Perfecting New Zealand’s Consumption Tax System

Olena KHYTKO

Abstract

This essay weighs up the efficiency of different forms of consumption taxes, and balances the positives and negatives to find the best approach for New Zealand. It considers the ease of use and low administrative cost of the current uniform consumption tax in New Zealand (GST). Conversely, the regressive nature and the effect it has on low income earners shows that it is not a perfect system. Possible improvements are put forward, such as imposing a zero tax on necessities, or compensating the poor with benefits. The conclusion reached is that GST is the most efficient system of consumption tax.

1 Introduction

The consumption tax system in New Zealand varies to that of other countries, and could be considered quite efficient on the world scale. New Zealand has probably the broadest GST base in the OECD, which restricts tax evasion and facilitates the collection of more tax by the government. This uniform tax was imposed in New Zealand in 1986 at a rate of 10%. Goods and services tax (GST) is a tax on most goods and services in New Zealand, most imported goods, and certain imported services. It is added to the price of taxable goods and services, currently at a rate of 15%.[1] In terms of the GST, there is consideration as to whether certain goods and services should be taxed at lower, or zero rates. Meanwhile, a higher tax could be imposed on other goods and services. The converse issue is whether a uniform tax would be more economically efficient than varying taxes.

2 Goods and Services Tax

In any society, tax is an important mechanism for redistributing wealth and financing public services. In order to establish a 'good' tax system, the requirements set by Adam Smith should be satisfied. These include efficiency, equity, simplicity and low administrative cost. In this case, the biggest issue is that taxes can cause problems of inefficiency. They can restrict the incentive for workers to work, for producers to produce, and for consumers to consume.[2] GST, in general, is an efficient form of tax, as it does not interfere with production efficiency by taxing intermediate consumption.[3] It taxes the end good. This avoids the problem of double-taxing, and is less restrictive on producer's incentive to produce. Simplicity and low administrative cost is most effectively achieved with a wide tax base. Varied tax rates can cause problems with compliance, and can be costly to

[1]IRD. (21/04/2011). *GST (goods and services tax)*. Retrieved from http://www.ird.govt.New Zealand/gst/gst-registering/gst-about/
[2]Connolly, S., & Munro, A. (1999). ***Economics of the Public Sector.*** Essex, England: Pearson Education Limited.
[3]Grimmond, D. (14/04/2009). *Dominion Post Articles There's a hole in my GST, dear Liza*. Retrieved from http://www.infometrics.co.New Zealand/article.asp?id=4822

implement and collect. While a wide tax base is efficient, it is not the most equitable option, as will be discussed below.

3 Lowering tax on necessities

GST acts in a regressive manner as a share of income. The average rate of tax on goods and services is higher for those with low income, as they have to allocate a higher proportion of their income to expenditure. Those with higher incomes allocate a smaller portion of income to the same basket of goods and services.[4] This goes against the principle of vertical equity - that those who are more able to pay should pay relatively more tax. It would appear to be more fair and equitable to make goods and services such as necessities tax-free, or carry a small tax, so that low-income earners are left with more disposable income after purchasing necessities. This would make the goods and services tax system more progressive. The problem with this is that while such a change is directed at helping poor spend less, it would also benefit the rich as they also buy necessities. The rich would probably benefit the most, as they are likely to purchase a larger quantity of goods and services. Income benefits and transfers would be a more efficient and targeted way of helping the poor. This would allow for tax to still be collected on necessities purchased by the rich. An example of a zero-rate tax is Labour's proposal to take GST off fresh fruit and vegetables if they are elected. They argue that this will help low and middle income earners, and will boost the economy as a whole. An important point which is made is that fruit and vegetables should not become a luxury because of their price, but should be encouraged (as a merit good). Cutting GST off the price would certainly encourage more consumption and lead to healthier households. The policy is a good idea; however there would be problems in practice. In reality, fruit and vegetable sellers are likely to increase their prices back to the GST inclusive price over time, to gain more profit. Also, the lost revenue of this policy ($250 million) will mean that the public will have to pay this tax in

[4]Connolly, S., & Munro, A. (1999). ***Economics of the Public Sector.*** Essex, England: Pearson Education Limited.

some other way. [5] While reductions in tax are equitable, there are always practical problems with their effectiveness and implementation.

