POSSIBLE LESSONS FOR THE UNITED STATES FROM NEW ZEALAND’S GST

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New Zealand’s broad-based GST has often been suggested as a desirable model for a value added tax. This paper explains how New Zealand’s GST works and discusses how its broad-based approach came about, why this has been acceptable in New Zealand when it has not been in many other countries, and outlines what we see as problem areas of the tax.

Keywords: value added tax, international taxation, goods and services tax

JEL Codes: H21, H25, 056,

I. INTRODUCTION

The goals of this paper are to explain how New Zealand’s Goods and Services Tax (GST) works, to comment on its breadth of base, to explain how this came about, to ask why a broad-based GST at a uniform rate has been acceptable in New Zealand when such a reform has not been acceptable in many other countries, and to discuss what we see as problem areas of the tax.

New Zealand’s GST is a broad-based value added tax (VAT) at a uniform rate over a wide range of goods and services. A number of commentators have suggested that it provides a possible model for other countries. For example, Mirrlees et al. (2011, p. 484) states that, “New Zealand provides a working example of how it is possible to apply the standard rate of VAT to almost all goods and services.” Mirrlees et al. (2011) concludes that broadening the VAT base is a desirable reform and that if the United Kingdom were to extend VAT at 17.5 percent to most zero-rated and reduced-rated items, then the government could (in principle) make each household as well off as it is now and still have £3 billion of revenue left over.

European countries are quite constrained by EU directives on the design of value added taxes. For example, the EU mandates a minimum rate of tax of 15 percent and a substantial set of exemptions. If the United States were to decide to adopt a value added tax, it would likely face similar constraints.
added tax, it does not have these constraints. This puts it in the fortunate position New Zealand was in when it put in place its GST reform.

New Zealand’s broad-based GST was introduced on October 1, 1986 and has proved remarkably stable. It was introduced at a rate of 10 percent by a Labor Government as part of a broad package of reforms. Its rate has since been raised twice to 12.5 percent by a Labor Government in July 1, 1989 without other tax cuts to raise additional revenue and then, most recently, on October 1, 2010 by a National Government as part of a package of measures including cuts to personal tax rates and the company tax rate. Thus, both of the two major political parties have adjusted the tax system in ways that put greater weight on GST. New Zealand’s GST has a single standard rate that applies to almost all supplies including those that are in the vast majority of countries either outside the tax base, exempt, or lowly taxed. The New Zealand base includes all food, health and education, local authority rates, and government appropriations and charges. Through successive administrations, this broad base has been maintained. A uniform rate of GST need not be most efficient in theory. Since Ramsey, it has been well known that if all taxed goods were independent (and neither net substitutes nor net complements), it would be most efficient to set consumption tax rates proportional to the inverse of the elasticity of demand for individual goods and services; thus, more inelastic goods would face higher rates of tax.

Crawford, Keen, and Smith (2010) explain limitations to this simple Ramsey analysis. First, and most obviously, the assumption that all taxed goods are independent is highly unrealistic. Secondly, and more fundamentally, efficiency will depend on the effects of the taxation of goods on labor supply. This is in line with the analysis in Corlett and Hague (1953), which showed that goods that are complements to leisure should be taxed at higher rates than goods that are substitutes. However, this condition is extremely difficult to apply in practice. The Ramsey model assumes that the problem for a government is to tax a single consumer as efficiently as possible using only consumption taxes, but this seems an artificial problem. If there were only a single consumer, it would be quite feasible to tax the consumer perfectly efficiently by means of a lump-sum tax. Atkinson and Stiglitz (1976) show that if preferences are separable between taxable goods and leisure and if income is taxed optimally, it would be optimal to have a uniform rate of tax on taxable goods. There are good grounds to be sceptical about our ability to design and implement a value added tax that does much better than taxing as many goods and services as possible at a uniform rate. This insight was critical in the design of New Zealand’s GST reform.

A common rate of tax acknowledges that it is difficult to estimate “optimal” tax rates, and that line drawing is complex and uncertain. Differential rates will add to administration and compliance costs and invite rent seeking. If certain goods and services are taxed at preferential rates, then the question arises, “Why not others too?” A big reason for the stability in New Zealand’s GST reform is the absence of special cases.

On the other hand, low rates of tax on certain goods and services are sometimes advocated on fairness grounds. New Zealand’s broad-based, uniform-rate approach has been influenced by considerable (although not universal) acceptance that in a modern
economy there are more effective ways of helping the poor than by having lower rates of tax on certain goods and services.

While New Zealand's GST has a very broad base, there have been deliberate moves in some areas to narrow the base in efficiency-enhancing ways. An example is the treatment of business-to-business financial services, which are zero-rated. This removes a cascading tax on business inputs.

