GST

Background Paper for Session 2
of the Tax Working Group

This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

The Tax Working Group will release its interim report containing its recommendations in September and the views of the Group will be informed by public submissions alongside Secretariat advice.

February 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

TABLE OF CONTENTS

Executive Summary

This paper provides a brief summary of New Zealand's GST system and framework. The paper considers the case for making further exemptions from our GST base and also considers the application of GST to low-value imported goods.

GST is a broad-based tax on consumption in New Zealand. GST is imposed at a single rate of 15% across a broad base of goods and services with few exemptions. Internationally New Zealand has one of the broadest GST bases.

There are currently two main 'exemptions' from GST in New Zealand which are for residential accommodation and financial services. Both of these exemptions are made due to pragmatic difficulties in applying GST to these respective areas and are not intended as deliberate concessions. The 'exemptions' mean that these services are input taxed which results in there still being a GST cost for residential accommodation and financial services.

GST is generally considered an efficient and stable tax that has not undergone significant overhaul since introduction. However, there is concern about the distributional impact of GST as it has proportionally greater impact on households with lower incomes. GST also has relatively higher compliance costs compared with New Zealand's other taxes.

Due to concerns about the distributional impact of GST there have been calls to create further exemptions from GST for items which lower income households consume more of. In particular there have been calls to remove GST from food and drink. The difficulty with such an approach is that it is a poorly targeted mechanism for improving progressivity because in absolute terms higher income households spend more on such goods than lower income households do.

As a result, removing GST from food and drink would provide a greater absolute benefit to higher income households than lower income households. For the same revenue loss as an exemption from GST other measures to achieve distributional or other concerns such as government services or welfare transfers are likely to have greater benefits. Exemptions from GST are also generally complex and generate large compliance and administration costs.

GST operates on the destination principle. Under this principle GST applies to goods and services that are traded across borders when they are consumed in New Zealand. Therefore, in principle, GST should be collected on all imported goods, regardless of value.

Currently, the New Zealand Customs Service only collects GST on imported goods when $60 or more of total duty[1] applies. This '*de minimis*' for these parcels creates a competitive distortion and results in an increasing amount of foregone GST revenue. This is an increasing problem as the amount of low-value parcels imported is growing at around 12 percent each year. Estimates suggest the foregone revenue will amount to $127 million for the 2020/21 fiscal year.

The key question for these low-value imported goods is how to collect GST in a low cost and effective way. Officials have identified a number of options to achieve this. These include requiring offshore suppliers to register and remit GST, using the logistics industry to collect GST between the point of sale and delivery and requiring consumers to pay the GST after delivery. Which of these options is the best depends on each option's feasibility and considerations of which option would achieve the highest rate

[1] Duty includes GST, tariffs, and a small range of small levies and excise tax. This $60 threshold equates to a parcel valued at $400 if GST is the only duty owing. However, this threshold could be as low as $226, depending on whether tariffs are payable.

of compliance at the lowest cost. Consultation will help in making this determination. As a result we recommend referring this issue back to Government to consult on feasible options to collect GST on low-value goods.

1. Introduction

1.1 Purpose

1. The purpose of this paper is to provide a summary of New Zealand's GST system and framework for the Group's consideration. The paper intends to enable consideration of whether our broad-base low-rate approach to GST is still appropriate.

2. The Minister of Finance and Minister of Revenue have written to the Group asking the Group to consider options for collecting GST on low-value goods imported in New Zealand. In the letter the Minister of Finance and Minister of Revenue noted that the Government is minded to proceed with this work, and would welcome early advice from the Group on the merits of reform options, ahead of the production of the Group's Interim Report in September. This paper provides advice on this issue to enable the Group's consideration of the application of GST on low-value imported goods.

2. Background

3. GST is a broad-based tax on consumption in New Zealand. GST is imposed at a single rate of 15%, across a broad base of goods and services with few exemptions. The primary objective of GST is to raise tax revenue in a manner that is as fair and efficient as possible. To achieve this, our GST system aims to tax consumption of different goods and services equally and not distort consumers' choices between different goods and services.

4. GST was introduced in 1986 as part of a wide-ranging tax reform. Tax revenue at the time relied more heavily on income tax, which featured rates of up to 66 percent and many rebates and reductions. The introduction of GST (as part of a wider reform of the tax system) intended to ensure that tax moved from a narrow base to a broad base, reducing the economic distortions created by the tax system as well as the compliance and administration costs associated with of narrow bases. The introduction of GST was explicitly intended to enable a reduction in income tax rates and reduce the reliance on income taxes.

5. GST is generally considered an efficient tax relative to income tax. GST can be viewed as an indirect tax on labour income together with a lump-sum tax on wealth on the day that the tax is introduced.

2.1 GST design

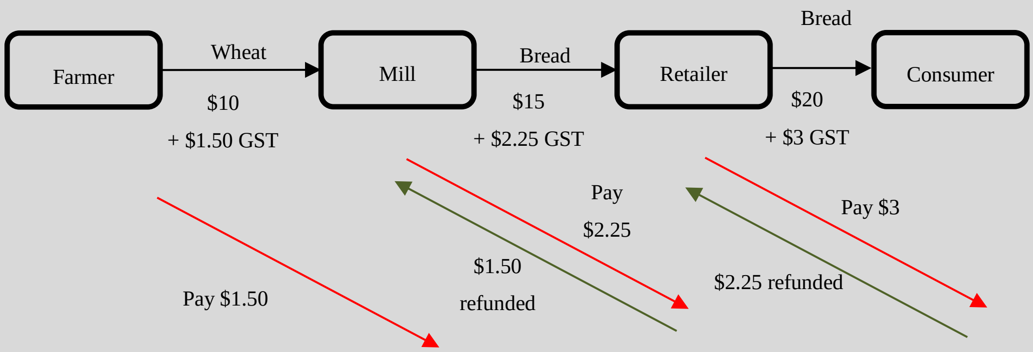
6. New Zealand resident businesses[2] that supply more than $60,000 in goods or services in New Zealand are required to register for GST and charge GST on all goods and services they supply in New Zealand[3]. Because GST is designed to tax consumption rather than production, one of the basic principles of GST is that businesses should not bear the cost of GST when producing goods and services. This is achieved through the credit-invoice mechanism.

7. Under the credit-invoice mechanism GST registered businesses may claim back any GST charged on goods and services they acquire for the purposes of making further supplies. Through this, GST is not borne by the business, preventing what are known as tax cascades where GST could potentially be borne at more than one point in the supply chain, resulting in the effective rate of the tax being more than 15%.

[2] Non-resident businesses may also be required to register for GST if they make supplies of goods that are in New Zealand at the time of supply, or make supplies of services that are either physically performed in New Zealand or supplied remotely to New Zealand consumers. These businesses are required to register if the total value of their New Zealand supplies in a 12-month period exceeds the $60,000 registration threshold.

[3] Businesses that supply less than $60,000 may however voluntarily register if, for example, they wished to claim back the GST on their inputs.

Example: GST and bread production



In this example, GST is charged throughout the production process. However, this does not create a cost for business as any GST charged to another business is refunded.

