

**TAX DESIGN INSIGHTS FROM THE
NEW ZEALAND GOODS AND SERVICES TAX
(GST) MODEL**

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Ian Dickson and David White

Correspondence to:

David White, Associate Professor
School of Accounting Commercial Law
Victoria University of Wellington,
PO Box 600, Wellington, New Zealand.
E-mail: david.white@vuw.ac.nz

**Centre for Accounting, Governance and Taxation Research
School of Accounting and Commercial Law
Victoria University of Wellington
PO Box 600
Wellington
NEW ZEALAND**

Tel. + 64 4 463 5078

Fax. + 64 4 463 5076

<http://www.victoria.ac.nz/sacl/CAGTR/CAGTRhomepage.aspx>

Ian Dickson* and David White**

“Tax Design Insights from the New Zealand Goods and Services Tax (GST) Model”

A commentary on Ian Crawford, Michael Keen, and Stephen Smith,
“Value Added Tax and Excises”, chapter 4 in Sir James Mirrlees *et al* (eds),
Dimensions of Tax Design, a book to be published by Oxford University Press
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* Director, Burleigh Evatt Consulting, Wellington, New Zealand. Ian worked in the New Zealand Treasury tax policy branch 1977-1986 and was Head of the New Zealand Treasury GST unit 1984-86. He has recently assisted in the introduction of a VAT in the Kingdom of Tonga in 2005.

** Associate Professor and Associate Director, Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, Wellington, New Zealand, and Senior Fellow, Taxation Law and Policy Research Institute, Monash University, Melbourne. David worked in the New Zealand Treasury tax policy branch 1987-2000.

1. Introduction

The editors of the Mirrlees Review asked us to evaluate the UK VAT and the European Union VAT Directive and compare them to the New Zealand VAT model, which is called GST (Goods and Services Tax). At first sight, this brief might seem strange. After all, the VAT is a European invention that has swept the world, now applying in around 150 countries while GST is merely a more recent, modified European VAT.

Yet, for the whole life of the New Zealand GST, international VAT experts, including from Europe, have made favourable comparisons between the old European VAT model and the GST model.¹ In many cases, these comparisons have concluded that the changes that New Zealand made when introducing its VAT in the mid-1980s were improvements on the European model – a case of same wine, new bottle. Countries seeking to introduce VAT have often been advised to consider New Zealand's approach, and many countries have done so.

Surprisingly, there has been little research on GST, particularly of an empirical nature, to test objectively the merits of the innovations and the international experts' advice.² The recent 20th anniversary of the New Zealand GST, however, did provide an opportunity to begin rectifying that omission and to develop a research agenda.³ A multidisciplinary team of 29 experts from eight countries analysed and discussed the New Zealand GST experience, the influence of the New Zealand model around the world, and current issues for VAT tax systems everywhere. This commentary draws on material in this book,⁴ our experience as tax policymakers and our research.

New Zealand's GST is different from the UK VAT in the important respect that it is applied comprehensively at a single domestic rate. There are no reduced or super reduced rates, exemptions or zero-rates – other than those necessary to define the appropriate base of the tax.⁵ Food, children's clothing, medical care, education services, publications, energy and other necessities of life are taxed at 12½ per cent like all other goods and services. This was a deliberate policy choice made at the time of introduction and maintained intact over the intervening years. Applying the most widely-used indicator of VAT performance, the C-efficiency ratio,⁶ the New Zealand GST scores twice as highly as the UK VAT.⁷ Indeed, the GST is apparently a huge

¹ See, for example, Sijbren Cnossen's recent call for a comprehensive overhaul of the EU VAT Directive: "Is the VAT's Sixth Directive Becoming an Anachronism?" (December 2003) *European Taxation*, 43 (12): 434-42.

² Early analysis by New Zealand Institute of Economic Research staff is summarised and discussed in AE Bollard, "New Zealand's Experience with Consumption Tax" (1992) *Australian Tax Forum*: 473-93.

³ DI White, "Twenty Years of GST: The Best Path Forward," (2007) *New Zealand Journal of Taxation Law and Policy*, 13 (3): 357-80, especially 372-74. A shorter version of this article also appeared in (2007) *International VAT Monitor*, 18 (5): 343-51, especially 348-49.

⁴ R Krever and DI White (eds), *GST in Retrospect and Prospect* (Wellington: Brookers Ltd, 2007).

⁵ In the category of 'base-defining' exemptions and zero rates, we include exports, provision of labour services, and investment capital.

⁶ C-efficiency is the ratio of VAT revenue to consumption expenditure, divided by the standard tax rate, expressed as a percentage.

⁷ OECD, *Consumption Tax Trends* (Paris: OECD, 2006), 53.

43.5 points above the OECD average for C-efficiency.⁸ It is this long standing, comprehensive application of GST that provides insights for formulation of indirect tax policy for the United Kingdom. The commentary will also briefly consider aspects of how the New Zealand GST applies to services and organisations that in Europe are often considered too hard to tax.