This is by necessity a brief discussion of New Zealand’s GST. Krever and White (2007) present a set of papers from a symposium on New Zealand’s GST that provides a much more detailed discussion of the tax. Crawford, Keen, and Smith (2010) provide a comprehensive survey of the effects of a value added tax in their chapter in the Mirrlees Review and Dickson and White (2010) provide a commentary that compares the United Kingdom’s VAT and New Zealand’s GST.

The structure of this paper is as follows. Section II discusses the basic mechanics of New Zealand’s GST and its breadth of base. Section III provides some historical and social context that explains, in part, why a broad-based, uniform rate of GST was introduced and has been maintained in New Zealand. However, despite the many positive economic attributes of the GST, it is far from an unproblematic tax. Section IV discusses some difficult problem areas. Section V concludes.

II. THE MECHANICS OF NEW ZEALAND’S GST AND ITS BREADTH OF BASE

New Zealand levies GST at a rate of 15 percent on a very broad range of goods and services. In common with other countries, the tax is levied on a credit-invoice basis. Suppliers who are subject to the tax are required to levy GST on their domestic sales, but when they do so the purchaser is entitled to receive a tax invoice. Purchasers who are subject to GST on their sales can claim credits for the tax that has been levied on their inputs, which can be used to offset output tax or be refunded if GST on inputs exceeds GST on outputs. Again, in common with other countries, the tax is levied on a destination basis (i.e., where goods and services are consumed rather than where they are produced). Exports are zero-rated. This means that exporters pay no GST on their exports but are able to claim GST credits for GST that has been levied on their inputs. Imports are generally subject to GST.

The net result of GST is a tax on final consumption. The effect of the tax is very similar to what would be achieved by having a 15 percent retail sales tax (RST) on a very wide range of goods and services. Like a broad-based RST, the tax avoids production distortions. Diamond and Mirrlees (1971) argued that in the absence of externalities and with perfect competition, it is generally desirable for taxes to avoid distorting production decisions. Any given level of tax on final consumption can be levied most efficiently if it does not distort production, for example, by encouraging vertical integration and affecting the number of steps in a production chain. While the Diamond and Mirrlees assumptions are unlikely to hold in practice, avoiding production distortions remains a widely accepted goal of tax reform. A GST can be contrasted with a turnover tax that levies higher amounts of tax the greater the number of steps in the production process.
Because of this, a turnover tax is sometimes described as a cascading tax, which tends to be very inefficient.

Many countries have certain goods and services that are taxed at low rates or zero-rated. Typical examples include food, water, pharmaceuticals, books, and newspapers. In New Zealand there is no attempt to address fairness concerns by leaving certain goods and services out of the tax net or taxing them at lower rates. This is because there are more efficient ways of making things fair than leaving particular goods or services out of the tax net.

In addition to having goods and services that are taxed at low or zero rates, most EU countries have a range of “standard exemptions,” including postal services, hospital and medical care, dental care, education, sporting services, cultural service, and charitable work. With exemption, a provider pays no tax on the goods and services it provides. At the same time it cannot claim credits for tax that has been levied on its inputs. This breaks the tax and credit chain and distorts production decisions. In particular it means that a business that purchases goods and services from an exempt supplier is unable to claim credit for tax that has been levied on the inputs of the exempt supplier. This reintroduces the sorts of tax cascades that would arise with turnover taxes. The New Zealand model is aimed at minimizing such tax cascades.

Exemption also distorts production decisions when an exempt supplier provides goods and services to final consumers. In this case the supplier will pay no tax on its value added but will not have relief from tax that has previously been levied on its inputs. Irrespective of whether the exempt supplier sells to final consumers or other businesses there will be incentives for as much production as possible to be within the firm. Thus, a hospital will have incentives to perform its own accounting services rather than buying them from other firms. All of this creates production distortions. Of course, exempting sales to final consumers is likely to distort consumption decisions as well.

New Zealand has a much more limited set of exemptions. In particular, it has none of “the standard exemptions” discussed above. This is likely to be important in keeping the tax as efficient as practicable.

One area of exemption from GST is financial services. Financial services supplied to final consumers are exempt and those supplied to other businesses are zero-rated. Before 2005 when zero-rating of financial services supplied to businesses was introduced, in common with most Organisation for Economic Co-operation and Development (OECD) countries there was a general exemption for financial services. To remove tax cascades, financial service providers are now able to claim credits for GST levied on the inputs they purchase from other suppliers for use in the production of financial services.

There is no tax levied on the “imputed rental income” from owner-occupied housing. Likewise, rental income is exempt. However, GST is levied when housing is constructed. If all housing were buildings (i.e., there was no land), it would be expected that the value

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1 This is unless, of course, there is an efficiency reason for preferential tax treatment of a particular good or service. But in this case, it would generally be better to achieve preferential tax treatment by reducing the rate of tax so as not to distort production decisions.
of a new house would normally be equal to the present value of its future imputed or actual net rents. Thus, the taxation of imputed rents and actual rents are approximated by GST on housing construction. To this extent the taxation of housing is similar to the taxation of other consumer durables such as cars, computers, and clothing where tax is levied on the initial purchase price of the assets rather than on the imputed rental income these assets provide. In practice, however, buildings make up less than 50 percent of the value of residential property (which consists of $175 billion of improvements and $221 billion in land values). This means that the tax base is likely to be significantly narrower than it would be if land rents and imputed rental income were instead taxable.