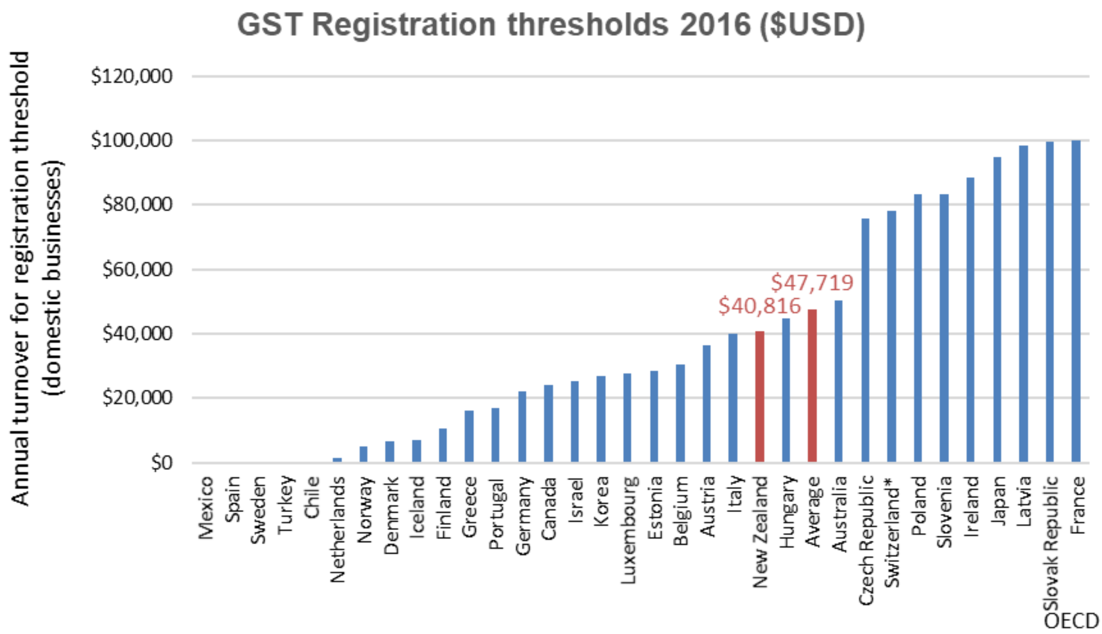
As a result, the only person that bears the GST cost is the final consumer who cannot get the $3 of GST charged to them refunded.

GST threshold

8. Businesses that supply less than $60,000 of goods and services in New Zealand over a 12 month period are not required to register and pay GST on goods and services they provide. If they do not register, they are also not able to claim back any GST charged to them for their inputs. This $60,000 threshold is intended to reduce compliance costs by removing the cost of complying with GST for businesses that supply a relatively small amount of goods and services. The threshold is a balancing exercise between having a broad GST base and reducing compliance costs.

9. New Zealand's GST registration threshold is slightly below the OECD average[4].

[4] The average has been calculated using countries that have a registration threshold. If countries with no threshold are included the average decreases to $42,934.



Destination principle

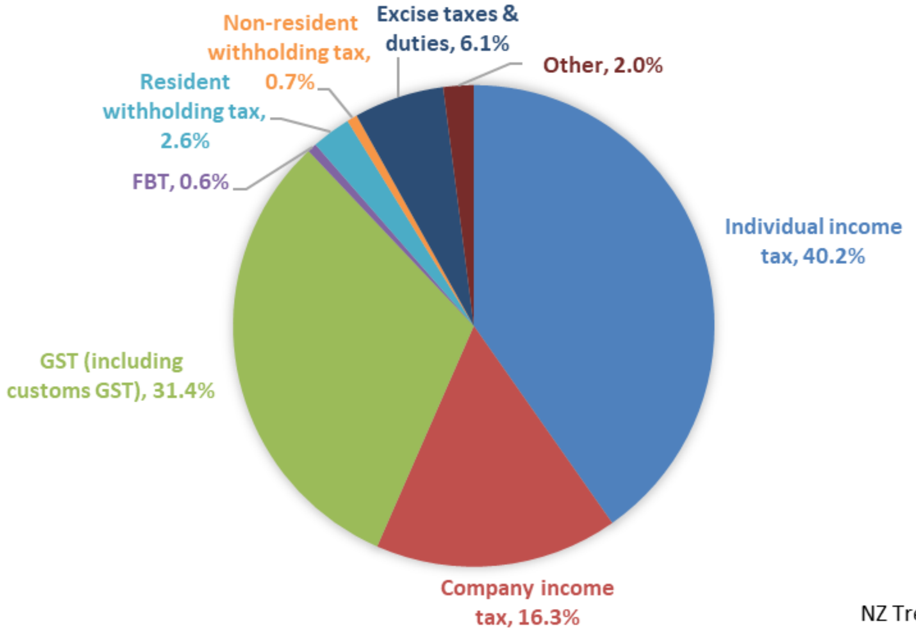
10. GST operates on the "destination principle". Under this principle, GST applies to goods and services that are traded across borders when they are consumed in New Zealand. Under this principle, GST does not apply to exported goods and services and should apply to all imported goods and services.

11. Removing GST from exports is achieved through 'zero-rating' exported goods and services. Zero-rating means that an exporter does not need to charge GST on the supply of the export and may have any GST charged to them for their inputs refunded. This is different to an 'exemption' for GST, as with an exemption a business is not able to get their inputs refunded. Not being able to get inputs refunded means that goods and services which are exempted still have a GST cost while goods and services that are zero-rated have no GST cost. This is discussed more below at 2.5 in the context of residential accommodation and financial services and in chapter 3 in relation to GST on imported goods.

2.2 GST revenue

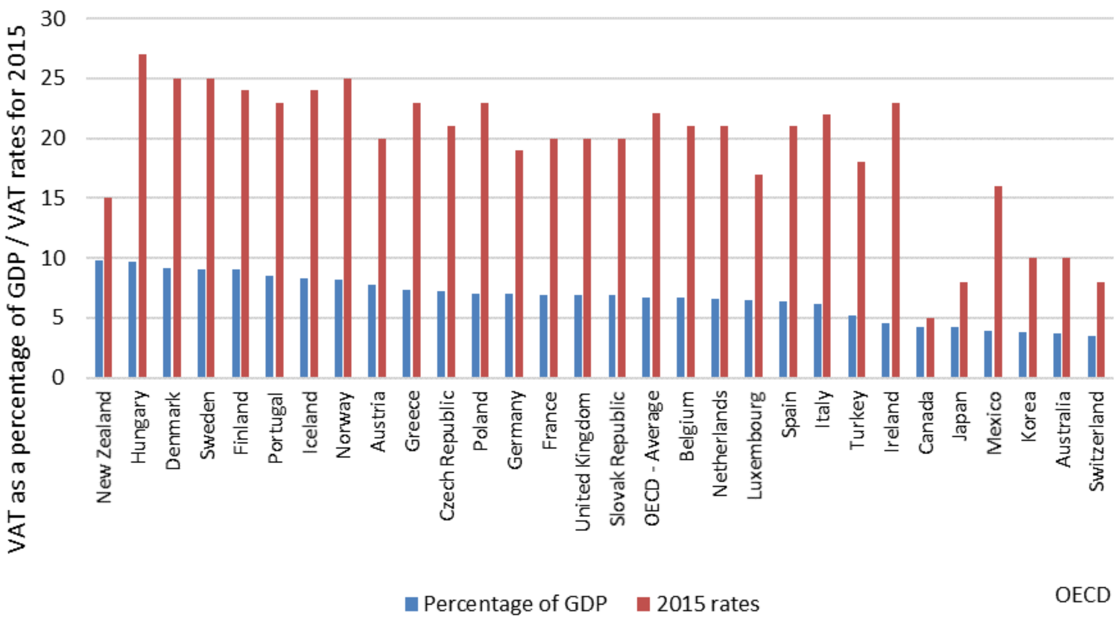
12. GST revenue for 2016-17 was $26,391 million. GST makes up over 30% of New Zealand's taxation revenue. Internationally, New Zealand collects a relatively high amount of GST compared with other taxes.