2. United Kingdom and New Zealand: Commonalities and differences

Before analysing the New Zealand ‘GST model’, the contextual similarities and differences between New Zealand and the United Kingdom need to be examined. The similarities are easiest. Both countries are islands of roughly the same area. New Zealand is a former colony of the United Kingdom and is English-speaking. The two countries have a great many cultural similarities and historical ties, including a common legal heritage, political institutions and experience of geopolitical conflict. Naturally, the development of many areas of government policy in New Zealand has over time followed the lead of policy in the United Kingdom – although the development of indirect tax policy in the last 20 years is a notable exception. Britain’s policy choices, such as to enter the Common Market in 1973, have also affected aspects of social, economic, and foreign policy and the sense of national identity in its remote former colony. Both countries have modern information technology systems in both the private and public sectors (including, in the customs and revenue authorities).

New Zealand and the United Kingdom also employ broadly similar tax types, with some variation. New Zealand has neither separate capital taxes nor national insurance contributions (pensions are funded from general revenue on a pay-as-you-go basis). New Zealand relies a little more heavily on its VAT as a source of taxation than the UK while the UK relies a little more heavily on its excise duties on specific goods and services, like motor fuels, alcohol beverages and tobacco products (see table 1 below).

Both countries have extensive social welfare systems and both provide income tax credits for families with insufficient market income to provide an acceptable living standard. New Zealand's tax-funded universal pension is available at the age of 65 years to all who meet residential requirements. The level of payment is reviewed each year and is adjusted to take account of increases in inflation and wages. When wages increase, New Zealand Superannuation is adjusted so that it is between 65 per cent and 72.5 per cent of average ordinary time earnings after tax.

The settings of the respective countries, however, are very different. New Zealand is a nation of 4.5 million individuals separated from its nearest neighbour, Australia, by 2000 kilometres of sea, so that New Zealand has no proximate borders with any other countries. While New Zealand has economic integration agreements with Australia, and a growing number of trade agreements with countries in the Asia-Pacific region

⁸ If ‘departmental GST’ is excluded from the calculation (since it results in no net revenue to government), the New Zealand C-efficiency ratio reduces by about one-third, as shown in the following table.

Years ended 30 June	1999	2000	2001	2002	2003	2004	2005
C-efficiency ratio	105.9	107.6	106.3	88.3	90.9	94.9	93.1
C-efficiency ratio adjusted for departmental GST	78.2	79.4	78.4	65.2	67.1	70.1	68.7
Sources: Statistics New Zealand’s Consolidated Accounts of the Nation; Financial Statements of the Government of New Zealand (Annual).							

that generally have VATs of their own, it is not a member of any multilateral relationship that compares with the UK's membership of the European Union in limiting domestic policy flexibility. Consequently, VAT administration issues that arose for the United Kingdom with the elimination of internal frontiers in the European Union, and the potential tax competition, have not been ones for New Zealand.

	United Kingdom	New Zealand
Year VAT introduced	1973	1986
Standard VAT rate	17.5	12.5
General threshold	US\$93,700	US\$26,846
VAT revenues as % of total taxation (2003) ⁹	19.8	26.1
C-efficiency ratio for VAT (2003) ^{10 11}	46.4	96.4
Tax on general consumption as % of GDP ¹²	7.0	9.1
Tax on general consumption as % of total taxation	19.5	25.6
Tax on specific goods and services as % of GDP	4.0	2.3
Tax on specific goods and services as % of total taxation	11.2	6.5

Source: OECD, *Consumption Tax Trends* (Paris: OECD, 2006), 25-28, 30, 32, 52-53.

3. A comprehensive base and single rate: Lessons from New Zealand

The Meade Report¹³ had an immense influence on the development of tax policy thinking in New Zealand in the years following its publication. It was much pored over, studied, debated and quoted at length in officials' reports to New Zealand ministers. It provided guidance about how problems relating to the taxation of individuals and businesses, and wealth, should be addressed. Under *Meade's* influence, the formulation of tax policy advice became systematic and principles-based.

By the early 1980s, New Zealand was lumbered with an awful wholesale tax that omitted around 67 per cent of the potential indirect tax base, and the country relied significantly upon international trade taxes. Other horrors abounded in the tax, regulation and subsidisation of industry, as well as the conduct of economic management generally. The *ad hoc* grab bag of taxes could not fund existing expenditure demands, let alone shoulder the burden of a switch towards a greater reliance on indirect taxation that was government policy. *Meade* could give New Zealand policymakers no direct guidance on how to address this problem, nor on the pressing question of the day, 'which is better, VAT or retail sales tax?' *Meade*,

⁹ OECD, *Consumption Tax Trends* (Paris: OECD, 2006), 52 (2003 data).

¹⁰ *Id.* at 53 (2003 data).

¹¹ See note 6 above for the definition of the C-efficiency ratio. Also, in note 8 above, we suggested an adjustment to the C-efficiency ratio for New Zealand in order to exclude departmental GST. Using official New Zealand statistics, we calculate the C-efficiency ratio adjusted for departmental GST in 2003 at 67.1.

¹² These last four tax ratios use 2004 data. See OECD, *Consumption Tax Trends* (Paris: OECD, 2005), 25-28.

¹³ *The Structure and Reform of Direct Taxation: Report of a Committee chaired by Professor J. E. Meade*. The Institute for Fiscal Studies. (George Allen & Unwin, London, 1978).

however, inspired an investigative approach to these problems that eventually resolved these questions.

There are still many questions about the directions for indirect taxation in the 21st century. There are two central questions where the evidence from New Zealand can provide insights for the authors' proposed reforms of the UK VAT, which imposes reduced rates on more total consumption expenditure than the VAT in any other EU-15 Member State:¹⁴

- Are the alleged administration and compliance benefits of a comprehensive single-rate VAT¹⁵ borne out by the New Zealand experience?
- What is the evidence on the ability to alleviate the distributional impacts of a comprehensive single-rate GST on the poor and lowest paid?

