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ABOUT THE JOURNAL

The importance of China on the global economic stage cannot be ignored, and its unique legal and tax systems are of great inters to international scholars and business people alike. China's tax system is acquiring western features while remaining entrenched in its rich cultural and historical roots. This makes for interesting study, analysis and comparison as its laws are becoming more accessible.

The *Journal of Chinese Tax & Policy* focuses on the policy, administrative and compliance aspects of the Chinese tax system. It also welcomes comparative studies between China and other countries. The Journal is an internationally peer-reviewed scholarly publication.

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Editorial

This issue of the *Journal of Chinese Tax and Policy* features an article examining China's tax policies on charitable foundations, two articles providing comparative views on the VAT reform in China, and an article on the taxation of financial institutions.

Long and Xie' paper, *The Research on Fiscal and Tax Effects on Donation Income of China's Foundation*, used donation income as a dependent variable, and pre-tax deduction qualification, government grants, type of the foundation (charitable or not) as explanatory variables to conduct an analysis on factors that might affect donation income of foundations in China. Based on its empirical findings, the paper provided suggestions for fiscal and tax policies to promote the development of China's foundations.

Sawyer's paper, *VAT Reform in China: Can New Zealand's Goods and Services Tax Provide Helpful Guidance?*, extensively reviewed the economic background, policy design and implementation process of GST in New Zealand. It took a case study approach to evaluate a possible 'initial model' for adaptation in China as it seeks to reform its VAT. This paper offers insights into why the author believes the NZ GST experience should be of both interest and relevance to China.

The Australian and New Zealand's VAT Model on Financial Service Industry: an Introduction on Experience to China, by Wu, Bai and Huang, focused on China's VAT reform regarding the financial sector. It further introduced the VAT laws and regulations of Australia and New Zealand and provided comparisons between the effectiveness of the Australian model and the European Union model. It made a series of practical suggestions for the forthcoming VAT laws and regulations regarding the financial sector in China, In consideration of China's special realities.

Eva Huang

Sydney, November 2015

The Research on Fiscal and Tax Effects on Donation Income of China’s Foundation

Zhaohui LONG, Rongchang, XIE☆

Abstract: In this paper, which is based on China’s current fiscal and tax policies and data collected from national foundations in 2010, we used donation income as a dependent variable, and pre-tax deduction qualification, government grants, type of the foundation (charitable or not) as explanatory variables, and thus propose three hypotheses. Total assets, investment income, public benevolent activities expenditure, and definitive net asset ratio were also used as control variables in constructing an econometric model to analyse the effects of the fiscal and tax policies.

We conclude that: Pre-tax deduction qualification has a significantly positive effect on the donation income of a foundation. The income of government grants and the donation income show a U-shape relationship, which suggest the existence of crowding-out effect and complementary effect. Given its charitable nature and necessity, however, charitable foundations do not receive more donation income. Total assets, philanthropy expenditure and donation income present significantly positive correlations, while investment income and donation income are negatively correlated, although not significantly. Definitive net asset ratio and donation income present a U-shape relationship. We finish by forwarding several suggestions on the current fiscal and taxation policies based on the above findings.

Key words: Foundation, Donation Income, Charitable Foundation, Pre-Tax Deduction Qualification, Government Grants

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The number of foundations in China had reached 2500 in 2011. The majority were either public endowments or private foundations. Meanwhile, it was the first time that the number of private foundations overtook that of public endowments. The total assets of foundations in China has reached 60.42 billion yuan by the end of the year 2010, but the average for each foundation was less than 25 million yuan. Except few national large-scale foundations, the assets of most foundations in China are only several millions yuan, that is, the scale of foundations in China is generally small. In terms of employees, currently the number of full-time employees is only 7,527, with each foundation having an average of 3.5 employees. Most of the foundations in their operations tend to rely largely on volunteers and part-timers. In respect of the areas in which the foundations serve, most expenses could be contributed to the areas of poverty alleviation and disaster relief, social welfare, education, and medical treatment, which account for 70% of the social benevolence expenditure, with the main beneficiaries being poor mothers, children, students, the unemployed, people with disability or mental illness, and so on.[1] In a report to the 18th National Congress of Communist Party of China, the Chinese government stated that it would enhance social construction through improving people's livelihood and promoting innovative management, guide NGOs including foundations to develop healthily and orderly, and exert fully the basis of popular participation in social management. Therefore, it is vital to research on the fiscal and tax effects on donation income of China’s foundations.

1. The Composition of Revenue and Expenditure in China’s Foundations

In recent years, the total number of China’s foundation shows a tendency of rapid increase. After the introduction of the *Regulations on the Administration of Foundations*[2] in 2004, the government permitted enterprises, individuals, and other institutions to establish private foundations, and since then private foundations have been developing rapidly. In 2005, only 974 foundations participated in the national inspection (with 253 being private foundations), whereas the number ascended to 2143 in year 2010 (with 1065 being private foundations). And later in 2011, the number of private foundations exceeded that of public endowment. However, there is still a significant gap between China’s foundations and those of developed countries in terms of the number of foundations. In year 2010, there were 75595 in the United States, and 9155 in Canada. From this perspective, it can be said that Chinese foundations are still at the initial stage of development.

In 2010, the total revenue raised by Chinese foundations was 37.4 billion yuan, and each foundation had an average of 17.46 million yuan. The revenue mainly consisted of donation income, government subsidies, investment income, income for providing services, and other sources. Donation Income accounted for over 90%; Government subsidies accounted for 5%; Investment income and service income contributed 2% and 1% respectively. On one hand, China’s foundations are very prudent when investing, which give them moderate returns; on the other hand, their services are rarely purchased by the government.

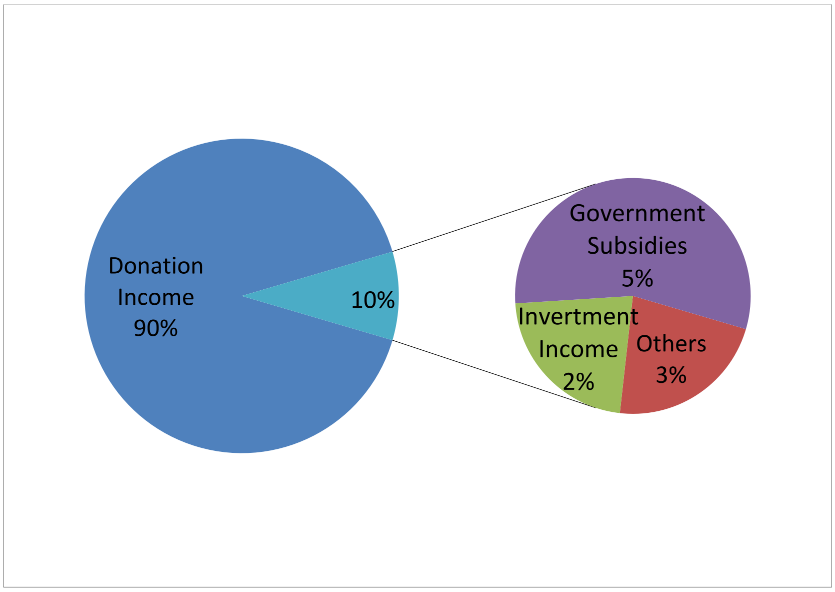
In 2010, the total expenditure of China’s foundations was 25.6 billion yuan, and on average each foundation expended 11.96 million yuan. This includes operating expenses, management expenses, fund-raising expenses and other expenses. Operating expenses refer to the costs of public benevolent activities, and management expenses refer to the expenses of administration, and wages and staff benefits. Expenses on public benevolent activities are the most important

[1] 刘忠祥 [Liu Zhongxiang],《中国基金会发展报告（2011）》[*Annual Report of China’s Foundations (2011)*]社会科学文献出版社[Social Sciences Academic Press(CHINA)], 2011.

[2] 《基金会管理条例》[Regulations on the Administration of Foundations] (People’s Republic of China) State Council, 8 March 2004.

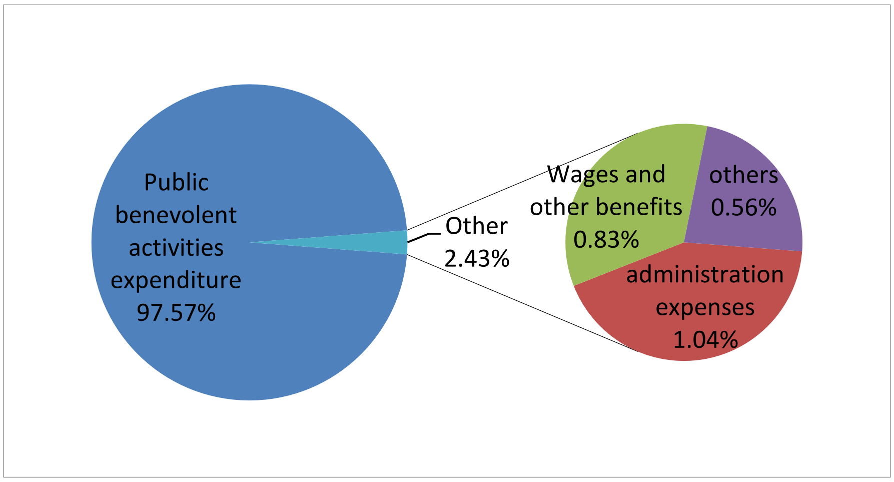
part in the expenditure of Chinese foundations, which had a number of 25 billion yuan in 2010, representing 97.6% of the total expenditure. The expenses on administration, and wages and staff benefits contributed only about 2%, which were far below the ceiling of 10% set by the *Regulations on the Administration of Foundations*[3].

Chart 1 The Composition of Revenue of China's Foundations In 2010



Data Source: Liu, Zhongxiang, 2011[4]

Chart 2 The Composition of Expenditure of China's Foundations In 2010



Data Source: Liu, Zhongxiang, 2011[5]

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[3] 《基金会管理条例》[*Regulations on the Administration of Foundations*] (People's Republic of China) State Council, 8 March 2004.
[4] 刘忠祥 [Liu Zhongxiang],《中国基金会发展报告（2011）》[*Annual Report of China's Foundations (2011)*]社会科学文献出版社[Social Sciences Academic Press(CHINA)], 2011.
[5] 刘忠祥 [Liu Zhongxiang],《中国基金会发展报告（2011）》[*Annual Report of China's Foundations (2011)*]社会科学文献出版社[Social Sciences Academic Press(CHINA)], 2011.

2. The Fiscal and Tax Policies of China's Foundations

2.1 Fiscal Policy

According to the data collected by the China Foundation Center[6], in 2010, 16 out of 163 national foundations received government subsidies, among which 15 were public endowment and 1 was a private foundation, and the total government subsidies income amounted to 1.2 billion yuan. Moreover, according to the inspection report produced by the China Charity and Donation Center, which surveyed 42 national foundations in 2009, 8 foundations received 497 million yuan of financial allocation. Statistics provided by the China Charity and Donation Center, which looked into the inspection reports of 107 foundations, show that in 2008 14 foundations received government subsidies, with 6 of them being national public endowments, 7 being regional public endowments, and 1 being a regional private foundation. It is evident that fiscal support is essential to the development of public endowment. However, this kind of support tends to concentrate on large-scale foundations with government backgrounds.

International experiences suggest that the development of foundations is inseparable from the support and subsidisation by the government. 37% of the income of non-profit organisations in Britain came from the government in 2005.[7] According to the research project at the Johns Hopkins University, in 1995 the income of non-profit organisations in 34 countries mainly came from their service charge (49%), government aid (40%) and charitable income (11%). Especially in the fields of healthcare, education and social services, government subsidies account for 45%-55%. Comparatively speaking, foundations in China receive limited financial aid from the government.

2.2 Taxation Policy

The legislation with which most foundations encounter in their operation is the *Enterprise Income Tax Law of the People's Republic of China*. According to the law and its implementing rules, eligible non-profit organisations are exempted from income tax. The normative documents published later stipulate that governmental subsidy income and the interest income (other than donation income and financial allocation) are exempted from tax. However, revenue from government purchases cannot be exempted from the tax. In addition, the law stipulates clearly that business profits, such as investment income, are taxable, unless the State Council's financial and taxation departments release exceptional rules.

From the view of taxation management, pre-tax deduction qualification is another kind of tax benefit awarded by the government. Donators who donate to foundations with pre-tax deduction qualification can acquire the corresponding deduction according to the law, and by doing so the value of donation is lowered. After the Enterprise Tax Integration in 2008, it is specified in the taxation law that donations made by an enterprise through social benevolent groups or government departments at or above county level to support public benevolence, for the part within 12% of the enterprise's annual profit, can be deducted when calculating taxable income. For an eligible individual, donations made that do not exceed 30% of the person's taxable income, can be deducted from taxable income.

[6] China Foundation Center is the information platform for China's foundations, which was founded in July, 2010. http://www.foundationcenter.org.cn/

[7] Salamon, Laster M. and Anheier, Helmut K., 1999, *Global Civil Society: Dimensions of the Nonprofit Sector*, The Johns Hopkins University, Maryland, pp. 27-33.

New rules on pre-tax deduction came in-force since 1 January 2008. All public benevolent social groups, whether or not they had acquired pre-tax deduction qualification before the introduction of the new regulation, should apply for the qualification according to the new rules. Pre-tax deduction qualification must be re-assessed annually, and for groups that are not qualified such a qualification will not be awarded. The first list of qualified foundations was published on 20 August, 2009, and the second list was published on 30 September, 2010. Therefore, by the end of 2010, foundations in China could be divided into three categories. The first category includes foundations that were listed on the first list, most of which were also on the second list; the second category includes foundations that were newly added to the second list; the third category includes foundations that still have not acquired the qualification.

2.3 Research Hypotheses

There is a difference of time between when foundations acquire their pre-tax deduction qualification and when donors make donations, with the acquisition of qualification generally happening after donations are made. Since donors do not know which foundation will actually get the qualification, they have to speculate based on the past records of foundations. According to the adaptive expectation theory, donors tend to donate to foundations that were also qualified in the previous year because there is a higher possibility that these foundations will get the qualification again next year. Based on the above analysis, we propose our first hypothesis:

Hypothesis 1: Compared to other foundations, foundations that had acquired pre-tax deduction qualification before see remarkable increases in donation income

Government grants will have both crowding out effect and complementary effect on donation income. When foundations receive government grants at a low level, although they may need financial support, their donation income may decrease. This is because the government had sent a signal to enterprises and individuals that these foundations had received the sufficient support from the government. Thus crowding out effect is observed; when foundations receive government grants at a high level, their donation income may also increase because enterprises and individuals may regard the area of services that these foundations provide as attracting the government's attention and thus of great importance to the society. And therefore a complementary effect exists. To test the effects of the fiscal and taxation policies, we propose our second hypothesis.

Hypothesis 2: Government subsidy may have two kinds of effects: When it is at a low level, it will have significant crowding out effect on donation income; When it is at a high level, it will have significant complementary effect on donation income.

Nowadays, China's foundations are still at the elementary stage of development, but traditional service areas like poverty alleviation, disaster relief, helping the disabled and the elderly should still remain the focus of public benevolence. Many foundations have devoted more or less into these areas. Since the Wenchuan earthquake in 2008, more and more people have devoted themselves into helping and taking care of minority groups in the society. Therefore we think that a foundation will receive more donation if it participates in the field of philanthropy. We would like to also present our third hypothesis.

Hypothesis 3: Compared to the income of other foundations, donation income of foundations that involve in charitable areas experience significant increases.

3. Empirical Research on the Effects of Fiscal and Taxation Policies on China's Foundations

3.1 Sample Selection and Data Sources

We chose 163 national foundations that are registered with the Ministry of Civil Affairs of China as samples for three reasons: (1) Integrity of the data. Compared to regional foundations, national foundations provide more systematic and comprehensive data to the relative government departments. (2) Representativeness of the data. National foundations are of bigger scale. Therefore their donation income and public benevolent expenditure are higher than other foundations and nearly cover half of the total amount of all foundations in China. Also, these foundations operate in various areas, which almost cover all fields in which a foundation can be involved. (3) Practicality of the research. As national foundations' pre-tax deduction qualification is awarded jointly by Ministry of Finance, State Administration of Taxation, and Ministry of Civil Affairs, while regional foundations' qualification is affirmed and awarded by local departments, there will be differentiation in time. It is not practical to include all foundations in the dataset.

We collected and summarised the data used, which were published by China Foundation Center[8] The initial data contained 165 samples, and samples were excluded for any of the following reasons: (1) The foundation was registered after 2010. (2) The foundation did not provide financial data of 2010. (3) The Foundation had obviously abnormal numbers in its data. After screening, 123 samples were left in the dataset.

3.2 Variable Design

3.2.1 Dependent Variable

The logarithm of donation income is chosen as the dependent variable. Donation income consists of four parts: Donations from domestic natural persons, donations from domestic institutions and organisations, donations from foreign natural persons, and donations from foreign institutions and organisations. We sum up the four income sources to get overall donation income.

3.2.2 Explanatory Variables

Pre-tax deduction qualification, government grants, and charitable or not are chosen as the explanatory variables. Pre-tax deduction qualification is a kind of tax preference qualification awarded by the government. Donors who donate to foundations that have the qualification can acquire income tax deduction; Government grant income is the duty free income received by foundations from the government; Charitable or not refers to whether a foundation participates into charitable activities or not, and traditional charitable activities include poverty alleviation, disaster relief, and supporting minority social groups.

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[8] China Foundation Center is the information platform for China's foundations, which was founded in July, 2010. http://www.foundationcenter.org.cn/

3.2.3 Control Variables

Total assets, investment income, public benevolent activities expenditure, and definitive net asset ratio are chosen as the control variables. We then studied the impacts of these four variables on donation income.

Total assets: We chose total assets as the control variable of the scale of the foundations. Normally, the larger the scale of a foundation, the more donation income it receives. Thus, we think controlling the scale of the foundations has a significant impact on donation income.

Investment income: According to the research of Posnett and Sandler[9], investment income and donation income show a remarkably positive correlation, and thus there exists complementary effect between them. However, Weisbrod[10] proposed that these two factors have crowding out effect, since when non-profit organisations engage in business activities, they tend to ignore their social missions or devote less into fund-raising activities, which will have negative influence on the donation income. Here we recognise that investment income has an impact on donation income.

Public benevolent activities expenditure: We subdivided the total expenditure of the foundations into three parts: Public benevolent activities expenditure, Administration expenditure, and expenses on the wages and staff benefits. And public benevolent activities expenditure in China is equivalent to planned function fees in the United States. Kingma[11] held that when non-profit organisations use most of the donations on social commissions (planned function), they are more favoured by donors.

Definitive net asset ratio: Definitive net asset ratio refers to the ratio of net assets, the usage of which has been restricted. The higher the ratio, the less freedom the foundations have over their choices of expenditure. When donors limit the usage of donations, the level of information asymmetry between donors and foundations is lowered, and therefore the higher the definitive net asset ratio, the higher the donors' willingness to donate. However, if the ratio is too high, a large number of the foundations' projects would be hard to change, which will subsequently negatively impact the donation choice of donors with other preferences.

[9] Posnett, J. & Sandler, T. 'Demand for charity donations in private non-profit markets',(1989), *Journal of Public Economics* 40, 187.
[10] Weisbrod, G & Weisbrod, B, 'Measuring Economic Impacts of Projects and Programs', Economic Development Research Group, 1997.
[11] Kingma, B. R. (1996), Economics for nonprofit management and the charitable tax exemption. Nonprofit Management and Leadership, 7: 197–201.

