

THE CHOICE OF CHINA'S BUSINESS
TAX TO VALUE ADDED TAX REFORM:
THE TRADITIONAL VAT MODEL OR
THE MODERN GST MODEL?

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ABSTRACT

By implementing the *Pilot Program for the Collection of Value Added Tax instead of Business Tax*, China has started a move to a Value Added Tax (VAT). There were two models of VAT/Goods and Services Tax (GST) available to policymakers: the traditional VAT model and the modern GST model. VATs adopted in the European Union are the typical examples of using the traditional VAT model, whereas the GST system introduced in 1986 in New Zealand is regarded as the leading example of the modern GST model.

This research aims to determine which model China should use going forward to develop further its VAT regime, and provide recommendations for future reforms. First, the thesis introduces the theory and history of VAT, and discusses Adam Smith's four principles of taxation, which are equity, certainty, convenience, and efficiency, along with the principles of simplicity and neutrality. These principles are crucial due to the fact that they are the standard criteria used to evaluate a tax regime. In addition to these principles, debates over the tax base (wide or narrow), tax rate (single or multiple), and the registration threshold (high or low), are also discussed.

Second, this research examines three VAT/GST systems, namely, China's VAT system, the European Union's VAT system, and New Zealand's GST system, in terms of the tax base, tax rate structure, and the registration approach.

Finally, the results of this research show that China chose the traditional VAT model to develop its new VAT regime. By conducting research on the

modern GST model, it is suggested that the single tax rate structure and a broad tax base are the essential requirements for an ideal VAT/GST system. In the light of the *status quo*, the culture of Chinese society may not suit the modern GST system as used in New Zealand because the tax collection and administration level is not at a high standard in China. On the basis that the researcher believes the modern GST model is the best model for China, policymakers in China could develop its VAT by gradually moving towards the modern GST model.

All the laws and exchange rates used in this thesis are as at 12 February 2016.

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CHAPTER 1 INTRODUCTION

This chapter gives an introduction to the background of this research, research questions, and research methods used in this thesis.

1.1 Background

On 16 November 2011, the *Pilot Program for the Collection of Value Added Tax instead of Business Tax* was jointly issued by the Ministry of Finance and the State Administration of Taxation of China (SAT).¹ Under this pilot program, the Central Government of China started the implementation of replacing the turnover tax, called Business Tax² (BT), with the Value Added Tax (VAT) in Shanghai, including the transportation and six modern services industries,³ with effect from 1 January 2012 onwards. Thus the reform of China's turnover tax regime had started, and the action of enlarging the scope of VAT has been gradually unfolding since that date.

In China's turnover tax regime, the scope of the VAT and BT are both mutually exclusive and complementary. The VAT mainly includes marketing goods, imported goods, and providing processing, repair and/or replacements services. The BT mainly includes service industries. Following the rapid economic growth in China in the past twenty years, the co-existence of VAT and BT has

¹ 陈少克, "增值税扩围效应研究: 基于营业税改征增值税试点方案的分析" (2012) 4 *贵州财经学院学报* 46, at 46 (translation: Chen, Shaoke, "The effect of VAT expansion: An analysis based on the pilot program of the collection of VAT instead of Business Tax" (2012) 4 *Journal of Guizhou University of Finance and Economics* 46, at 46).

² The Business Tax in China is a retail sales tax, and is explained in Section 3.2.2 of this thesis.

³ The six services industries include research, development and technical services, information technology services, cultural and creative services, logistics auxiliary services, authentication and consulting services, and movable tangible property leasing services (including operating and finance leasing).

become problematic.⁴ Therefore, in 2012, the Central Government of China launched the Business Tax to Value Added Tax (B2V) reform to address the problems caused by the co-existence of VAT and BT, and also to stimulate economic recovery. The B2V reform has made a substantial impact on the tax burden, and more importantly the overall tax system in China.