Embodied in these two questions are the essential contrasts between the European-style and New Zealand-style VATs. This section first considers the New Zealand debate on comprehensiveness prior to introduction of GST in 1986, secondly, administration, compliance and public acceptance issues, and, finally, the evidence on distributional impacts.

The New Zealand debate on GST base comprehensiveness: 1981-86¹⁶

New Zealand policymakers were fortunate in having a dry run at indirect tax reform issues and arguments in 1981-82, several years before the successful campaign to introduce a GST in 1984-86. A task force that reviewed the tax system had proposed that the wholesale sales tax should be converted to a credit-offset basis, the indirect tax base should be broadened and supplies of services should be taxed separately.¹⁷ The then New Zealand Prime Minister adopted much of the task force's advice in 1982 but not their indirect tax proposal.

New Zealand policymakers learnt from the 1981-82 experience that maintaining a comprehensive tax base would be one of the most difficult issues, particularly in relation to food and clothing. They developed arguments for taxing food and other necessities on equity and economic efficiency grounds. They realised, moreover, that they would need to run public relations, consultation and education campaigns on a scale previously not carried out and fully involving both the public and private sectors.¹⁸ This was a high risk strategy since it focussed on the very things the public would be most sensitive about paying tax on. If that debate were won, the strategy suggested, other people seeking exemptions would find it much harder to get public

¹⁴ S Cnossen, note 1, 434.

¹⁵ S Cnossen, "Administrative and Compliance Costs of the VAT: A Review of the Evidence," (1994) *Tax Notes International*, 8: 1649 at 1667. Cnossen concludes this review by arguing that overall compliance costs and administrative costs can be reduced by, among other things, broadening the VAT base, imposing a single rate and increasing the threshold for registration.

¹⁶ This section draws on the historical and policy perspective in I Dickson, "The New Zealand GST Policy Choice: An Historical and Policy Perspective," in R Krever and DI White, note 4, 45-63, especially 45-52.

¹⁷ PM McCaw, *Report of the Task Force on Tax Reform* (Wellington: Government Printer, 1982).

¹⁸ See the following chapters in R Krever and DI White, note 4: R Douglas, "The New Zealand GST Policy Choice and its Political Implications," 3-11; R Green, "Consulting the Public in Developing a GST," 13-25; J Todd, "Implementing GST – Information, Education, Co-ordination," 27-43; I Dickson, "The New Zealand GST Policy Choice: An Historical and Policy Perspective," 45-63.

acceptance of their claim and there was a better chance of enacting a comprehensive indirect tax.

The argument conceded that taxing food was regressive. Evidence available at the time suggested that while the bottom 20 per cent of households allocated between 23 and 29 per cent of their budgets to food, the top two deciles spent between 7 and 10 per cent of weekly expenditure on food. However, the answer to the question “who spends the most on food?” was that upper income households spend twice as much as low-income households. Of every \$100 spent on food in New Zealand, the least well off spent \$6.50, whereas the most well off spent \$12. Taxing all food thus made revenue available to redistribute and supplement the income of the poor. This argument, presented by a Government with credibility, was broadly accepted and GST went ahead with a comprehensive base and single domestic rate.

Administration costs, compliance costs and public acceptance

The first question under this heading is whether the alleged administration benefits of the comprehensive single-rate VAT are borne out by the New Zealand experience. Unfortunately, the administrative costs of operating GST are not separately identified because GST-related work is often not separate from other tax gathering functions.

It is possible, however, to identify areas of considerable administrative cost saving in the GST system. GST does not require hundreds of pages of classifications of goods, services and providers and the associated interpretations and rulings. It does not, to take one recent UK example, require officials to distinguish a ‘biscuit’ from a ‘cake’, and, if they make a mistake, to consider whether the refund should be for the total amount wrongly charged or whether this would constitute “unjust enrichment” of the taxpayer.¹⁹ It also does not require officials to identify the public organisations that shall, and shall not, be subject to GST. GST remains quietly agnostic on such questions: the general rules apply.

It is also possible to identify areas of administrative cost and risk in the GST system.²⁰ First, even a comprehensive tax applied in an island country without near neighbours is a ‘cash refund’ tax that carries the attendant risks of refunds. Even with the taxation of imports, some missing trader fraud occurs and a particular problem area has been property developers. Secondly, GST requires regular legislative maintenance, in one recent case blocking GST refunds with an estimated revenue cost of up to NZ\$200 million.²¹ Thirdly, in contrast to the UK, New Zealand still has separate agencies administering the border and inland collection of GST. The fragmented administration in New Zealand requires agency-to-agency information

¹⁹ The Marks & Spencer teacake case, concerning the misclassification of their chocolate teacakes as standard-rated biscuits rather than zero-rated cakes from 1973 to 1994, is still not settled after 10 years of argument. Marks & Spencer claim repayment of £3.5 million but the Commissioners of Customs & Excise refuse to refund more than 10 per cent of the overpaid VAT.

²⁰ The consideration of revenue risk draws, in part, on D Snell, “GST – Revenue and Business Risk,” in R Krever and DI White, note 4, 423-30, especially at 424 and 429.