Table 1 Variables and Definitions

Types of variables	Names of the variable	Variable notation	Definition
Dependent variable	Donation income	Log(DR)	The logarithm of the foundations' annual donation income
Independent variables	Pre-tax deduction qualification	TAXPRE	If the foundation had pre-tax deduction qualification by the end of year 2010 Yes 1; No 0
		TAXPRE1	If the foundation was on the first list of foundations that had pre-tax deduction qualification Yes 1; No 0
		TAXPRE2	If the foundation was on the second list of foundations that had pre-tax deduction qualification Yes 1; No 0
	Government grants	GR	Government grants
	Charitable foundation	CHARITY	If the foundation is in the field of charity service Yes 1; No 0
Control variables	Total assets	Log(TA)	The logarithm of the foundation's total assets
	Investment income	IR	Investment income of the foundation
	Public benevolent activities expenditure	CHEX	Public benevolent activities expenditure of the foundation
	Definitive net asset ratio	DFR	The ratio of definitive net assets to net assets

3.3 Model Design

Based on the analysis above, we designed the regression model to examine the three hypotheses.

$$\log(DR) = \beta_0 + \beta_1 TAXPRE + \beta_2 GR + \beta_3 GR^2 + \beta_4 CHARITY +$$
$$\beta_5 \log(TA) + \beta_6 IR + \beta_7 CHEX + \beta_8 DFR + \beta_9 DFR^2 + \varepsilon$$

log(DR) is the natural logarithm of donation income. Log(TA) is the natural logarithm of the total assets. GR^2 is the square of government grant income. DFR^2 is the square of the rate of definitive net assets. It is predicted that the coefficients of $\beta 1$, $\beta 3$ and $\beta 4$ are significantly positive, while the coefficient of $\beta 2$ is significantly negative.

3.4 Analysis of the Empirical Research Results

By controlling the properties of the foundations' organisational structure, revenue and expenditure, we analysed the impact of pre-tax deduction qualification on China's foundations' donation income. The empirical study includes descriptive statistics, correlation coefficient analysis, regression analysis and robust analysis.

3.4.1 Descriptive Statistics

The descriptive analysis of the variables shows that, the average income from donation of the 123 foundations was 67 million yuan. The highest donation received by foundations reached 690 million yuan, while there are few donations that did not have any donation income. By the end of 2010, there were 90 foundations that acquired pre-tax deduction qualification, among which 67 foundations were on the first list published on 20 August 2009, 23 were on the second list published on 30 September 2010, and the remaining 33 foundations had never acquired the qualification. Only 16 foundations received government grants, which accounted for 13% of the total number. The average amount of government grants was 10 million yuan, with the highest amount being 630 million yuan. 33% of the 123 foundations participated in charity field, which is a relatively high percentage compared to other fields. There was a large gap between different foundations in terms of their total assets, for the largest foundation had assets value that is 1000 times that of the smallest one. The average of investment income was 2.39 million yuan, with the highest income being 100 million yuan and the lowest being a loss of 1.28 million. Foundations also differed remarkably on public benevolent activities expenditure, with the highest amount being more than 1 billion whereas the lowest being less than 30000 yuan. The average of definitive net asset ratio was around 39%, with the highest ratio being 107% and the lowest ratio being 0%.

3.4.2 Correlation Analysis

Both Correlation Coefficient Method and Inflation Factor Method can be used to test multicollinearity. To test whether there is any high correlation among the variables, we chose Correlation Coefficient Method, so as to confirm that there is no serious multicollinearity. As the table below shows, except for government grants and public benevolent activities expenditure, which have a correlation coefficient that is slightly above 0.7, most of the variables gave coefficients that are lower than 0.5. The preliminary results suggest that there is not serious multicollinearity.

Chart 2 The Correlation Analysis of the Variables

	log(DR)	TAXPRE	GR	CHARITY	log(TA)	IR	CHEX	DFR
log(DR)	1.000							
TAXPRE	0.479	1.000						
GR	-0.129	-0.035	1.000					
CHARITY	0.318	0.209	0.081	1.000				
log(TA)	0.605	0.531	0.21	0.337	1.000			
IR	0.27	0.131	-0.033	0.02	0.435	1.000		
CHEX	0.364	0.149	0.717	0.269	0.558	0.243	1.000	
DFR	0.364	0.125	0.05	-0.096	0.245	0.167	0.226	1.000

3.4.3 Regression Analysis

The results of the model (1) regression analysis by using EVIEWS are as follows:

Chart 3: The Effects of Donation Income the Foundations Have on Fiscal and Taxation Policies

variables	The names of the variables	Expected direction	Coefficients and significance
C	Intercept term		-1.3743 *** (-3.0941)
TAXPRE	Pre-tax deduction qualification	+	0.8292 ** (2.5327)
GR	Government subsidized income	-	-0.0638*** (-7.2018)
GR^2	Square of government	+	0.0001***

	subsidized income		(5.3057)
CHARITY	Charitable foundation	+	0.3932 (1.4634)
LOG(TA)	Logarithm of the total asset	+	0.6004 *** (4.1734)
IR	Investment income	-	-0.0178 (-1.3975)
CHEX	Public benevolent activities expenses	+	0.0071 *** (4.8305)
DFR	Definitive net asset ratio	+	6.0563 *** (4.7568)
DFR^2	Square of definitive net asset ratio	-	-5.5765*** (-4.0835)
Adj R^2	0.7106		
F	32.3806***		

The number in the brackets is the t statistic, "*""**""***"refer to the significance level of 10%,5%,1% respectively.

1) Empirical results of the effects of pre-tax deduction qualification, government subsidies and charitable foundations on donation income

According to chart 3, pre-tax deduction qualification has a significant positive relationship with donation income under a significance level of 5%. Therefore, hypothesis one can be supported. As those foundations which once have had the pre-tax deduction qualifications could give more expectation to the donators that they can get the qualifications in the future, donators are more willing to make the donations to get the tax deduction benefit. In terms of the coefficient, foundations with pre-tax deduction qualifications could increase their donation income by **e** to the power of 0.8292, which is around 2.3 times compared to those that do not have the qualifications. This shows a significant influence.

In addition, the government subsidies GR and donation income show a Negative relationship below a significance level of 1%. When government subsidized income doubles, donation income will decrease by 6.38%, which reveals that when these foundations have received government subsidies, the public will assume that such foundations has obtained a stable income source（source of capital, thus reducing donations. A significant crowding out effect then emerges. Moreover, although under the significance level of 1%, GR^2 and donation income show a positive relationship, the coefficient is just 0.0001. This indicates that when government subsidies are above a certain level, the crowding out effect may be transformed to become complementary effect, but the effect is not significant.

Although the regression coefficient is positive in charitable foundations, it cannot be verified even under a significance level of 10%. Therefore hypothesis 3 cannot be supported. The charitable foundations did not get more attention because of their relief or urgency features in their service domain. The reason why the expectation is inconsistent with the results may be that the enterprises, organizations and individuals do not have a charity preference formed. However, the disabled, orphan, and disaster relief are in strong demand after the Wenchuan earthquake in 2008 and Yushu earthquake in 2010. The development of charity foundations should be given more attention on these fields.

2) Empirical results of the effects of relative control variables on donation income

According to chart 3, the total asset and donation income show a positive correlation below a significance level of 1%. The larger a foundation is, the better it is in project operation and fund raising to some extent, thus it could get more donation income.

Investment incomes and the donation incomes show negative correlation, but it is not very significant. As the investment income belong to for-profit income, some donators will be worried about investment activities deviating them from the non-profit characteristic or the likeliness of suffering loss due to risky investment. However, so far in China, investments in foundations are not active and donators know little about investment conditions of the foundations.

Charitable expense and donation incomes show significant positive correlation below a level of 1% significance. The more public benevolence expenses they incur, the more resources the foundations will devote in charity. Hence, the more positive messages they convey to the donators, the more donations they tend to obtain.

Definitive net asset ratio and donation incomes show inverse U curve relationship below a level of 1% significance. When the ratio is low, to increase the ratio will increase the donation income significantly. Since limiting the net asset will ease information asymmetry between donators and foundations, the donators will be relieved from the suspicion of the utilisation of the donation. But when the ratio exceeds a limit (about 54%), excessive fixed projects will influence some donators who have other preference leading to total donation incomes decreasing.

3.4.4 Robust Test

1) White heteroscedasticity Test

If there is a heteroscedasticity in the sample, the regression results in model 1 will not be reliable. Thus to ensure the empirical results are not influenced by the heteroscedasticity, we need to do the White test on it. The result shows that even under the significance level of 10%, the null hypothesis of homoscedasticity still can not be rejected. Therefore, it can be tested that there is no heteroscedasticity in the sample, and the above shown regression results are reliable.

Chart 4 White Test Results

F-statistic	1.5140	Probability	0.1194
Obs*R-squared	20.1218	Probability	0.1263

2) White heteroscedasticity-consistent covariance estimation

Although chart 4 shows that under the significance level of 10%, the hypothesis of homoscedasticity cannot be rejected, the P-values in the White test are only around 0.12, which are not too high. To some extent, it is not a strong evidence to reject the alternative hypothesis of heteroscedasticity. Therefore, to ensure the reliability of model 1 results when heteroscedasticity exists, we use **white heteroscedasticity-consistent covariance estimation** on model (1), the regression results are as follows:

Chart 5 White Heteroscedasticity-Consistent Covariance Estimation

Variables	The names of the variables	Expected direction	Coefficients and significance
C	Intercept term		-1.3743 *** (-3.0107)
TAXPRE	Pre-tax deduction qualification	+	0.8292 ** (2.5023)
GR	Government subsidized income	-	-0.0638*** (-6.4177)
GR^2	The square of government subsidized income	+	0.0001*** (5.2448)
CHARITY	Charitable foundations	+	0.3932 (1.5853)
LOG(TA)	The logarithm of total asset	+	0.6004 *** (4.4104)
IR	Investment income	-	-0.0178*** (-2.6699)
CHEX	Public benevolence expenses	+	0.0071 *** (5.3405)
DFR	Definitive net asset ratio	+	6.0563 *** (4.9972)

DFR^2	The square of definitive net asset ratio	?	-5.5765*** (-4.4369)
Adj R^2	0.7106		
F	32.3806***		

The number in the brackets is the t-statistic, "*""**""***"refer to the significance level of 10%,5%,1% repectively.

Comparing chart 3 and chart 5, it can be found that the results of the two regressions are basically the same. The significance levels of the variables do not change except for the investment income, which change from an insignificant level to a very(strong) significant level. Therefore, it is proved that the results from testing the three hypotheses through OLS are robust.

3) Variable substitution

The index of pre-tax deduction qualification showed in model 1 includes all the foundations that obtained the qualifications before the end of 2010. In quantitative terms, it equals to the sum of the number of the foundations in the first list and the number in the second list, which is: TAXPRE=TAXPRE1+TAXPRE2. Therefore, to test whether the time difference of obtaining the qualification will have an influence on donation income, the two dummy variables TAXPRE1 and TAXPRE2 can be used to replace TAXPRE. Hence, we proposed the second model to testify the above mentioned three hypotheses.

Model 2:

$$\log(DR)=\beta_0+\beta_1 TAXPRE1+\beta_2 TAXPRE2+\beta_3 GR+\beta_4 GR^2 + \beta_5 CHARITY+\beta_6 \log(TA) +\beta_7 IR + \beta_8 CHEX +\beta_9 DFR +\beta_{10} DFR^2 +\varepsilon$$

Chart 6 the Effects of Donation Income of China's Foundation on Fiscal and Taxation Policies

variables	Names of the variables	Expected directions	Coefficients and significance
C	Intercept term		-1.3807 *** (-3.0988)
TAXPRE1	The foundations on the first list that have Pre-tax obtained deduction qualification	+	0.8857 ** (2.6042)
TAXPRE2	The foundations on the second list that have obtained Pre-	+	0.6847* (1.7159)

	tax deduction qualification		
GR	Government subsidized income	-	-0.0639*** (-7.1936)
GR^2	The square of government subsidized income	+	0.0001*** (5.3189)
CHARITY	Charitable foundations	+	0.3812 (1.4113)
LOG(TA)	The logarithm of total asset	+	0.6041 *** (4.1839)
IR	Investment income	-	-0.0180 (-1.4140)
CHEX	Public benevolent activities expenses	+	0.0069 *** (4.5945)
DFR	Definitive net asset ratio	+	6.0273 *** (4.7177)
DFR^2	The square of definitive net asset ratio	?	-5.5285*** (-4.0309)
Adj R^2	0.7090		
F	29.0196***		

The number in the brackets is the statistic, "*""**""***"refer to the significance level of 10%,5%,1% respectively.

According to chart 6, the results frommodel 1 and model 2 are basically consistent. Except for the difference on the dummy variables, the coefficients of other variables don't have obvious changes compared to the t statistics. The coefficient of dummy variable TAXPRE1 is greater than that of TAXPRE in the model 1, and becomes more significant even though it doesn't arrive 1%. The coefficient of TAXPRE 2 is however less than that of TAXPRE, and the significance level reduces from 5% to 10%. The coefficient of TAXPRE1 is greater than TAXPRE2 which shows that according to the list published in 2009, the foundations that obtained the qualifications in 2008 and 2009 could get more preferences from the donators and therefore obtain more donation income in 2010.

4. The Suggestions for Fiscal and Tax Policies to Promote the Development of China's Foundations

4.1 The Suggestions for Fiscal Policies

4.1.1 Be Prudent in Direct Financial Subsidies

Foundations are non-government organizations, which mainly depend on the public`s voluntary donation. Empirical results reveal that Chinese government subsidies and donation income have significantly crowding out effects, even when the aids reach some extent, the complementary is weak. Moreover, generous subsidies will result in the foundations relying too much on the government, hence affecting their independence and voluntariness. Therefore, the government should be prudent in using direct financial subsidies.

Since charitable foundations have no significant increase in donation income, due to the urgency and curative effects of charitable activities we recommend that for some charitable foundations with government backgrounds, the government could give some financial aid to maintain their historical brand and exemplary function, while the rest of the foundations should not be supported by financial subsidies.

4.1.2 Increase Government Purchase

Foundation is one of the three main social organizations in China. A lot of foundations directly participate in social services instead of solely raising money. In terms of foundations` social services, government purchase should be one of the key incomes. Currently, the income from the government purchase of the foundations only accounts for about 1%, which is far below the donation income of 90% and the government financial aids of 5%. According to the statistics in America, among the American non-profit organizations, the amount American government purchased from NGOs is 1.5 times the amount of donation income and is close to 500 billion US dollars.[12]

We suggest that the government gradually increase the purchase from those foundations which are directly involved in public benevolent activities. By transferring part of the public services to more professional philanthropic organizations, not only can cost be lowered, but efficiency will also be improved. For example, the government could take open tender to support some charitable programs like nursing houses and orphanages, and therefore the qualified charitable foundations will bid for appropriate projects. Public bidding can promote reasonable competition among foundations and thus they will compete for the government purchase through constant improvement of their management and service quality.

4.2 The Suggestions for Taxation Policies

4.2.1 Unify the Legislation of Non-Profit Organizations and Improve To Perfect the Tax System

Currently, China does not have tax laws on non-profit organizations including foundations. The relevant regulations are too widely scattered, and this situation not only goes against the management of authorities, but also is inconvenient for the public to comprehend and check. Therefore, it is necessary to unify the legislation on non-profit organizations and to improve the tax system. The laws of taxation on foundations should include the rights and obligations

[12]朱晓萌 [Zhu Xiaomeng]. 《政府购买 NGO 服务：看上去很美[N]》 [government purchase NGO service: looks beautiful [N]], (中华工商时报 Chinese indury and commerce Times)，2011.

of the three tax subjects: foundation, donator and beneficiary. The scope of the application should cover all the relative business and revenue of the foundations.

China's existing tax laws referring to foundations still focus on the income tax of the donors. As for foundations' own income, such as business tax, value-added tax and consumption tax, and the pre-tax deduction of the beneficiaries' income, the laws are still unclear on them. Therefore, when unifying the taxation legislation on non-profit organizations, the relative departments should perfect the tax preference of the foundations and clarify the specific preference policies, which include the definition of the foundations, categories of preference tax, margin of preference, preferential terms, application process and so on.

4.2.2 Offer Certain Tax Preference to the For-Profit Income of Charitable Foundations

According to the current policies, deducting reasonable costs and expenses, all of foundations' assets belong to public welfare assets, which can only be used in charitable programs and can not be distributed. In addition, the government also encourages charitable organizations to preserve or increase the value of donation income through legal, secure and effective ways. However, the foundations' for-profit income should still be accounted and collected by the rate of business income tax of 25%. In the composition of the foundation's assets, most will have for-profit income. This will be charged by 25% business income tax, and it will definitely affect their ability to ensure that substantial charitable asset will assure enough amounts for charitable expense. Especially for private foundations, the high taxation will force them to resort to the capitals, and then lead to the shrink of scales. However, if the government offers tax exemption to all of them, it will make the foundations prefer for-profit activities as well as the unfair tax bearing between foundations and other for-profit organizations.

In our opinion, China should currently provide strong support to charitable foundations. Different kinds of taxation policies should be applied to charitable foundations according to their proportions of for-profit incomes to the total assets. When the proportion is lower than an index, they should be given some preferences. For example, only be levied 15% or 25% of the taxation, for the part that is above the standard, it will still be levied by 25%. It can not only satisfy the diversified financing demands of the foundations, but also prevent donation incomes being affected by excessive devotion on for-benefit income. Meanwhile, it should be noted that as the empirical research showed a negative correlation between investment income and the logarithm of donation income, when the government decides to give some taxation preference to the foundations, it should also strengthen the supervision and publish relevant information in time to reassure the donators.

4.2.3 Offer Tax Exemption to Charitable Foundations' Government Purchase of Service

During recent years, many local governments around China began to promote government purchasing and publish the list of the Government Purchase of service. Government Purchasing is the main income of many current charitable organizations, and it will be the major income source of the charitable foundation in the future. If this kind of income can not be tax-free, it will affect these organizations negatively. In fact, government purchasing belongs to non-profit income, which is not production and operation profit, and therefore should be included in the duty-free list.

4.2.4 Apply Deferred Deduction Policy to the Donators of Foundations

When the enterprises and individuals donate to the foundations that have the pre-tax deduction qualifications, the donations can only be deducted from the taxable income of that year, but can not be deferred. This policy limits the donators' initiatives to make a large amount of donations, and it is also inconsistent with practical work of the foundations. The donation income is uneven most of the time, hence, in some particular periods, the demand of the public benevolent activities expenditure is great; the enthusiasm of donations runs high, thus the donation rises perpendicularly. While some of the donators intend to donate more, due to the fact the donations cannot be deferred deduction, the exceeded part can't get the preference which results in them choosing to reduce the amount of the donations.

The American government has stipulated that for the individuals who donate to the foundations, the highest pre-tax deduction is 50% of personal gross income; for the enterprises, the highest is 10% of their taxable income. The exceeded part can be deferred deducted in the next five years. The French government has stipulated that the tax exemption can't exceed 0.3% of the taxpayers' annual turnover, and the exceeded part can be deferred deducted in the next five years. Although, these countries have stipulated the highest amount of deduction to control the tax expenditure, offering deferred deduction to the exceeded part is an encouragement to large amount of donations. Comparing international experiences to China's actual condition, we suggest that the government can offer 3-5 years deferred deduction qualifications to the individuals and enterprises that donate to the foundations.

4.2.5 Set A Scientific Standard for Affirmation and Review of the Foundations' Pre-Tax Deduction Qualification and Implement Strictly

According to the results of the empirical research, pre-tax deduction qualification has significant effects on the foundations' donation income, and it is also the key point affecting the financial ability of the foundations in China; which is the key and core of the taxation policy on foundations. However, the donation income of charitable foundations doesn't increase significantly according the empirical result. Moreover, the policies don't have any preference on charitable foundations.

The examination and approval of the pre-tax deduction qualifications should have standardised quantitative criteria to avoid arbitrary. Through establishing explicit standard, procedure, examination, verification and disqualification, as well as creating coordination mechanism between Ministry of Civil Affairs and business departments in charge; the government should create a fair competition environment and expose the foundations in a "survival of the fittest" option, so as to push them to enforce information disclosure and improve management level and service quality. On the other hand, in terms of the quantitative criteria, the government should increase the proportion in the relative index of charitable foundations, so that it will be easier for them to obtain qualifications compared to the other foundations.