Figure 3: New Zealand source of taxation revenue (2017)



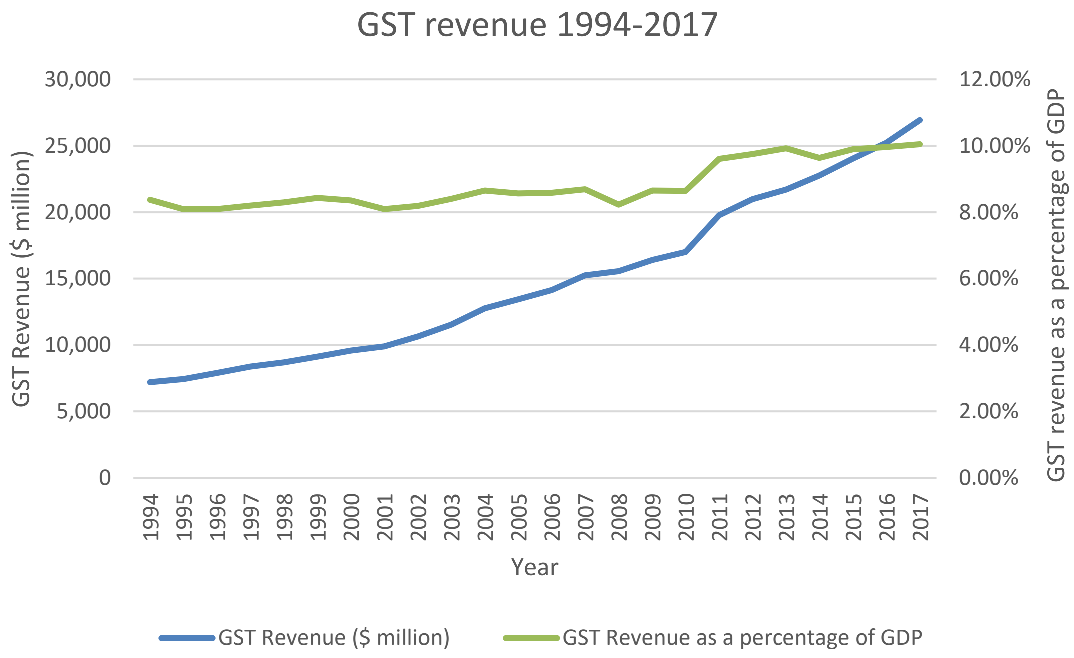
NZ Treasury

Figure 8: Value-added taxes as a percentage of GDP (2015)



OECD

13. GST has proven to be a relatively stable revenue base. Revenues from GST have not faced significant fluctuations and the rules themselves have not faced major upheaval since introduction, although there have been two increases to the GST rate.



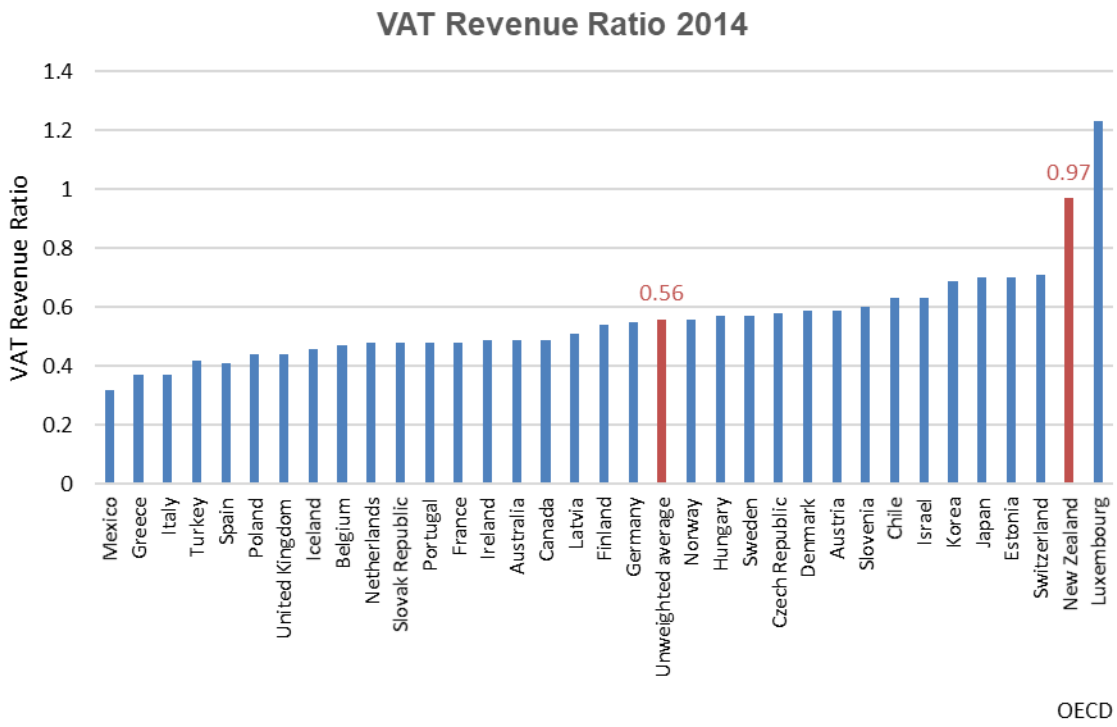
2.3 Broad-base low-rate GST

14. GST follows New Zealand's broad base low rate approach to taxation. There are very few exemptions to GST in New Zealand, meaning that it applies to a broad range of goods and services.

15. Internationally, New Zealand has one of the broadest GST bases. The OECD Value Added Tax Revenue Ratio puts New Zealand as having the second broadest GST base amongst the OECD[5][6].

[5] The VRR measures the difference between the VAT revenue actually collected and what would theoretically be raised if VAT was applied at the standard rate to the entire potential tax base in a "pure" VAT regime and all revenue was collected. This aims to measure the breadth of different countries' VAT and GST bases so that international comparisons may be made. New Zealand's score of 0.97 indicates that our GST is applied very broadly by international standards. However, it should be noted that a large part of our high score is because New Zealand is unique in applying GST to government appropriations.

[6] Luxembourg has a VRR greater than 1 because it has a large financial services sector. Because financial services are input-taxed (including supplies to non-residents), this means that Luxembourg applies GST to the consumption of financial services by non-residents. The VRR compares GST revenues against domestic consumption so having significant GST revenues from non-residents can mean the ratio exceeds 1.



2.4 Compliance costs

16. GST has relatively higher compliance costs compared with other taxes. Inland Revenue research indicates that for 2016 GST was the most time-consuming tax for small and medium sized enterprises[7] (Inland Revenue, 2016).

Median annual hours of in-house time SMEs spent by tax type (2004-2016)

Tax type	**2004**	**2009**	**2013**	**2016**
GST	33	24	24	14
Income Tax	18	12	12	6
PAYE	15	12	12	12
KiwiSaver	-	9	9	9
FBT	8	3	4	2
All tax types (median annual hours)*	**55**	**48**	**36**	**27**

*Note: As these are medians, the total hours do not equal the sum of the components.

2.5 Current exemptions

17. There are two main departures from the broad-base low rate approach in our GST system. These are for rental residential accommodation and financial services[8]. Both of these exemptions are made due to pragmatic difficulties in trying to apply GST to these areas, rather than being made for distributional concerns or to try to alter consumer behaviour.

[7] The GST costs may be overstated in studies such as this as businesses may attribute core accounting tasks to tax compliance. For example the main cost stated by businesses in complying with GST in this study is recording information which for many businesses the amount of information recorded may be the same in the absence of a GST due to core accounting needs.

[8] Other exemptions exist for services by employees, and investment goods. However these exemptions are not considered departures from our broad-base low-rate approach. This is because for employees their services are generally provided to businesses who would be able to have any GST charged refunded and as a result removing them from the base reduces compliance costs without any fiscal impact. Investment goods are excluded because GST is not a tax on savings.