This treatment has also had an important distributional impact when the GST was introduced and subsequently when its rate has been raised. When a GST is introduced or its rate is raised, the tax will normally reduce the purchasing power of those with wealth at that time. For example, it will reduce the purchasing power of an individual’s bank balance. The New Zealand treatment has meant that those holding residential property will escape the normal lump-sum tax on existing wealth in proportion to the share of wealth held in this form.

The GST will tend to push up the price of all housing. Purchasers of second-hand housing pay no tax directly on the houses they purchase but will nonetheless bear a burden through the GST being capitalized in a higher price of housing.

New Zealanders who consume tourism services overseas are of course not subject to New Zealand GST, but foreign tourists consuming tourism services in New Zealand are subject to GST on these services. Consumption by non-residents in New Zealand is approximately 5 percent of the GST base (Treasury and Inland Revenue, 2009).

Local authority rates, which are a tax on property values and the main way local authorities fund their expenditure, are subject to GST. The taxation of rates puts local authorities who are providing goods and services to their residents on as similar as possible a footing as private firms providing goods and services to the same people. Government departments also pay GST on their appropriations, although government appropriations are increased to take this into account. To our knowledge, New Zealand is unique in this regard.

In principle, there are at least three ways of treating expenditure by government departments. The first is New Zealand’s approach of taxing the appropriation as well as any sales that departments make to the public but allowing credits for GST that has been levied on the inputs and investment goods they purchase. This effectively means that government departments are paying tax on their value added (valuing government expenditure at cost). A second possible approach is to exempt government departments. This would introduce a bias encouraging them to use their own resources (e.g., staff) rather than buying outside resources (e.g., consultants). A third possible approach would be to zero-rate sales from the government and not tax any appropriation. But zero-rating sales from the government could seem difficult to justify when the government is competing with the private sector.

A general objective of the government was to put government departments on as even a footing with the private sector as possible to minimize competitive distortions. If sales
to the public are made subject to GST, government departments clearly should be able to claim credits for tax on their inputs that relate to these sales. However, there seems to be a compelling logic in New Zealand’s approach of taxing appropriations as well.

Dickson (2007) states that New Zealand’s approach was aimed at making departments indifferent between charging for their services and having the government pay for their activity. New Zealand’s approach has some attractions although it is more complex than exemption. A person is required to be a “registered person” and to pay GST if their “taxable supplies” exceed $60,000 per year in New Zealand (which is equivalent to about $51,000 in the United States). They may voluntarily register if they fall below that threshold but have a “taxable activity.” A taxable activity is defined as a continuous or regular activity of supplying goods and services to another person in exchange for consideration (normally money). Approximately 19 percent of registrants in New Zealand are voluntary.

Unlike most countries, New Zealand taxes charities and other non-profit entities. Many might normally be below the taxable threshold. For charities and other non-profit entities, voluntary registration enables application of a specific concession that refunds input tax, generally irrespective of any output tax paid. However, as a whole the charitable and not-for-profit sector is a net payer of GST. Over the last one-year period ending March 2012, this sector paid a net $832 million in tax (positive payments of $951.9 million offset by $143.0 million in tax refunds).

New Zealand is not the only country with a broad VAT base. Chile and Japan have no goods or services taxed at less than the standard rate and Denmark and Israel have negligible lightly taxed goods and services. However, most countries have a much broader set of exemptions. Only Turkey and New Zealand do not exempt health and education.

However, taxing these activities does not always mean a broader base and more revenue. When health services or education are provided to businesses, New Zealand’s GST generates less revenue than would be the case if these services were exempt, as it is not creating inefficient tax cascades. OECD (2012) argued that the exemption of healthcare was primarily a business-to-consumer issue so the cascading effect is minimal. The same is likely to be true of education. Even if sales to businesses are minimal, however, New Zealand’s inclusion of these services does have the attraction of removing production biases when services are provided to final consumers. OECD (2012) argues for removing these production distortions and that if some concession is considered desirable that a reduced rate may be better than an exemption on these grounds.

The OECD provides data on what they describe as the “VAT revenue ratio” (see the discussion in Chapter 4 of OECD, 2012). This is value added taxation as a proportion of the potential VAT base. As the OECD comments, the biggest methodological difficulty in estimating the VAT revenue ratio is in defining the potential base. The OECD uses final consumption which includes the private final consumption of households together with the final consumption expenditures of households and the final consumption expenditure of general government. In most countries, the government is exempt from VAT but to the extent that they purchase goods and services from the private sector, VAT will be included in the prices the government pays.