4.2.6 Publish the List of Foundations That Have Pre-Tax Deduction Qualifications in Advance

Currently, the list the government published in the current year is usually the foundations that obtained the qualifications last year. A few foundations that obtained the qualifications in the current year usually enjoy this preference after the list is published in the second half of the year. This policy is disadvantageous to the donators who make choices, because they are not sure whether the foundations they choose could get the qualifications when they make the donations this year(especially in the beginning of the year). Thus, they have to make estimations according to the past situation. If it is hard to predict, they may only make the donations out of their trust or enthusiasm towards charity. In fact, many donators finally give up their donation because they doubt that the foundations will not obtain qualifications. To eliminate the negative influence from this uncertainty, the government should quicken the review procedure to advance the time of publishing the list to the beginning of year.

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VAT Reform in China: Can New Zealand's Goods and services tax Provide helpful Guidance?

Adrian SAWYER☆

Abstract: Value Added Taxes (VATs or Goods and Services Taxes - GSTs) are being increasingly adopted globally, with VAT/GST revenues similarly increasing through higher contributions from indirect taxation to total tax revenues. Unsurprisingly, increased focus is being placed on the design of such taxes, encompassing policy choices and legislative drafting styles. New Zealand's (NZ's) GST, introduced in 1986, is held up as the 'model' VAT in a post-European VAT environment, especially when measured against the key tax principles of efficiency and simplicity. Importantly, the trade-off has been less equity within the tax itself, which necessitates forms of compensation elsewhere in the tax system. The vast majority of GSTs developed since 1986 have used the NZ GST model as a starting point, although no subsequent GST/VAT has been as 'pure' as the NZ model. A number of factors have been influential in resulting VAT/GSTs. This includes: the actual design, prevailing tax policy process; general economic environment; and jurisdictional political philosophies (at the time the VAT/GST is promulgated and implemented). Of particular importance in NZ is the Generic Tax Policy Process (GTPP) which encourages both early and widespread consultation over tax policy design and draft legislation.

This paper seeks to provide an overview of NZ's GST (including the core concepts within the GTPP) as a case study for evaluation as a possible 'initial model' for adaptation in China as it seeks to reform its VAT. Through building on prior work reviewing the Hong Kong Special Administrative Region's (the HKSAR's) GST experience and policy development framework, this paper offers insights into why the author believes the NZ GST experience should be of both interest and relevance to the People's Republic of China (the PRC). This is premised on the basis that NZ's GST has been endorsed in subsequent tax system reviews, and survived notwithstanding major changes in the NZ political environment and prevailing economic conditions.

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1. Introduction

It is important to emphasise at the outset that this paper provides a high level policy perspective of the New Zealand (NZ) Goods and Services Tax (GST) – the first of the value added taxes (VAT) to move away from the VAT nomenclature to that of GST. This is much more than just a change in name – it represents a significant move away from the relatively complex VATs that members of the European Union have developed as part of their membership. New Zealand's GST represents the benchmark for an efficient and effective GST, from which other jurisdictions have based their GSTs (such as Australia, Canada and Singapore, to name but three examples).

To set the scene, NZ's GST commenced in 1986, some 12 months after the legislation was enacted. The NZ Government's intention was to improve the fiscal environment through a broad based tax, changing the tax mix, and 'compensating' low income taxpayers affected by this change in the tax mix. Consultation with individuals and organisations was included prior to its introduction and with subsequent changes of significance.

In contrast to earlier European VATs, a very limited number of concessions were made to allow zero rating or exemption from GST – most were on grounds of efficiency or practical measurement issues (indeed, NZ's GST base has expanded over time, such as to include business to business financial services). As a consequence, NZ's GST is arguably the 'purist' form of a VAT/GST in operation anywhere in the world.[13] However, subsequent amendments have added additional legislative complexity to the GST but have also clarified some areas of uncertainty. A significant recent development is the increase in the rate to 15 percent in 2010 which accompanied a reduction in the top marginal tax rate on income for individuals.

In the mid-1990s, NZ took a new and innovative route with the adoption of the Generic Tax Policy Process (GTPP), a bi-product of a review of the Inland Revenue Department (IRD) conducted through a committee (the Organisational Review of Inland Revenue) chaired by Rt Hon Sir Ivor Richardson, a former President of the NZ Court of Appeal.[14] Sir Ivor identified a number of problems with the previous tax policy development process, noting that[15]:

> "… the subject matter is complex, and tax legislation is very complex and difficult to understand. The *tax policy process was not clear*, neither were the accountabilities for each stage of the process. There was *insufficient external consultation in the process*."

Essentially, the GTPP provides a more rigorous process necessitating public scrutiny within its various phases, including submissions on both underlying policy and draft legislation. This is particularly important given NZ only has one house of Parliament, the House of Representatives. The GTPP has been reviewed by policymakers and academics in several overseas jurisdictions, with Dirkis and Bondfield viewing it favourably for Australia.[16]

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[13] David White, 'Comment: Twenty Years of GST: The Best Path Forward' (2007) 13(4) *New Zealand Journal of Taxation Law and Policy* 357. See also Gabriel Makhlouf (Secretary to the Treasury), 'The New Zealand Economy and Tax Policy' (Speech delivered at the 2012 International Fiscal Association, Queenstown, 17 March 2012); <http://www.treasury.govt.nz/publications/media-speeches/speeches/nzeconomytaxpolicy/sp-nzeconomytaxpolicy-17mar12.pdf> (emphasis added).

[14] Rt. Hon Sir I. Richardson, *Organisational Review of the Inland Revenue Department, Report to the Minister of Revenue and the Minister of Finance* (April 1994).

[15] Ibid 5 (emphasis added).

[16] Michael Dirkis and Brett Bondfield, 'At the Extremes of a "Good Tax Policy Process": A Case Study Contrasting the Role Accorded to Consultation in Tax Policy Development in Australia and New Zealand' (2005) 11(2) *New Zealand Journal of*

The motivation behind this paper is two-fold; first, it is to share the experiences of NZ's successful GST (the international benchmark for efficiency and simplicity), as well as the innovative and very successful tax policy process, the GTPP. Second, it is to offer practical insights for consideration by the Peoples' Republic of China (the PRC) as it seeks to review and rationalise its consumption taxes into a more comprehensive VAT. This paper draws upon contributions by the author in two recent articles that undertake a comparative GST analysis. Both articles offered the Hong Kong Special Administrative Region (HKSAR) guidance, the first reflecting upon the New Zealand GST experience, and the second on NZ's tax policy development framework (the GTPP).[17]

This paper adopts both positivist and normative philosophies. The analysis of NZ's GST and GTPP takes a positivist perspective, combining a review of perspectives of key players and the author's observations with respect to policy. It also offers a normative perspective in regard to how the PRC could consider the NZ policy experience with regard to its VAT development.

The remainder of this paper is organised as follows. In the next section, NZ's experience with GST is examined, followed by a review of the tax policy framework for NZ (the GTPP) in section 3. Section 4 provides some insights from the NZ experience with GST that could be of value to the PRC, with section 5 setting out the concluding observations.

2. New Zealand's Experience with GST

This section will focus on the background as to how the NZ GST came about, reflect upon why the GST was able to be successfully introduced and continue to remain sustainable, and how it became a critical component of the NZ tax system. It will also in part reflect upon why the NZ GST is held up as an aspirational model for other jurisdictions contemplating introducing a GST, and forms the basis for the vast majority of modern VATs/GSTs introduced since the mid-1980s.

2.1 The arguments supporting a GST in NZ

The NZ story has been well rehearsed by many commentators as reaching a critical point in 1984 when the then incoming Labour Government faced an economy in crisis and in need of a radical overhaul.[18] Much of what occurred over the following three years (1984-1987) can be seen as a radical economic liberalisation experiment that was facilitated by 'perfect conditions', namely an economy in desperate need of a radical overhaul, a new government with an electoral mandate to implement change, and a Minister of Finance with a clear plan to overhaul the economic environment. Importantly, tax reform was an integral part of the reform process.[19]

Taxation Law and Policy 250. Little, Nightingale and Fenwick also reviewed the GTPP and the role of independent tax reform; see Struan Little, Geof D Nightingale and Ainslie Fenwick, 'Development of Tax Policy in New Zealand: The Generic Tax Policy Process' (2013) 61(4) *Canadian Tax Journal – Revue Fiscale Canadienne* 1043. See also C.J. Wales and C.P. Wales, 'Structures, processes and governance in tax policy-making: an initial report' (Speech delivered at the Structures, Processes and Governance in Tax Policy-making Conference, Saïd Business School, Oxford, March 8–9, 2012), where the authors express enthusiasm for the rigour of tax policy-making in NZ.

[17] For further details, see Adrian Sawyer, 'New Zealand's Successful Experience with Introducing GST: Informative Guidance for Hong Kong?' (2013) 43(1) *Hong Kong Law Journal* 161; and Adrian Sawyer, 'Establishing a Rigorous Framework for Tax Policy Development: Can New Zealand Offer Instructional Guidance for Hong Kong?; (2013) 43(2) *Hong Kong Law Journal* 579.

[18] For an overview of the political and economic issues facing NZ in the lead up to the 1984 General Election, see for example, Jon Johansen, *Two Titans: Muldoon, Lange and Leadership* (Dunmore Publishing, 2005); and Barry Gustafson, *His Way – A Biography of Robert Muldoon* (Auckland University Press, 2000). Sir Roger Douglas published his own work in 1996; see Roger Douglas, *Completing the Circle* (Seascape Press, 1996).

[19] For further discussion and analysis, see John Singleton, 'An Economic History of New Zealand in the Nineteenth and Twentieth Centuries', *Economic History* (February 2010); available at: https://eh.net/encyclopedia/an-economic-history-of-

A major component of the tax reform platform was the GST, combined with a reduction in the top marginal tax rate on income tax of 66 per cent to 33 per cent. This high rate applied to many taxpayers as a result of bracket creep due to wage increases, reflecting in part rising inflation. The GST was a major component of a partial, but significant, move away from direct to indirect taxation, along with a broadening of the tax base. Of note is that GST was a component of major tax reform intended to minimise the net impact on individuals but position NZ for economic revival.

An early analysis of the GST is provided by Teixeira, Scott and Devlin in 1986.[20] The authors trace the evolution of the NZ GST from the first announcement of its introduction in 1984, to the stage of final legislation in 1986. Teixeira et al included brief reviews of the work of the Advisory Panel on the Goods and Services Tax and the Select Committee process that reviewed the draft legislation and recommended a delay in the implementation date. The authors also considered various administrative aspects of the tax through a discussion of provisions from the NZ Government's *White Paper*[21] to the amended legislation. Some comparisons are made between the NZ GST and other VAT taxes, particularly the UK VAT.[22] Teixeira et al also considered various features that would be important in shaping the associated administrative and compliance costs of the GST.

Quiggin[23] observed that the Minister of Finance in NZ at the time of the GST proposal, Roger Douglas, was firmly committed to the concept of a GST, and had the firm backing of the Government that commanded a majority in the unicameral Parliament.[24] Writing in 1992 by Bollard[25] (a former NZ Reserve Bank Governor) endorsed these comments, and observed that the idea of a broad-based consumption tax (a GST) was outlined in principle in the Labour Government's first 1984 Budget. A private sector advisory panel was constituted, received a large number of submissions and drafted amendments. Subsequently an announcement was made in 1985 that the GST would take effect from October 1986. All of these key steps followed a major advertising campaign and a series of business seminars. Largely as a consequence of the preparation and publicity, the actual implementation went relatively smoothly. However, Bollard noted that there was some measurable disruption to the pattern of retail sales in the period around the implementation date of the GST.

Bollard observed that the introduction of GST was reasonably well received.[26] While small scale retailers were opposed to compliance requirements, large scale business interests generally supported the GST. This was in contrast to a proposed capital gains tax (CGT) which

new-zealand-in-the-nineteenth-and-twentieth-centuries/ ; and Lewis Evans, Arthur Grimes and Bryce Wilkinson, 'Economic reform in New Zealand 1984–95: The pursuit of efficiency' (1996) 34(4) *Journal of Economic Literature* 1856.

[20] Alan Teixeira, Claudia Scott, and Martin Devlin, *Inside GST: The Development of the Goods and Services Tax* (Institute for Policy Studies, 1986). For an earlier analysis of the major issues surrounding the introduction of the NZ GST, see the work by Claudia Scott and Howard Davis, *The Gist of GST* (Institute for Policy Studies, 1985).

[21] *White Paper on Goods and Services Tax: Proposals for the Administration of the Goods and Services Tax* (New Zealand Government, 1985).

[22] For a comparison of the UK VAT and NZ GST, see Simon James and Adrian Sawyer, 'Comparing the United Kingdom's VAT with New Zealand's GST: Fairness versus Policy Benchmarks?', under review with the *World VAT Journal*.

[23] John Quiggin, 'Social Democracy and Market Reform in Australia and New Zealand' (1998) 14(1*) Oxford Review of Economic Policy* 76, 84 (emphasis added).

[24] In fact Roger Douglas was a very right-of-centre free market leaning politician, such that after leaving the Labour Party, he came back into Parliament as a member of the right-of-centre ACT Party under the new (and current) Mixed Member Proportional (MMP) political system. See further the discussion in footnote 35 on MMP.

[25] Alan Bollard, 'New Zealand's Experience with Consumption Tax' (1992) 9(4) *Australian Tax Forum* 473.

[26] Ibid.

received a broadly hostile response from the business sector.[27] Bollard commented that estimates of the GST impact on consumer prices varied from 5.7 per cent to 7 per cent, indicating there was an inflationary effect. Bollard also reviewed the price effects, distributional effects and macroeconomic effects brought about by the tax reform package incorporating the GST.

The Labour Government at the time was especially reluctant to grant any exemptions but permitted a small number, including financial services, life insurance, non-profit organisations and existing house sales (some of these were due to an inability at that time to measure the value added without undue complexity). Thus, the GST substantially broadened the tax base that was previously heavily reliant upon income tax, and piecemeal wholesale and retail sales taxes on certain goods. GST's introduction also extracted tax payments from many who had paid less in the way of taxation previously (that is, it altered the incidence of taxation). However, the introduction of the GST was part of a package of reforms, and needs to be viewed as part of a tax reform process. The package included a reduction of personal income tax to a lower flatter structure, making the overall tax structure less progressive.

Thus to summarise, the GST was part of an overall package to rebalance the tax mix, with minimal disruption to the business sector, and a well thought out process of conceptualisation, planning and implementation. But this is not the entire story.

2.2 The arguments against a GST in NZ

There has been little in the way of argument put forward against having a GST in NZ conceptually,[28] although there has not been universal acceptance that the focus on efficiency, at the expense of fairness, was the best approach. Indeed, recent calls for introducing exemptions or lower rates for goods, such as fresh fruit and vegetables, are aimed at introducing more fairness into the GST, and reducing its regressionary impact. While initially gaining some traction through support from a number of opposition political parties, these calls have not been developed as far as any firm policy proposals for change.[29]

The theme of radical tax reform through a significant redistribution of the tax burden is reflected in the seminal work of Stephens.[30] Commenting on the introduction of GST, Stephens observed that much of the reform was aimed at a redistribution of the tax burden. While some targeted tax preferences were removed, much of the reform led to a redistribution that may be termed "pro-rich". Stephens also commented that since the relative purity of the 1984 initiated reform, much of this has been lost through added complexity and major forms of income assistance to low income earners and families. Stephens' analysis supports that of Bollard in relation to the impact of GST on prices.

Since its introduction, criticism of the GST has remained, but there has been no reduction in its base, reflecting a general acceptance by subsequent governments that the trade-off for greater efficiency and revenues outweighed the negative impact on equity (which could be

[27] Subsequent attempts to propose a CGT have been unsuccessful with no government willing to make a CGT part of its tax reform agenda, although several opposition parties (including the Labour party) included a CGT as part of their manifesto for the 2011 and 2014 General Elections, along with the Green Party in its manifesto for the 2014 General Election.
[28] In the 1990s, the Alliance Party proposed to replace the GST with a Financial Transactions Tax; this proposal never advanced any further. The Mana Party proposed abolishing GST and replacing it with a levy on financial transactions as part of its 2014 election policy; the party is no longer represented in the NZ Parliament.
[29] As part of the 2014 General Election, the NZ First Party's manifesto included removing GST from food and property rates, along with the Maori Party for food. Neither party's proposals will advance any further in the next three years.
[30] Robert Stephens, 'Radical Tax Reform in New Zealand' (1993) 14(3) *Fiscal Studies* 45.

addressed through various forms of financial assistance provided through income support and welfare).

2.3 Analysing NZ's Policy Experience with GST

In reflecting upon the first twenty years of operation of the NZ GST, White observed that "[i]n many respects, the design and implementation of this tax is still regarded as international best practice. Its basic design features remain unchanged."[31] As part of the twenty year celebrations, a symposium was held in late 2006 in which a number of leading commentators prepared papers addressing aspects of the NZ GST. The opening paper was the address by Sir Roger Douglas (the architect of the NZ GST), who commented on the political issues associated with the introduction of the GST. Douglas remained firmly of the view that the introduction of the GST was successful, a position that he based on five "facts":[32]

- it was supported by two out of every three New Zealanders within days of its introduction;
- it ceased to be a political issue within six months of introduction;
- it was an accepted part of the economic frameworks of NZ within months;
- its introduction ran smoothly; and
- twenty years later it remains fundamentally unchanged.

'Acceptance' by such a large group of taxpayers in such a short time is in part a result of the educational and information campaign conducted prior to implementation, backed by various surveys undertaken by research organisations. Much of this success is attributed to a strong commitment to the GST by the Labour Party Cabinet (led by Douglas), notwithstanding resistance from trade unions and their members. Also vital to its success was the quality of the officials that worked on the design and implementation, the 'packaging' of GST – it was not a new tax introduced in isolation but part of a realignment and broadening of the tax base, with lower tax rates on income.

Furthermore, the process of consultation was extensive, including the establishment of a consultative committee to review over one thousand substantive submissions and make technical changes.[33] This consultation process did not aim to seek a consensus between various interest groups. There was a preparedness by the government at the time to take the pain at the beginning (such as through unpopularity) and be judged on the good results later. In a time of First Past the Post (FPP) electoral system, following an endorsement for change in 1984, such a bold approach is understandable. Had a Mixed Member Proportional (MMP) electoral system operated at the time, where minority governments are the norm, such a bold approach is unlikely to have been taken.

[31] See White, above n 1, 363–364.
[32] Roger Douglas, 'The New Zealand GST Policy Choice and its Political Implications' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Thomson Reuters, 2007) 3.
[33] It is important to observe that at the time of the GST, NZ's consultation on tax policy was very limited, and the internationally renowned Generic Tax Policy Process (GTPP) did not come into operation until 1994. For further discussion, see Adrian Sawyer, 'Reviewing Tax Policy Development in New Zealand: Lessons from a Delicate Balancing of Law and Policy"' (2013) 28(3) *Australian Tax Forum* 401.

Green, a member of the Advisory Panel on the Goods and Services Tax, commented that GST was a critical component of the tax reforms in train during the 1980s.[34] Green observes that the Minister of Finance was taking a "hands-on approach" and that the timeframe for change was incredibly tight. Green reflects upon the way in which the Advisory Panel set about analysing the submissions, preparing its reports and making recommendations (including deferring the introduction date to allow the supporting work to be completed). All of these activities assisted with the smooth implementation.

Todd, as Director of the GST Coordinating Office, focused on the information and educational coordination role that the Coordinating Office undertook.[35] The GST Coordinating Office managed all of the publicity and educational guidance. A key aspect was to ensure that all of the relevant government departments were working together, and that the necessary messages were provided to businesses and the general public. The focus was on demonstrating how the GST would make the tax system fairer and that everyone would be compensated for the imposition of the new tax on goods and services.

