two percent. With some of the UK's VAT cuts offset by an increase in excise duties on tobacco and alcohol, the overall effects of the UK Government's tax interventions reduced the price of purchases by one percent.

Total domestic expenditure fell sharply over 2008 following the onset of the financial crisis. This decline ended in 2009, which roughly coincides with the start of the VAT cut. Expenditure continued to grow slowly through 2009 and 2010 before falling back in 2011 when the temporary VAT expired. There was also a large rise in the purchase of durable goods over 2009 which declined over 2010 after the VAT cut ended.

Retail sales, which made up 34 percent of aggregate expenditure in 2009, also increased during the period of the VAT cut. The Retail Sales Index is broken down into food and non-food components. At the start of the VAT cut, the non-food components saw a large rise in sales, which was followed by a dip after the VAT cut. The VAT cut produced a short-lived substitution where consumers moved forward purchases from the start of 2010 to 2009.

This indicates that consumption was indeed brought forward.

One complication with comparisons with the United Kingdom, from New Zealand's perspective, would be the complexity involved in the application of the VAT relative to New Zealand's GST. The UK's VAT has more exemptions than New Zealand's GST, which has just two exemptions in financial services and rental accommodation.

# FISCAL IMPLICATION

The fiscal cost of our proposal is $7.36 billion on a yearly basis.

In gross terms, the initial effect of the GST cut would be a reduction of $8.65 billion in GST revenue. However, some of this reduced revenue will be regained via the GST system.

The $8.6 billion "lost" by the Government equates to an extra $4726.78 in disposable income for the average household. Data from Stats NZ in 2019 suggests this money will be spent. In March 2019, average household disposable income increased 4.9 percent and yet consumption expenditure increased by 5.1 percent. Household savings (the balance of household disposable income and final consumption expenditure) was negative. This means that New Zealand households are net borrowers, or in other words, the average household spends all its disposable income.

Stats NZ also indicates households spend roughly 60 percent of disposable income on GST-applicable goods (i.e. food, alcohol, clothing, household contents, transport, health, communications, recreation and education).

Making the conservative assumption that households continue to spend just 60 percent of their extra disposable income on GST-applicable goods, households across New Zealand will spend an extra $5.19 billion on these goods under our proposal, $519 million of which will be re-collected by the Government via GST at the new 10 percent rate.

This amount does not include additional spending caused by the multiplier effect. Increased spending will result in increased revenues for businesses, passed on to employees and shareholders who will in turn spend their increased earnings on GST-applicable goods and services.

If we apply a basic multiplier, [1/(1-c)] – where c is the additional consumption after a $1 increase in income – to the extra amount spent on GST-applicable goods due to a tax cut, we see the total amount of spending increase from $5.19 billion to $12.9 billion. This creates $1.29 billion in GST revenue.

So, ultimately, the Government will lose $8.65 billion, and claw back $1.29 billion.'

Total net annual revenue from GST will decrease from $25.95 billion to $18.59 billion – a fiscal cost of $7.36 billion.

For the sake of comparison, as of July 2020, the COVID-19 wage subsidy scheme has cost the Government $13 billion and counting – approaching double the fiscal cost of our GST proposal.

# ANALYSIS

**Is it worth it?**

A reduction in New Zealand's GST would mean the constriction of a steady and substantial stream of revenue to the government. At a time when some essential government spending is needed in an economy recovering from the COVID-19 pandemic, the GST cut would would likely necessitate increased debt or a loss in spending on existing services.

A temporary reduction in GST to 10 percent may seem beneficial to the consumers facing hardship during a recession, but such a large loss in public revenue would almost certainly be unconvincing to a policymaker. Nevertheless, we are attracted to this measure for its lack of distortionary economic effects as compared to alternative monetary and fiscal stimulus proposals put forward by the Reserve Bank, policymakers, and commentators.

The fiscal cost of our proposal could of course be mitigated by adjusting the time period for which it applies. While we have calculated the cost for a year, the policy could be implemented for just six months, or even three, with reductions in fiscal costs and stimulus effects.

**Limitation: Adjustments in lifetime purchasing**

An assumption used in this paper while assessing the effects of a GST reduction was to hold lifetime purchasing as constant.