The VAT revenue ratio is not a measure of efficiency. For example, if GST on business costs were not creditable this would increase the “VAT revenue ratio” even though it reflects an inefficiency. The key issue is not the size of the VAT base but its neutral-
ity. Zero-rating business-to-business financial services in New Zealand has been an efficiency-enhancing but revenue-reducing measure.

Also there are measurement difficulties in attempting to measure a VAT revenue ratio across different countries. As Dickson and White (2010) have pointed out, one reason why the New Zealand ratio is so high is that GST is levied on the appropriations of government departments. For countries that exempt the government, the only part of government spending that is subject to GST is their purchase of taxed inputs and investment goods. Published data are provided in Figure 1 below.²

III. HISTORY OF THE TAX

The GST was introduced in 1986 as part of a series of reforms aimed at making the tax system fairer and more efficient by lowering tax rates and broadening bases. In

² If GST paid by government departments on their appropriations were omitted from the New Zealand ratio, this would lower New Zealand’s VAT revenue ratio considerably, placing New Zealand somewhere between Israel and Chile in the rankings. However, this would understate New Zealand’s breadth of base, as it would completely remove any tax levied on government consumption in New Zealand while figures for other countries generally take account of tax that is included in the prices of goods and services purchased by government departments.
1984 when the Lange Labor Government came into office, there was considerable need for tax reform. There was spiralling government debt and a government deficit of nine percent of GDP, a top personal income tax rate of 66 percent, and a company rate of 45 percent. There was a classical company tax system that endeavoured to double tax income earned through companies, but there were major gaps in the income tax base (including investment incentives for a huge variety of different forms of investment, accelerated depreciation, export incentives, other tax subsidies, and no taxation of any fringe benefits). All of this meant that many companies and individuals with high economic incomes were paying little income tax and the personal and corporate income tax bases were very distorting.

There was a Wholesale Sales Tax that levied high rates of tax on certain so-called luxury goods with lower rates on other goods and none on services. It applied to only about 27 percent of household consumption, largely confined to durable items such as motor vehicles and home appliances. Around one-third of the tax was derived from taxes on business inputs. There were standard concerns that taxing business inputs was very inefficient because they lead to different amounts of tax if similar goods are produced in different ways (Douglas, 1984). Tax was levied at high and varying rates of 0, 10, 20, 30, 37.5, 40, 50, and 60 percent. The rate of tax applied could lead to bitter arguments. For example, in 1979 boats and caravans were made subject to tax at a rate of 20 percent and this was believed to be responsible for firms producing these goods going out of business.

A particular concern was the proportion of tax revenue raised from personal income tax. More than 60 percent of tax revenue was raised by the personal income tax, which was more than 10 percentage points higher than any other OECD country. The high reliance on the personal income tax and large scope for many to avoid it led to concerns that the system was unfair and inefficient.

Replacing the Wholesale Sales Tax with a GST was one part of a much broader set of tax reforms aimed at making the tax system fairer and more efficient, generally by broadening tax bases and lowering rates. By the end of the 1980s a raft of income tax incentives had also been removed, the top personal tax rate and company tax rate had been reduced to 33 percent, a full imputation company tax system had been introduced, and fringe benefits had become taxable.

Reforms to indirect taxes had been debated for some time. The previous National Government had established the McCaw Task Force on Tax Reform (hereafter, referred to as the Taskforce), which had reported in 1982. The Taskforce suggested either broadening the Wholesale Sales Tax base (as a short-term measure) or introducing a value added tax. While the National Government responded to some of the recommendations of the Taskforce it made no changes to indirect taxes.

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Figure 2 shows how the importance of different components of the tax system have changed over time. The data for a given year reflect the values from April of that year to the following March. Thus, for example, data labelled 2011 are for the one-year period ending March 31, 2012. In 1985 (the one year period ending March 31, 1986), before the GST was introduced, the personal tax was just over 60 percent and wholesale sales
tax was about 10 percent of total tax collections. Since then the personal tax has fallen to 37 percent and the GST has increased to 31 percent of total tax collections. There was a marked increase in sales tax/GST and a marked decline in personal tax collections and indirect taxes on specific goods and services as a consequence of the Lange Labor Government’s tax changes.

Figure 3 shows the components of revenue as a percentage of GDP. The GST has proved to be a robust source of revenue. The Wholesale Sales Tax was 3.2 percent of GDP in 1985. In the first full year of GST in 1987, the GST amounted to 5.9 percent of GDP. Subsequently, with further rate increases to 12.5 percent in May 1989 and 15 percent in October 2010, GST revenue has increased to about 9.9 percent of GDP.
An important consideration for the government was whether to have a retail sales tax (RST) or a value added tax such as the GST. The Minister of Finance, Sir Roger Douglas, had initially advocated an RST. However, he changed his mind and agreed on a value added tax instead at the urging of Ian Dickson, the manager of the Treasury indirect tax team (Douglas, 2007). Both a retail sales tax levied only on final sales to consumers and a value added tax could, in theory, be efficient ways of taxing final consumption without inefficient tax cascades through taxes on business inputs.