Dickson, a member of the NZ Treasury at the time of the development and implementation of the GST, reflected on the matters raised by the other commentators at the symposium.[36] He places particular emphasis on the three-year GST campaign that ran from 1984 to 1986, the little known fact that the Treasury never recommended the GST, the technical aspects of the GST, and the importance of the consultation process. Dickson also singled out for attention the high level of commitment to the GST which was given at considerable political risk to the government at the time.

In an academic commentary on NZ's GST, James and Alley suggested that NZ was able to benefit from the introduction of VATs in other jurisdictions before it introduced its GST.[37] Potentially having a shorter period of consultation than in the UK may have led to the simpler GST in NZ, with less time for those in opposition to mount detailed and concerted campaigns. However, this may have led to a GST in need of considerable remedial amendment. It should also be recognised that NZ was in dire economic circumstances at the time and needed a major overhaul of its tax system, along with additional revenue derived from a broader base. The authors emphasised that the choice of the name 'GST', rather than 'VAT', was intended to distinguish the NZ model from that of the UK.[38] The issue over the regressive nature of consumption taxes was largely offset by adjustments to other taxes and support for families and low income earners.

Vial observed that the NZ GST is not only "… an international benchmark for indirect tax design" but that it has the highest C-efficiency ratio in the OECD (currently standing at 99 per cent) – the next closest is Luxembourg at 92 per cent.[39] Politicians have resisted major changes

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[34] Richard Green, 'Consulting the Public in developing a GST' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Thomson Reuters, 2007) 13.
[35] Jeff Todd, 'Implementing GST – Information, Education, Coordination' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Thomson Reuters, 2007) 27.
[36] Ian Dickson, 'The New Zealand GST Policy Choice: An Historical and Policy Perspective' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Thomson Reuters, 2007) 45.
[37] Simon James and Clinton Alley, 'Successful Tax Reform: The Experience of Value Added Tax in the United Kingdom and Goods and Services Tax in New Zealand' (2008) 8(1) *Journal of Finance and Management in Public Services* 35. The authors make extensive reference to the contributors to the work by Krever and White; Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Thomson Reuters, 2007).
[38] James and Alley, above n 25.
[39] Peter Vial, 'The Sustainability of the New Zealand Tax Base: Are we at the End of the Road for the New Zealand Tax System?' (2009) 15(1*) New Zealand Journal of Taxation Law and Policy* 17, 22; citing Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Thomson Reuters, 2007), viii. The C-efficiency ratio (or VAT Revenue Ratio - VRR) is the ratio of VAT revenue to consumption expenditure, divided by the standard tax rate, expressed as a percentage. With NZ having one rate, a comprehensive base and virtually no exemptions, this high ratio comes as no surprise. Since Vial's work, the latest

to the GST since its introduction, with the exception of increasing the rate twice (the first time to 12.5 per cent in 1989, and later to 15 per cent with the major tax review in 2010),[40] increasing the breadth to include certain excluded areas (for example, certain financial services), and remedial legislative amendments. Significantly, the Tax Review 2001, set up by a left-of-centre government, rejected submissions to narrow the GST base.[41] As noted earlier, several opposition parties have been calling for significant amendments to exempt certain items (such as fresh fruit and vegetables, and other essential healthy food items, plus property rates), although these calls have yet to gain traction.

Barrett undertook comparative analysis of the VATs/GSTs in each of Australia, New Zealand, South Africa and the UK.[42] From his application of various tax philosophers, his conclusion is that the GST does not do well in isolation, but with a wider perspective, taking into account the justice of the tax-transfer system, the position can be defended. To this end he concluded with a quote from the Henry Tax Review in Australia:[43]

> "Income redistribution to make [a country] fairer is primarily the job of the income tax and transfer system … *other taxes and charges can be used in the most efficient way, reducing the overall complexity of the system*. It is very difficult to target GST exemptions on some products to certain groups."

The Secretary to the NZ Treasury is very complimentary of the NZ GST model, stating:[44]

> "It has been said plenty of times before but it still bears repeating: *New Zealand's GST is the best VAT in the world and our strong consistent advice is that it should be protected from exemptions that undermine it*. ….

There have been 17 VAT increases in the EU in the last 2 years. In 2011 an average VAT rate across the OECD was 18.5% – it is 20% in the United Kingdom. One reason these countries have higher value added taxes is because they exempt all sorts of goods and services. *As with income tax, we prefer a broad based low rate to a narrow base with a high rate*".

2.4 Summarising the prior analysis of the NZ GST

Thus, to summarise, the sustainability of the GST strategy for over 25 years is based on a combination of economic, legal, geographical and constitutional factors, supported by an open, patient and politically supported implementation. It is important to remember, as White concluded, that the NZ GST was designed to produce 20–25 per cent of tax revenue, with the

estimates place this at 99 per cent as the base has been slightly extended. This is also the figure used in the Tax Foundation's *International Tax Competitiveness Index* (2014), where NZ's VAT base as a percentage of total consumption is 99 per cent, and Luxembourg's is 92 per cent. See also OECD, *Consumption Tax Trends 2012: VAT/GST and Excise Rates, Trends and Administration Issues* (2012, OECD: Paris).

[40] This review followed a report from the VUW Tax Working Group; Victoria University of Wellington Tax Working Group, *A Tax System for New Zealand's Future* (January 2010); available at: http://www.victoria.ac.nz/sacl/cagtr/pdf/tax-report-website.pdf/ (accessed 3 August 2012). Even with the move to 15 per cent an advisory panel was set up to assist businesses with the transition. For details of this most recent advisory panel, which include tax practitioners and business leaders, see http://www.gstadvisory.govt.nz/panel (accessed 3 August 2012).

[41] Tax Review 2001, *Final Report* (Wellington, October 2011).

[42] Jonathan Barrett, 'Equity and GST Policy' (2010) *Journal of Applied Law and Policy* 15.

[43] Ibid 31; citing Commonwealth of Australia, *Australia's Future Tax System: Report to the Treasurer* (2010) ('Henry Report') vol 1, [D 2–1] (emphasis added).

[44] See Makhlouf, above n 1.

largest contributor continuing to be the income tax (this tax itself went through major reform in the 1980s, and again in the early 2000s and most recently in 2010).[45]

The prior literature suggests a number of critical elements to the success of the NZ GST, both prior to, and following, its implementation. Prior to the implementation, NZ was in an economic crisis, with the economy in need of a radical overhaul, including tax reform with a system excessively reliant upon income tax and inefficient indirect taxes. As a geographically isolated nation, heavily reliant on trade and foreign capital, this presented the incoming Labour Government with greater flexibility in determining its tax mix. This Labour Government comprised several “bold” politicians, no more so than the Minister of Finance, Roger Douglas. The political and electoral system facilitated a one party government (operating with a single house in Parliament, the House of Representatives) with a sizeable majority to implement change following the virtual stagnation of the economy and rising debt levels with the previous government.

Douglas, as Minister of Finance, not only drove the development process, but utilised independent consultative and implementation bodies, drawing upon expertise outside of Government and the bureaucracy. This environment, along with the tenacity of the GST’s architect, has been supported over the intervening 20 plus years, with the original GST conceptually remaining intact. Indeed research indicates that the bureaucrats took an activist role in policy-making in NZ at this time (and again in the period 2008-10 during which the Tax Working Group[46] operated), encouraging the move in the direction to low rates, broad bases and neutrality in tax policy.[47]

It is interesting to contemplate whether the same GST would be implemented in 2014 as that of 1986. Major changes since 1986 include the move to a MMP political system, which has led to coalition governments (or minority governments dependent on other parties for support). The 2014 General Election initially looked as if it had resulted in, for the first time under a Mixed Member Proportional (MMP) system, a single party having a narrow majority of the party votes, and thereby able to govern alone.[48] However, following confirmation of the impact of special voting, the National Party ended up with 60 out of 121 seats, meaning it needed to form a coalition government. It commenced signing agreements with several minor parties; as a result has formed a coalition government with 64 out of 121 seats enabling it to govern. It would be much more difficult to implement major policy changes, although the result of the Tax Working Group’s (TWG’s) recommendations in 2010 led to the largest tax policy reforms

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[45] It should not be forgotten that a proposal for a single low rate, broad base income tax in 1987 led to the demise of the working relationship between the Prime Minister and Minister of Finance. This indicates that the approach that worked for the development of the GST will not necessarily work for other taxes. The NZ GST, with the increase to a rate of 15 per cent from 1 October 2010, contributes close to 25 per cent of tax revenues collected for the year ended 30 June 2014; see Treasury data from http://www.treasury.govt.nz/budget/2014/taxpayers/02.htm#_whopaystax (accessed 6 October 2014).

[46] See Tax Working Group, above n 28.

[47] Johan Christensen, ‘Bringing the bureaucrats back in: neo-liberal tax reform in New Zealand’ (2013) 32(2) *Journal of Public Policy* 141, 164-165.

[48] A feature of the MMP system has been (minority) coalition governments, with the major party needing to work closely with several other smaller parties to develop tax policy. Furthermore, Sawyer comments with respect to the operation of MMP:

“MMP is an ‘additional member’ voting system used to elect representatives to numerous legislatures around the world, including New Zealand. MMP is a form of proportional representation in that the overall total of party members in the elected body is intended to mirror the overall proportion of votes received. It includes a set of members elected by geographic constituency (currently 60 seats in New Zealand comprising 5 Maori seats and 55 general electorate seats) who are deducted from the party totals to maintain overall proportionality. Thus, the additional party seats are compensatory in that they ‘top up’ the electorate seat results to maintain overall proportionality. There are minimum thresholds, including the need to gain at least 5 per cent of the party vote to gain seats, unless an electorate seat is secured in which case there is no minimum threshold and party seats are provided to top up.”

See Adrian Sawyer, ‘Reviewing Tax Policy Development in New Zealand: Lessons from a delicate balancing of ‘Law and Politics’ (2013) 28(2) *Australian Tax Forum* 401, 406.

in over 25 years.[49] That said, several opposition parties and various lobby groups advocated for the introduction of exemptions into the GST for items such as fresh fruit and vegetables, and the further potential to include other basic food items and even property rates.[50] With the outcome of the 2014 General Election, any changes of this nature are not expected to be on the agenda until after the 2017 General Election at the earliest.

2.5 International perspectives

In the context of other countries that introduced a GST based on the NZ model, most have included exemptions and multiple rates, leading to a less than optimal GST from a tax policy perspective. Tenacity is also crucial, with the experience of Australia in 1990 a poignant reminder. The then Opposition leader (and potentially incoming Prime Minister) lost the "unlosable election" in proposing a GST, which suggests that timing and the accompanying package are crucial factors to success.[51] In 2000, GST was introduced in Australia based on the benefit of an extensive consultation, although the coalition composition of the Australian Government at that time led to a number of last minute concessions to enable the GST to be enacted, with the result being a less than optimal GST from a policy perspective.

The European Union (EU) had looked at the NZ GST model. PricewaterhouseCoopers (PwC) commented:[52]

> "New Zealand's bold policy approach in the 1980s – of a broad base/(low) standard rate model – will be a golden lesson to others; and the *New Zealand GST model will be at the forefront of study for European policymakers, which is a fascinating dimension* … [T]he New Zealand model was seen as best practice for a VAT/GST regime."

The EU has many problems of its own, taxation and otherwise, both within and outside its multiple jurisdiction members. Thus, it would be unlikely for the EU to focus its attention on

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[49] For an overview of the key Budget 2010 tax changes, see Adrian J Sawyer, '2010 Budget Brings Biggest Tax Changes in 25 Years' (2010) 58 *Tax Notes International* 790. Major changes included a reduction in the top tax rate to 33 per cent (and other changes to rate thresholds), an increase in the GST rate to 15 per cent, the removal of depreciation for tax purposes on most buildings, changes to the taxation of certain companies and a number of related reforms, such as changes to the Fringe Benefit Tax rates. The Tax Working Group (TWG) had recommended that one option could be to introduce some form of land tax; land taxation had ceased to apply in NZ from 1992. This option was not adopted by the government.

[50] See for example the arguments raised by the Child Poverty Action Group arguing for a GST exemption on fruit and vegetables; http://www.cpag.org.nz/assets/Tax%20Issues/Backgrounder_GSTExemptions%20on%20Food%20final.pdf. This proposal led to extensive debate in the lead up to the 2011 General Election, with the Labour, Greens, Maori and Mana Parties all proposing various exemptions to GST (the latter seeking to replace GST with a financial transactions tax). The NZ First Party proposed reducing the GST rate back to 12.5 per cent. See also the following link with details on the policy proposal to remove GST from food: http://nzfirst.org.nz/policy/finance-and-tax. In the lead up to the 2014 General Election, several parties proposed changes to the GST (NZ First Party and Maori Party exempting GST on food (the former also on property rates); the Mana Party, which had formed an alliance with the Internet Party, continued with its proposal of replacing GST with a financial transactions tax).

[51] For a personal recount of the "failed" GST attempt in Australia in 1993, see John Hewson, 'The Politics of Tax Reform in Australia' (2014) 1(3) *Asia and the Pacific Policy Studies* 590, 593-4. See also Kathryn James, 'We of the 'never ever': the history of the introduction of a goods and services tax in Australia' [2007] 3 *British Tax Review* 320. John Hewson proposed a 15 per cent GST with minimal exemptions, accompanied by a reduction in income tax and a tidying up of indirect taxes. A scare campaign by the waning Labour Government saw them retain the government benches.

[52] Eugen Trombitas (PwC), 'GST: One of our Best Exports' (2012) *PwC Media release* (28 January) <http://www.pwc.co.nz/media-centre/opinion-pieces/gst-one-of-our-best-exports/> (emphasis added). The NZ Retailers Association has also called for the exemption from GST for imports less than $NZ400 (approximately $HK2,600) to be scrapped; see Hamish Rutherford, *Call to scrap GST policy on some imports* (January 2011) Businessday <http://www.stuff.co.nz/business/industries/4514945/Call-to-scrap-GST-policy-on-some-imports>.

major reform to its members' VATs until more pressing issues are resolved. Furthermore, while the NZ GST model is the closest to "perfection" from a tax policy design perspective, it can still be improved. That said, I would suggest that NZ's GST should be the blueprint to be used by jurisdictions when contemplating a GST/VAT or refining their existing GST/VAT. While NZ's GST is 'fit for purpose' for NZ, this does not mean it would be entirely appropriate for other jurisdictions, such as the PRC as it refines its existing VAT and related taxes.

3. New Zealand's Tax Policy Approach – the Generic Tax Policy Process

In this section of the paper, I set out a summary of the experience of the operation of the Generic Tax Policy Process (GTPP) in NZ, along with the approach and impact that the Tax Working Group (TWG) had as the most significant recent contribution to tax reform in NZ in the last five years.

3.1 The GTPP

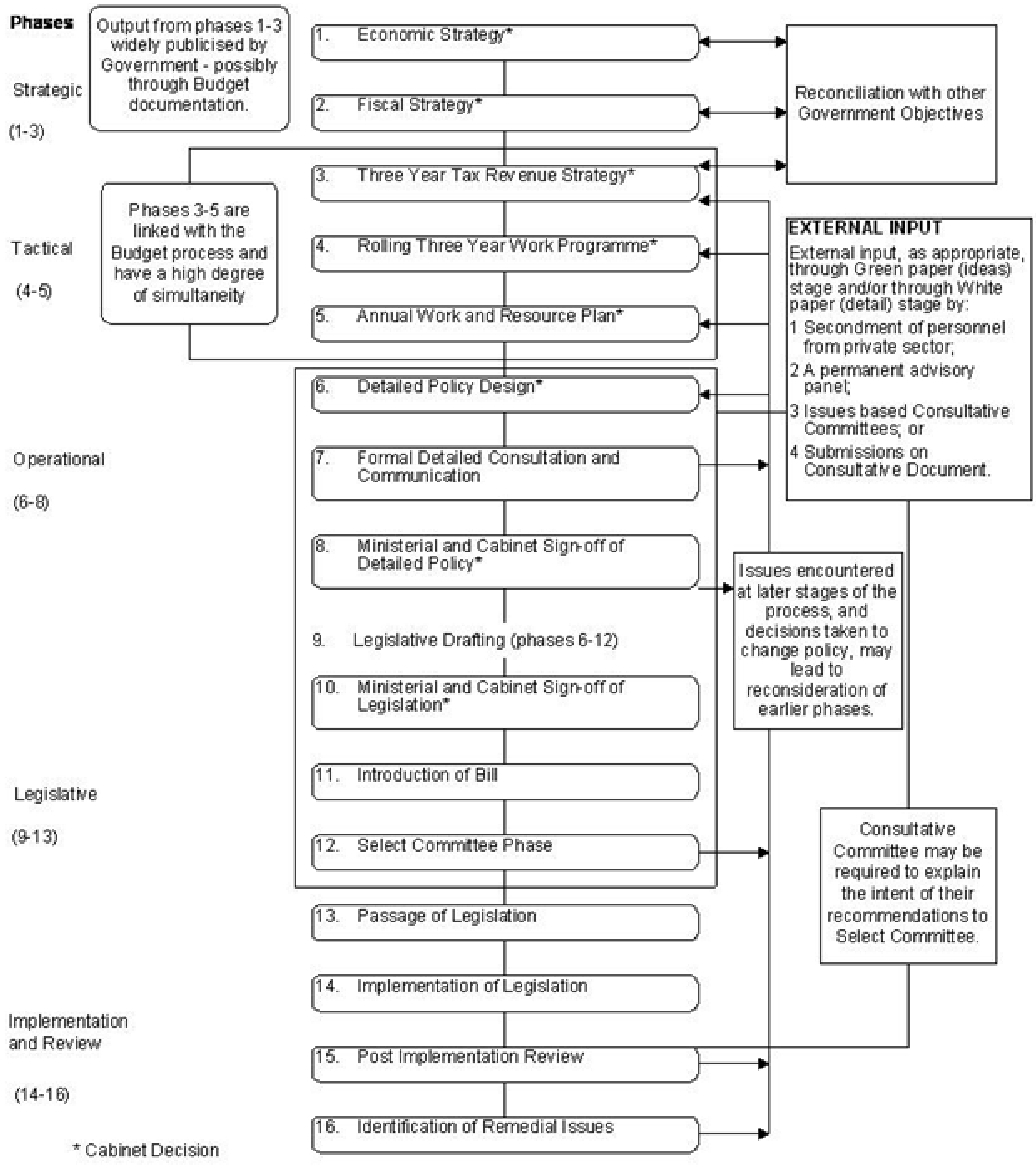
The following discussion is based on a recently published review of the NZ GTPP, reflecting upon its perseverance over the almost twenty years since it was first proposed, and subsequently adopted by the NZ Government. As I have commented elsewhere,[53] NZ chose to take a new and innovative route in the mid-1990s with the adoption of the GTPP, a blueprint for formulating tax policy. As noted in the introduction to this paper, the GTPP emerged as a bi-product of a review of the NZ Inland Revenue Department (NZIRD) conducted through the Organisational Review of Inland Revenue chaired by Rt Hon Sir Ivor Richardson.[54]

A Cabinet directive implemented the GTPP during the review process as a form of administrative or customary practice, rather than formally by way of legislation or regulation. This approach in part, as noted elsewhere, reflects both the strengths and weaknesses of the GTPP.[55] In part, the GTPP arose from consultation undertaken by the Organisational Review Committee with tax experts from both the private and public sectors. Importantly, the GTPP is in stark contrast to the previous policy environment, characterised by an absence of clarity and ascertainable accountabilities during each stage of the process. Furthermore, the perception was that the external consultation was insufficient to the extent of being virtually ineffective.[56]

With the GTPP, the NZ Government and officials are able to draw upon the technical and practical expertise of the business community, and to factor in compliance and administrative effects of potential policy changes. Furthermore, it also provides a mechanism to communicate the rationale for policy changes. The GTPP may appear to be complex and potentially unwieldy, but when examined closely, it provides a comprehensive and robust structure for the development, refinement and enactment of tax policy into legislation.[57] Figure 1 sets out the GTPP in diagrammatical form.