²¹ The Taxation (Annual Rates, Taxpayer Assessment and Miscellaneous Provisions) Bill 2001 retrospectively blocked some GST refunds affecting inbound tour operators and educational institutes. See officials’ letter to the Finance and Expenditure Committee of the New Zealand Parliament dated 31 July 2001, attached as Annex A in R Oliver, “Taking a Fixed Tax Position in a Changing World – A Personal Perspective”, 19-25, available at <<http://taxpolicy.ird.govt.nz/publications/files/icanz2003.pdf>> (as at 26 February 2008).

exchanges to audit the deduction for GST collected at the border and this may be more costly. The New Zealand Customs Service increasingly focuses on border security rather than revenue collection, so differing agency priorities are a risk issue.

While administrative costs of GST may be difficult to ascertain, policy administration costs are demonstrably low. In 20 years, GST has had one major policy review, which produced no recommended structural change. The Inland Revenue Department, responsible for most of the legislative work on GST, has the time of just 1½ professional policy staff dedicated to GST out of a total tax policy complement of 45. The key point is that GST has been a ‘low maintenance tax’ from a policy administration cost perspective²² and this is generally attributed to the twin policy pillars of comprehensive coverage and a single domestic rate.

The second question is whether the alleged compliance benefits of the comprehensive single-rate VAT are borne out by the New Zealand experience. Here the evidence is less conclusive so this question cannot receive a short answer. There are five main observations that we would like to make. First, as international experts argue, VAT compliance costs are difficult to measure and interpret correctly²³ and “international comparisons of administrative and compliance costs should be regarded as tools to raise questions rather than providing immediate answers.”²⁴ Therefore, care is needed in interpreting and drawing conclusions from the various surveys.

Secondly, two major New Zealand surveys in the last 15 years have attempted to quantify GST compliance costs:

- In 1991-92, a benchmark survey by Sandford and Hasseldine²⁵ concluded that total compliance costs of the GST were large (7.3 per cent of GST net revenue) and that mean annual compliance costs were regressive (\$1,066 or 1.6 per cent of turnover for firms with \$30,000-\$100,000 turnover; \$3,521 or 0.2 per cent of turnover for firms with \$1-2 million turnover; \$9,615 or 0.005 per cent of turnover for firms with more than \$50 million turnover). The overall value of the cash flow benefit from the delayed payment of GST reduced these compliance costs figures by around 39 per cent, providing greatest benefit to larger firms. Substantial offsetting managerial benefits from improved accounting practices were reported, mostly by smaller firms. At the time, only 23 per cent of respondents used computers for their GST accounting.
- In 2004, a survey of SMEs²⁶ to provide a baseline for evaluating the effectiveness of future policy and administrative initiatives was conducted by

²² This label was used to describe the perspective of another key tax policy advising agency in New Zealand, the Treasury. See D Snell, “GST – Revenue and Business Risk,” in R Krever and DI White note 4, 423-30, at 424.

²³ S Cnossen, note 15 above, at 1665.

²⁴ C Sandford, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Bath, Fiscal Publications, 2000), 137.

²⁵ C Sandford and J Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (Wellington, Institute of Policy Studies, Victoria University of Wellington, 1992), 57-79. All figures in New Zealand dollars.

²⁶ Firms that employed 50 or more staff and had an annual turnover of more than NZ\$10 million were excluded.

an independent research organisation for the Inland Revenue.²⁷ On average, respondents reported mean annual compliance costs of \$2,471 for income tax and \$1,553 for GST. GST compliance costs are regressive (\$1,285 for firms with \$40,000-99,000 turnover; \$2,646 for firms with more than \$1.3 million turnover). Fifty-three per cent used computers for their GST accounting. The survey revealed that levels of stress in meeting tax compliance requirements and finding the money to pay the tax were higher for GST (3.8 per cent) and provisional income tax (3.7 per cent) than for pay-as-you-earn income tax (3.2 per cent) and fringe benefit tax (3.2 per cent).

The results of both surveys are consistent with what is known about the relatively fixed nature of costs associated with administrative tasks in small businesses. They show that GST compliance costs are very regressive. The 2004 SME study says, for example, that the irreducible cost of GST compliance is around £40 per month.

Thirdly, a difficult issue concerns the marginal cost of GST compliance (that is, the amount that would be saved if the GST did not exist). There are two aspects to this issue. First, compliance costs must be attributed between tax types (in particular, the income tax and the GST). Secondly, compliance costs must be attributed between tax and core accounting costs. We believe that marginal GST compliance costs may not be as high as the New Zealand surveys suggest. A New Zealand case study that required participants to record tax and accounting functions in a weekly diary over 12 months, supplemented by regular interviews, provides an interesting insight. It concluded that the high proportion of tax compliance costs allocated to GST rather than to income tax in earlier New Zealand studies (the main one being Sandford and Hasseldine (1992)), may well be explained by the fact that GST reporting is more frequent (monthly, bimonthly or six monthly) and that small business people perceive income tax as the by-product of accounting first prepared for GST returns.²⁸ This suggests it may be fraught to attempt a meaningful attribution of tax compliance costs by tax type. The potential overlap between core external and internal accounting costs and GST compliance costs is even more problematic.²⁹ A strong possibility remains that the costs of basic business record keeping are represented as GST compliance, since merchants commonly refer to “doing their GST” as shorthand for such activities.