In the light of the B2V reform still being in process,⁵ the future expansion of VAT must be in accordance with the long-term readjustment of tax structures in China, and be beneficial to the transformation of the pattern of economic development.⁶ Also, the VAT system should be improved by considering worldwide advanced tax systems, such as New Zealand's Goods and Services Tax (GST) system. Such consideration should include an analysis of each of the tax base, tax rates, registration, tax preference, and coordination of tax collection.

1.2 Importance and Contribution of Research

As mentioned above, in order to tackle the conflict between the rapid economic development and an imperfect turnover taxation system, a nationwide taxation reform process has been implemented in China.

⁴ Lin, Zhijun, "VAT replacing business tax: A major tax reform in China (Value Added Tax)" (2013) 39 *The International Tax Journal* 17, at 18.

⁵ Some industries in China are still subject to the Business Tax, such as the building industry, finance and insurance industry, sports service industry, entertainment industry, and the service trade industry.

⁶ Chen, Shaoke, above n 1, at 47.

New Zealand's GST system is regarded as the most effective and the purest system worldwide.⁷ Douglas provides five "facts" showing that the introduction of New Zealand's GST was successful. The five facts are:⁸

- (1) Within days of its introduction, the GST had the support of two out of every three New Zealanders.
- (2) Within six months of introduction of GST, pollsters no longer asked the public whether or not they agreed with the GST system and GST had ceased to be a political issue.
- (3) Within months, the GST had become an accepted part of the economic framework of New Zealand.
- (4) At a technical level, the introduction of GST went very smoothly, despite all the pressure faced by the IRD, with GST being but one part of the tax reform agenda being put in place.
- (5) Twenty years later, it is still in place, fundamentally unchanged.

However, there is little research relating to New Zealand's GST system that has been undertaken in China.⁹ Most of the academics in China are keen to conduct research on the European Union's VAT system, especially the *Sixth*

⁷ Sawyer, Adrian, "VAT reform in China: Can New Zealand's Goods and Services Tax provide helpful guidance?" (2014) 4 *Journal of Chinese Tax and Policy* 92, at 93.

⁸ Douglas, Roger, "The New Zealand GST policy choice and its political implications" in Krever, Richard and White, David (eds) *GST in Retrospect and Prospect* (Thomson Brookers, Wellington, 2007) 3, at 3.

⁹ See 吴祥佑, "新西兰保险增值税的一个理论解释: 保险本位商品说" (2011) 6 *税务与经济* 84 (translation: see Wu, Xiangyou, "An theoretical explanation of New Zealand's insurance VAT: Insurance product ontology" (2011) 6 *Taxation and Economy* 84). See also 张敏洁, "保险业营业税改增值税的税制设计" (2014) 15 *企业技术开发* 117 (translation: see Zhang, Minjie, "The taxation design of the Business Tax to the VAT on insurance industry" (2014) 15 *Technological Development of Enterprise* 117).

Council Directive, which should be regarded as an example of what the VAT/GST system should not look like.¹⁰ Although this traditional VAT model has its deficiencies, its experience is still useful for China in developing its own VAT system.¹¹ New Zealand's GST system is regarded as the most ideal and effective VAT/GST system in the world,¹² which undoubtedly could provide helpful guidance to the B2V reform in China.

By evaluating the traditional VAT model and the modern GST model, this will assist with gaining an in-depth understanding of these two models, including their basic elements.¹³ More importantly, this research provides an insight to New Zealand's very effective GST system, which has not yet been researched in detail by Chinese academics. Also, some suggestions are offered to the B2V reform based on the analysis on the three VAT/GST systems in terms of Adam Smith's four taxation principles,¹⁴ as well as the principles of simplicity and neutrality because they are two common additions that are adopted by some organisations, such as the Organisation for Economic Co-operation and

¹⁰ Krever, Richard, "Understanding Chinese VAT law: Lessons from abroad [Chinese Language Version]" (2008) 12 *Financial and Economic Law Review* 139, at 147.

¹¹ 邹昱, "欧盟型增值税制: 完善增值税的一种选择" (2013) 5 *地方财政研究* 36, at 37 (translation: Zou, Yu, "European VAT system: A choice of improvement of China's VAT" (2013) 5 *Sub National Fiscal Research* 36, at 37).

