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Incidence of GST exceptions

Background Paper for session 12
of the Tax Working Group

June 2018

Prepared by the Inland Revenue Department and the Treasury

1. Incidence of GST exceptions

1.1 Content and scope

1. This paper responds to the Group's request for information about the incidence of exceptions for GST In particular, the Group requested information on whether the benefit of a GST exception (for example for food and drink) would be fully passed through to consumers.

2. This paper provides a summary of the international evidence regarding this.

1.2 Summary

3. The literature, both theoretical and empirical, indicates that, because there is substantial variation in the characteristics of different markets, the incidence of GST/VAT changes varies substantially. While GST/VAT changes typically result in either a partial or full shift of the tax onto the consumer the degree of this differs significantly depending on the circumstances.

4. The two key determinants/variables that influence the incidence from a GST/VAT change are market competition and the elasticity of demand and supply for the goods and services:

   - **Market competition** – The competitive dynamics/structure of the market plays a significant role in determining the tax incidence of a GST/VAT rate change.
     - In the case of perfect competition (i.e. when firms and consumers are price takers), shifting the tax incidence depends on the sensitivity of demand and supply to price changes.
     - For imperfectly competitive markets, the impact (in terms of changes in price and quantity) of a VAT change depends on the various forms of imperfectly competitive markets (e.g. oligopoly, monopoly etc.).
     - As general observation, empirical evidence indicates that markets which are close representatives of perfect competition are more likely to feature full shifting of taxes (to the price paid by the consumer), whereas less competitive markets are more likely to feature more under-shifting.

   - **Elasticity** – The elasticity of demand and supply is the other key determinant of the tax incidence of a GST/VAT change. The key variables that influence elasticity of demand include:
     - *Substitutability* – The availability of substitute goods and how closely the substitute the original good (for example, a consumer may consider the Pepsi is reasonably close substitute for Coca Cola, but a poor substitute for milk). Whether the GST/VAT rate change is uniform or differentiated also makes a difference to substitutability between goods. For example, if a GST/VAT increase was applied to orange juice but not apple juice, then consumers are more likely to substitute apple juice for orange juice.

- *Basic vs. luxury goods* – The demand for basic goods, like food items, is typically less elastic than for non-essential, luxury items like jewellery and holidays.

5. As a result it is difficult to estimate the incidence of GST exceptions in New Zealand, in particular as the incidence would depend on the specific design of the exception. In addition, New Zealand has no past experience of creating exceptions from GST to provide an evidence base to draw on. However, international experience regarding rate reductions can provide some insight.

1.3 Research into VAT reductions in Europe

6. The most comprehensive research into VAT rate reductions comes from (Benedek, De Mooij, Keen, & Wingender, 2015). This research looked at VAT rates for 17 Eurozone countries over 1999-2013. The research considered the incidence of 1,231 VAT rate changes including 191 reductions in VAT rates for specific items.

7. This research estimated that changes in the general VAT rate were on average fully passed through to consumers. However, changes in rates for specific goods and services were on average not fully passed through and had an estimated average pass through rate of approximately 30 percent.

8. Other research into VAT rate reductions in Europe indicate that there is a high degree of variation in pass through rates.

VAT reduction on food in Norway (Gaarder, 2016)***:***

- In 2001, Norway reduced the VAT rate on all food items from 24% to 12%, while the VAT rate on non-food items remained at 24%.
- Post-implementation evaluation indicates that this rate change was fully passed through to consumers.

VAT reduction on restaurant and catering services in Finland (Simola, 2012)***:***

- In 2010, Finland reduced the VAT rate on restaurant and catering services (excluding alcoholic beverages) from 22% to 13%. This aligned the tax rate for restaurant meals with other food.
- This led to a price reduction of 2.3%, which equates to a pass-through rate of 31%.
- The amount of reduction was highly variable among restaurants.

VAT reduction in restaurant services in France (Institute for Fiscal Studies, 2011)

- In 2009, France reduced the VAT rate on restaurant services from 19.6% to 5.5% (excluding alcoholic beverages, which continued to be taxed at 19.6%).
- Post-implementation analysis indicated that after a year and a half there was a degree of pass through of 45% of the rate cut to consumer prices.

Reduction in the VAT rate on hotels in Germany (Institute for Fiscal Studies, 2011)

- In 2010, the VAT rate on hotels, guest-houses and campsites in Germany was reduced from 19% to 7%.
- The total pass-through of the VAT reduction is estimated to be 28.4%.
- Evidence indicates that the price pass-through that did occur was not instant and instead was spread out over an extended period.

References

Benedek, D., De Mooij, R., Keen, M., & Wingender, P. (2015). *Estimating VAT Pass Through.* IMF.

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