[53] Sawyer, above n 36.
[54] Rt. Hon Sir Ivor Richardson, *Organisational Review of the Inland Revenue Department, Report to the Minister of Revenue and the Minister of Finance* (April 1994). Sir Ivor Richardson was also instrumental in his oversight of the Rewrite Advisory Panel that worked alongside the NZ Government's fourteen year project to rewrite the Income Tax Act; for an analysis *see* Adrian Sawyer, 'RAP(ping) in Taxation: A Review of New Zealand's Rewrite Advisory Panel and its Potential for Adaptation to Other Jurisdictions' (2008) 37(3) *Australian Tax Review* 148.
[55] Sawyer, above n 36, 403.
[56] Ibid 403.
[57] For an in-depth early discussion of the various stages of the GTPP, *see* Adrian Sawyer, 'Broadening the Scope of Consultation and Strategic Focus in Tax Policy Formulation: Some Recent Developments' (1996) 2(1) *New Zealand Journal of Taxation Law and Policy* 17.

Figure 1: The Generic Tax Policy Process (Organisational Review Committee, 1994)



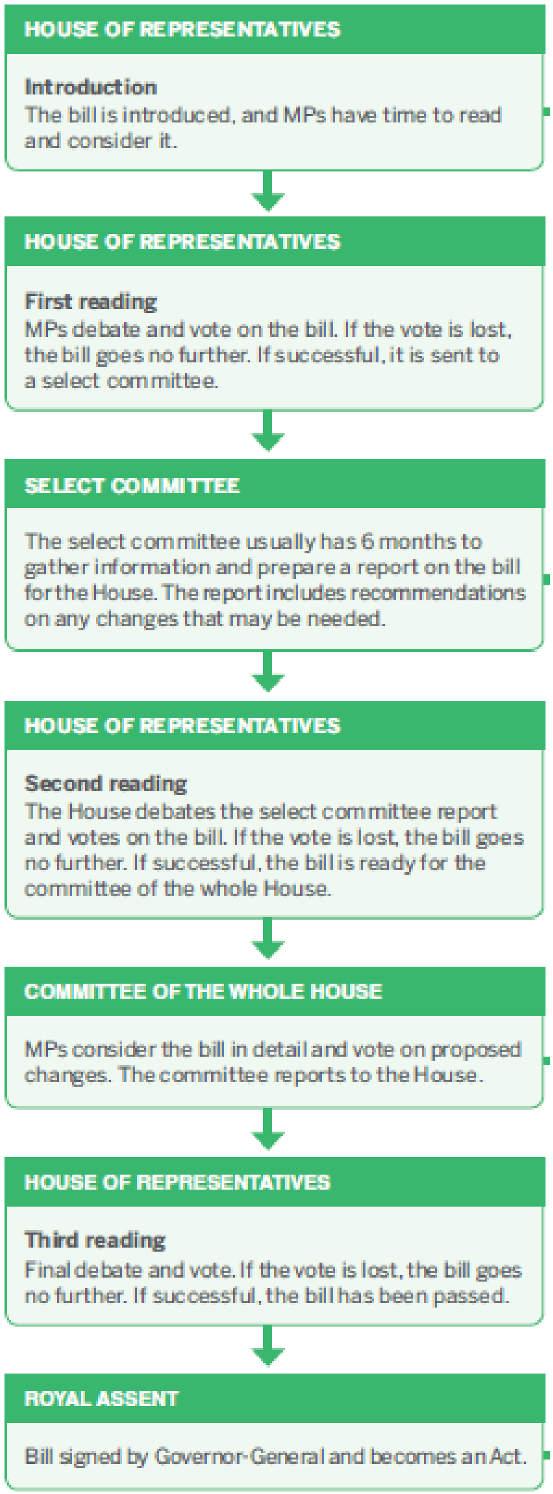
The GTPP has five core stages, each of which has their own phases, totalling 16 phases. The GTPP contains a number of external inputs and feedback loops, including a post implementation of legislation review. Throughout the GTPP, the linkages and feedback loops are intended to reflect a flexible process that recognises that some activities may occur simultaneously or in a slightly modified order, such as the timing of legislative drafting (within Phases 6–12). Essentially the GTPP is designed to improve the technical quality of the tax reform process, whatever the political background of the government at the time. Nevertheless, the subject matter of reform is usually firmly based on the economic, fiscal and revenue strategies of the government at the time (Phases 1–3). A further feature of the GTPP is the requirement for the government to announce annually its Rolling Three Year Work Programme.

Furthermore, the GTPP has three main objectives which stimulated the government's decision to adopt the process.[58] First, the GTPP encourages earlier and explicit consideration of key tax policy elements and trade-offs through linking the first three stages. Secondly, the GTPP provides an opportunity for external input into the process for formulating tax policy to increase both the actual and perceived transparency of the process, and provide for greater contestability and quality of policy advice. Importantly, consultation can occur at the initial stage of policy consideration, the detailed design stage, the legislative drafting phase, the select committee stage and the post-implementation review. Thirdly, the process sets out to clarify the responsibilities and accountabilities of the two major departments actively involved in the process, namely the NZIRD and the NZ Treasury.

Within the Passage of Legislation Phase (Step 13), there are several key steps, as set out in Figure 2, which follows:

[58] Sawyer, above n 36, 404.

Figure 2: Process for enacting government initiated changes to NZ's laws[59]



[59] NZ Parliament, *How a Bill becomes Law* (2014) <http://www.parliament.nz/resource/en-nz/00CLOOCHowPWorksLawsHow1/f072ccbc5a57287160d2511b5504c7de078915fd>.

One minor but yet important weakness in the GTPP is that late policy or legislative developments may be added by way of a Supplementary Order Paper (SOP)[60] during the parliamentary phase (post Select Committee), and as a consequence, such policy is not exposed to public scrutiny via formal consultation. Where the change is remedial and corrective of minor defects in existing legislation, this is not of significant concern.[61] However, with the introduction of significant new developments, this effectively bypasses the GTPP and is a real concern since this late political involvement may fail to maintain the technical quality of the legislation that the GTPP provides.[62] I have previously[63] reviewed the prior literature on the GTPP and examined why it has been successful and managed to survive the highly political policy environment that operates in NZ. One important element has been its adaptability to change to the various manifestations of political policy development in NZ, along with the electoral system, and a general acceptance of its merits from politicians across the spectrum.

A further challenge to the GTPP came about with the commencement of the MMP political system shortly after adoption of the GTPP in 1996. When the GTPP was introduced, NZ had a First Past the Post (FPP)[64] election system for its single house Parliament, the House of Representatives. However, since the 1996 General Election, all general elections utilise a MMP representation system. While MMP was anticipated to lead to less significant and much more protracted tax policy development, it has not prevented major tax reform in NZ. This is where the TWG, most recently, has complemented the contributions of the GTPP to tax policy development in NZ.

3.2 The Victoria University of Wellington Tax Working Group

Sawyer observed[65] that in 2009, following a conference held at Victoria University of Wellington (VUW), that it was decided to establish an independent group (known as the TWG) comprising experts from academia, NZIRD, NZ Treasury and tax practice, to undertake a review of the NZ tax system from a core principles policy focused perspective.[66] The TWG differed from earlier reviews of the tax system in NZ, such as the Tax Review 2001,[67] specifically in that it was not a NZ Government initiative, and that its terms of reference were self-generated. Furthermore, while the TWG received resource support from the NZIRD and the NZ Treasury, it operated separately from and outside the "government appointed

[60] An SOP is a late legislative amendment introduced by the government at the Second Reading of the Bill stage (during Step 13 in the GTPP) after the Select Committee has reported on the Bill (i.e., after the consultation process has been completed). Step 13 in reality involves several steps, as shown in Figure 2.

[61] Sawyer, above n 36, 404.

[62] See the comments of Peter Vial, 'The Generic Tax Policy Process: A "Jewel in Our Policy Formation Crown"?' (2012) 25(2) *New Zealand Universities Law Review* 318.

[63] Sawyer, above n 36, 404–425.

[64] FFP is a system whereby the person who receives the highest number of votes for their electorate seat will win that seat. The party with the highest number of electorate seats will then be asked to form a government. If that party has more than 50 per cent of the electorate seats then it can become the government without needing to form a collation with one or more additional parties. Usually a government would be formed by a single political party that holds a majority of electoral seats.

[65] Adrian Sawyer, 'Moving on from the Tax Legislation Rewrite Projects: A Comparison of New Zealand Tax Working Group/Generic Tax Policy Process and the United Kingdom Office of Tax Simplification' (2013) 3 *British Tax Review* 321.

[66] Details of independent, Inland Revenue and Treasury members of the TWG can be found at "The Centre for Accounting, Governance and Taxation Research – VUW Tax Working Group" <http://www.victoria.ac.nz/sacl/cagtr/twg>. Details of the number of experts who assisted the TWG are also provided.

[67] The Tax Review 2001 (also known as the McLeod Review) was established by the NZ Government in 2001 to carry out a public review into the tax system. The functions of the Tax Review 2001 were to: examine and inquire into the structure and effects of the tax system in NZ; to formulate proposals for improving that system, either by way of making changes to the system, abolishing any existing form of tax, or introducing new forms of tax; and to report to the NZ Parliament through the Minister of Finance, the Minister of Revenue and the Minister of Economic Development. The terms of reference were set within the constraints of maintaining revenue neutrality with any recommendations for change; available at <http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001>.

committee" framework of earlier tax reviews.[68] It is arguable that this was a critical factor in its success, in that the TWG complemented the role of the GTPP which seeks to remove, as far as practicable, political influences on the process of tax reform (after the Strategic Phase), with respect to producing high quality legislation. In this regard, the TWG is not a necessity for an effective GTPP, but it facilitated the development of higher quality policy and legislation through its input into the GTPP.[69]

The TWG undertook widespread consultation and extensive reporting to government, which resulted in a series of recommended options for major tax policy reform.[70] The TWG sought to:[71]

(1) identify concerns with the current taxation system;

(2) describe what a good tax system should be like;

(3) consider options for reform; and

(4) evaluate the pros and cons of these options.

In its 2010 Report, the TWG concluded that NZ's tax system faced three critical issues:[72]

(1) its structure was inappropriate;

(2) it lacked coherence, integrity and fairness; and

(3) significant risks to the sustainability of the tax revenue base existed.

Consequently, the TWG established six principles for reform,[73] and made a number of significant recommendations for reform, including major changes to tax rates, structures and bases.[74] The TWG referred its recommendations, which included a series of options or combinations of structural tax reforms, to the NZ Government for its consideration.[75] Several months later, in its Budget delivered on 20 May 2010, the NZ Government announced a major overhaul of the NZ tax system, adopting many of the recommendations of the TWG.[76]

3.3 Interaction between the TWG and GTPP

Turning the focus on how the TWG operated within the GTPP, prior analysis[77] reviewed the comments on the contributions of the TWG within the GTPP environment from those involved

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[68] These operate within the External Input phase of the GTPP.
[69] Sawyer, above n 53, 323.
[70] Tax Working Group, *A Tax System for New Zealand's Future Report of the Victoria University of Wellington Tax Working Group*, (Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, January 2010) (*A Tax System for New Zealand's Future)*.
[71] See *A Tax System for New Zealand's Future*, above n 58, 19. For further details, *see* The TWG Report <http://www.victoria.ac.nz/sacl/cagtr/twg/report>.
[72] Ibid.
[73] The six principles are: the overall coherence of the system; efficiency and growth; equity and fairness; revenue integrity; fiscal cost; and compliance and administration costs.
[74] For a summary, *see* Tax Working Group, above n 58, 10–11.
[75] The recommendations were included in the TWG's January 2010 report that was publicly available; see Tax Working Group, above n 58.
[76] For details of the New Zealand Budget 2010 announcements, see <http://www.treasury.govt.nz/budget/2010>.
[77] Sawyer, above n 53, 322–327.

either as members of the GTPP, advisors, and expert consultants. Collectively, these commentators/academics emphasised the importance of the interdisciplinary backgrounds and expertise of those involved, the attempt to rationalise tax policy debate, and the engagement of the public in the debate. A major constraining factor with most reviews, the TWG being no exception, is the revenue neutral constraint placed on reviews. Focusing on addressing issues of fairness, especially horizontal equity, was also crucial to the TWG's success.

I have observed that the work of the TWG illustrates a recent example of the operation of the GTPP, through an extension of the usual external input into the policy making process, namely an independent temporary advisory body that has made one of the more significant contributions to tax policy development in NZ.[78] The GTPP has continued to operate largely unscathed under both left-of-centre and right-of-centre governments. Thus, it is my contention that the GTPP (even without the TWG), has facilitated a surprisingly high level of tax policy review that in turn has led to significant structural and legislative tax reform. This is all the more remarkable in that NZ operates under a MMP system that usually leads to coalition (minority) governments, although the outcome of the most recent 2014 General Election offered the party with the largest party vote the opportunity to govern alone.

Overall in this paper, I argue that the GTPP (even without the contribution of the TWG) is genuinely world-class, illustrating how politics can be separated from much of the tax reform and review process. Nevertheless, this comment should not be interpreted as indicating that taxation is not inherently political – policy ideas will almost always be put forward by politicians and governments. In that regard, the GTPP offers an alternative approach from which other jurisdictions, such as the PRC, may be inclined to examine further.

4. Insights from the New Zealand GST Experience and Policy Approach

4.1 Why has NZ's GST been so 'successful'?

What can be said about the success of NZ's GST? First, extensive consultation was undertaken prior to implementation – this included key policy framework and later a detailed operative structure emerged.

Secondly, the consultation led to minimal compromise with NZ's GST, where there was arguably greater focus on efficiency, and less so on equity. To support this observation, NZ has a C-efficiency rating of around 99 percent from OECD – no other GST/VAT comes close. However, this is at the expense of taxpayer equity/fairness in relation to lower income earners. Most other jurisdictions have adopted a more equitable, and less efficient and simple GST/VAT.[79] This may suggest that taxpayers (and the government) in those jurisdictions are 'different' than those in NZ. This may be the result of a range of factors such as different patterns of industrialisation and urbanisation, and different perspectives regarding such issues as the expected roles of government in areas such as income redistribution, food pricing, agriculture and 'essential' goods and services.

Establishing itself as the international benchmark, no other jurisdiction has had the same level of political will to recommend and retain a theoretically pure GST from an efficiency perspective. As far as I am aware no non-OECD member country has a GST/VAT that comes close to the NZ GST on the basis of this measure, but whether this is the most appropriate

[78] Ibid 329. See also Vial, above n 50.

[79] For comments on the UK's reasons for implementing their VAT, see Simon James, 'The contribution of behavioural economics to tax reform in the United Kingdom' (2012) 41 *The Journal of Socio-Economics* 468, 472-474.

measure to assess a VAT/GST is a debatable point. Other measures, such as the degree of equity, may be more appropriate for some jurisdictions.

Thirdly, the economic environment of the time of proposing the VAT/GST is an important factor. New Zealand was facing a dire situation economically and fiscally in 1984, whereas few countries that implement a VAT/GST have been in that situation at the time. The PRC is certainly not in a similar situation as that of NZ at that time.

Fourthly, there is evidence of the success of the NZ approach through the sustainability of the consumption tax. Thus, even after nearly 30 years of operation, only minimal changes have been made, largely to increase the rate, expand the base and clarify some key concepts.

This paper does not seek to evaluate the PRC's current VAT and associated taxes. Not only would such an analysis be outside the motivation for this paper, it is not within the author's expertise to do so. Nevertheless, given the PRC is seeking to rationalise and streamline its current consumption taxes, NZ's experience may prove instructive for the PRC. Table 1 which follows summarises the key aspects of the NZ GST experience with some very tentative comparison of the current environment and fiscal situation faced by the PRC:

Table 1: Comparative analysis of NZ GST v PRC VAT

Evaluation characteristics	NZ	PRC
Economic environment	Economy in difficulty, heavy reliance on income tax creating a narrow tax base, a heavily regulated small economy	A rapidly growing economy in need of raising additional revenues to finance ongoing growth and provision of services. Second largest economy in the world
Debt structure	Heavily indebted at Government level, with debt reduction programme in place from 1984 (increased following 2008 Global Financial Crisis and 2010–11 Canterbury earthquakes)	Debt levels relatively low with considerable offshore investment. May need to raise finances overseas to fund domestic demand if growth rates decline significantly
Constitutional environment	Parliamentary system with one House of Representatives based in Wellington	Taxation legislation should be made by NPC and its Standing Committee as part of a centralised Communist Party (State Council) based in Beijing. State Council introduced the VAT and other taxes/duties
Political structure	Domination by two parties, under First Past the Post (FPP) system; proposal developed and implemented within parliamentary term. Now a Mixed Member Proportional (MMP) model with coalition governments	One party system with varying degrees of delegated authority to provinces, municipalities and counties
Role of consultation	White paper released, independent consultative committee, publicity committee and period to refine legislation of over 2 years	Directives issued by Central Committee of the Communist Party. State Council is both legislative and law enforcement agency. Implementation by State Administration of Taxation (SAT) and Ministry of Finance (MoF) – no formal consultation
Publicity campaign	Independent committee to coordinate all aspects of development and implementation; little in way of opposition	Little in the way of publicity other than announcement of policy direction. Use of VAT Pilot Reform
"Purity" of GST	Purist model of GST ever proposed, minimal exemptions	A mix of business tax and VAT, with varied bases and rates - proposals for change do not suggest a "pure" VAT
Reform package	Extensive reduction in income tax rates, compensation packages for households – revenue neutral approach	Issue under discussion – will need to be some changes in distribution of revenues between localities and central PRC. Some tax cuts expected

While Table 1 indicates very different environments and fiscal situations faced by each of NZ and the PRC, one important common feature that should not be overlooked is the political environment whereby one party had the 'mandate' to implement change. In NZ, this facilitated the broadening of the tax base via introducing a comprehensive and 'pure' GST, while the

Communist Party in the PRC occupies the position of sole arbiter of tax policy. Where the PRC has a 'choice' is in regard to the extent to which consultation is utilised and the process by which changes to the current consumption taxes are implemented. Qiu observed that:[80]

> "[t]he unique feature in the interpretation of tax laws in China is that administrative organs have enjoyed a near monopoly status in interpreting rules. *Problems arise due to the high centralization of powers and the lack of effective checks.* These problems include ultra vires interpretations, inconsistencies among the rules, retroactive application, infringement to taxpayers' rights without available channels for remedies, etc."

In this context, Qiu highlighted an important development, namely the "…general awakening of awareness among Chinese citizens of their 'rights as taxpayers' in recent years."[81] This includes the supervision of administrative bodies from civilians, tax professionals and non-government entities. Qiu concluded with the observation that "… the integration of China into the international tax community requires the government to be *more attentive to international norms and the practice in other countries*."[82]

In this regard NZ's experience, as an example of best practice with regard to GST, offers a potential blueprint for the PRC. However, such consideration will necessarily require adaptation to incorporate significant cultural and constitutional variances between the two jurisdictions. Importantly, in terms of the policy process, there is little similarity between NZ and the PRC. Nevertheless, the NZ experience and approach offers a well-tested and resilient approach to modern tax reform that has operated since 1994.