¹² Sawyer, above n 7, at 93. Douglas, above n 8, at 3. See Dickson, Ian, "The New Zealand GST policy choice: An historical and policy perspective" in Krever, Richard and White, David (eds) *GST in Retrospect and Prospect* (Thomson Brookers, Wellington, 2007) 1. See Charlet, Alain and Owens, Jeffrey, "An international perspective on VAT" (2010) 20 *Tax Notes International* 943. See also Cnossen, Sijbren, "A VAT primer for lawyers, economists, and accountants" (2009) 124 *Tax Notes International* 319.

¹³ In this research, the basic elements of a VAT/GST system are the tax rates, tax bases and the rules of registration.

¹⁴ These principles are equity, certainty, convenience, and efficiency.

Development (OECD)¹⁵ and the American Institute of Certified Public Accountants (AICPA).¹⁶

1.3 Research Questions

1.3.1 Which model did China choose to develop its new VAT system? And why?

First of all, this question aims to give a detailed elaboration of the three VAT/GST systems¹⁷ by analysing the basic elements. These elements include the tax base, tax rate and the rules of registration. In this thesis, the discussion of the tax base mainly focuses on the breadth of the tax base and the scope of exemptions. As to the tax rate, both the single tax rate and the multiple rates options are fully analysed. The rules of registration are also examined, for instance, the threshold for VAT/GST. Second, by tracing the process of the B2V reform and analysing the main characteristics of the basic elements in these jurisdictions, this research question will be answered. By examining why China chose its model will deepen the researcher's understanding of China's VAT system, by providing reasoned justifications and assumptions. Therefore, this assists in providing suggestions to improve the B2V reform process in China.

¹⁵ OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (OECD Publishing, Paris, 2001) 1, at 50.

¹⁶ The American Institute of Certified Public Accountants, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (AICPA, New York, 2001) 1, at 8.

¹⁷ The three VAT/GST systems refer to the European Union's VAT system, New Zealand's GST system and China's VAT system.

1.3.2 What experiences can be drawn from the modern GST model?

As mentioned, the first research question in this thesis analyses the basic elements of the traditional VAT model and the modern GST model. In addition to this, a comparative method analysis is used between the traditional VAT model and the modern GST model. The comparison focuses on the advantages and disadvantages of these two models through assessing these VAT/GST systems in accordance with Adam Smith's principles of taxation (equity, certainty, convenience and efficiency),¹⁸ and the principles of simplicity and neutrality. Since the first question has been addressed, this comparison is necessary to evaluate the advantages and disadvantages of the VAT system in China. As a result, both the disadvantages of the model which China is following, and the advantages of the New Zealand's model that China is not following, provide important lessons for China's B2V reform.

1.4 Research Approach

1.4.1 Epistemology

Epistemologically, this research adopts a constructionist perspective. This epistemological stance refers to the truth or meaning which comes into existence in the course of our activities in the real world.¹⁹ In regard to the beliefs about the physical and social reality, Chua states:²⁰

¹⁸ Smith, Adam and Cannan, Edwin, *An Inquiry into the Nature and Causes of the Wealth of Nations* (6th ed, Methuen, London, 1950) vol 2, at 310-312. This is a reprint of the original work.

¹⁹ Crotty, Michael, *The Foundations of Social Research: Meaning and Perspective in the Research Process* (Sage Publications, London, 1998) 1, at 9.

²⁰ Chua, Wai Fong, "Radical developments in accounting thought" (1986) 61 *The Accounting Review* 601, at 615.

- (1) Reality is socially created and objectified through human interaction.
- (2) Human action is intentional and has meaning grounded in the social and historical context.
- (3) Social order is assumed and conflict mediated through shared meanings.

The epistemological position of the research is that the objects of this research exist as a result of human interaction. The three VAT/GST systems are socially constructed by human interaction through social and historical practices.