There are some advantages of a value added tax relative to an RST. For example, if businesses are supplying to other businesses, the VAT reduces incentives for suppliers to avoid tax. Indeed, businesses that purchase goods from other businesses on which value added tax has already been charged, have an incentive to make sure these businesses are in the system. This assists with wider tax compliance as registration will capture businesses that might otherwise choose to remain outside the tax system. The requirements to issue and retain invoices and to account for GST several times a year are likely to also aid broader tax compliance.

At the same time, there are avoidance pressures with sales to final consumers under either system. There are also dangers in refunding credits and more recent changes
in specific areas have moved back in the direction of an RST by zero-rating certain business-to-business transactions. These are limited to high value items such as land that can be readily audited or transactions solely between businesses such as emissions trading credits where the GST outcome is neutral.

Dickson (2007) argues that the key argument that convinced the Minister of Finance to adopt a value added tax was the question of who bears the burden of proof in determining tax status. Under a value added tax, it is the purchaser who must be able to justify that purchased goods and services are associated with a taxable activity in order to claim a rebate for GST on these goods — and the purchaser is in a good position to know. Under a retail sales tax, the vendor must ascertain the likely use of goods and services, and will often be less able — and perhaps less willing — to ascertain this.

A critical feature of the reform was its comprehensiveness. There was a concern that differentiated rates on different goods and services typical of European VATs and, in particular, the UK VAT could end up being quite distorting, result in much complexity, and create significant scope for avoidance. The key reason for New Zealand calling its tax a GST was to distinguish it from these other VATs.

In practice, a very important achievement was ensuring that the tax applied to food and other necessities. While the poor spend a greater percentage of their incomes on these goods, the rich spend more in absolute terms. The bottom two deciles of households allocated 23 percent and 29 percent of their budgets to food while the top two deciles allocated 7 percent and 10 percent. But for every $100 spent on food, $6.50 was spent by the bottom decile whereas $12 was spent by the top decile.

At the time of reform New Zealand had a universal payment to families of six dollars per child known as Family Benefit. This made it easy for the government to draw a link between the family benefit and the taxation of food. The government asked, “Would it be fair to have a family benefit of six dollars to low-income families but $12 to high-income families?”

This argument was important in stemming criticisms of groups that were initially in opposition to the taxation of necessities, such as charities, welfare groups, and representatives of the elderly. The churches and charities ended up providing qualified support for the taxation of food. Once that happened, it became much easier for the government to keep the GST base broad by turning down others who argued for exemptions for various products such as booksellers and newspaper publishers. It is not necessary for every element in a tax system to be progressive in order for the tax system as a whole to be progressive. Progressivity should be delivered as efficiently as possible. Adjustments to personal income tax rates or income support for low-income groups and beneficiaries is a far more efficient way of delivering a progressive fiscal system than exempting certain goods and services from a GST.

The main factor in gaining public acceptance of the tax was that GST was part of a package of measures and was combined with substantial payments and support to low-income families and beneficiaries. For example, the final package was adjusted to

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3 This section draws heavily on Dickson (2007).
make single-earner working families with three children who earned $300 before tax, better off by $34.60 per week after tax (Douglas, 2007). That said, there was not general compensation to all low-income earners for the GST on its introduction. Compensation was targeted to beneficiaries (whose entitlements were adjusted for the expected inflationary effects before its introduction) and through relatively large payments to low-income families with children.

The tax reform process was a huge factor in the subsequent acceptability of the tax. Prior to the Lange Labor Government there had been considerable concern about a lack of consultation on tax matters and idiosyncratic tax changes. When the GST was introduced, there was high degree of consultation, which was ultimately an important factor in changing the way that tax policy reform is conducted in New Zealand.

The GST and other tax policy changes were implemented rapidly. The government announced that it would introduce a broadly-based GST in its Budget in November 1984. A White Paper that described the proposed details of the tax was drafted by Treasury and published in March 1985. The government then used a Consultative Committee chaired by Dr. Don Brash who had stood for opposing the National Party in the last election and with other respected private sector participants to consider submissions on the proposals. The Committee was tasked with the job of determining how best to introduce the GST. The composition of the Committee made transparent that there was no cronyism in the Committee and reassured the public that issues would be looked at by people with commercial experience.

The findings of the Consultative Committee were published, which made their recommendations transparent. Many of the recommendations were accepted while some were rejected. At times the government went further than the Consultative Committee. For example, the White Paper had suggested a $2,500 threshold for providers to be required to register for GST. The Consultative Committee raised this to $20,000 and the government raised this further to $24,000. The reasons for such decisions were transparent.