Reinforcing this argument is the point that if GST compliance costs were an unreasonable burden on smaller businesses there would have been much more adverse comment than has occurred. Compliance costs with tax, regulatory, health and safety, and statistical obligations, have been an on-going complaint from business advocacy groups, but the focus has been on other areas of fiscal encroachment on day-to-day business affairs rather than GST. This speaks to us of a GST system that nevertheless

²⁷ Colmar Brunton, *Measuring the Tax Compliance Costs of Small and Medium-Sized Businesses- A Benchmark Survey* (Wellington, 2005), 95-103. All figures in New Zealand dollars.

²⁸ K Ritchie, “The Tax Compliance Costs of Small Business in New Zealand” in C. Evans, J. Pope, J. Hasseldine, (eds) *Taxation Compliance Costs: A Festschrift for Cedric Sandford* (Sydney, Prospect Media, 2001), 297-315, at 312.

²⁹ For a discussion of the considerable efforts made to improve the compliance cost estimates in the 2004 survey and some of the outstanding issues, see: P Oxley, S Turner and C Sullivan, “Tax Compliance Costs of Small Businesses 2004: Improving the Estimates,” a paper presented at the 2005 IRS Research Conference held in Washington DC on 7 June 2005, <http://www.irs.gov/pub/irs-soi/05oxley.pdf>; and, P Oxley and D Elwela, “Tax Compliance Costs of New Zealand Small Businesses, 2004: Designing the Survey for its Policy Purpose” a paper presented at the Seventh International Conference on Tax Administration held in Sydney on 20-21 April 2006.

finds acceptance amongst the business community that collects the tax. Compliance with the huge volume of income tax changes, with fringe benefit tax and provisional income tax, where there is an element of uncertainty about establishing liability (as there would be in a VAT system with extensive exemptions), and with requirements that do not mirror ordinary day-to-day business activities (in the way that issuing and receiving invoices do), have attracted more comment and criticism.³⁰

Fourthly, further corroborating evidence on the level of compliance costs of GST may come from the tax advisory (as opposed to the tax compliance) profession. Until recently, the tax teams of all large law and accounting professional firms in New Zealand, with one exception, did not include a specialist GST partner. It was only in 2006 that a small number of other large professional firms considered giving GST advice justified appointing a specialist GST partner.

Fifthly, a 15-year-old New Zealand and UK compliance cost comparison is available. The two studies had one author in common (Sandford) and used the same methodology. The comparison shows UK VAT compliance costs were lower at low turnovers (US\$0-500,000) and higher at high turnovers (above US\$500,000) than in New Zealand. For example, for turnover under US\$50,000, UK VAT compliance costs as a percentage of taxable turnover were 1.49 compared to 2.06 in New Zealand, for turnover of US\$50,000-100,000 0.70 compared to 0.91, for turnover of US\$100,000-200,000, 0.50 compared to 0.67, and for turnover of US\$200,000-500,000, 0.44 compared to 0.47. On the other hand, for turnover of US\$500,000-1 million UK VAT compliance costs as a percentage of taxable turnover were 0.34 compared to 0.28 in New Zealand and for turnover of US\$1-10 million, 0.07 compared to 0.04.³¹

A common author of these studies suggests the following explanation of the higher New Zealand GST compliance costs for smaller businesses: “Because compliance cost as a percentage of turnover are negatively correlated with size, the overwhelming reason for the difference will be the much lower registration level for the New Zealand tax (about one-third of the United Kingdom threshold of 1986-87) and its wider coverage and the pressure put on small operators in New Zealand to register voluntarily.”³² Another factor may be the different tax return periods most commonly used in the two countries (in most cases, two months for New Zealand and three months for the UK).

We are inclined to put most weight on the threshold, voluntary registration and the tax return period factors. Cnossen would add the registration of nonprofits in New Zealand. After preparing the table comparing the 15-year-old UK VAT and the New Zealand GST compliance costs surveys, Cnossen still concludes that broadening the

³⁰ From 2003 onwards, an annual private-sector survey of tax compliance costs for all sizes of enterprise has reported very high tax compliance costs (in 2007, annual total average internal and external compliance costs for all types of tax advice was \$11,592 and the average total cost per full-time equivalent staff was \$402). This survey does not break down tax compliance costs by size of enterprise or tax type. The marked changes in the respondents each year mean that year-on-year comparisons are difficult. Business New Zealand-KPMG Compliance Cost Survey, October 2007, 35-39. See <http://www.businessnz.org.nz/surveys/504> (as at 26 February 2008).

³¹ Sandford, note 24 above, 132, reporting the comparison and conversion into US dollars made by Cnossen, note 15 above, 1665-67.

³² Sandford, note 24 above, 137. Cf Sandford and Hasseldine, note 25 above, 112.

VAT base is one of three ways of reducing overall compliance costs.³³ We agree with Cnossen and with the conclusion that Sandford earlier reached with his co-author Hasseldine that, “the wider base of the New Zealand tax ... could be expected to reduce compliance costs compared with the United Kingdom. Only a much more detailed comparison than is currently possible would reveal the areas of significant difference in compliance costs.”³⁴ That work has still not been done.

The final question under this heading concerns public acceptance of the twin pillars policy. Acceptance of GST by the business community, in particular, was aided by extensive consultation and adaptation prior to enactment of legislation. This was the first time that the New Zealand public had been consulted on tax policy and legislation. Moreover, submitters could see the results of expressing their views as the draft legislation contained in the *White Paper*³⁵ was completely re-written before enactment. An extensive public relations programme aimed at educating taxpayers was also undertaken under the auspices of the GST Coordinating Office.