18. The exemptions for rental residential accommodation and financial services do not mean that they are free from any GST cost. Instead the exemptions mean these services are 'input taxed'. This means that, although providers of rental residential accommodation and financial services do not charge GST on the services they provide, they are also not able to claim back GST charged to them on any inputs they acquire in the production process. Choosing to input tax these services reflects that these exemptions are due to practical difficulties in applying GST rather than a desire to provide deliberate concessions. As a result, there is still some level of GST cost for financial services and residential rental accommodation.

Residential accommodation

19. The rationale for the exemption for rental residential accommodation is primarily to provide neutrality between rented accommodation and owner-occupied accommodation.

20. The difficulty in coherently applying GST to residential accommodation arises because owner occupiers 'self supply' residential accommodation to themselves. It is generally not considered practically feasible to attach GST to this self-supply of accommodation[9]. As a result, if GST applied to residential rental accommodation it would mean that renters would need to pay GST on the rental payments while owner-occupiers would not. This is similar to the issue of imputed rent for income tax.

21. For this reason, supplies of rental residential accommodation were exempted upon the introduction of GST. This approach is the international norm as the majority of consumption tax regimes choose to exempt residential accommodation. The exemption can also be considered a pragmatic approach to applying GST in the rental sector given there are a significant number of rental providers, many of whom are expected to be below the GST registration threshold.

Example

Take for example a rental provider who has the following revenues and costs:

- They acquire a house for $500,000 plus $75,000 in GST
- They incur holding costs such as rates and repairs of $10,000 plus $1,500 in GST a year
- They charge rent of $50,000 a year

In this case, the rental provider does not charge GST on the $50,000 of rent. However, they still face a GST cost as they paid $75,000 in GST to acquire the property and pay $1,500 in GST a year on their holding costs.

If the rental provider was instead an owner-occupier who lived in the property, they would face the same GST costs. Input taxing them when they use the house as a rental and when they use the house for owner-occupation means the GST position is the same and provides neutrality for GST between renters and owner-occupiers.

[9] This is in the absence of a tax on imputed rents. It would be possible to have neutral treatment if GST applied to the imputed rent of residential accommodation alongside rental payments.

Financial services

22. Financial services are exempt from GST because of the practical difficulty in trying to isolate the service provided by financial institutions.

23. In principle, GST should apply to the service that financial institutions supply in intermediating borrowing and lending between borrowers and savers. However, GST is not intended to apply to savings as they represent deferred consumption, which GST will apply to when eventually spent and consumed.

> ***Example***
>
> Take a very simple scenario where a person borrows $100 from a bank at an interest rate of 10%. To provide this lending the bank borrows money at a rate of 7%.
>
> When the person pays $10 of interest in the following year, $7 of this represents the savings component of the loan, while $3 represents the service the bank provided in matching a borrower with a lender (excluding any risk premiums).
>
> As a result, in principle GST should apply to the $3 of services the bank provided.

24. However, in reality this sort of matching exercise is not possible as there is no tracing between the source of funds and whom they are lent to. This makes it very difficult to isolate the value of the service provided by financial institutions. In the absence of financial institutions charging explicit fees instead of profiting from interest rate margins, it is generally considered not possible to apply GST to these services under a credit-invoice mechanism.

25. Alternative approaches for applying GST to financial services have been considered previously. These include applying GST to the difference between all cash inflows and outflows, charging GST on interest above a certain defined margin, or charging GST on consumer loans on the sum of profits and wages for financial institutions[10].

26. However, all of these approaches are problematic and each respectively comes with its downsides. For example, the approach of taxing all cash inflows and outflows can result in significant over- and under-taxation if borrowing does not match lending on a month-by-month basis. There is also scope for manipulation by financial institutions to claim large GST refunds. The margin approach relies on being able to accurately set an appropriate margin on lending. The sum of profits and wages approach appears to be the most promising of the three but is also problematic in its complexity.

27. Due to these difficulties, countries have tried and failed to find an effective way to apply GST to financial services. This means that financial services are undertaxed compared with

[10] Applying GST on financial services in New Zealand has been considered more feasible after the introduction of zero rating of business to business financial services. Under these rules, financial service providers can claim input credits for inputs acquired to provide financial services to other businesses, which is designed to avoid tax cascades. These rules require financial service providers to identify consumer and business loans which could be used as a basis for applying GST to consumer loans.

other goods and services[11] and creates some inefficiencies, in particular a bias for financial service providers towards in-sourcing (self-supplying) their inputs.

[11] We do not have an estimate of the lost revenue to New Zealand as a result of the financial services exemption. In its Tax Expenditure Statement, the Australian Treasury estimated the cost of input-taxing financial supplies was $3.45 billion in 2016/17.

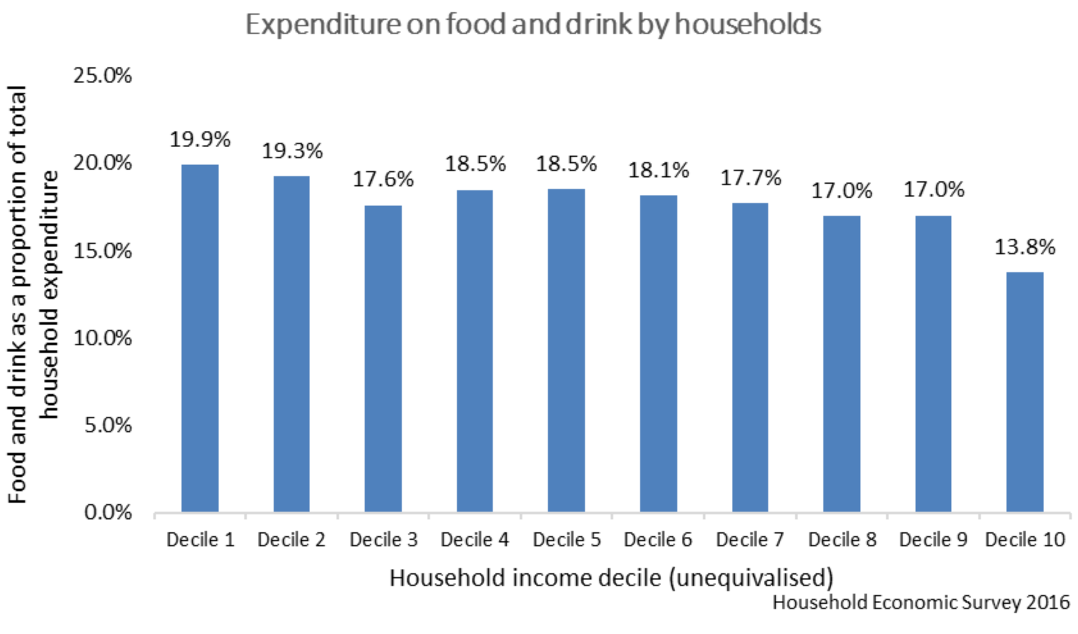
3. Should there be more exceptions in our GST base?

28. GST and VAT systems overseas often have exceptions from GST in order to achieve distributional objectives as well as other social objectives such as promoting consumption of healthy products. In New Zealand similar concerns are often raised and in particular commentary on New Zealand has often argued that GST is regressive and this leads to calls to move away from our broad based approach to GST. The distributional impact of GST is considered further in Appendix 1.

29. There are a number of options for addressing distributional or other social concerns for which GST exceptions are one. This chapter provides a consideration of the impact of creating GST exceptions for New Zealand, in particular for addressing distributional concerns.