The expectation here is that, as stated, purchasing is brought forward with inflationary expectations due to an indirect increase in incomes due to the cut. However, consumers are also faced with the uncertainty of their future employment prospects. With New Zealand unemployment figures forecast to increase to 10 percent by the end of the year and these forecasts subject to being inflated further, consumers will build an expectation of a future loss of income. When assessing lifetime earnings and lifetime consumption, individuals will temper their current consumption if they anticipate a loss in future income. Consumers may not consume as much if they know they can't afford the eventual price increase in the future. Generally speaking, consumers will adjust their behaviour with shifting expectations around income and prices. However, we do need to consider the GST cut at a time when monetary policy is failing to bring forward purchases and when the only fiscal measure is to raise public spending.

**Limitation: Revenue implications of the substitution effect**

Our forecast impact on revenue only looks at the proposal's income effect. What we have not calculated is the impact on revenue caused by the substitution effect – i.e. spending being brought forward from tomorrow to today.

It is difficult to determine exactly how much spending will be brought forward in anticipated of the GST increase. The United Kingdom's VAT cut cannot be used as a direct comparator, because VAT does not apply to the same mix of goods nor at the same rate that GST does. New Zealand does have precedents of anticipated GST increases – in 1989 and 2010 – but these increases were 2.5 percentage points each, not our proposed five percent. Further, these increased were not preceded by a cut to GST as we propose, which may have a behavioural effect.

The extent to which spending is brought forward will decrease the immediate fiscal cost of the policy, due to positive GST revenue effects. However, in the long run revenue will be lost due to lower spending after GST is increased again. Even if spending changes across these periods balance out, the substitution effect's impact on GST revenue will be a net negative, because spending is shifted into a time period during which a lower GST rate is charged.

# PERMANENT USE OF GST AS A MONETARY STABILISATION TOOL

There have been alternative approaches to GST proposed by researchers. One novel approach would be to have a variable GST rate, which would be countercyclical. One issue raised in the previous section was the changes in inter-temporal decisions made by households. A variable GST rate would influence inter temporal decisions to save and invest.

This approach was first submitted by academics from the University of Otago.

Price differential between current consumption and future consumption is the key benefit behind the reduction in GST. The goal is to have the variable GST rate as a stabilisation tool for monetary policy. The suggestion would be to raise the GST rate during periods of intense pressure on resources and lowered when inflationary pressures are weak.

This would make expectations around price changes in the future clearer for consumers.

Although stable in terms of expectations, we must consider the potential adverse impacts.

The introduction of the variable rate as a monetary policy tool would deviate from the primary purpose of the tax system, which is to raise a stable source of tax revenue for the government. Altering this set of taxes would have effects on the neutrality and efficiency of New Zealand's tax system. The main reason behind an unchanging GST would be to affect decisions to spend now or later. This would be violated by the introduction of a variable GST rate. We can say that this approach is radically different to our proposed temporary GST cut, but in unique circumstances where monetary policy is ineffective, this new approach may work as a way of stimulating the economy.

# CONCLUSION

There is a clear mood for fiscal stimulus among New Zealand policymakers and even the public.

Fiscal conservatives, even those usually averse to such interventions, must engage in the stimulus debate or risk distortionary, politically-motivated spending proposals advanced in the name of fiscal stimulus.

This paper has outlined a simple alternative to targeted loans, minimum incomes, and job creation schemes. While a temporary reduction in GST is by no means a panacea, it achieves the basic goal of fiscal stimulus with minimal distortion in the economy.

Further, the scale of the intervention can easily be adjusted – both in terms of the depth of the GST cut, and the period of time for which it applies – in order to mitigate concerns around fiscal cost for the government.

Spending brought forward as a result of the GST reduction would breathe life into revenue-starved businesses, ensuring they can continue to employ New Zealanders and keep supply chains unbroken.

Some politicians may be tempted to make the change permanent. We do not advise this. In fact, a sunset clause applying after a year would be necessary to avoid long-term deficit effects or politicians replacing the lost revenue with increases to more economically damaging taxes.

With that caveat, we offer this proposal for debate.

# KEY SOURCE DOCUMENTS

Institute of Fiscal Studies, *Using a Temporary Indirect Tax Cut as a Fiscal Stimulus: Evidence from the UK*:* https://www.ifs.org.uk/uploads/publications/wps/wp201416.pdf *(p 21)*

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