A comprehensive single-rate VAT has found such acceptance in the New Zealand social, political and economic context that the concept has gone virtually unchallenged for two decades. There have been no serious attempts to challenge the model.³⁶ In 1987, the year after GST’s introduction, the main opposition National Party proposed an ‘Extax’ that would have introduced exemptions and suspended the credit-offset mechanism. Following their defeat in the general election, the National Party dropped Extax. Later, after the change of Government at the 1990 general election, National’s Minister of Finance described the introduction of GST as “a model of tax reform.”³⁷

To what extent does this public acceptance result from unique circumstances in New Zealand not replicable in the UK? One set of circumstances might be the broad national consensus in New Zealand in 1984 that reform was desperately needed. This swept the Fourth Labour government to power and returned the same administration three years later, despite its ‘root and branch’ reform policies. There is a sense that in a national emergency, such as New Zealand faced in 1984, the public will temporarily accept the ‘unacceptable’. By the end of the 1990s the emergency had ended, yet acceptance of, indeed popular support for, a comprehensive single rate VAT system appears to be as strong as ever. Some other economic reforms of the Fourth Labour Government, including the move towards a more comprehensive income tax, may have been partly or wholly reversed in the last 20 years but the twin pillars of the GST model remain standing. This suggests that the public is able to be convinced of the merits of such an approach when the arguments are presented and provides support for the authors’ proposal of a more comprehensive 15 per cent VAT applied to all non-housing consumption goods for the UK.

³³ Cnossen, note 15 above, 1667.

³⁴ Sandford and Hasseldine, note 25 above, 112-13.

³⁵ *White Paper on Goods and Services Tax: Proposals for the Administration of the Goods and Services Tax* (Wellington: New Zealand Government, March 1985).

³⁶ The application of GST to local authority property rates and to tourist expenditure have been continuing issues that successive governments have declined to change.

³⁷ Quoted in J Todd, “Implementing GST – Information, Education, Coordination,” in R Krever and DI White, note 4, 27-43, at 40.

Evidence on distributional impacts

The position of two groups in society is of particular concern when examining the distributional impacts of a proposal to extend VAT to food, clothing and the other necessities of life:

- Pensioners;
- Low-paid workers and social security beneficiaries.³⁸

Distributional impacts for pensioners arising from the introduction of GST were dealt with adequately with a one-off benefit adjustment that reflected the estimated consumer price effect of the reform.³⁹ It should be noted, moreover, that under the universal New Zealand Superannuation scheme (a pay-as-you-go scheme) the pension is explicitly linked to average after-tax wages. Pensioners therefore participate in the higher after-tax incomes of working age individuals and are protected, at least as far as their state-funded pensions are concerned, from the inter-generation equity implications of a direct-to-indirect tax shift. Obviously, no such protection is available in respect of savings and non-indexed private pensions.

Low-paid worker and social security⁴⁰ beneficiaries present different issues. At GST's introduction there were one-off adjustments to social security benefits as occurred for pensions. The low-paid were recipients of targeted relief through income tax credits. However, the income tax credits were confined to families with dependent children, meaning that low paid individuals and couples not on a benefit received nothing other than small tax cuts. This decision reflected the results of official studies of the incidence when a 10 per cent GST was substituted for the wholesale sales tax.⁴¹ These studies, based on data gathered from household income and expenditure surveys, showed that the vertical incidence of the increase in the indirect tax burden⁴² would be regressive by income level for each family type, but manageably so within the scope of the available compensatory measures. Three interesting results clearly stood out and influenced the shape of the compensation package:

- The incidence of indirect taxes is regressive, with a much higher average impact on households in low-income deciles⁴³ compared to higher-income

³⁸ This section draws, in part, on R Stephens "The Economic and Equity Effects of GST in New Zealand," in R Krever and DI White, note 4, 65-87, especially 77-87.

³⁹ The official estimate of the price impact of GST's introduction was a one-off increase in the general level of prices of 5.5 per cent. Other estimates ranged between 5 and 7 per cent. The actual increase in consumer prices measured in the December quarter 1986 was 8.9 per cent up from 3.3 per cent in the September quarter. The March 1987 quarter recorded a 2.4 per cent increase in consumer prices.

⁴⁰ Income tested benefits paid to individuals reflecting unemployment, sickness, widowhood, or being a solo parent.

⁴¹ New Zealand Planning Council, *Who Gets What? The Distribution of Income and Wealth in New Zealand* (Wellington: New Zealand Planning Council, 1990). See also the following unofficial studies: C Scott, P Goss, and H Davis, *The Incidence of Indirect Taxes*, vol 1 (Wellington: Institute of Policy Studies, 1985); A Broad and L Bacica, *The Incidence of Indirect Taxes*, Vol. 2 (Wellington: Institute of Policy Studies, 1985).

⁴² The average household burden from indirect taxes rose from 11.4 per cent to 18.4 per cent between 1985/6 (the year before GST's introduction) and 1987/8.

⁴³ A decile divides sorted data into 10 equal parts, so that each part represents 1/10th of the population. The 1st decile cuts off the lowest 10 per cent of data at the 10th percentile and the 9th decile cuts off the lowest 90 per cent of data at the 9th percentile.

deciles.⁴⁴ For example, the incidence on the second decile was 25 per cent compared to 15 per cent for top income earners.