3.1 Impact of removing food from GST base

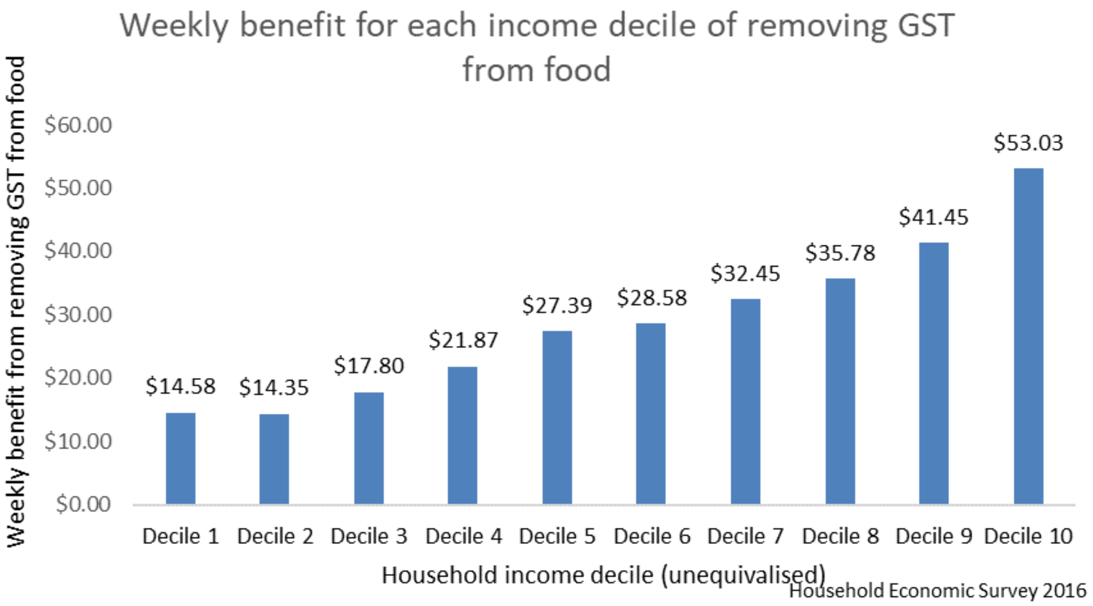
30. Lower income households consume more of certain goods and services than higher income households do. For example, expenditure on food and drink represents approximately 20% of the average weekly household expenditure of a decile 1 household while it represents only 14% of the weekly household expenditure of a decile 10 household[12]. As a result if GST was removed from food it would have a proportionally greater impact on lower income households than higher income households and therefore would improve the progressivity of GST.



31. However, this distributional impact needs to be balanced against the efficiency and administrative disadvantages an exception would create. It also needs to be considered whether there are better alternative mechanisms for achieving distributional goals such as through income tax progressivity or welfare transfers.

[12] A decile 1 household has household income less than $23,800 and a decile 10 household has household income greater than $180,200.

32. For example removing food and drink from the GST base has a greater absolute benefit for higher income households than lower income households. Such an exception would benefit a decile 1 household by $14.58 a week and would benefit a decile 10 household by $53.03 a week[13].



33. Such an exception would reduce GST revenues by an estimated $2.6 billion. With this same amount of revenue each household could instead be given a cash transfer of $28.85. Removing GST from food instead of such a transfer would therefore provide approximately an additional $24 weekly benefit to the richest households and $14 less to decile 1 households compared with lump sum payments. In addition, for the same fiscal cost a more targeted welfare transfer could provide greater benefits to lower income households[14].

34. Research in New Zealand has also supported the view that GST exceptions are a poorly targeted instruments for achieving distributional aims. Research in 2014 on food expenditure and GST in New Zealand found that "the absolute and relative gains and losses from a revenue neutral policy of zero-rating food in a GST are small relative to total expenditure, despite the fact that the policy can achieve some progressivity" and "a policy of raising transfer payments – even where these are received by everyone – is capable of producing more progressivity" (Ball, Creedy, & Ryan, 2014).

35. Providing exceptions through the GST system also generally leads to complex and often arbitrary boundaries. This is particularly the case when the relief is targeted to ensure it is focused towards specific goods and services that are deemed necessary or desirable. Any boundary will create compliance costs, even when relatively simple boundaries are used, as it requires businesses to identify and separate out exempted transactions.

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[13] This is an estimate based on static impacts and does not take into account behavioural change.

[14] A cash transfer is also be considered to be more efficient and welfare enhancing method of achieving progressivity. This is because an exception from GST is distortionary, affects the relative price of food, and therefore causes households to spend more on food than they otherwise would have. If given an equal cash transfer as the benefit of a GST exception a household would be likely to spend less on food and more on other items which would better reflect their preferences and as a result would improve their welfare more than a GST exception.

Example – United Kingdom VAT rules for food

The United Kingdom provides VAT exemptions for a range of food items to achieve distributional goals and to encourage the consumption of particular food.

HMRC guidance on the exemptions for food and catering show that these exemptions can be complex. The guidance totals 40 pages of the different treatment of over 130 example categories of food and drink. The distinctions often require judgements about whether something is fit for human consumption and which category different foods fall into. The boundaries between particular items do not appear to have a clear policy rationale. The section on frozen products is reproduced below for illustration (HM Revenue & Customs, 2017).

The boundaries have also caused dispute. In a famous case, United Biscuits Ltd took HMRC to the VAT Tribunal to argue that Jaffa Cakes are cakes rather than biscuits, with their arguments including that cakes generally go hard while stale biscuits go soft. The VAT Tribunal agreed with United Biscuits.

The example of the UK exemption is used to illustrate the difficult boundaries that can occur when exempting certain products as the UK is considered one of the more complex regimes for food. Better-designed systems are likely to be less complex. However even in systems that are considered relatively simpler, significant complexities remain. For example, Australia may be considered to have a more coherent and effective set of rules for food (van Klink & Hyang, 2012) however their guidance on food contains 87 pages of explanation covering over 1,500 types of food items.

Ice cream and other similar frozen products

You must standard-rate your supplies of any product designed to be eaten while frozen.

Products which are supplied frozen, but have to be cooked before they can be eaten, or which have to be thawed completely before eating, are zero-rated.

Please see examples below:

Zero-Rated	Standard-Rated
Baked Alaska	Ice cream and ice lollies
Cream gateaux	Ice cream gateaux and cakes, including arctic rolls
Mousse	Water ices, sorbets and granitas
Frozen yoghurt which needs to be thawed completely before it can be eaten and which has been frozen purely for storage or distribution	Frozen yoghurt
Desserts which are equally suitable for consumption frozen or defrosted (unless primarily designed for eating frozen and made substantially of ice cream or similar products)	Powders and mixes for making ice creams and similar frozen products, including incomplete mixes and emulsions used by the trade and fruit syrups sold in plastic tubes for home freezing as ice lollies
Wafers and cones (unless wholly or partly covered in chocolate or a similar product)	Wafers and cones sold with ice cream or similar products
Toppings, sauces and syrups unless sold with ice cream or similar products	

36. Other arguments for exempting items from GST include encouraging socially desirable activities (for example healthy food or education) or a desire not to tax necessities (for example health care products). However, exemptions on these grounds face the same distributional, and compliance concerns as above. In particular targeting exemptions towards specific activities will generally increase the complexity of the boundaries as it can be difficult to determine which goods and services achieve the social goal or should be considered necessities.

37. Exempting certain goods or services also creates the risk of being a slippery slope. If one type of good or service is exempted due to distributional or other goals it becomes more difficult to argue against further exemptions argued on similar grounds. This has the potential to erode the GST base, which would mean the revenue would need to be made up elsewhere.