An important observation is that both the GTPP (and to a lesser extent the TWG) are structures that emerged following recommendations of review groups that were not set up by the NZ Government to reform tax policy. The GTPP was a recommendation from the Organisational Review of the NZIRD,[83] and arguably while it was not the most significant of its recommendations for the NZIRD and the NZ Government, it is one that has had a substantial impact on tax policy development in NZ since its adoption in 1994. That said the GTPP's course has not always been one that is smooth sailing, with a number of obstacles and challenges faced along its journey, especially in 1999–2000 and more recently in 2010.[84] One factor behind its resilience[85] can be attributed to the insights and perceptions of the GTPP's architect, Sir Ivor Richardson.

Furthermore, its strength is attributable to NZ's constitutional framework and unicameral Parliament, along with the conscious decision that each Government have made to using it as the basis for tax policy development. Nevertheless, the relative ease with which a government can bypass or circumvent the GTPP's processes demonstrates its major weakness, and to that extent, demonstrates the GTPP's relative 'fragility'.

Little et al made the following comment in relation to the transportability of the GTPP:[86]

[80] See Dongmei Qiu, 'Interpretation of Tax Law in China: Moving towards the Rule of Law?' (2014) 44(2) *Hong Kong Law Journal* 589, 620 (emphasis added).
[81] Ibid 616.
[82] Ibid 620 (emphasis added).
[83] See Richardson, above n 2.
[84] For a discussion on the GTPP's most recent "failing", see Vial, above n 50.
[85] See Sawyer, above n 53, 329.
[86] Little et al, above n 4, 1055 (emphasis added).

> "When considering the transportability of the GTPP, it is important to recognize that because New Zealand's relatively small size facilitates interactions between key tax practitioners and officials, *it is easier for the GTPP to work in New Zealand than would likely be the case in a much larger economy*. The GTPP also works well in New Zealand because there is a clear and coherent policy paradigm that is well understood, and the private sector has bought into the process. To that extent, policy settings that are amenable to the GTPP will be less flexible than would otherwise be the case."

While there are substantial differences between the legislative and constitutional frameworks in NZ and the PRC, I do not see these differences as necessarily preventing the development of a tax policy process based upon the GTPP model that could fit within the PRC's constitutional and legislative structure, assuming that transparency and broader consultation are considered to be essential features of tax policy development. Assuming this is the case, it is my humble suggestion that greater transparency and consultation be undertaken by the SAT and the Communist Party with respect to tax policy development. This would include undertaking a rigorous analysis of the PRC's tax system, and releasing papers and consultation documents from which submissions and feedback is sought from those within the wider Communist Party and outside these organisations and structures. Underlying the research that lies behind any policy proposals should be econometric analysis, regulatory impact analysis, and an evaluation of the issues and implications of each option for reform.[87] The literature on the PRC's VAT is growing; a major focus is on reforms to broaden the base.[88] In the context of the VAT, this should include utilising the experience and data gathered from the VAT Pilot Reform.[89] Conclusions on the best options need to be based on the analysis, as well as reflect the fundamental principles adopted for the analysis (principles that should be widely accepted, such as equity, certainty, efficiency, and simplicity).[90]

Turning to the TWG,[91] this is the most recent example of the vehicle for initiating major tax policy reform in NZ that feeds into the GTPP, but one that departs from most of the prior examples in that it was instigated from outside of the NZ Government. The NZ Government

[87] For prior research on the effectiveness of such measures in tax policy reform, *see* for example, Adrian Sawyer, 'Compliance Cost Impact Statements in New Zealand – How far have we come?: Tribute to Cedric Sandford' (2002) 17(4) *Australian Tax Forum* 441; and Adrian Sawyer, 'Regulatory Impact Statements and Accountability: Recent Australasian Evidence' (2008) 11(1) *Journal of Australian Taxation* 42. Regulatory Impact Analysis (RIA) refers to analysis undertaken prior to enacting a regulation or law. The role of an RIA is to provide a detailed and systematic appraisal of the potential impacts of a new regulation in order to assess whether the regulation/legislation is likely to achieve the desired objectives. Regulation/legislation commonly has numerous impacts and detailed study and consultation with affected parties is important to reveal these issues. From an economic perspective, it is important to identify whether the regulatory costs exceed the benefits. RIA is frequently comparative, with analysis of the different ways in which the desired objective may be achieved.

[88] For further details on VAT reform in the PRC, see for example: Bolivia SW Cheung and Alice PL Cui, 'A Comparison of the International Monetary Fund and the People's Republic of China VAT Policies' (2004) 30 *International Tax Journal* 10; Wei Cui, 'Business Tax: China's Quasi-VAT' (2009*) International VAT Monitor* (July-August) 291; Xu Yan, 'Putting the 'Value Added' in China's VAT' (2010) *Tax Notes International* (May 10) 487; Wei Cui, 'Learning to Keep the Consumption Tax Base Broad: Australian and Chinese VAT Design for the Housing Sector' in Christine Peacock (ed,), *GST in Australia: Looking Forward from the First Decade* (Thomson Reuters, 2011); Bin Yan and Eva Huang, 'Characteristics of the Chinese Tax System and its Cultural Underpinnings: A Comparison with the West' (2011) 1(1) *Journal of Chinese Tax & Policy* 13; Bin Yang, 'Extending the VAT to Services in China: Special Difficulties and Choices' (2012) 2(1) *Journal of Chinese Tax & Policy* 2; Nolan Sharkey, 'Localization of central taxation in China' in Nolan Sharkey (ed) Taxation in ASEAN and China (Routledge, 2012); Kenny Z Lin and Pauline WY Wong, 'Recent Reform in Chinese VAT Policies' (2012) *International Tax Journal* (July-August) 39; Sarah Chin and Polly Wan, 'How is China's VAT Reform Progressing?' (2013) 17(2) *Asia-Pacific Journal of Taxation* 22; and Bert Brys, Stephen Matthews, Richard Herd and Xiao Wang, 'Tax Policy and Tax Reform in the People's Republic of China' (2013) *OECD Taxation Working Papers No 18.*

[89] See for example, Fuqiang Zhang and Menglu Li, 'The Top-Level Institutional Design of the Perfection & Expansion of VAT Reform Pilot' (2014) 8(1) *International Business and Management* 1.

[90] These fundamental principles have their origins in the work of Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776: 1910 reprint).

[91] See Tax Working Group, above n 58.

set up the prior tax review, the Tax Review 2001,[92] and therefore the terms of reference were determined by the government in place at that time. As noted earlier, while the Tax Review 2001 made a number of recommendations, it comprised a mix of left- and right-of-centre members. Given the political views of the left-of-centre government at the time, few recommendations were implemented, and its terms of reference were narrowly constructed.[93]

A major advantage of the TWG, therefore, was that it was set up by a major NZ university (VUW), which was independent of the NZ Government. Of importance too was that VUW had the support of the then Ministers of Finance and Revenue, along with government officials, tax practitioners and academics (throughout NZ and overseas). Throughout the process, the TWG was consultative, making available papers for its various meetings (many of these papers were very technical, with summaries provided), issuing both an interim report and final report, in which options were presented to the Government for its consideration.[94] The NZ Government, therefore, while making information available to the TWG via officials, was in a sense a step removed from the process. The NZ Government was able to reflect upon the recommendations of the TWG without the restrictions placed on it if it had established the terms of reference and controlled the policy analysis process.

Nevertheless, it should be pointed out that the NZ Government at the time was right-of-centre, and had signalled that it would be receptive to a review of the tax system, recognising that there had been no major review or change for the preceding 25 years.[95] With a largely right-of-centre composition of the TWG, the environment at the time was also right for reform. Whether this would be true with a left-of-centre government at some future time remains unclear. This may become critical if a CGT proposal is formally tabled and opened for submissions as part of a consultation process that would inform NZ Government policy that is then fed into the GTPP.

A further critical element is that once a government initiates or endorses a review of the tax system, it needs to be resolute and committed to seeing the process through to the end. This does not mean that it cannot accept valid feedback through consultation and modify its approach and the options. Indeed if it does not do this, then the consultation process is not genuine and the reform process will be undermined.

It should be clear that the preceding discussion does not attempt to review the effectiveness of the PRC's VAT reform to date. Much has been written on this topic which provides valuable insights and issues for consideration, but this is beyond the scope of this paper.

5. Conclusions

Tax reform is a difficult area for any government to engage in, not surprisingly, as taxes are inherently political and reflect to varying degrees what a society expects its government to provide by way of goods and services. However, it would be naive for any government to believe that its tax system can be entirely the product of its own preferences, since almost all jurisdictions interact with one another (as do businesses), and taxpayers frequently hold assets in numerous jurisdictions. It is also unreasonable, and arguably impertinent, for another jurisdiction, individual or researcher, to suggest what another independent jurisdiction should

[92] See Tax Review 2001, above n 55.
[93] See Tax Review 2001, *Issues Paper* (2001), Chapter 1: Frameworks, 5–26.
[94] These reports are available from: "The Centre for Accounting, Governance and Taxation Research – VUW Tax Working Group <http://www.victoria.ac.nz/sacl/cagtr/twg>.
[95] For a comment on the largest tax changes in NZ for 25 years, *see* the commentary on the 2010 NZ Budget by Adrian Sawyer, '2010 Budget Brings Biggest Tax Changes in 25 Years' (2010) 58 (7 June) *Tax Notes International* 790.

do with respect to its tax system or how it should respond to global tax developments. However, this does not mean that one jurisdiction cannot learn from events, processes and developments in another jurisdiction, and evaluate whether this would be suitable/adaptable for their own jurisdiction and its tax system. In many instances, researchers, including academics, lead or promote such comparative research.[96]

Implementing any form of tax reform is a balancing exercise that in part reflects: the political will of the government; the competing pressures facing the economy; and the level of planning and willingness to allow genuine public consultation in refining the policy and subsequent legislation. New Zealand's experience with GST, while positive from the perspective of the purity of the GST and successful implementation, is not entirely without good fortune and trade-offs. New Zealand's GST focuses on efficiency with a trade-off that the tax is less equitable (indeed there is a strong argument that in isolation its effect can be regressive on low income earners; this is addressed through the income support and guaranteed minimum family income measures).

Having the chief proponent as a key member of the Government, in this situation the Minister of Finance, was crucial to advancing the initiative and resisting the pressure to acquiesce to the demands of various protest groups. Radical reforms, such as NZ's GST at the time of implementation, are usually much easier when they are made early on in the election cycle, rather than straddling over a major election when there is a risk of change in government. Politicians are usually more focused on re-election than major policy initiatives when these have the potential to significantly influence voters' decisions. In the case of the PRC, this is not such a critical issue, although the best timing for implementation of a major change in taxation will be important.

A second observation is that the approach to consultation is critical; NZ was a purist in its approach, benefiting from the prior VAT experience such as that with the UK. It took two to three years from the point of initial policy announcement to introduction. In particular, the extent of consultation and publicity facilitated by bodies' independent of the government, but made with the strong backing of the government and associated bureaucracy. Furthermore, the period for consultation did not need to be compromised by the forthcoming intervention of an election that could have led to a change in government. The choice of name for the NZ tax is not an accident; NZ sought to distant itself from the VAT concept in the UK and elsewhere, devising the concept of a goods and services tax (this is what the tax is levied upon, rather than the portion of value which it taxes), and forming the new international benchmark and nomenclature. Thus for the PRC, the consultative process undertaken will be a critical component to the level of 'acceptability' and potentially 'workability'.

Consultation is a critical part of NZ's tax policy process, the GTPP. As discussed earlier in the paper, this consultation is critical to both the policy development and draft legislative phases. It involves submissions and feedback from organisations and persons outside of the bureaucracy, including the potential set up of special bodies with a mandate to develop policy proposals for a government to consider. Thus, outside of GST/VAT, having a transparent and effective tax policy process could be a major catalyst in improving all tax policy development and implementation.

[96] See for example, Cedric Sandford, *Why Tax Systems Differ* (Fiscal Publications, 2000); Carlo Garbarino, 'An Evolutionary Approach to Comparative Taxation: Methods and Agenda for Research' (2009) 57(3) *American Journal of Comparative Law* 415; and Kathryn James, 'An Examination of Convergence and Resistance in Global Tax Reform Trends' (2010) 11(2) *Theoretical Inquires in Law* 475.

A third factor is the economic environment of the time and the associated government indebtedness. In 1984, NZ was facing its worst financial crisis since the substantial oil price increases during the early 1970s. With immense pressure economically and fiscally, this necessitated radial change for the country's survival. With the PRC looking to 'modernise' its taxation system, rationalising various turnover and other taxes in a manner to create a tax closer to a standard VAT, it represents a key step in this process.[97] Furthermore, a VAT/GST is not something that needs to be seen as having only short term objectives, but rather for the PRC, it may serve to prepare the jurisdiction for future demands on its resources, as well as potentially change the tax mix and relative burdens on taxpayers. For NZ, as noted earlier, the economy was facing a severe financial crisis in all major areas, including huge debts, an over-valued currency, negative trade balances and insufficient tax revenues to meet expenditure needs. Major tax reform was a necessity, not one of a series of choices that the then incoming Labour Government could select from.

Evidence that NZ's approach was successful with implementing its GST is also emphasised by the sustainability of the GST over its almost thirty years of existence. Subsequent amendments have largely been remedial to improve the operation of the GST and to further reduce its minimal number of exemptions.[98] A GST/VAT also assists with maintaining the integrity of the tax system through reporting requirements and links with the associated income tax obligations of GST registered taxpayers. Establishing itself as the international benchmark, no other jurisdiction has had the same level of political will to recommend and retain a theoretically pure GST from a policy perspective as NZ. Furthermore, as far as I am aware, no non-OECD member country has a GST/VAT that comes close to the NZ GST on the basis of this measure.

Successful tax reform also requires a package of reform, a characteristic common to both proposals. Since NZ and the PRC are contrasting economies (the former a small open economy and the latter a large planned economy), this suggests that the literature that pertains to tax reform for such economies will differ. Nevertheless, one could argue NZ made good use of the knowledge offered by the literature and international experience concerning VATs, and since the enactment of the GST, much of the tax policy literature now has NZ's GST as a focus.

How might the PRC develop a more comprehensive and cohesive VAT/GST? This paper suggests that in learning from a jurisdiction that has successfully implemented a GST, the PRC government should closely examine the NZ experience as part of the policy development process. A 'simple' and efficient GST would align with the relative simplicity of the PRC's tax system, although this should not be at the expense of addressing equity concerns. Depending on issues such as rate and thresholds, the majority of businesses in the PRC could either be required to register or be able to stay out of the GST/VAT system when it comes to registering and accounting for VAT/GST.

It is important that I acknowledge that I am an 'outsider' with limited knowledge and experience of the operations of the PRC with respect to developing tax policy and

[97] See Genevieve Lee, 'China's Transition from Turnover Taxes to VAT' (2012) 67 *Tax Notes International* (September 10) 1033.

[98] A significant review was conducted in 1999 when the issue of financial services, amongst others, came under the spotlight. Marie Pallot and Hayden Fenwick comment on the review and the changes that came about by way of remedial legislation. The authors, who come from Inland Revenue, observe that "Over the nearly 14 years since its introduction, GST has proven to be an efficient and relatively problem-free tax to administer, as well as a key contributor to Government revenue"; see Marie Pallot and Hayden Fenwick, 'Recent GST Reforms and Proposals in New Zealand' (2000) 10(1) *Revenue Law Journal* 88, 97.

administering taxes. Furthermore, my experience of the PRC's reforms with respect to VAT has its foundations in my review and analysis of the research contributions by a number of experts. In contrast, my experience with NZ's GST is extensive, including that of a NZ consumer affected by the GST, as well as individual and joint comparative researcher that has compared GST/VAT in other countries, such as Australia, the HKSAR and the UK.

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The Australian and New Zealand's VAT Model on Financial Service Industry: an Introduction on Experience to China

[Abstract] In the current stage of China's VAT Reform the proper model and tax rates that are applicable to financial services are yet to be finalised. Unlike developed countries in Europe, Australia and New Zealand took different approaches in dealing with VAT issues in the financial industry. Their experience in implementing special VAT treatment of financial services can provide an alternative and informative perspective into the conundrum that the Chinese government is facing. This paper introduces the VAT laws and regulations of Australia and New Zealand and compares the effectiveness of the two different models. In consideration of China's special realities, it endeavours to make a series of practical suggestions for the forthcoming VAT laws and regulations regarding the financial sector.

Key words：Reform on Business tax, Financial Services, International Comparison, Value-added Tax

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1. Introduction

In recent years, China's pilot programs that replaces business tax with Value added tax (VAT) have received positive feedback since 2001 when the Ministry of Finance and State Administration of Taxation issued the *Provisions on Issues Relating to the Pilot Program for the Imposition of Value-added Tax to Replace Business Taxa in the Transportation Industry and Certain Modern Service Industries.* A complete reform at the national level will kick off. So far, VAT has been implemented in transportation, postal and several modern services industries[99] of 9 regions (including Beijing, Shanghai and most eastern coast provinces[100]). A complete reform at the national level adapted from the pilot programs is likely to be carried out in the near future. Meanwhile, consultations regarding certain industries are being conducted

[99]China Ministry of Finance, State Administration of Taxation, 《关于将铁路运输和邮政业纳入营业税改征增值税试点的通知》附件 1"Notice of the Ministry of Finance and the State Administration of Taxation on Including Railway Transport and Postal Services under the Pilot Program of Replacing Business Tax with Value-Added Tax" appendices 1,《营业税改征增值税试点实施办法》"Implementing Measures for the Pilot Program of Replacing Business Tax with Value-Added Tax", Appendix.

[100]China Ministry of Finance, State Administration of Taxation, 《关于将铁路运输和邮政业纳入营业税改征增值税试点的通知》附件 2"Notice of the Ministry of Finance and the State Administration of Taxation on Including Railway Trasport andPostal Services under the Pilot Program of Replacing Business Tax with Value-Added Tax" appendices 2,《营业税改征增值税试点有关事项的规定》, "Provisions on Issues concerning the Pilot Program of Replacing Business Tax with Value-Added Tax" , Chapter 1, Article 4.

actively, amongst which financial services attract the most attention from reformers, academics and practitioners.

VAT, as a type of modern tax, has the advantage of easy tax administration and stable tax sources. It is also for this same reason that VAT has been widely adopted in western developed nations. However, implementing VAT in the financial industry has always been challenging. This is due to the special nature of financial services, making it difficult to proportionate input costs to every single transaction and ultimately isolating the value added. Therefore, in most countries and regions, for example the European Union, financial industries are exempted from VAT in order to avoid administration troubles. One of the unintended consequences is that financial institutes cannot deduct their costs. The undesirability of the existing VAT regime inspired countries such as Australia, New Zealand, Singapore and South Africa to explore other possibilities and eventually introduced "the modern VAT".[101] One attempt is to extend the scope of VAT and tax "visible" financial services, while others boldly push the reform in the direction of imposing the same general VAT principles on financial services as other sectors. Following this track, the VAT burden is shifted from banks to the ultimate consumer of financial services. This paper seeks to compare the Australian and New Zealand's VAT models in financial industry. Based on the assumption that the current financial market of countries are usually monopolistic competition or oligopoly, this paper also uses the "supply and demand" model to analyse the effect of different models on the market to illustrate the advantages and disadvantages of each model. Furthermore, advice will be provided on how China should deal with the trade-off between efficiency of tax administration and retaining of tax revenue. In the meanwhile, this paper identifies the necessity to reduce compliance cost to improve the competitiveness of China's financial services in the global market.