1.4.2 Theoretical perspective

The theoretical perspective of this research is interpretivism which provides an understanding of social reality founded on the researcher's subjective interpretation.²¹ Interpretivism holds that social interaction is being meaningful to humans therefore needs to be interpreted.²² Interpretivism postulates that knowledge generated is subjective and that the findings are presumably true in their given context. Therefore, one of the objectives of interpretivism is to gain access to people's "common-sense thinking" and to interpret their actions from their point of view.²³ The aim of interpretivism is to enrich people's understanding of the meaning of their actions, hence to increase the possibility of mutual communication and influence.²⁴ In terms of this area of research, the

²¹ McKerchar, Margaret, *Design and Conduct of Research in Tax, Law and Accounting* (Thomson Reuters/Lawbook Co, Sydney, 2010) 1, at 75.

²² Bryman, Alan and Bell, Emma, *Business Research Methods* (Oxford University Press, New York, 2011) 1, at 19.

²³ Ibid, at 18.

²⁴ Chua, above n 20, at 615.

evaluation of the three VAT/GST systems is interpreted from various individuals' points of view. The aim of reviewing documents related to these three systems is for the researcher to gain access to people's "common-sense thinking" so that knowledge about the three VAT/GST systems can be interpreted.

1.4.3 Methodology

1.4.3.1 Comparative law

A comparative approach is adopted to provide an insight into the traditional VAT model and the modern GST model, by which advantages and disadvantages of the two models are analysed in detail. By doing so, this research provides helpful guidance to the B2V reform in China.

Before analysing how this methodology will be applied to the research, it is essential to clarify the definition of "comparative law". In the literature, the term means comparing the different legal systems in the world instead of the different rules within a jurisdiction.²⁵ There are two approaches of comparative law in terms of the contents of comparison: macro-comparison and micro-comparison. The object of macro-comparison is a procedure for addressing disputes; in other words, macro-comparison is designed to compare the spirit and style of different legal systems.²⁶ In contrast, micro-comparison seeks to address actual legal problems or a particular conflict of interests.²⁷

²⁵ Zweigert, Konrad and Kötz, Hein, *Introduction to Comparative Law* (3rd ed, Clarendon Press, Oxford, New York, 1998) 1, at 2.

²⁶ *Ibid*, at 4.

²⁷ *Ibid*, at 5.

Research cannot be called a comparative analysis if it only consists of comparing laws in different jurisdictions without providing comments.²⁸ Also, it is less than helpful if the comparison is carried out by simply listing the similarities and differences.²⁹ More importantly, each rule and regulation should be "released" from the context of its own system when the process of comparison begins; this enables the function of rules and regulations to be tested so they can be used as approaches to solve particular issues in other jurisdictions.³⁰ Another distinct feature of the comparative law research methodology is the critical evaluation of the research findings. A comparatist still ought to take into consideration all factors even though there may be a clearly superior solution.

1.4.3.2 Legal research

Legal research comprises two key contents: doctrinal research and non-doctrinal research. Doctrinal research focuses on the analysis of rules or regulations. This type of research is used by researchers who are in search of finding the meaning of rules and regulations according to the philosophy of legal positivism.³¹ On the other hand, McKerchar states that "non-doctrinal legal research usually reflects inductive reasoning and is more in accordance with non- or anti-positivism in terms of its underlying philosophy".³² In other words, non-doctrinal research is research "about law" rather than "in law".³³ Within non-doctrinal research, there are two types: reform-orientated and

²⁸ Ibid, at 43.

²⁹ Ibid, at 43.

³⁰ Ibid, at 44.

³¹ McKerchar, above n 21, at 115.

³² Ibid, at 116.

³³ Ibid, at 9.

theoretical research. However, these two methodologies may not be completely mutually exclusive.³⁴

1.4.3.3 Application

Together, comparative law and legal research form the general guidelines of this study. This research compares the advantages and disadvantages of the traditional VAT model and the modern GST model. As mentioned above, research cannot be called a comparative analysis if it only lists the advantages and disadvantages of the system(s) under consideration. Therefore, this research adopted Adam Smith's four principles of taxation,³⁵ and the principles of simplicity and neutrality as the fundamental standards of assessment. In addition to this, the research focuses on non-doctrinal research in terms of the tax rates, tax bases and the rules of registration, with the aim of analysing the effects of rules and regulations in order to provide useful guidance to China's B2V reform process.