38. Tax reviews overseas have recommended moving to single rate consumption taxes. The Mirrlees review in the UK noted:

> This is not simply a preference for textbook tidiness. Moving towards a more uniform rate would increase consumers' welfare by distorting their spending decisions less. People would make choices based on relative prices that reflect the underlying costs of producing the goods rather than differences in tax rates. Our calculations suggest that if almost all zero and reduced rates of VAT in the UK were removed, the government could (in principle) compensate every household to leave them as well off as they were before and still have about £3 billion of revenue left over.

39. The OECD report on Tax and Growth noted that

> An effective redistribution policy is not implemented through each tax in isolation but should be implemented by considering the entire tax system as well as the benefit system. Because the redistributional impact of the reduced VAT rates is ambiguous, the income distribution goals could better be achieved through means of targeted PIT relief and/or targeted benefits. Deaton and Stern (1986) for instance show that direct lump-sum payments to households depending only on their socio-economic characteristics are better for both equity and efficiency. Ebrill et al. (2001) argue that direct targeted transfers to lowincome households are more effective in enhancing equity than VAT exemptions, zero and reduced rates.

3.2 Conclusion

40. Governments have a number of options for addressing distributional or other wider social goals. Providing GST exceptions is one option that is often raised in particular due to concerns about the distributional impact of GST, and desires to make GST more progressive.

41. However, exempting items such as food and drink is poorly targeted towards achieving distributional goals and has a disproportionally large revenue impact. For the same fiscal cost as an exemption from GST other measures to achieve distributional aims are likely to have greater benefits. Exceptions from GST are also generally complex and generate large compliance and administration costs which welfare transfers and other mechanisms can avoid.

4. GST on low-value imported goods

42. Collecting GST on all imported goods is consistent with our broad-base low-rate GST framework and with the destination principle[15]. Following these frameworks, there is in principle no reason why imported goods should be treated any differently to locally sold goods.

43. For the purpose of this chapter, “low-value goods” are those goods imported into New Zealand valued at less than $1,000.

4.1 Current rules and processes

44. The New Zealand Customs Service (Customs) collects duty on imported goods, including low-value goods when $60 or more of ‘total duty’ applies. Total duty includes GST, tariffs, a range of small levies and excise tax. Cost recovery charges are also collected on these goods, which primarily fund the related border risk management activities of Customs and the Ministry for Primary Industries (MPI).

45. The $60 threshold is known as the *de minimis* and equates to a parcel valued at $400 if GST is the only duty owing; however the parcel’s value could be as low as $226 if the tariff duty is also owing. The rationale for the *de minimis* is to achieve a balance between the cost of collection and the revenue collected, as well as to facilitate the clearance of goods at the border.

46. Approximately 5 percent of low-value imported goods by volume (approximately 30% by value) exceed the *de minimis* and attract duty. Duty is generally not paid on the remaining 95 percent of low-value imported goods (approximately 70% by value), which fall below the *de minimis*.

47. Customs has a relatively robust process for collecting duty on goods valued between the *de minimis* and $1,000. A simplified import declaration is required to be filed for such goods which is considered to provide a good balance between revenue collection and transaction costs. Customs has more robust and efficient collection systems that collect GST on all imported goods valued above $1,000, along with cost recovery charges and tariffs. This include distinct and more stringent import entry requirements.[16]

4.2 Problem

48. Historically, goods under the *de minimis* were not commonly imported by final consumers so the GST collection and border processing systems for imported goods were not designed with these low-value items in mind. However, consumers now have access to global markets and a wide-range of competitively priced goods online. The growth of online shopping means the volume of low-value goods under the *de minimis* on which GST is not collected is becoming increasingly significant.

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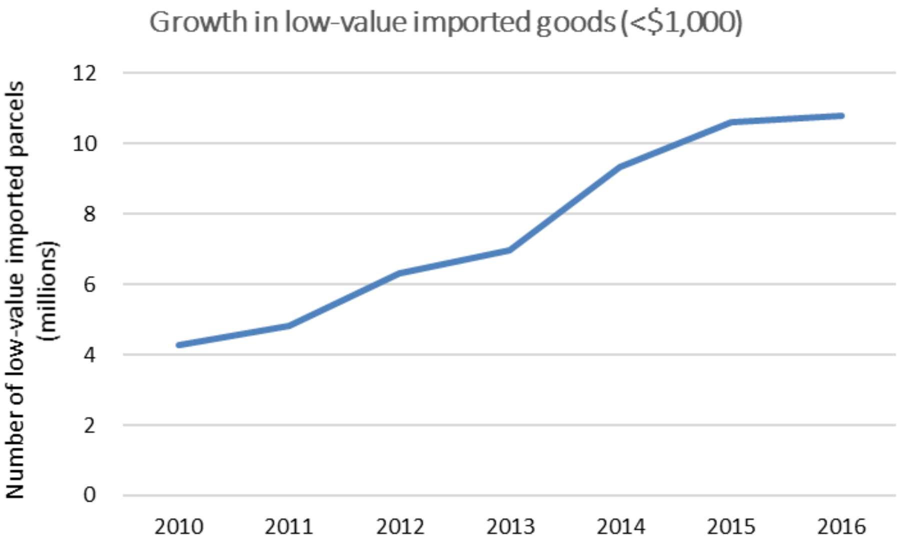
[15] See the explanation of the destination principle at paragraph 10.

[16] Whether GST on low-value goods continues to be collected at the border or not, requirements for at least simplified import entries will remain as these also serve as crucial information sources to support Customs and the Ministry for Primary Industries roles in managing risk at the border.

49. Based on a five-year average, the number of low-value parcels is growing at around 12 percent each year[17], a rate that is projected to continue into the future.



50. When GST is not collected on goods under the *de minimis* it may bias consumer and business decisions, which can lead to unfair and inefficient outcomes. The non-collection of GST on imported goods below the de minimis creates a distortion in the tax system whereby the vast majority of goods valued at below $400 that are purchased from offshore suppliers are not subject to GST, while all purchases from domestic retailers are subject to GST.

51. This distortion leaves domestic suppliers of goods at a competitive disadvantage compared with offshore suppliers that are able to transport low-value goods directly to their customers without the imposition of GST.

52. This also has fiscal implications as the amount of GST foregone is increasing over time. As goods are increasingly sourced from untaxed sources, revenue must be made up elsewhere.

53. Estimating the total foregone GST revenue on low-value goods relies on a number of assumptions, and estimates of the foregone revenue vary. Estimates are particularly sensitive to assumptions about coverage and compliance rates and the nature of the underlying data used to model future foregone GST revenue.

54. In 2015, officials estimated the maximum potential foregone GST revenue was around $140 million. This estimate was derived from survey and credit card spending information. Since then, further work has been undertaken using a mixed dataset that includes Customs' sample data of goods coming across the border. An estimate was calculated based on an assessment of the value of goods under the current *de minimis* threshold. This work conservatively estimates that foregone GST revenue for the 2016 year was around $80 million which is projected to increase to $127 million in 2020/21. This is lower than other estimates; for example, an estimate by Retail NZ places the current foregone revenue at $235 million, which they expected to increase to $935 million within nine years.

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[17] Volumes are increasing at approximately 5.6% per annum in the fast freight stream and 23% per annum in the postal stream.

4.3 Options

55. The key issue with low-value imported goods is how to collect GST in a way so that the costs of collection do not exceed the amount of revenue at stake.

56. Customs, Inland Revenue, the Ministry of Primary Industries and Treasury have been working on options for collecting GST on low-value imported goods to achieve this. A number of options have been considered including:
    - Offshore supplier registration: Offshore suppliers would be required to return GST on low-value goods supplied to New Zealand consumers if their total supplies to New Zealand exceed the GST registration threshold
    - Between the point of sale and delivery: Freight couriers and New Zealand Post would collect revenue on low-value imported goods they deliver
    - Pay after delivery: Consumers would pay the GST on low-value imported goods after they have been delivered to them.