2. Goods and Services Tax in Australia

Australian Goods and Services Tax (GST) is a type of value-added tax on the transactions of most products and services in Australia. Promoted by the Howard Government in 1999, GST was implemented on July 1, 2000. The chapter about financial services in the *A New Tax System (Goods and Services Tax) Act 1999* (*GST Act*) had been amended a great deal right before the implementation, and eventually No.177 Amendment in 1999 abolish this part of provisions.[102] Instead, *A New Tax System (Goods and Services Tax) Regulations 1999* (*GST Regulations*) was enacted to regulate the VAT issues in the financial Services industry, with the aim to add, subtract and amend the relevant provisions more flexibly if given circumstances vary in the future.[103]

GST Regulations has given a detailed definition of the word "financial". The regulations have made clear the nature and the providers of financial supplies.[104] In addition, a non-exhaustive list of what supplies are financial supplies is given.[105] At the same time, reg 40- 5.12 lists 21 different non-financial supplies, including information and advice in relation to a financial supply, insurance and reinsurance except for life insurance, brokerage services, management of the assets or liabilities of another entity, etc. Despite regulation 40-5.12, if something is

[101]KPMG China，《中国金融服务业增值税改革政策建议》，*Proposals to apply VAT to the financial services sector in China*, (November 2013) <http://www.kpmg.com/CN/zh/IssuesAndInsights/ArticlesPublications/Documents/Proposals-to-apply-VAT-to-the-financial-services-sector-in-China-201311-c.pdf>.
[102]*GST Act*, s 40-5.
[103] See *GST Regulations*, Division 40 Subdivision A for more.
[104]*GST Regulations*, reg 40-5.06.
[105]*GST Regulations* reg 40 -5.09(3) provides a table of 11 types of services, including a debt, credit arrangement, a charge or mortgage, securities, life insurance, a guarantee, etc.

supplied by an entity to a recipient directly in connection with a financial supply to the recipient by the entity, the thing is an incidental financial supply if: (a) it is incident to the financial supply; and (b) it and the financial supply are supplied, at or about the same time, but not for separate consideration; and (c) it is the usual practice of the entity to supply the thing, or similar things, and the financial supply together in the ordinary course of the entity's enterprise.[106] It will receive the same kind of tax treatment as the primary financial supply.[107] If a supply falls into the scope of both financial supply and non-financial supply, the supply is not a financial supply.[108] The way the regulations prescribe the subject matter and the presumption of non-financial supplies have constrained the spectrum of financial supplies to a limited one. Consequently, only a handful of supplies are GST-exempt or input-taxed. Those that fall out of the scope are subject to the general GST principles.

In order to levitate the GST burden for small and medium sized financial providers and enterprises that provide limited financial services, a special regime called Financial Acquisitions Threshold (FAT) is incorporated in *GST Act*. Under FAT, if assuming that all the financial acquisition you have made, or are likely to make, during the 12 months ending at the end of that month were made solely for a creditable purpose, either or both of the following would apply: (a) the amount of all the input tax credits to which you would be entitled for those acquisitions would exceed $150,000 [109]or such other amount specified in the regulations; (b) the amount of the input tax credits referred to in paragraph (a) would be more than 10% of the total amount of the input tax credits to which you would be entitled for all your acquisitions and importations during that 12 months (including the financial acquisitions).[110] But financial supply consisting of a borrowing does not qualify as a financial acquisition.[111] It depends on the extent to which the acquisition is made for a creditable purpose.[112] Though the intention is to reduce GST borne by financial suppliers, it fails to take into account the costs in making full use of credits by predicting future transactions and timing the relevant transactions.[113]

A number of financial service providers choose to vertically integrate their operation as no credit is allowed for major inputs. They take most services in-house which are meant to be outsourced at a much lower price. As a direct result, it reduces healthy competition and causes serious damage to productivity, impeding the development and maturing of the financial market.[114] To address this issue, the Australian Government has implemented Reduced Input Tax Credit (RITC). S 70-5 of the *GST Act* allows the regulations to provide that acquisitions of a specified kind that relate to making financial supplies can give rise to an entitlement to a reduced input tax credit. So far there are 31 types of acquisition meeting RITC, including transaction banking and cash management, payment and fund transfers, securities transactions, funds management services, loans, etc.[115] Reg 70 – 5.03 has provided that the percentage of the input tax credit for each kind of reduced credit acquisition is 75%. Besides, certain offshore supplies related to making financial supplies also give rise to an entitlement to reduced input

[106] *GST* Regulations, reg 40 – 5.10.
[107] *GST Regulations*, reg 40 – 5.08(1)(b).
[108] *GST Regulations,* reg 40 – 5.08(2).
[109] This threshold has been bumped up from $50,000 to $150,000 in 2012. See more in No.11 Amendment Act in 2012.
[110] *GST Act,* ss 189-5 and 189-10.
[111] *GST Act,* s 189-15.
[112] *GST Act,* s 11-15(5).
[113] Rita De La Feria and Michael Walpole, Options *for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Models Compared, International Comparative Law Quarterly* Vol 58, October 2009, 920.
[114] Harry Grubert and Richard Krever， *VAT and Financial Services: Competing Perspectives on What Should be Taxed, Tax Law Review* Vol 2 2012, 227.
[115] *GST Regulations,* reg 70 -5.02(2)

tax credit.[116] So if a bank purchased an internal information process system from an offshore IT company, the import value added tax can also attract credits.

The advantages of these rules are that it can solve the difficulty of calculating the value added in the process of common financial services as well as reduce the effect of double taxation. However, the way RITC lists the types of acquisition that are entitled to reduce input tax credit has given rise to a number of borderline cases. The Tax Office has to make ad hoc decision about which side those complicated acquisition fall onto, increasing the uncertainty of tax treatment and causing endless litigations. Another problem is that it is not very straightforward for the acquisition of goods and services made for mixed purposes. Before any RITC can be claimed, the total value of the acquisition must be proportionated according to creditable and non-creditable purpose. However, there is no clear standard in the relevant law and regulations. The Tax Commissioner in 2006 suggested that the fair and reasonable principle should be adopted in such cases.[117] The portion assigned should reflect the plan of use or use that has actually occurred. Sufficient records should be kept for future reference.[118]

3. Goods and Services Tax in New Zealand

On October 1, 1986, GST first came into effect in New Zealand. *Goods and Services Tax Act 1985* (*GST Act NZ*) followed the traditional approach that financial supplies were VAT-exempted. Not until 2003 No.122 Amendment changed it from VAT-exempted to zero rating. This took effect on 1 January 2005.

Unlike the *GST Act* in Australia, *GST Act NZ* gives a broad and loose definition of financial services. Specifically, s 3(1)(l) includes activities of agreeing to do, or arranging, and of the common financial services other than advising on investment or evaluation of investment. That is to say, security brokerage and asset management and other third party services are considered as financial services, while similar services in Australia are non-financial supplies. It is worth noticing that *GST Act NZ*, similar to its counterpart in Australia, has also excluded advisory services from financial services. But it also encounters the conundrum how to characterise consulting services and facilitating financial services. The most likely solution is the Tax Commissioner's special rulings.

S 11A(1)(q) of the *GST Act NZ* provides that financial services that are supplied in respect of a taxable period, by a registered person to a registered person who makes supplies of goods and services such that taxable supplies that are not charged with tax at the rate of 0% make up not less than 75% of the total value of the supplies in respect of a 12-month period that include the taxable period or a period acceptable to the Commissioner. Such requirement is to eliminate the possibility that the total VAT payable for financial services amounts to zero.[119] The information about the proportion of taxable supplies that are not charged with tax at the rate of 0% comes from the recipient of the financial supplies. Alternatively, the supplier can come to an agreed percentage with the Tax Commissioner.[120] The *Australian and New Zealand Standard Industrial Classification* produced by the Department of Statistics can be used for

[116] *GST Regulations,* regs 70 – 5.02A and 70 – 5.02B.
[117] Fair and reasonable principle is reflected in the High Court decision in *Ronpibon Tin NL v. FCT (1949) 78 CLR 47*. The principle has been used to determine income tax payable. The Commissioner suggested this principle could be followed in deciding the extent to which the acquisition is entitled RITC. If disputes arise, it is likely for High Court to take the same position.
[118] GSTR 2006/3 [33] http://law.ato.gov.au/atolaw/view.htm?Docid=GST/GSTR20063/NAT/ATO/00001&PiT=99991231235958
[119] Lee Burns, *Indirect Taxation of Financial Sector Supplies in the Asia Pacific Region, Asia Tax Forum* August 2008, 352.
[120] *GST Act NZ,* s 20E.

reference.[121] If the recipient does not meet all the requirements, the recipient can still receive credits as a member of a group companies that meets the requirements. This is an innovation in levying value added tax by lifting the corporate veil.[122]

More importantly, the transactions between financial services providers will fail the condition of not less than 75% of total value of the supplies are not taxed at zero rate. Therefore, it will still be input-taxed. To reduce the cascading effect, s 20 of the *GST Act NZ* provides that if Bank A provides financial services to Bank B that uses the services acquired to provide further financial supplies to clients who meet the requirements, Bank A is entitled to input tax credit. But if Bank A wishes to claim the credit, it must obtain all the relevant information and report accurately to the Inland Revenue Office. Unfortunately, this means more difficulty and costs to comply with the rules. Therefore, *GST Act NZ* allows the suppliers to opt in zero-rating policy after thorough cost-effective analysis.

Even in NZ model, the allocation between creditable transaction and non-creditable transaction still needs to be done. Before 2011, the purpose of transactions determines apportion. Namely, if more than 50% of the value of transactions are taxable, input tax paid can be deducted entirely. Periodical adjustments will be made to reflect the reality. After 1st April 2011, New Zealand has adopted the same approach as Australia, using the budgeted usage or real usage incurred to deal with services made for compound purposes.

NZ model mainly aims to reduce the cascade effect and double taxation, lower the costs of financial services, and enhance the computability of financial services players in overseas market. The revenue lost can be made up through imposing reverse charge on recipients of offshore financial services. The protectionist nature of treatment may potentially infringe the national treatment principle in TRIPS.

4. The Australian and New Zealand's Current VAT Model and the Economic Issues

4.1 Economic Effects on VAT Models

In terms of policy options on VAT applied to financial services, there are generally three types of model available: zero-rating (the New Zealand Model), exempt or partly exempt (Australia and the European Union Model), and non-zero rate levying. These three models bring different effects on the financial services market. All of these effects will be analysed in later sections. Before that, there are some key characteristics of the financial services market and the differences in markets between China, Australia and New Zealand that should be pointed out.

Firstly, the financial services market is a "monopolistic competition market" in most areas of the world including China and Oceania countries (in this paper, it means Australia and New Zealand). In China, state owned banks, including the big 4 banks (Bank of China, Industrial and Commercial Bank of China, China Construction Bank and Agricultural Bank of China) and other large banking groups (for example, the China Merchants Bank and CITIC Bank), occupies approximately 75% market share of the entire banking market.[123] Meanwhile, in Australia, the market share of the big four banks- Westpac Bank, ANZ Bank, Commonwealth

[121]New Zealand Inland Revenue Department, *Tax Information Bulletin Vol16 November 2004, 59-60.*
[122]*GST Act NZ,* s 11A(1)(r).
[123]China Banking Regulatory Commission《中国银行业监督管理委员会》 *Annual Report on Banking Market of 2013*, 16 April 2014

Bank and National Australian Bank (NAB) is approximately 77% in 2011 [124]. The characteristics of a monopolistic competition market are that "goods are supplied by a number of firms within the market; each supplier within the market has strong market power and capital; the barriers on the market are high, which excludes smaller firms to entry". In this market, although banks, as a monopolistic competitor, are trying to maximise their profits, the return on addition transactions of banking services is diminishing due to marginal cost. All the economic models used in this paper are based on an oligopoly market.

Secondly, there are differences in the banking industry between China and the Oceania countries. China is currently a rapid developing country with a large economy; the demand investment of firms is relatively large. As the result, the demand and price elasticity on banking services and financial products are different from Oceania countries. Excluding the impacts on other general economic issues such as inflation, the differences on real demand on financial services products (or credit services, including all credit services provided by banks such as direct lending, interest rate and foreign exchange rate instruments, and other long or short term credit), the level of effect on the market is different. In order to apply these effects on China's financial services market, the later section will pilot the China's financial services market data into the "price elasticity" model.

Finally, this paper will focus on the short run economic effects on the financial services market, using the results of different models to estimate the longer runs outcome and the equilibrium of the market. This paper will model the impacts on price (where the tax implemented on) changes and other factors on the result. Since there is a general level of cost on the interest paid by banks to the deposit, the "added value" is the difference between "deposit cost" and the return on financial services, which is the taxable amount of VAT. This paper models the trends of financial services as a market, the "price", or the cost of firms to borrow money is the "market interest rate" provided by banks, the quantity axis stands for the units (for example, 1 million) of financial credit that has been clinched. Within this market, the supply curve is given by the certain amount of credit that banks are willing to supply at every interest level while demand curves are given by the credit that firms are willing to borrow at every interest level.

Another issue that needs to be mentioned is that the OECD, which is mainly comprised of developed countries within European Union, has leading position on the research of the modern VAT model. A lot of the current models are built by OECD's research. The current European VAT model is highly related to OECD's research.[125]

4.2 The Supply and Demand of the Financial Industry

When analysing tax on a specific market, the elasticity of supply and demand in the market is important, the reason being that the elasticity on supply and demand determines the proportion of tax burden on both sides. China has an extremely huge financial credit market, although the annual national Credit Turnover data is available, the amount can only show the equilibrium of the total amount within the year or at that specific time. This report however uses the data of a few monthly time periods provided by People's Bank of China to analyse the supply and demand situation of financial market by comparing three months' credit supply and demand with different interest rates, so that the elasticity level on supply and demand can be figured out by comparing two periods rather than two specific points. This paper compares economy

[124] Australian Trade Commission, *Australia's Banking Industry* (May 2011).

[125] OECD, *Value Added Tax- A Possible Revenue Source for MENA Countries?* (June 2012) <http://www.oecd.org/mena/investment/45573623.pdf>.

data of China for two periods, using the data of the total financial credit that firms need as the demand function and the big four banks' total loans released as the supply amount.

Table 1: 2013-2014 National Credit Supply and Demand Data[126]

（All the interest rates given is the rate as of the 15th of the month given）

Units: Million RMB	May. 2014	Difference	Feb. 2014[127]	Difference	Dec. 2013
Monthly Credit Demand (short term, state owned banks)	1,405	468	937	-316	1,253
Monthly loan Supply (1 year)	9,469	188	9,281	141	9,141
RMB loan interest rate[128] (Using one year interest rate as the reference)	5.75%	-0.018%[129]	5.74%	0.03%	5.70%
Demand Elasticity Level	190.76		44.97	Average 117.86	
Supply Elasticity Level	7.75		2.74	Average 5.24	

At the bottom of the table, the elasticity was calculated by the proportion change on quantity of credit supply and demand and the price-interest rate proportion change. Since China's central bank did not adjust the interest rate while the 4 biggest state-owned banks were using same rates for same period of loan which is required by the China's policy, the interest rates used in this section are the 1 year loan interest rate of the state-owned banks.

$$\text{Price Elasticity} = \frac{\text{Change on Credit Quantity} \ / \ \text{Credit Quantity of Basing Month}}{\text{Change on Interest Rate} \ / \ \text{Interest Rate of Basing Month}}$$

Through the calculation above, in the first half of 2014, the demand elasticity level of demand is 177.86 on average, but the supply is only 5.24. The demand side of credit is clearly more elastic, whcih means firms have to significantly change their financing activities as the cost of credit change. However, the amount of credit supplied by financial institutions is relatively stable.

It has been pointed that the financial markets in most countries are oligopoly market where financial institutions maximise their profit by setting an appropriate price. Since the cost of financial products comes from the interest of customer deposits, within the supply-demand model, with more deposits being attracted, a higher interest rate is needed, which indicates that

126Survey and Statistics Department of People's Bank of China《中国人民银行调查统计司》*National Statistics Data of 2013, National Statistics Data of 2014*,<http://www.pbc.gov.cn/publish/diaochatongjisi/133/index.html>.

127Major commercial banks of China increased interest rate twice in the first half year of 2014, the interest rate was adjusted from 5.7030% to 5.735% and then 5.75%, which led to a significant drop on the financial services market.

128 Bank of China 《中国银行》 *Historical Loan Basic Interest Rate Data*, <http://www.boc.cn/fimarkets/lilv/fd32/201310/t20131028_2578984.html>.

129This is proportional change on the interest rate rather than the absolute change.

the marginal cost curve, or in other words the supply curve. Is upward sloping. That is, only where the financial product has a higher price, will financial institutions (supply-side) be willing to provide more, as the quantity and price on the supply curve has a positive relationship. On the other hand, the demand curve is an opposite of the supply curve. In general, the lower cost of borrowing causes firms to become more willing to "purchase" financial products. It has been proven that the demand elasticity level is above the supply elasticity, which indicates that the supply curve has a larger slope that is deeper.

The statutory taxpayers in this paper are the supplier of financial products, i.e. the financial institution. The VAT rate is neither progressive nor regressive, that means under a certain quantity level of financial market, the "added-value" between banks' deposit cost and borrowing income is generally stable, indicating that the tax burden level is stable. As the result, the VAT used in this paper is recognized as a "unit tax" on the supply side, the "tax" is under the condition that "the tax burden of unit (i.e. million RMB per unit) quantity of financial products purchased", that is a fixed amount under every given level. On the other hand, the supply side within the model is the recipient of financial products and services, which is the "buyer". Therefore, the following graph on the market can be deduced. The "quantity" is how many units (i.e. million RMB per unit) being clinched, and the price (or cost of financial products) is the market interest rate under certain quantity level.

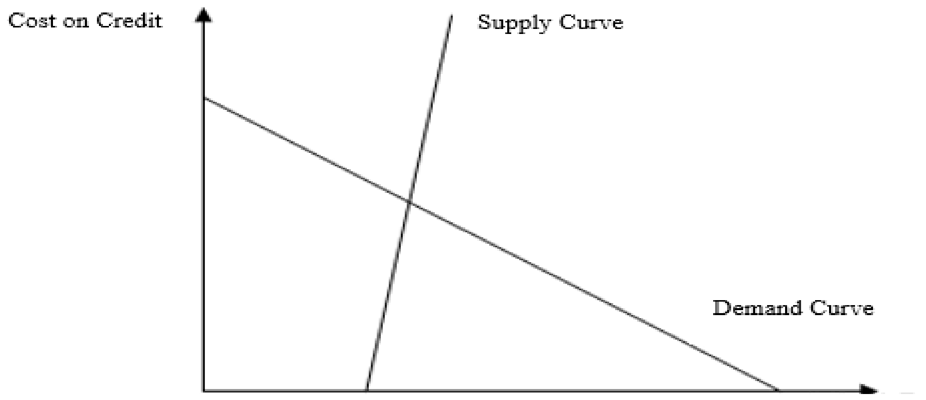

Figure 1 Financial Market

4.3 Financial Market under Zero Rating System

One of the current available models for the financial institutions in New Zealand is to apply a zero rate for financial institutions that have registered themselves as the VAT payers. However, if the purchasers of financial products are not registered VAT payers, the transactions are still not applicable for zero-rating.[130]

It is clear that the zero rating is meant to tax taxpayers under zero per cent tax rate. The key difference between this type of model and the exemption is that, under zero rating, the financial institutions are still "taxpayers", who are paying 0 per cent tax, as a result, financial institutions can still deduct input expense. That leads to a series of chain effects: since financial institutions are no longer the "final consumer" under the zero rate system, the further "consumers" can also deduct the cost of financial products. Therefore, the zero rating system is in fact giving "actual" benefit when compared with other systems.

130 KPMG, *New Zealand Country VAT/GST Essentials*, (2011) <http://www.kpmg.com/Global/en/services/Tax/GlobalIndirectTax/Documents/vat-gst-essentials-2012/new-zealand-2011-vat-gst-essentials.pdf>.