A final decision to go ahead with the tax was announced in the Government’s Taxation and Benefit Reform Statement in August 2005 as part of a widespread set of taxation and benefit reform measures. There was a chance for further submissions at the Select Committee stage. There was also a considerable effort put into communicating changes to the public, with a specialist GST Coordinating Office established for communications.

The GST originally was intended be introduced by April 1, 1986. Ultimately, the introduction date was pushed back to October 1, 1986.

The GST is administered by Inland Revenue, except for goods crossing the border where the tax is administered by Customs. Originally it was thought that 700–800 staff would be required to administer the tax, but ultimately more than 1,000 staff were employed (Dickson, 2007).

The GST was quickly accepted. Prior to introduction, support in the polls was 30–35 percent but within two weeks public approval had increased to 65 percent. In the following election the National Party recommended its repeal in favor of an “ExTax” variant that would have introduced exemptions and repealed the invoice-credit mechanism, but they were soundly defeated. Subsequent governments have continued with the broad-
based approach. There have been a number of changes but these have been aimed at improving the tax within the broadly accepted policy framework.

Since the GST was introduced, there have been two major tax reviews. McLeod et al. (2001) examined New Zealand’s tax system and indicated their general support of the overall design of the GST. In particular, the report argued that a strong case could not be made for narrowing the GST base or for taxing some goods and services at lower rates. It argued that the GST was likely to be more efficient than income taxation. This meant that any overall increase in tax should generally be implemented through GST and any tax reduction should be focused on the income tax.

More recently, a majority of the Tax Working Group in 2010 supported increasing the rate of GST from 12.5 percent to 15 percent as part of a package that included personal tax cuts to lower savings and investment distortions. Their report argued that GST should continue to apply broadly without exemptions. In 2010, the government increased the rate of GST to 15 percent and cut personal tax rates as part of a larger package of changes consistent with the Tax Working Group’s suggestion.

Lowering personal tax rates and, in particular, removing any difference between the top marginal rate and the trustee tax rate responded to concerns that the tax system allowed individuals to shelter income from higher personal tax rates, especially through the use of trusts. The switch was also motivated by concerns that GST is likely to be a more efficient tax than the personal income tax. This is likely to be more true for New Zealand than many other countries because of the underlying efficiency of its GST.

It is well known that a GST is broadly equivalent to a labor income tax combined with a lump-sum tax on wealth existing at the time it is introduced. Unlike a general income tax, the GST does not tax the return to capital, which means that the tax substitution has allowed New Zealand to move at the margin in the direction of lowering taxes on capital income without the complexities of a dual-income tax system. To see this, suppose that there were a 10 percent interest rate and no tax. An individual who earns $100 in year 0 could consume $100 in this year or $110 in year 1. If there were a 20 percent tax on labor income, he or she could consume $80 in year 0 or $88 in year 1. Likewise, with a 20 percent GST but no tax on labor income, the individual could consume $80 in year 0 or $88 in year 1. As with a tax on labor income only, the individual’s benefit from forgoing consumption is the pre-tax interest rate.

Whenever there is any discussion of changing the rate of GST, concerns are raised about fairness and the fact that those with higher incomes tend to save more of their income than those on lower incomes. However, much of this is for lifecycle reasons. For this reason it is likely to be preferable to measure equity effects in terms of lifetime rather than annual income. Expenditure is likely to be a better proxy for lifetime income than annual income.

Figure 4 is from data presented to the Tax Working Group that shows how GST revenue varies across deciles. The bars show that apart from an anomaly for the lowest decile (which may involve some with low taxable income but considerable assets), GST paid increases as income increases. GST as a proportion of income and as a proportion of disposable income tends to fall as income increases while GST as a proportion of
expenditure is relatively constant. GST is likely to be a broadly proportional tax with respect to lifetime income.

It is easier in New Zealand to compensate lower income individuals for an increase in the GST rate than it is in many other countries because New Zealand has no tax-free threshold and people pay tax from the first dollar. In 2010, there were cuts in all rates of personal tax and a number of other base broadening changes as well. The New Zealand Treasury has estimated that the 2010 budget changes were broadly neutral across income groups.

At the same time while governments have always resisted any push to narrow the GST base, raising the rate of GST does increase pressures on New Zealand’s paradigm. For example, the latest increase in the GST rate led to calls to remove fresh fruit and vegetables from the tax base, highlighting the existence of considerable tensions that constrain how much New Zealand can increase its GST rate without narrowing its base.

IV. PROBLEM AREAS

While New Zealand’s GST works well, there are a number of areas where problems have arisen. Often these relate to questions over borderlines.
A. Residential/Commercial Property

As has been discussed above, rental income and imputed rental income on residential rental property is exempt from GST. At the same time, new residential housing is subject to GST when sold to the initial purchaser. This makes housing subject to tax on a prepayment basis similar to other consumer durables.