57. A brief discussion of these is in appendix 2.

4.4 Next steps

58. The in-principle case for collecting GST on low-value imported goods is clear, as GST should be collected on all imported goods consumed in New Zealand in accordance with the destination principle. The key issue is how to ensure that GST is collected on these goods in a way such that compliance and administration costs do not outweigh the revenue at stake.

59. The key issue is therefore ensuring that there is a collection method that has sufficiently low compliance costs (so that compliance costs do not outweigh the revenue at stake), has high compliance rates and is consumer friendly. There are three main options officials have identified for achieving this.

60. Which of the identified options is the best depends on which best meets the stated objectives. This may involve a balance between these objectives. We consider that the best way of informing the consideration of these options would be though public consultation. As a result we would recommend referring this issue back to Government to consult on feasible options to collect GST on low-value goods.

5. Conclusion

62. Our GST system is generally considered a very efficient, stable and has not faced significant upheaval since introduction. Our GST system follows New Zealand's broad base low rate framework, there are few exemptions, and the few exemptions that do exist have been made on pragmatic grounds rather than desires to influence behaviour achieve distributional goals.

63. However, there continue to be concerns about the distributional impact of GST and as a result there are calls for particular items which low income households consume proportionally more of, such as food and drink, to be made exempt from GST. However, GST provides a poorly targeted means of addressing distributional concerns, as exemptions provide a greater benefit for higher income households than lower income households on an absolute dollar basis. Exemptions also creates complex boundaries, increase compliance costs, and can be a slippery slope. As a result, income tax changes or welfare transfers are generally considered a more targeted and simpler way of addressing distributional concerns.

64. The application of GST to low-value imported goods is a growing problem that leaves domestic retailers at a competitive disadvantage and is leading to an increasing amount of foregone GST revenue. In principle, GST should apply to these goods under the destination principle, as they will be consumed in New Zealand. However, the key question is how to collect GST in a way such that the costs of collection do not outweigh the amount of revenue at stake. There are a number of options on how to collect these and which one is best depends on the feasibility of the options and the expected degree of compliance. Consultation will help determine this and therefore we would recommend referring this issue back to Government to consult on options.

Appendix 1: Distributional impact of GST

65. The question of whether the goods and services tax is a “regressive” tax is often raised in commentary on New Zealand’s tax system.

66. It is common to measure progressivity of taxes in terms of taxes paid as a proportion of a household’s annual income. Using this measure GST looks regressive as it affects households with lower current income than households with higher current income. The reason for this result is because higher income households have higher savings rates and as a result, consume less in the current period as a proportion of their income.

67. However, there is debate about whether current income is the best measure to assess progressivity. In particular, a person’s income will generally change over their lifetime as they save for retirement. They will generally consume more than their current income while young, less while over their working life and consume more than their current income when retired.

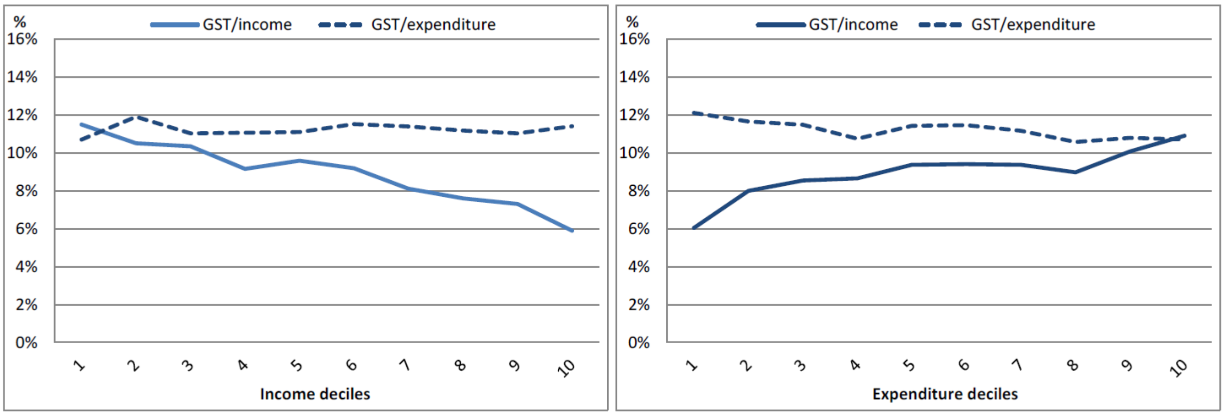
68. When comparing the burden of GST against income for these groups, GST costs will look relatively high when their income is low and relatively low when their income is high. However, across their lifetime the GST impact against their lifetime income may be considered roughly proportional.

69. As a result, it is argued that comparing GST to consumption or lifetime income is a better approach to measuring whether it is regressive (Thomas, 2015) (OECD, 2014).

70. In New Zealand, the most recent research on the issue has described the lifetime impact of GST as “either proportional or at worst slightly regressive”. The reason that GST is likely to be slightly regressive rather than perfectly proportional to total consumption is due to things like consumption while on overseas holidays not being subject to New Zealand GST, despite it being consumption.

71. Thomas, 2015 also simulates the impact of measures to increase the progressivity of GST through the adoption of a UK value-added tax rate structure (which attempts to introduce progressivity by exempting basic consumption items such as food), which arguably would increase the progressivity of the GST. The paper concluded that “in general [this type of consumption tax structure] would provide more – often significantly more – aggregate benefit to the rich than the poor”. This greater aggregate benefit for the rich arises because richer households spend more on these items than poorer households in absolute dollar terms.

Figure 2: Average GST burdens per household



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72. This analysis is based on the idea that people spend all their income over their lifetime. If people are saving money for a bequest then these results may not hold as the time period between the original income being earned and the eventual spending may increase the likelihood of the inheritance being consumed overseas.

[18] GST looks progressive when comparing GST burden as a proportion of income across expenditure deciles. However this result arises because lower expenditure deciles have more households that are net savers and higher expenditure deciles have more households with lower current savings rates.

Appendix 2: Low-value goods options

Option 1: Offshore supplier registration

73. Under an offshore supplier registration system, offshore suppliers would be required to return GST on all goods below a certain value if their total supplies of goods and services to New Zealand exceed a per annum threshold. Goods above the defined value would be collected by Customs according to current processes.

74. This system would subject offshore suppliers of goods to broadly the same GST rules currently applying to domestic businesses and offshore suppliers of cross-border services. For instance, the requirement to register for GST could apply to all offshore suppliers supplying a total annual value of goods and services to New Zealand consumers above $60,000, consistent with the domestic GST registration requirement and the registration threshold that already applies to offshore suppliers of cross-border services.

75. A number of other countries have announced their intention to implement offshore supplier registration systems for collecting GST on low-value goods. Australia will be the first country to do this from 1 July 2018, followed by Switzerland from 1 January 2019 and EU member countries from 2021.

76. While it would impose some cost on offshore suppliers, an offshore supplier registration system would also realise significant cost savings for the courier companies and New Zealand Post and would provide price certainty and low compliance costs for consumers.

77. The greatest concern with an offshore registration system for low-value imported goods is potential compliance with the rules. The success of the rules for cross-border services, is therefore an encouraging sign.

78. Depending on the design of the system, offshore supplier registration could feasibly offer a low-cost addition to the existing border collection system to generate additional revenue from goods valued below a threshold.

New Zealand's experience with off-shore supplier registration for cross-border services and intangibles

On 1 October 2016, an offshore supplier registration system for collecting GST on cross-border services and intangibles supplied to New Zealand consumers came into forces. The rules cover supplies of "remote services" (such as video, music, software downloads and streaming services) and require offshore suppliers to register and return GST on these supplies.