In comparison to New Zealand, which does not currently exempt necessities from tax, the US has a zero tax rate on food and children's clothing.[6] Currently New Zealand only exempts the following goods and services from tax:

- goods and services supplied by businesses that aren't registered for GST, and
- exempt supplies such as:

    - letting or renting a dwelling for use as a private home
    - interest you receive
    - donated goods and services and services sold by a non-profit body, and
    - certain financial services.[7]

Another reason to lower taxes is that it may help to limit tax avoidance. If GST makes purchases too expensive for low-income earners, they may find ways, such as through the black market, to evade tax. In the case of black market goods and services, the government raises no revenue from their consumption, as they are sold illegally. This is an inefficient outcome.[8]

4 Benefit of wide Value Added Tax Base

[5] *Labour confirms GST-free fruit and vegetable policy.* (27/09/2010). Retrieved from http://www.nbr.co.nz/article/labour-confirms-gst-free-fruit-and-veg-policy-130584
[6] Connolly, S., & Munro, A. (1999). ***Economics of the Public Sector.*** Essex, England: Pearson Education Limited.
[7] IRD. (21/04/2011). *GST (goods and services tax)*. Retrieved from http://www.ird.govt.New Zealand/gst/gst-registering/gst-about/
[8] Connolly, S., & Munro, A. (1999). ***Economics of the Public Sector.*** Essex, England: Pearson Education Limited.

GST is a form of Value Added Tax ("VAT"), which is a tax passed on by the firm to the government on the value added at that stage of production or distribution. New Zealand has a very wide VAT base, and very few goods and services are excluded from it. This is compared to the UK, where not all goods and services fall under the uniform tax; many have a zero rate. Broadening the VAT base is preferred in the Mirrlees Review, as it increases consumer's welfare.[9]

Having a broad VAT base, so having a uniform tax, increases economic efficiency, and also increases consumer's welfare. A wide VAT base allows for administrative costs such as the cost of collecting tax to be lower. It is also simpler for producers to implement a uniform tax on their goods. With a wide VAT base, it is easier compensate those on low incomes through direct tax and benefit reforms. It is also beneficial to consumers, as their consumption choices are not distorted by differentiated taxes on various goods and services. Conversely, it is sometimes necessary to encourage or discourage consumption of certain goods and services To limit distortion of consumer's purchasing decisions, and raise tax efficiently, the Marginal Extra Benefit (MEB) from any tax should be the same. (**cite)**

5 Increasing certain taxes incentivises workers

GST can also be manipulated to incentivise people to work. The government can tax time-saving goods and services less, and leisure goods and services more. This would encourage people to spend less time relaxing and more time working. An example of this can be seen in the UK in 1978, when luxury goods were taxed at a rate of 12.5%, compared to the 8% on normal goods and 0% on necessities. However, the policy of higher tax on luxuries was dropped in 1979. Taxing luxuries more may increase economic

[9]*Broadening the VAT base.* Retrieved from http://www.ifs.org.uk/mirrleesreview/design/ch9.pdf
10. 9

efficiency, however social efficiency may fall as people may not want to spend so much time working. It would also be hard to define a list of luxury goods to be taxed. Overall, it is probably better to limit such distortions on workers.

6 Merit and Demerit Goods

The government can also control what the public should and should not consume. To encourage the consumption of merit goods and services, it can decrease the tax on them. Conversely, to discourage consumption of demerit goods and services, it can raise tax on them. One example of this in New Zealand is increase in tax on tobacco by 24% and on cigarettes by 10% in 2010, with more increases scheduled.