At the same time, commercial rents are subject to GST. Purchasers of commercial rental property can claim credits for their purchase in the same way as purchasers of other business assets. If commercial rents were instead exempt like residential rents, the standard problems of a cascading tax would arise. The fact that commercial property is subject to the GST while residential property is not can be problematic. For example, the treatment of a person’s private residence that may be used as a bed and breakfast establishment, a shop with a residence above, a holiday home leased out when not occupied privately, or a retirement village will all have residential and commercial aspects that can lead to difficult definitional or apportionment issues.

New Zealand recently changed its legislation to more clearly differentiate the tax treatment of residential and commercial property. This has removed some of the past difficulties in this area as well as ensuring that exemption is limited to rental housing that is a close substitute for owner-occupied housing.

B. Financial Services

When GST was introduced, New Zealand treated financial services as GST-exempt in the same way as other jurisdictions to avoid having to differentiate and ascribe values to the (readily substitutable) investment income and intermediation service components of financial transactions. From 2005, business-to-business supplies of financial services have been zero-rated to allow financial institutions a greater proportion of deductions for inputs and reduce tax cascades.

A significant gap in the GST base is the exemption of business to customer financial services. This is a problem that no country has solved. Crawford, Keen, and Smith (2010) argue for bringing financial services within the tax net by zero-rating business-to-business services as New Zealand has done and supplementing this with separate cash flow taxation of business-to-customer financial services. This merits further thought, although a practical difficulty is likely to be the scope for financial services that can be supplied from offshore without the imposition of any GST, which could possibly put pressure on domestically supplied business-to-customer financial services.

Under zero-rating of business-to-business financial services, financial institutions must value these services but are able to do so at an aggregate level without the involvement of their customers. An approach that similarly aggregated business-to-consumer supplies could theoretically be adopted to address the under-taxation of financial services in this sector.

New Zealand has a precedent for this type of treatment in its general insurance rules under which, in contrast to many other jurisdictions, insurance is subject to full taxa-
General insurance premiums are taxed at the standard rate by the insurer, with the payer generally entitled to deduct input tax on the premium if they are a GST-registered person. A payment made by the insurer under the insurance contract is, if made to a registered person, treated as if it were for a good supplied by that person. This means that the person must pay GST and the insurer is entitled to deduct an equivalent amount as input tax. The overall effect of these rules is that the insurer’s net GST liability is based on its outputs less its inputs, thereby reflecting the value of the insurance service.

C. Tourism

In principle, an argument can be made for zero-rating tourist services in the same way as other exports. Initially the New Zealand Treasury supported this treatment. The government decided to tax tourism services largely on practical grounds, particularly concerns about the compliance costs that businesses would have to incur in determining whether a customer is a resident or a non-resident and the associated avoidance issues. Another question is whether to allow refunds of GST to those purchasing large ticket items; if a country does not do so, it can potentially disadvantage domestic firms. New Zealand’s judgement has been that the loss in revenue combined with the large administrative cost of allowing refunds outweigh the benefits of doing so.

D. Second-Hand Goods

A notional credit for second-hand good purchases is allowed on the basis that GST paid earlier in the supply chain will not otherwise be credited if the goods enter the tax base because they are supplied to a registered person. Tax base risks can arise, however, if there are any situations in which second-hand goods have been purchased without GST having been levied. Supplies of land purchased before 1986 (land being characterized as second-hand goods) were particularly problematic as associated parties faced incentives for sales among themselves to take advantage of the notional credit. This required a specific legislative response. Problems also arose with super yachts that had come into New Zealand without the imposition of any GST.

E. The Registration Threshold

The registration threshold is set balancing a number of different considerations. On the one hand, it is undesirable to have firms out of the GST net. If firms are out of the net, the credit mechanism breaks down, creating cascading if these firms make sales to other businesses. For firms selling to final consumers, the result is only partial taxation of final consumption.

New Zealand’s registration threshold at $60,000 is relatively low. Crawford, Keen, and Smith (2010) argue that the United Kingdom’s considerably higher threshold of £61,000 might not be unreasonable for the United Kingdom.
A low threshold is consistent with maintaining a broad-based system, since most businesses face the same pricing considerations and are therefore less likely to be placed at a competitive disadvantage with businesses that are below the registration threshold. The low threshold also reduces the incentive for certain undesirable activities, such as sales suppression, so that a business can continue to operate under the threshold.

While a higher threshold could reduce compliance costs for businesses, this may be less critical in New Zealand than in some other jurisdictions, as the broad base and single rate of the GST result in a less complex system. On the other hand, a higher registration threshold could allow sectors that have a high proportion of final consumers as customers, such as hairdressing and taxi driving, to operate outside the GST base.

Dickson and White (2010) cite evidence which suggests that the compliance costs of New Zealand’s GST are lower than those of the United Kingdom for larger firms while the costs may be higher for smaller firms, perhaps in part because of New Zealand’s lower threshold. As the authors comment, it is hard to know how much weight to put on these comparisons. There are formidable difficulties in making cross-country comparisons of compliance costs. How the compliance costs of a GST should be calculated is problematic when many of the costs may be related to income taxation as well as GST or be providing useful accounting as well as tax information.

