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THE TREASURY
Kaitohutohu Kaupapa Rawa

To: Minister of Finance

CC: Minister of Revenue

AIDE MEMOIRE: IMPACT ON CPI FROM RAISING THE GST RATE TO 15%

Officials recently reported to you on an increase to the GST rate (T2010/191 refers), and will soon be reporting to you on compensation options associated with a rise in GST. This note outlines advice on the CPI impact following a 2.5% point lift to the GST rate.

If the GST rate was to be increased, prices for a range of consumption goods and services would also increase to reflect this higher rate. If we assumed retailers passed on the full amount of the increase to their customers (ie, assuming a competitive market), lifting GST to 15% from its current level would result in a 2.22% lift in prices [(1.15/1.125)-1 = 2.22%] on goods and services that attract GST.

However, there are three components in the benchmark CPI that do not attract GST, meaning the price of these goods and services would be expected to remain unchanged as a direct result of a higher GST rate, immediately following the increase. The sum of the three components accounts for 9% of the weight of the CPI basket, with residential rents being the largest at almost 8% and with the remaining two components (credit services charges and school donations) making up the other 1%. Over time, rents and credit services charges would be expected to rise to reflect higher GST, given the lagged relationship between higher input costs and higher prices, but the immediate impact would be expected to be minimal, if any.

Rents in the CPI are calculated as an average price for all renting households (rather than the average price of new rents lodged with the Department of Building and Housing), so these would not be expected to increase immediately as a direct consequence of raising the GST rate. If rents and credit services charges were to rise in the quarters following the rate change, these would be accounted for, along with all other price changes, in the April 1 indexation of benefits. Therefore, using 91% of the assumed change in consumer goods and services is the most appropriate measure for determining the immediate impact on the prices of goods and services. As a result, the impact on prices is estimated at around 2% (0.91*2.22%=2.02%) as opposed to 2.22%. This is consistent with the Statistics New Zealand estimate released on 21 January 2010[1]

Treasury's initial costings and analysis were based on compensating beneficiaries for prices rising 2.22% on the basis that it would be an estimated upper limit of the price rise over time and if anything, would over-compensate for the GST rise. However, using this higher rate may lift inflation expectations, given the immediate impact on consumer prices is only expected to be 2.02%. Higher inflation expectations would be an unwelcome development given the strong relationship of expectations with future

[1] Refer www.stats.govt.nz/browse_for_stats/corporate/corporate/corporatecommunications_mrimpact-of-gst-on-cpiimpact-of-gst-on-cpi.aspx

inflation. If the rate of GST was to increase on 1 October 2010, the risk of higher inflation expectations may be exacerbated following government-related price increases in the previous quarter (including the Emissions Trading Scheme and increased ACC levies). To avoid raising inflation expectations further, we recommend using 2.02% as the assumed immediate increase in the CPI as a direct result of lifting GST from its current level to 15%.

On 1 April 2011, New Zealand superannuation and benefit rates will be inflation-indexed, based on annual growth in the CPI to the previous December quarter. As a consequence, if the short-term impact of the GST rise on inflation is stronger (or weaker) than the 2.02% allowed for in compensation, this will be accounted for at this indexation round.

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