1.4.4 *Methods*

1.4.4.1 Case study

A "case study" usually refers to the use of a pedagogical device in the classroom, whereas a "case" commonly refers to a company in a non-legal context.³⁶ This term may have different meanings under different circumstances. In the academic literature, "case study" is sometimes extended to a comparative study of several cases.³⁷ Therefore, a case study design may

³⁴ Ibid, at 116.

³⁵ These principles are equity, certainty, convenience and efficiency.

³⁶ McKerchar, above n 21, at 102.

³⁷ Ibid, at 102.

consist of a single unit or multiple units.³⁸ A single unit is suitable for research where a new or edificatory phenomenon is the objective.³⁹ In contrast, multiple units may be more appropriate where the researcher selects different phenomena to compare.⁴⁰

Yin articulates five applications of the case study in the book *Case Study Research: Design and Methods*.⁴¹ These include explanation, description, illustration, exploration and meta-evaluation:⁴²

- (1) The most important application is to explain the causal links.
- (2) The second application is to describe a case / cases in the real-world.
- (3) The third application is to illustrate a certain case with making a judgment.
- (4) The fourth application seeks to explore a new theory.
- (5) The last application is an evaluation study which has the prominent role in defining the evaluation questions and relevant data categories.

This thesis examines the VAT systems in the European Union, the GST system in New Zealand and the VAT system in China, as its three cases. First, this research describes and explains the three VAT/GST systems in terms of the tax rates, tax bases and the rules of registration. Then, this research focuses on making judgments in regard to Adam Smith's four principles of taxation, and

³⁸ Ibid, at 103.

³⁹ Ibid, at 103.

⁴⁰ Ibid, at 102-104.

⁴¹ See Yin, Robert, *Case Study Research: Design and Methods* (5th ed, Sage Publications, Thousand Oaks, 2013).

⁴² Ibid, at 15.

the principles of simplicity and neutrality. The aim of this research is to provide helpful guidance for China's B2V reform; thus, China's VAT system is one of the cases. As mentioned above, New Zealand's GST system is regarded as the benchmark; hence, it should be included. As the origin of VAT is from Europe, Krever states that because many academics in China think that China has a close business relationship with the European countries, they are keen to conduct research on their VAT systems, which indicates that those VAT systems are worthy of study.⁴³

1.4.4.2 Document analysis

Document analysis is a systematic process for examining or assessing documents, both printed and electronic.⁴⁴ Bowen states that "document analysis requires that data be examined and interpreted in order to elicit meaning, gain understanding, and develop empirical knowledge".⁴⁵ Six types of documents are referred to by Bryman and Bell. These include personal, public, organizational, mass media, visual and virtual documents.⁴⁶ In addition to these various document types, documents can provide background, data on the context, a means of tracing change and development, and a way to verify findings or corroborate evidence with other sources.⁴⁷ Four criteria from Scott were used to evaluate the quality of documents considered:⁴⁸

- (1) Authenticity. Is the evidence genuine and of unquestionable origin?

⁴³ Krever, above n 10, at 147.

⁴⁴ Bowen, Glenn, "Document analysis as a qualitative research method" (2009) 9 *Qualitative Research Journal* 27, at 27.

⁴⁵ Ibid, at 27.

⁴⁶ Bryman and Bell, above n 22, at 545-557.

⁴⁷ Bowen, above n 44, at 29-30.

⁴⁸ Bryman and Bell, above n 22, at 545.

- (2) Credibility. Is the evidence free from error and distortion?
- (3) Representativeness. Is the evidence typical of its kind, and, if not, is the extent of its untypicality [sic] known?
- (4) Meaning. Is the evidence clear and comprehensible?