F. Land Transactions

Land transactions have in the past been prone to abuse through the use of “phoenix” company structures. Typically, these involve a vendor company closing down before a GST payment is made leaving the (often associated) purchaser with an input deduction. This was recently addressed by zero-rating all transactions involving the sale of land between registered businesses. This ensures the correct GST-neutral outcome for the transaction.

The main risk with zero-rating land arises from the boundary between business and private consumer transactions. For example, registered sole traders who prepare their business accounts at home may argue that no GST should apply to the purchase of the home because of their registered status. A reverse charge applies in these situations so that any GST that should have been paid on the transaction must be paid by the final consumer.

The treatment of land transactions, being a combination of zero-rating and a default reverse charge, is similar to the European reverse charge but without the difficulty of joint liability associated with that system.

G. Online Sales and the Growing Use of the internet

For online purchases of goods, GST is payable by the consumer at the border but not if duty (including GST) is less than $60. This *de minimus* threshold reflects the significant administrative cost burden that would be placed on New Zealand Customs if duties were collected on parcels below that value. Given the growth in online shop-
ping, it is expected that the *de minimus* threshold will need to be revised so that more GST is collected through more effective processes.

Adjusting the *de minimus* threshold will not, however, necessarily deal with the even more problematic issue of collecting GST on online services (which include intangibles such as internet downloads of music, games, and so forth). Solutions that would address non-payment of GST on both goods and services would include an electronic system that imposes GST at the point of sale or a requirement, as exists in Europe, for the larger providers of electronic goods and services to register for and pay GST in New Zealand.

Some have argued that growing volume of internet purchases may provide a reason for switching from a destination basis (under which imports are taxed and exports zero-rated) to an origin basis. As Ebrill et al. (2001) point out, if levied at uniform rates, the two taxes are broadly equivalent. At first sight it might be thought that a destination basis tax would improve competitiveness by encouraging exports and discouraging imports. However, if a country switched from a destination basis to an origin basis, it would be expected that this change would lead to a fall in the exchange rate until the effects on competitiveness were negated.

There are also major practical concerns that make a switch of this nature impractical. One is that a firm that purchases goods from abroad and sells them to the public would need to be able to claim notional credits for the value of its inputs. This is likely to create very real transfer-pricing pressures. Internet purchases are likely to remain a difficult issue to resolve satisfactorily.

**V. CONCLUSIONS**

New Zealand’s GST reform has been remarkably stable. Its broad base has lasted for more than 25 years, and the tax has received a wide degree of acceptance over a long period of time.

We would argue that it is much easier to deny special treatment in all cases rather than allow certain special cases but not others. While theoretical arguments can be provided for lightly taxing certain goods or services on efficiency grounds, the data the government needs to make informed judgements on optimal departures from uniformity are demanding. Moreover, once certain special cases are allowed, decisions on whether or not to allow others are much more likely to be driven by lobbying and political realities than unbiased econometric analysis — a very compelling reason for keeping special cases to an absolute minimum. In addition, New Zealand’s limited use of exemptions helps keep the GST as efficient as possible in minimizing production distortions.

How has a very broad based GST been possible in New Zealand and not in other countries? Most likely there is no single reason. New Zealand was fortunate to have started with a very bad tax system that made radical reform to a neutral system with as broad a base as possible politically viable. The GST was only part of a large set of reforms that moved in this direction. Compensation to beneficiaries and low-income families also helped to make the reform possible.
New Zealand was fortunate to be able to design its GST system with a very broad base. Few countries have been successful at substantially broadening their value added tax base once the tax has been introduced. New Zealand was also helped by an extremely good consultative process that has changed the way that the tax policy process works in New Zealand.

A fortuitous event was the existence of a family benefit payment to households of a fixed amount per child. This made transparent the fact that zero-rating food would have provided a bigger absolute benefit to high-income households than to low-income households, even though the poor spend proportionately more on food than the rich. It helped substantial groups of New Zealanders understand that there may be better ways of helping the poor than zero-rating food.

The GST is now a major source of revenue for the government. After its initial introduction, its rate has been increased — twice by a Labor Government and once by a National Government. This may create fears that a value added tax is likely to be used as a money machine to increase tax revenues. But the key reason that the rate of GST has been increased over time is that the tax is likely to be a relatively efficient form of raising revenue which allows the government, therefore, to keep other rates down. Unlike fiscal drag, increasing the rate of GST is transparent and the pros and cons of doing so need to be argued publicly.

At the same time, GST is far from being an unproblematic tax. We have discussed a number of issues that have been difficult to resolve in New Zealand and will continue to present challenges. Are there lessons for the United States in New Zealand’s GST? That is a matter for the reader to decide.

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