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Westpac InstitutionalBank

The bigGST step

Implications of the NZ Government's economic reform plans

- **The Government has signalled a range of economic reforms, including changes to the tax treatment around property, with details to be provided in the May Budget.**
- **Specific taxes on property investment have been ruled out, but the overall mix of reforms will still weigh on house values.**
- **A cut in the top income tax rate and an increase in GST will improve the incentive for households to save over the longer term.**
- **But they will create significant volatility in inflation, consumer spending and the housing market around the time that they are implemented.**

At the opening of Parliament on Tuesday, Prime Minister John Key delivered a speech on the Government's plans for economic reform. The agenda is wide-ranging, with the main pillars being: a more growth-friendly mix to the tax system; better regulation of resources; deepening and improving access to capital markets; a greater emphasis on practical skills in education; investment in key infrastructure; support for science and innovation; and better delivery of public services.

Of these areas, tax reform has understandably received the most attention. This is where there was the most uncertainty about which direction the Government would take, after several working groups made recommendations at the end of last year; it's also where there is the greatest potential to create winners and losers.

The details of any tax changes won't be revealed until the Budget on 20 May. But from what's been discussed to date, the most likely outcomes are:

- The top income tax rate reduced from 38% to 33%.
- An increase in GST from 12.5% to 15%, with compensating increases to benefits, superannuation etc.
- Depreciation allowances for buildings (and subsequent clawbacks) rescinded.
- Ring-fencing of losses on investment properties may be re-enacted.

New taxes aimed specifically at property – such as land, capital gains, or deemed rate of return taxes – have been ruled out (though there could be greater enforcement of the existing capital gains tax for 'active' traders).

This article discusses the economic effects of these policies, with particular regard to tax changes, and to the property market where some of the proposed changes are aimed.

Macroeconomic impact

The Government's economic reforms are clearly beneficial for potential economic growth, even if they are difficult to quantify. Lower marginal tax rates and reduced abatement rates for Working for Families will increase the responsiveness of the labour supply. Productivity will be enhanced by improving firms' access to capital, and by encouraging more innovation for commercial purposes. Removing barriers to industries such as mining and aquaculture will generate export income and jobs.

The payoff to economic growth could have been larger if inroads were made into the size of government. However, the tax package is effectively trying to undo the damage done by poor tax options taken in the past decade. Projections of deficits for years to come mean that the tax package has had to be designed to be revenue-neutral.

The mix of tax changes should encourage more household saving. It's worth noting that a consumption tax like GST in itself doesn't promote saving, which after all is just delayed consumption. If people expect future consumption to be taxed as well, then there's no additional advantage to saving.[1] Rather, the incentive to save comes from the substitution away from income taxes. As it stands, saving is taxed twice – first when the income is earned, and again on accrued interest (and of course a third time if you count future consumption taxes). Cutting the marginal income tax rate will reduce this 'penalty' on saving.

As an aside, an increase in GST is often opposed on the grounds that it falls hardest on low-income earners. This is true in terms of cashflow, which is why an increase in GST is likely to be

[1] There would be an incentive to save if people expect the GST rate to be lower in the future. But it's more likely to head in the opposite direction.

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accompanied by increased government transfers. But it actually has the most impact on existing savers, because it reduces the purchasing power of what they've already saved. This group tends to be high-income earners, and the elderly.

An increase in GST will also have some significant short-term effects on inflation and consumption. But these will only require a careful interpretation of the data, not a policy response.

An increase in GST from 12.5 to 15% translates to a price increase of 2.2%. Given the difficult trading environment, we assume few retailers will be in a position to sneak through additional price increases. GST applies to around 91% of the CPI basket, so the net impact would be a 2% boost to headline inflation. Adding this to our current forecasts, we would expect annual inflation to peak around 4.8% between December 2010 and September 2011.

Second, consumers will bring forward some purchases to beat the GST hike. Taking the experience of the 30 June 1989 increase in GST (from 10% to 12.5%), we could expect a 10% lift in real consumption of durable goods, a 1% lift in non-durables consumption, and no discernable change for services. That adds up to a 3% rise in real household consumption in the quarter ahead of the GST hike, which would be fully unwound in the following quarter.

Residential property

Changes to the tax treatment of housing were the greatest source of concern going into this week's speech, in light of the recommendations made by various working groups at the end of last year. Indeed, the sharp slowdown in house sales in January was probably due to buyers holding back on concerns that they could face some combination of capital gains taxes, land taxes, and the removal of tax benefits.

We've previously detailed how some of the proposals would affect house values, using our framework of the 'investment value' of housing (see the Bulletin "Tax and house prices", 16 December 2009). With several changes to the tax system on the cards, the combined effect on housing is difficult to untangle, but the broad direction is clear:

- The 'investment value' of houses will be lower.
- There will be fewer rental properties as some investors exit the market.
- Remaining investors will be able to raise rents.
- Home ownership will rise, as higher rents and fewer rental properties will encourage some renters to become buyers.

The change that will be most effective at taking the heat out of the housing market is, ironically, the one that's not aimed at that purpose. Cutting the top personal tax rate reduces the rebate that landlords receive for losses on their rental properties (and the implicit value of tax-free accommodation for owner-occupiers).

Ring-fencing of losses and changes to depreciation allowances would actually have an ambiguous impact. In our framework, the 'investment value' is determined by the marginal buyer – that is, whoever is willing to pay the most. Under the current arrangements, the marginal buyer would be a fully leveraged investor with negative cashflow.

Ring-fencing and depreciation largely have an impact through the timing of cash flows. Applying either of these changes would fall hardest on cash-poor investors, and would see some of them exit the market – but it becomes a matter of finding the 'new' marginal buyer, who may be a less-leveraged investor with positive cashflow. So although there would initially be downward pressure on prices as leveraged investors sold up, the impact on the underlying value of housing is unclear.

A GST increase would have a positive (though relatively small) impact on house values, through two avenues. First, GST applies to the construction costs of new houses, so a GST hike will push up the replacement cost of housing, which in turn sets a benchmark for existing house prices. It also discourages new building, so New Zealand's recent underinvestment in residential construction would continue for a little longer.

The second effect is via substitution. GST doesn't apply to the flow of services from housing – both rented and owned – so an increase in GST makes housing services more attractive relative to other types of consumption. That would give a boost to both house prices and rents.

Waving a wet finger in the wind, we think the ballpark change in residential property values from the projected changes would be in the vicinity of -10%, dominated by the impact of the lower top tax rate. However, this is not a forecast that prices will actually fall by 10%. House prices tend to be stickier on the downside, since most owners won't have to sell into a falling market; the hit would come through lower turnover instead. Prices would tend to drift sideways for a number of years, until incomes – and rents – catch up and close the valuation gap.

Monetary policy implications

The RBNZ can ignore the first-round effects of a GST-induced 2% jump in headline inflation, though they will keep a wary eye to ensure it doesn't become embedded in inflation expectations. Given that the tax changes are designed to be revenue neutral, the aggregate effects will be muted. However, in the short term they will likely be negative for growth (higher household propensity to save and negative wealth effects from lower property price expectations). Also, there will be a lot more noise introduced into the economic data making interpretation of underlying developments more difficult at an already challenging time.

On balance, these changes lean towards delaying the start of the tightening cycle – or at the least they enable the RBNZ to stick to its expectation of raising rates "from around the middle of 2010". Over the longer term, the changes could lead to a marginally lower 'neutral' level for the cash rate. But this wouldn't materially disturb the RBNZ's plans to normalise the OCR from what is an extremely low level at the moment.

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