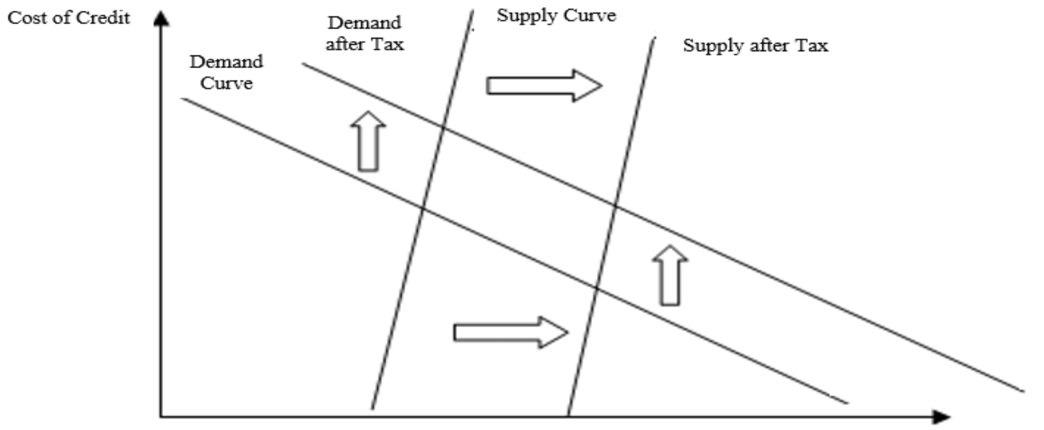

Figure 2 Zero-rating VAT on Financial market

Through the analysis above, the key ideas can be further explained by Figure 2. Firstly, zero interest rate does not bring any further burden on financial institution. Conversely, as the input deduction under this system is deductable, that means the zero rate is actually lowering the operating cost by comparing it with tax exempt model, the supply curve, therefore, shifted rightward (from “supply curve” to “supply after tax”), which results in a higher price and lower quantity in the market. On the other hand, as the result of the deduction for customers of financial products, the “actual price” of financial products under the same quantity is lower. Consumers of financial products will, therefore, increase their purchase of financial products. “Actual demand” of financial products will be increased which results in an upward shifting on the demand curve. The final result is, the zero-rating provides a higher level on both supply and demand, and the equilibrium quantity on financial products will be increased, which is beneficial for the investment sector in general. However, the disadvantages of the zero-rating system include the following. Zero-rating means relatively lower tax revenue. Further deductions lead to a decrease of the total tax revenue on the whole supply chain (in terms of same situation on non-deductable situation). Therefore, the result of zero-rating is that it lowers the amount of tax revenue while the financial market is encouraged through the lower “real cost”, which is beneficial for the market investment sector.

4.4 The Financial Market under Partial Exemption System (Australian System) and Full Exemption System (the European Union Model)

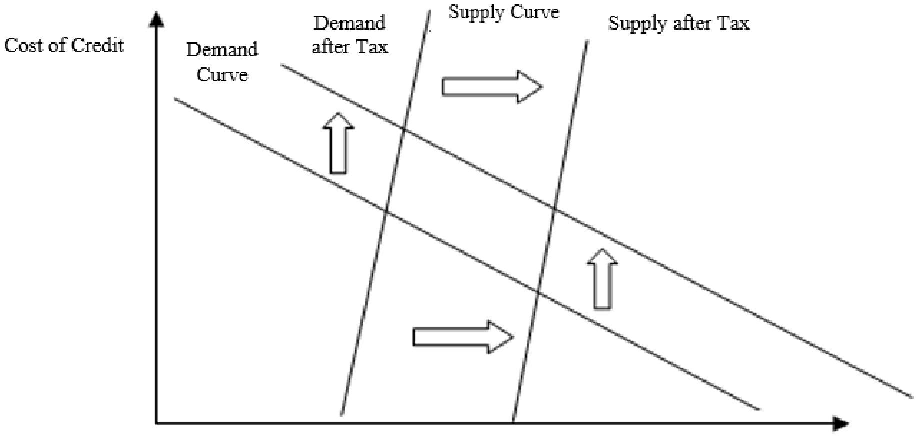

Figure 3 Exempted and Deductable Market

Australia is partially tax exempted on financial institutions for VAT, which allows the partial deduction on financial products, while the European Union is entirely exempted on VAT for financial market. The partial exemption in Australia means that applying zero rates to exported financial services, taxing the explicit income for financial institutions and exempting on non-explicit incomes (such as the differences on lending and deposit interest)[131]. The exempt amount is allowed for 75% as deduction.[132] The European Union uses a full exemption system. Therefore, the Australian system is a compromise approach of the European Union and New Zealand.

Although the full exemption model (the European Union model) avoids many problems such as the difficulty of identifying "added value" of financial services, the shortfall of it is fairly clear; full exemption induces the financial institutions to become the final consumer, that means neither banks (and other financial institutions) nor the consumers of financial products can deduct on the relative costs. That increases the cost of firms and limits the investment sector.[133] The Australian compromising approach is actually trying to balance the shortfalls of the non-deductable system and the loss in zero-rating system.

The Australian Model's impact on the market should be modeled in steps. The objective of this paper is to identify the current available models and difficulties on VAT in financial industry, therefore, the discussion point of the Australian model is on the "hidden fees" section where it is exempted and partly deductible. All the economic models in later sections are basing on this condition.

Firstly, exemptions for the financial industry means no deduction on financial input for financial product providers and the financial cost of the consumers of financial products, both the supply and demand on the market bears larger "actual" costs where a lower level of equilibrium is given when compared with the equilibrium of deductible equilibrium. A partial deduction gives a certain proportion of deductible value of the expenses. That results in a higher equilibrium level as it reduced a part of the cost (see Figure 3). Under this model, similar results as the New Zealand's model is obtained, which is that both of the VAT systems have positive effects on investment as both of them eliminate at least a part of the cost on non-deductible section. Both models will cause a higher level of investment, but the point of difference is that the partial deduction model used by Australia has a relatively smaller improvement on the market while the loss on total tax revenue in the supply chain is also smaller than the New Zealand's model.

On the other hand, the European Union's full exemption model is an entirely different situation, as no deduction is allowed, the "actual" supply and demand curves are in a lower level than any "deduction models", which reduce the overall level of investment.

[131]蔡晓聪, CaiXiaocong,《我国营业税改增值税在金融业的应用初探》, A primary exploration on China's VAT Reform on the practices of financial industry,《现代经济信息》, *The Modern Economic Information*, 2012isuue 18, 2012.
[132]Grubert, H, Krever., R, *VAT and Financial Services: Competing Perspectives on What should Be Taxed*, May, 2012.
[133]KPMG China,《中国金融服务业增值税改革政策建议》, *Advices on VAT reform of China's Financial Services*,<http://www.kpmg.com/CN/zh/IssuesAndInsights/ArticlesPublications/Documents/Proposals-to-apply-VAT-to-the-financial-services-sector-in-China-201311-c.pdf>, 2013, November.

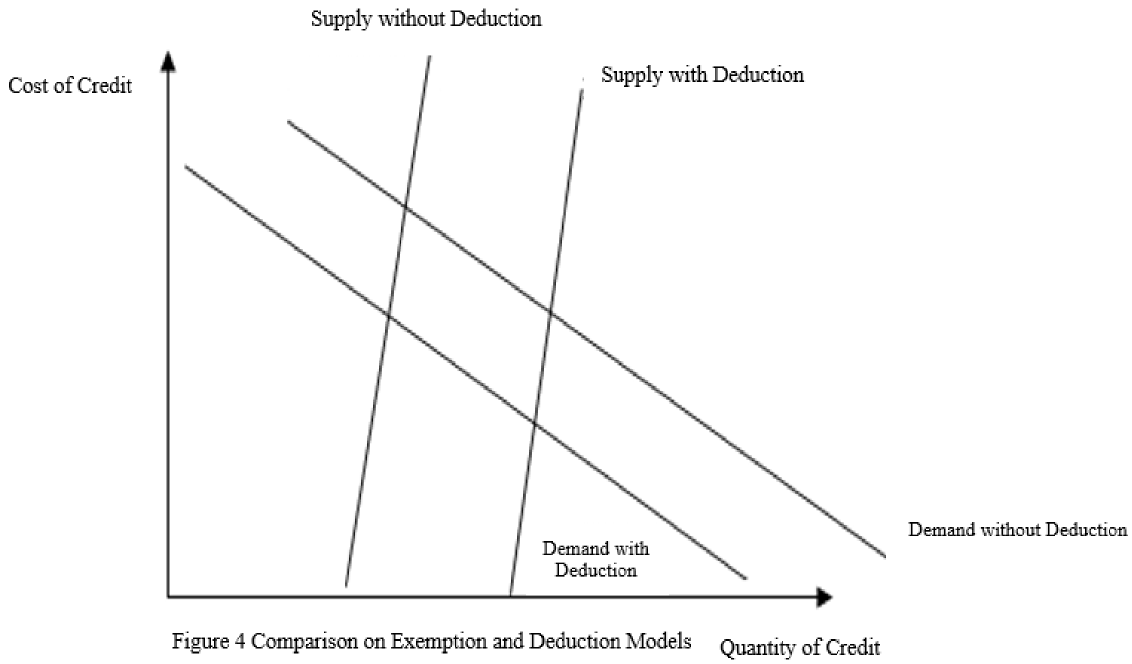

Figure 4 Comparison on Exemption and Deduction Models

As the result (see Figure 4), the financial market under the exemption condition gives larger costs on both supply and demand sides and results in a lower level of equilibrium since no deduction is allowed. However, as the deduction is not allowed, the total tax ravenue in the whole supply chain is higher, which is another positive effect on national welfare.

4.5 Market under the Non-zero Rating Model

The last model is to tax the financial market as all other types of services. There are two possible situations in the taxing system. Firstly, if the overall taxed amount is less than the deductible benefit from the system, financial institutions and their customers can still obtain benefits from the model when compared with the exemption model. The only difference from the zero-rating model is shown above and in this situation, the total benefit is not as large as the zero-rating one. The second situation is the focal point of this paper, where the benefit of deduction is less than the cost of tax and financial institutions are worse off in absolute terms. Currently, most countries either have an exemption system or a zero-rating system on the financial industry. Only a few countries are taxing a positive rate on financial industry.[134] The reason for that is not only because of the difficulty in determining the "added value" for financial products, but also the actual outcome indicating that the tax is not efficient in economic terms. The point here is, VAT is taxing on the amount of financial products being "sold" for a specific percentage, therefore, the model used here is a unit tax model where the tax is levied on every certain unit (for example, 1 million) of financial products being "sold".

[134] KPMG China，*Proposals to apply VAT to the financial services sector in China* 《中国金融服务业增值税改革政策建议》 (November 2013) <http://www.kpmg.com/CN/zh/IssuesAndInsights/ArticlesPublications/Documents/Proposals-to-apply-VAT-to-the-financial-services-sector-in-China-201311-c.pdf>,. Such as Argentina and Israel.

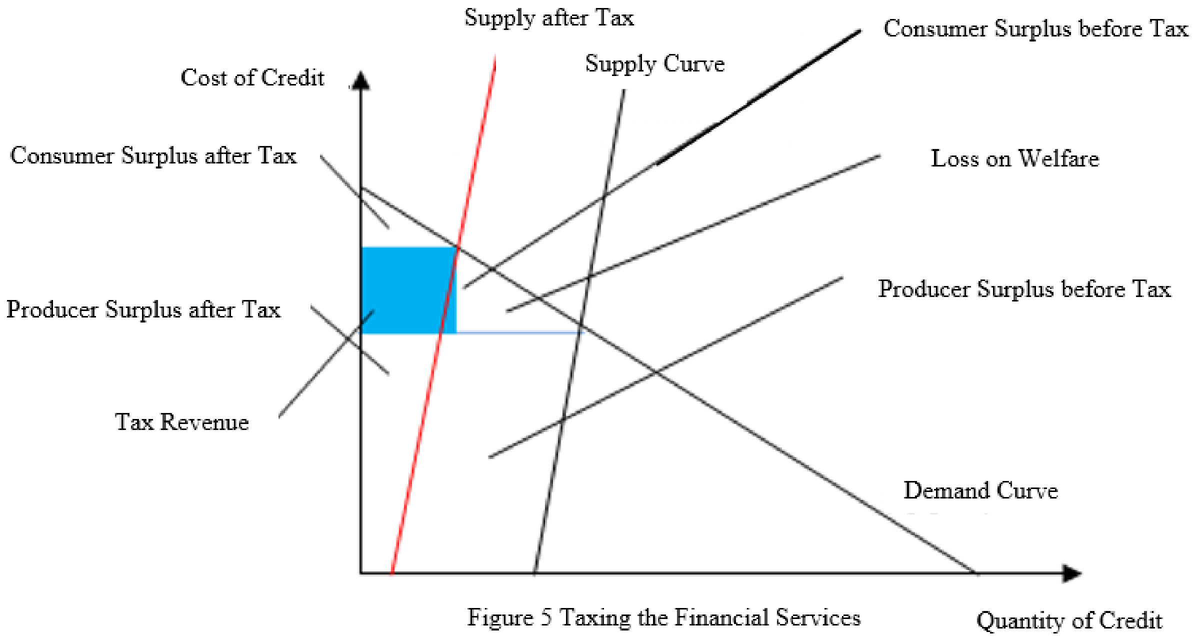

Figure 5 Taxing the Financial Services

In Figure 5, the red line stands for the supply curve after tax, as the result of tax, the cost of supply on every unit of financial products are more expensive. As a result, the producer surplus before tax has been reduced (the whole area below the equilibrium before tax and to the left of supply curve is the producer surplus before tax, and the whole area above equilibrium price and under demand curve is consumer surplus). If the VAT is implemented, there will be a tax revenue equivalent to the unit tax times the products being purchased (the blue rectangle in Figure 5) and both consumers and producers are worse off while a dead weight loss is created (shown in Figure 5). In general, if the tax is levied on supply side (financial institutions are the statutory taxpayers), their cost on supplying financial products is increased and both the surpluses of consumers and producers are decreased, although a tax revenue (blue area) is created, as the result of price increased and decrease on quantity, the overall welfare is decreased. As mentioned previously, in the financial market, both consumers and producers will change their quantity on demand and supply, and the supply side is relatively inelasticity (but not absolutely inelastic). The predictable result is as follows. Firstly, welfare loss must be made only if the supply and demand is not perfectly inelastic. Secondly, in China (see section 5.2), the suppliers of the financial market is more inelastic, the VAT on financial industry will be mostly paid by supply side while part of the tax is transferred to consumers. Finally, although there will be tax revenue to increase the total welfare, the loss in market shrinking and the further income reduction and costs in the supply chain induces larger tax revenue loss in the downstream industry chain.

5. Advice on VAT Reform of China

1) From an economic point of view, the VAT on China's financial industry can be implemented through one of the four types of available models: zero-rating, partial exemption or full exemption and taxing. The equilibriums of all these models are listed in Figure 6 from right to left, where the point located is on the right side, the quantity of financial products being purchased is larger and it is more beneficial for investment. Since the outcome of direct taxation is the least efficient, and the equilibrium is clearly restricting the investment (Figure 6), China's

VAT reform should be based on the other three types model, which is zero rating, partial exemption or fully exemption. On the other hand, China is still a developing country in need of a large amount of investment, the full exemption model sets too much restrictions on deductions for supply and demand, which is not beneficial for investment (see Figure 6, the equilibrium of this model is lower than zero-rating and exempt), therefore, it is not suitable for China's current situation. For the zero-rating model, it is the most efficient model and the best one to improve investment from the economic perspective without any welfare loss, it is also easy for administration: where almost all expenses are allowed for deduction. However, China has a larger and more complicated market than New Zealand who has a relatively small market that is easily to administer.[135] In China, the overly simplistic taxation system might be problematic with numerous disadvantages due to regional and market structural differences. Besides, the Australian model is closer to a "system for large economy", the details and rules are more specific. In actual practice, it is beneficial for China to consider the Australian model and distribute the industries with different VAT system, also, for China's current situation, in order to protect the investment, the New Zealand's model should also be partly considered to make the market more efficient. Therefore, the author believes that the China should implement a model between Australian and New Zealand's model to cover a larger scope of taxpayers with relatively lower loss on investment.

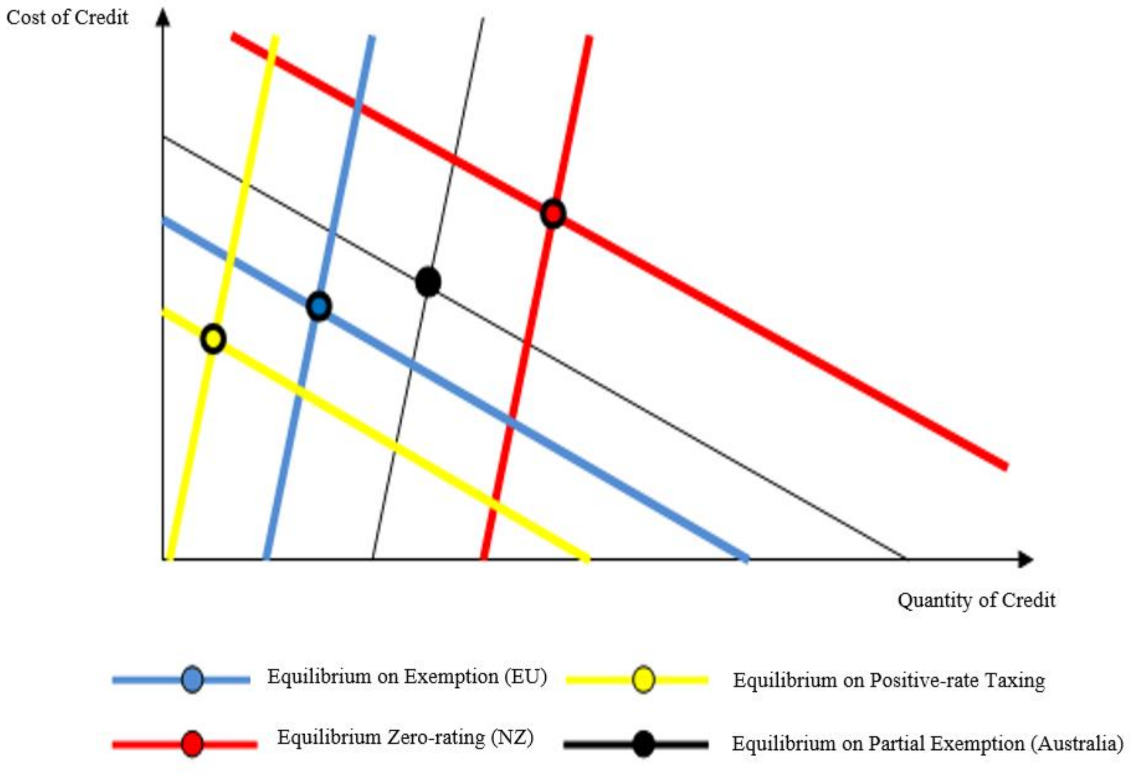

Figure 6 Comparison on Different Models

2) From the perspective of administration costs, the full exemption model is clearly the one that is simplest with lowest cost. By comparison, the New Zealand's zero rating model has a higher requirement for both taxpayers and tax departments, requiring more information: Financial institutions have to obtain more knowledge on their clients and the tax office has to confirm the information provided by consumers so that the deductions are allowed. Another

[135] According to the statistics of New Zealand's tax office, in the year end of 2012, only 600-800 financial institutions chose zero rating.

point is that the zero-rating model means a large number of VAT invoices have to be used and the administrative cost is increased. The Australian model has a moderate cost on tax administration where the tax office allows the financial institution to deduct a specific proportion of costs with a guideline. Financial institutions can adjust the proportion based on their needs and the tax office will subsequent undergo final checks.

3) From the perspective of financial revenue, the equilibriums from left to right in Figure 6 is a process where the government is giving increasing amounts of benefits while firms is receiving increasing amounts of benefits in the zero-rating situation (the red equilibrium). If the financial services purchaser is the final consumer, their actual tax burden is zero, which is the New Zealand's model. Under the full exemption model (blue equilibrium), the firms are being double taxed. If China attempts to use the Australian model, the government should set up a reasonable deduction proportion to maintain the total tax revenue and avoid double taxation.

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