- The presence of dependent children within a family type magnified the effect of taxing food and other necessities. This result strongly associated with the number of dependent children in the family unit. In the third decile, for example, it was estimated that the impact of GST would reduce household disposable income for families of 2 adults and 1 child by 6.1 per cent and reduce household disposable income for families of 2 adults and 3 children by 9.5 per cent. The net impact for the top decile for these family types would be just 4.5 per cent.
- The impact on pensioners was less than for a typical household due to their relatively low food consumption.

The identified above-average impacts were addressed through compensatory income supplementation. The compensatory approach is an available and workable alternative to preferring food and other necessities in the VAT. However, it relies on a social bargain between the government and low paid workers and beneficiaries that the supplementation will keep up with costs. There were periods in the 1990s and the early 2000s when social assistance lagged behind costs.

Stephens⁴⁵ makes an observation that may be important in assessing the ability to translate the New Zealand GST experience to the UK. He argues that a prime reason that mid-1980s New Zealand tax and economic reforms have endured was the attention given to the issue of horizontal equity. Horizontal equity – like treatment of people in similar circumstances - seems to underpin the notion of fair play in the New Zealand context to a greater degree than redistribution.

4. The hard-to tax: Lessons from New Zealand

In this section, we identify aspects of the New Zealand experience that may be relevant in addressing the problem of hard-to-tax services and organisations. We make comments in the table below on the following subjects and issues:

- Financial services (intermediation and for-fee);
- Residential dwellings;
- Threshold;
- Government services (including health and education);
- Overseas travel.

⁴⁴ As Stephens notes, the incidence for the first decile needs to be treated cautiously as self-employed people comprise a large part of that decile and they can declare income tax losses while spending freely. R Stephens “The Economic and Equity Effects of GST in New Zealand,” in R Krever and DI White, note 4, 65-87, at 79.

⁴⁵ *Id.* at 78.

Subject	Issue	Lessons from New Zealand
Intermediation financial services	<p>Financial services that are remunerated by a margin or spread are not able to be integrated with the general invoice system of VAT.</p> <p>There is no feasible, conceptually correct, solution. Is it not time to put the search for a ‘solution’ to intermediation financial services into the category of a quest that has no practical value? The choices are to zero-rate, exempt (without credit), or a hybrid of both.</p>	<p>In an attempt to reduce the cascading effects of exemption for businesses, New Zealand has applied a hybrid system since 2005. To date, the fiscal impact of the new zero rating for business-to-business financial services and reverse charge rules has been as officials forecast but it is too early to judge whether the new rules have opened up tax planning opportunities.⁴⁶</p>
For-fees financial services	<p>New Zealand has successfully taxed for-fee financial services, such as fire and general insurance, giving credit for a notional tax content of claims.</p>	<p>This is a potentially useful expansion of the UK VAT tax base.⁴⁷</p>
Real property	<p>Taxing supplies of real property causes compliance problems analogous to the missing trader fraud discussed by the authors in section III D at 31-38.</p>	<p>The problem essentially arises from the delay between claiming VAT during the construction phase and the completion tax point. The possible solutions replicate the authors’ suggestions in relation to missing traders in section III D at 36-38.⁴⁸ Fiscal risks can also arise from deferred settlement schemes that take advantage of differing accounting bases (accruals, cash or hybrid).</p>
Residential dwellings	<p>New Zealand taxes residential construction activities and the first sale of new dwellings while the UK does not. The issue noted by the authors in section III B at 24-25 appears to be increasing house prices to new buyers (housing affordability) and the windfall gain to existing owners.</p> <p>Landlords and owner-occupiers face the same GST treatment. All purchases, insurance, local authority rates, maintenance charges as well as construction costs – the inputs to the provision of shelter – are taxable, but the value added in the provision of shelter is not subject to the tax.</p>	<p>The authors correctly make the comment that taxing new construction would give a windfall to existing homeowners. Direct compensation is one approach. However, other factors affecting housing affordability should also be considered before dismissing an application of tax to repairs, improvements, and new dwelling construction. New Zealand made no special arrangements in this regard. Australia did.</p>

⁴⁶ M Pallot, “GST and Financial Services – Rating Zero Rating,” in R Krever and DI White, note 4, 163-78, especially at 169-70.

⁴⁷ For a discussion of the merits of the New Zealand and Australian regimes for taxing fire and general insurance, see T Edgar, “The Search for Alternatives to the Exempt Treatment of Financial Services under a Value Added Tax,” in R Krever and DI White, note 4, 131-61, at 156-61.

⁴⁸ See also the discussion and solutions suggested in, G Harley, “Dilemmas for GST Tax Policy Designers – Land Transactions,” in R Krever and DI White, note 4, 213-41, especially at 234-41. See also, D Snell, “GST – Revenue and Business Risk,” in R Krever and DI White, note 4, 423-30 at 429.