By differentiating tax rates on goods and services, the government could manipulate the amount of tax revenue raised. Raising the tax on goods and services that are inelastic will achieve this, as the consumer will keep purchasing a similar amount of them even at a higher tax. Consumption of necessities such as toilet paper is unlikely to change, for example. Taxing addictive goods and services for their harm to society, such as alcohol and cigarettes, will also raise tax revenue as their consumption will not decrease proportionally to the increase in price. This could, however, become economically inefficient as sales of goods and services in high demand would decrease. If the government was to tax elastic goods and services, their tax revenue would fall. This is because the consumer would choose an alternative good, instead of consuming at a high tax rate. In theory, it would be efficient to tax inelastic goods and services. However, in practice it is hard to measure elasticities accurately. It may also be unfair to tax inelastic goods and services, as consumers may not have cheaper substitutes to turn to. [10]

There are some goods and services which should defiantly not see a fall in tax. These include environmental goods and services such as fuel. Dropping

[10] *PUBL303-ECON307 Lecture 17 - Tax Policy (21 Sept).* Retrieved from Blackboard

tax on fuel will encourage its consumption, which in turn will raise CO_2 emissions. This would not be an efficient use of depletable resources.

7 Hypothecated taxes

It may be fairer to hypothecate some taxes. Hypothecated taxes are levied on particular goods or services, and the tax revenue raised is spent only on financing expenditure on that particular good or service. This means that those paying tax on the good are the ones receiving the benefit of the tax revenue.[11] This may compromise the simplicity of taxation, and increase the administrative costs of working out, collecting and allocating spending of the tax revenues raised here. It may also be very hard to finance pure public goods and services in this way. Charging for a public good when it is consumed is not always possible, and could be costly.[12] Hypothecated taxes may therefore be an inefficient option.

8 The tourism industry, an example of GST inefficiency

GST in New Zealand works under the 'destination principle'. Goods and services purchased in New Zealand are liable for GST. Typically, it is considered that imports will therefore be liable for GST, but exports will not, as they are purchased overseas. This raises problems for producers who sell their exports in New Zealand, rather than overseas. In the New Zealand tourism industry, tourists pay this tax. However, it is those in the tourism industry who get less income, as the government collects 15% of the sold goods and services. This is compared to exports sold overseas, which are not taxed by the New Zealand government, leaving the revenue for the producer. The result of this GST constraint on the tourism industry is that there is less

[11] Connolly, S., & Munro, A. (1999). ***Economics of the Public Sector.*** Essex, England: Pearson Education Limited.
[12] Ibid.

investment and growth in that industry. The allocation of investment is distorted by the GST. This impedes efficiency and affects the whole economy negatively. One way to improve fairness in the system is to tax all exports, and not tax imports. This would get rid of the distortions that affect investment, and decrease the administrative cost of collecting tax. [13]

9 Conclusion

Overall, GST is considered to be an economically efficient form of tax. In New Zealand, GST applies to almost all goods and services. A reduced or zero rate of tax on certain goods, predominantly necessities, would be beneficial to low-income earners. This is because they currently spent a higher portion of their income on necessities than high-income earners. Lowering taxes on certain goods could also reduce tax evasion and black markets, resulting in higher tax revenue. However, the costs of varying taxes appear to outweigh the benefits. New Zealand is already making progress on achieving economic efficiency, as GST is a Value Added Tax. This is especially so as New Zealand has a wide VAT base. A wide base ensures low administrative costs and compliance with the GST system. It also reduces the distortions to consumer spending and to the production process. On the weight of the arguments, it appears that while reduced taxes would certainly benefit consumers, the most efficient outcome is achieved by the current broad uniform tax.

References

Broadening the VAT base. Retrieved from http://www.ifs.org.uk/mirrleesreview/design/ch9.pdf

Connolly, S., & Munro, A. (1999). Economics of the Public Sector. Essex, England: Pearson Education Limited.

[13] Grimmond, D. (14/04/2009). *Dominion Post Articles There's a hole in my GST, dear Liza*. Retrieved from http://www.infometrics.co.New Zealand/article.asp?id=4822

Grimmond, D. (14/04/2009*). There's a hole in my GST, dear Liza*. Retrieved from http://www.infometrics.co.New Zealand/article.asp?id=4822

IRD. (21/04/2011). *GST (goods and services tax).* Retrieved from http://www.ird.govt.New Zealand/gst/gst-registering/gst-about/

Labour confirms GST-free fruit and vegetable policy. (27/09/2010). Retrieved from http://www.nbr.co.nz/article/labour-confirms-gst-free-fruit-and-veg-policy-130584

PUBL303-ECON307 Lecture 17 - Tax Policy (21 Sept). Retrieved from Blackboard