Inland Revenue has processed over 190 registrations by offshore suppliers and the total revenue figure from the returns filed by offshore suppliers for the first 12 months is over $113 million

Option 2: Between point of sale and delivery

79. Currently fast freight couriers collect duty on behalf of Customs, while Customs collects duty directly in the postal stream[19]. Under this option, fast freight couriers and New Zealand Post would both collect revenue on the low-value goods they deliver, but with a lower de minimis.

80. New Zealand Post does not currently collect on the majority of parcels it handles, largely because it does not have electronic advance data[20] to make this efficient. New Zealand Post and Customs have completed proof of concept and are looking to trial electronic data on Trans-Tasman mail.

81. Due to the lack of data in the postal stream it is not currently possible to use this option to collect GST on imported parcels that are delivered by New Zealand Post. Therefore, any move to utilise the logistics industry in the collection of GST would revert to the status quo (where courier companies voluntarily collect GST in the fast freight stream, New Zealand Post does not collect GST at all).

82. Unlike an offshore supplier registration system, collecting between point of sale and delivery would, under the current approach, still require a threshold below which GST is not collected at all on lower-value goods, as the marginal costs of collection would exceed the marginal revenue collected.

83. The potential for this option to collect additional revenue and level the playing field between domestic and offshore suppliers depends on how low the de minimis could be feasibly set. Feedback from fast freight couriers and New Zealand Post suggests that, at this time, significantly lowering the de minimis under this option would significantly increase costs and result in delivery delays.

84. A number of initiatives are underway that may eventually generate efficiencies in the clearance of goods and reduce costs to the logistics industry which would then enable a lower de minimis to be achieved under this collection option in the future. While some estimate these improvements may be realised as early as 2020, more conservative estimates suggest they will likely occur in 2023. The magnitude of any resulting reduction to the *de minimis* is uncertain; however, initiatives such as electronic advance data may see the *de minimis* eventually lowered to near zero.

Option 3: After delivery of the goods (pay after delivery)

85. A pay after delivery model places responsibility on the recipient or purchaser (that is, the final consumer) to pay the GST on the goods they have imported. Payment would occur after the delivery of the goods.

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[19] Courier companies are not legally required to collect GST, tariff duty and cost recovery charges on imported goods above the *de minimis*. However they currently play a large role in revenue collection on behalf of the Government for commercial reasons and as a service to their customers. By contraxt revenue is not collected in this way in the postal stream as existing international postal streams do not provide for the collection and use of electronic advance data on imported goods.

[20] Electronic advance data" refers to electronic data on import consignments that is sent from the postal operator in the export country to the postal operator in the destination country prior to clearance of the goods. Once fully implemented, electronic advance data will allow for the preclearance of goods, as well as the prepayment of duties and taxes, potentially improving the cost-effectiveness of collecting revenue at the border and assessing goods for risk.

86. This option would require the development of new processes to identify imported goods purchased by New Zealanders, and to send and receive payment for these goods from consumers. New technology may assist in this process and there has been some private sector interest in providing options to enable this.

87. Pay after delivery shifts almost all of the compliance costs associated with levying GST on low-value goods onto consumers. The individual cost for each consumer may be relatively low; however, these costs would be imposed on a large group and so could make overall compliance costs high compared with other options.

88. A pay after delivery system would rely on voluntary compliance by consumers and may be difficult and costly to enforce given the high numbers of individuals required to comply. As a result this option is potentially risky and if compliance is low could result in little benefits with high costs.

Appendix 3: Low-value goods recent international developments

1. The non-collection of GST on low-value goods is an international issue faced by countries that have a GST or Value Added Tax (VAT) system.

2. Internationally, collection at the border by customs agencies is the most common method of collecting GST or VAT on imported goods; however, a number of countries are proposing to adopt (or have already adopted) rules to collect GST or VAT on low-value goods from offshore suppliers.

3. In June 2017, the Australian Parliament legislated for an offshore supplier registration system to collect GST on imported goods valued at AU$1,000 or less. The legislation passed subject to:

   - a delay to the application date by one year, now effective from 1 July 2018; and
   - the Australian Productivity Commission conducting an inquiry into the effectiveness of the legislated offshore supplier registration system and of other options for collecting GST on low-value goods.

4. The debate around which option for collecting GST on low-value goods is the best collection mechanism has been a contentious issue in Australia. A number of leading online marketplaces expressed their opposition to the (then proposed) offshore supplier registration system during the Senate inquiry stage of the Treasury Laws Amendment (GST Low Value Goods) Bill. The purpose of the above conditions was therefore to address the concerns raised by submitters during the Senate inquiry on the bill, including the consideration of other collection options, the consultation process, and the implementation timeframe allowed for offshore suppliers to prepare for the new rules.

5. The Commission provided its final report to the Australian Government on 31 October 2017. The report concluded that, given the decision to collect GST on low-value imported goods, the legislated offshore supplier registration system is the most feasible among the imperfect alternatives at this time. The Commission noted that implementing the legislated model:

   - should go some way towards levelling the playing field between imported and domestically retailed low-value goods;
   - will bring only partial rates of GST collection (due mainly to exemptions for small suppliers below the registration threshold, as well as significant compliance challenges), but the revenue obtained is likely to significantly outweigh the compliance and administrative costs; and
   - should avoid major impacts on consumers importing goods.

6. The Commission considered that collection models where the legal liability falls on entities within Australia's jurisdiction, or which utilise information technologies to monitor enforcement or facilitate collection at modest cost would avoid some of the limitations of the legislated offshore supplier registration system. The Commission noted that models of this kind, where the logistics industry (courier companies and Australia Post), financial intermediaries (such as credit card companies, banks and payment processing providers like PayPal) or consumers are required to remit the GST, have been proposed. However, the

efficacy of the financial intermediary and pay after delivery models are untested and would not be ready for deployment by mid-2018.

7. Models that are based on GST collection by the logistics industry could capture more revenue, but their feasibility is hampered by paper-based declaration processes still used in the international postal system. The Commission considered these models would also impose high administrative and compliance costs, and some would cause inconvenience for consumers.

8. The Commission commented there is an in-principle case to consider delaying implementation of the legislated offshore supplier registration system to provide more time for technological changes to play out, to learn from the experiences of other countries and to avoid "first mover" risks. However, the Commission considered there is insufficient basis to recommend delaying the implementation schedule. This is because waiting for better alternatives will not necessarily prove fruitful, nor would implementation now preclude change later.

9. The Commission recommended the Australian Government conduct a comprehensive review of the collection of GST on low-value goods five years after the commencement of the legislated model, unless exceptional circumstances warrant an earlier review. The review should consider:

   - the performance of the legislated model;
   - if the model is achieving unduly low rates of compliance, the merits of measures to increase compliance;
   - if the model is achieving high rates of compliance, the merits of extending the model to higher-value imported goods; and
   - whether there is a case to adopt a different collection model, taking into account technological advances and policy developments in Australia and abroad, including in relation to electronic advance data in the international postal system.

European Union

10. The European Union has indicated that it intends to implement an offshore supplier registration system for collecting VAT on low-value goods by 2021. They propose to extend their current collection mechanism for digital services to include online supplies of physical goods.

Singapore

11. In May 2017, Singapore announced a proposal to introduce an offshore supplier registration system for collecting GST on imported goods (below S$400) and cross-border services. The details of Singapore's proposal are similar to both New Zealand's rules for cross-border services and to Australia's rules for imported goods and services. No details have been provided for the intended application date.

Switzerland

12. In September 2016, the Swiss Parliament approved the partially revised Federal Act on VAT. Changes include an offshore supplier registration system for collecting VAT on both imported services and low-value goods. These changes will now take effect from 1 January

2019, after having been delayed by one year from the original application date of 1 January 2018.

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