Threshold	<p>While an elegant exposition, we are not convinced that the Keen and Mintz optimal threshold formula⁴⁹ is a sufficient basis for the conclusion that a high threshold is justified for the UK. It seems to rely on key assumptions about the variability of administration and compliance costs with firm size, and does not capture the potential distortions of trade from unregistered input-taxed suppliers competing with registered firms, especially where services are being provided with high labour and low goods content.</p>	<p>The New Zealand solution is a low threshold⁵⁰ combined with a choice of three return periods⁵¹ and simplified accounting requirements for micro and small businesses. Complaints about competition from unregistered suppliers are rare. However the evidence would suggest a disproportionately higher compliance cost burden on the smallest firms is a negative consequence of the New Zealand approach.</p>
Government services (including health and education services)	<p>The conventional European treatment of Government-provided services excludes them from the VAT base. This means that services such as education, medical care and services to residents by local authorities are outside the VAT base. This is an erosion of the potential VAT base and may exacerbate problems of competition between public and private suppliers.⁵²</p> <p>The New Zealand model goes further and treats the policy and administration services supplied by Government departments as taxable activities regardless of whether their funding is appropriated by Parliament or sourced from fees and charges.</p>	<p>New Zealand taxes all government-provided services, including the notional outputs of policy and administrative agencies. Government-provided services, such as healthcare and education, are also taxed, as are such services in the private sector. The cost of this approach is that it may be more administratively complicated than exempting agencies, but not more complicated than zero-rating. It also inflates the size of GST receipts and expenditures by corresponding amounts (subject to timing mismatch). The advantage is that it makes agencies indifferent between charging and appropriations, and so preserves a competitive position between the state and private sectors.</p>

⁴⁹ M Keen and J Mintz, "The Optimal Threshold for a Value-Added Tax," (2004) *Journal of Public Economics*, 88, 3/4: 559-76.

⁵⁰ The New Zealand Government is currently seeking submissions on increasing the current GST threshold from NZ\$40,000 to NZ\$50,000. It observes that the New Zealand registration threshold is low by international standards but that about 40 per cent of the taxpayers currently registered for GST are voluntary registrants with an annual turnover of less than NZ\$40,000. The estimated cost of allowing about 24,000 taxpayers to exit the GST base is about NZ\$15 million a year. M Cullen and P Dunne, *Reducing Tax Compliance Costs for Small and Medium-Sized Enterprises* (Wellington: December 2007), 13-14.

⁵¹ The standard return period is two months, which is shorter than in many other jurisdictions. Micro businesses may apply to use a six-monthly return period. There is also a one-month return option.

⁵² The case for the VAT in the EU fully taxing all public sector bodies (and non-profit organisations) is well argued in M Aujean, P Jenkins, and S Poddar, "A New Approach to Public Sector Bodies," (1999) *International VAT Monitor*, 10 (4): 144-49.

Overseas travel	Tourist expenditure is by convention taxed in the country of destination, but expenditure on travel between countries generally falls outside any countries' tax net. Overseas travel is a significant (and growing) item of household consumption and worthy of attention by tax policymakers.	Very few countries impose VAT on overseas travel. New Zealand does not. Indirect taxation of overseas travel might require an arrangement analogous to postal revenue sharing between nations on either a regional or multilateral basis. Indirect tax reform is worthwhile contemplating. ⁵³
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6. Concluding comments

The authors have identified a compelling case for reforming the UK VAT supported by empirical evidence on the small potential gains from rate differentiation. Moreover, they have identified an interim step of a uniform standard rate of 15 per cent applied to all non-housing consumption goods, which, while not completely removing the distortions of the current UK VAT scheme, can be introduced without waiting for the EU ground rules for VAT to be renegotiated.

This commentary has sought to provide insights from the New Zealand GST model for UK indirect tax policy and the authors' proposals on the following three issues:

- Are the alleged administration and compliance benefits of the comprehensive single-rate VAT borne out by the New Zealand GST experience?
- What have been the distributional impacts of a comprehensive single-rate GST on the poor and lowest paid in New Zealand?
- What lessons arise from how New Zealand GST applies to services and organisations that in Europe are often considered too hard to tax?

The broad conclusion from two decades of the New Zealand GST is that the alleged benefits of maintaining a comprehensive base with a single domestic rate are, on balance, borne out by experience. While VAT/GST compliance costs are undoubtedly regressive in relation to turnover, we consider that the New Zealand surveys may overstate marginal GST compliance costs, in part because the regular reporting of VAT/GST on a one, two or six monthly basis means that GST is the first tax return for which a business must complete accounts each year. The wider base of the GST is likely to have reduced compliance costs compared with the UK VAT but this has not been empirically tested.

We have argued that the public is able to be convinced of the merits of a comprehensive single rate VAT and that this provides contextual support for the authors' proposal of a 15 per cent VAT applied to all non-housing consumption goods for the UK.

To the extent that taxing the basic necessities of life will affect the economic position of the poor, relief can be provided using more effective support tools than GST

⁵³ For a broad consideration of the indirect tax issues and an optimal policy proposal for fuel and ticket taxes, see M Keen and J Strand, "Indirect Taxes on International Aviation,"(2007) *Fiscal Studies*, 28 (1): 1–41.

exemptions. However, it relies on a social bargain between the government and low paid workers and beneficiaries that the income supplementation will keep up with costs. In New Zealand, the political consensus has been to apply compensating assistance via the income tax and social welfare systems, with an emphasis on supporting working families with children. Critics may point out that, as a result, New Zealand has an army of bureaucrats administering its social welfare and income tax credit systems instead of an army of revenue officers administering the boundaries between rates and exemptions. If the former army is taken as a given in a modern developed country, the absence of the latter is clearly a cost saving to be added to the reduced deadweight costs of the New Zealand style of GST.