This research mainly adopts the document analysis method, with the selection of documents strictly following Scott's four criteria. This research is conducted in the following steps:

- (1) The first step is to examine Adam Smith's four taxation principles and the principles of simplicity and neutrality. This step lays the foundation of this research due to the fact that the three VAT/GST systems are to be evaluated through these principles. Therefore, it is vital to have a deep understanding of these principles.
- (2) The second step is to analyse the VAT/GST laws of the European Union, New Zealand and China, respectively in regard to the tax rates, tax bases and the rules of registration. These three aspects are the objectives of the comparison.
- (3) The third step is to generalise comments related to the three VAT/GST systems in order to deepen the researcher's understanding of these systems. Here, the documents include both primary and secondary sources.⁴⁹
- (4) The fourth step is to examine certain secondary sources in further detail. The purpose of this step is to verify findings or corroborate

⁴⁹ Primary sources include: legislation, case law, and revenue authorities' regulations. Secondary sources include: journals, commentaries, submissions, and interpretations.

evidence between these documents, which further enables a critical evaluation.

- (5) The fifth step is to summarise the comments related to the research questions and make a comparison between the traditional VAT model and the modern GST model. The next is to analyse the reason why China choose the traditional EU model to develop its new VAT system. By doing so, the first research question will be addressed.
- (6) The sixth and final step is to provide useful lessons for China's B2V reform according to the *status quo* in China, and the second research question can be addressed.

1.5 Summary

In conclusion, China commenced a nationwide VAT reform in 2012. There were two models of VAT/GST available to China's policymakers: the traditional VAT model and the modern GST model. VATs used in the European Union are the typical examples of the traditional VAT model, whereas the GST system introduced in New Zealand is a leading example of the modern GST model.

This research aims to analyse the VAT/GST model that China chose on which to base the development of its new VAT regime. In addition, this research provides suggestions for consideration from New Zealand's GST experience. To answer these two research questions, comparative law and legal research form the general guidelines of this study. Case study and document analysis are adopted as the research methods of this study.

CHAPTER 2 LITERATURE REVIEW

There are three main components to this chapter. The first is an introduction of the origin and basic theory of the Value Added Tax/Goods and Services Tax (VAT/GST). Second, Adam Smith's four principles of taxation, including equity, certainty, convenience, and efficiency, and the principles of simplicity and neutrality, are discussed. Third, and in addition three basic elements of a VAT/GST system, which are the tax base, tax rate structure, and the registration threshold, are also discussed.

2.1 Introduction

Taxes on consumption of goods and services, which are called consumption taxes, represent a significant, stable source of revenue for governments around the world.¹ Consumption taxes can be categorised into two forms: taxes on specific goods and services, and taxes on general consumption.² The typical type of taxes on specific goods and services are excise taxes.³ On the other hand, there are four broad forms for taxes on general consumption: the single-stage sales tax, multi-stage turnover tax, retail sales tax, and the VAT/GST.⁴

The single-stage sales tax is the simplest tax among these four types, which is levied only at one stage in the production and distribution process.⁵ The

¹ Krever, Richard and van der Corput, Walter, "Value Added Tax and Business Tax" (2004) *China Tax Reform and WTO Accession Project* 449, at 449.

² OECD, *Consumption tax trends 2014: VAT/GST and excise rates, trends and policy issues* (OECD Publishing, Paris, 2014) 1, at 14.

³ Krever and van der Corput, above n 1, at 449.

⁴ Ibid, at 449-450.

⁵ Ibid, at 449.

multi-stage turnover tax applies at all stages, which is considered to be an inefficient and unfair tax⁶ due to the cascading effect. The retail sales tax aims to impose tax only on final consumption. By exempting transactions from tax, if a person is able to prove that he or she will apply the acquisition to make taxable business supplies in the course of a business, the retail sales tax defers the tax liability to the final stage of consumption.⁷

There are many definitions of VAT/GST. On 11 April 1967, the European Commission issued the *First Council Directive* on the harmonization of legislation of the Member States concerning turnover taxes, which includes a detailed definition of a VAT/GST:⁸

The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged.

On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components.

Schenk, Thuronyi, and Cui define VAT/GST as follows:⁹

⁶ Ibid, at 450.

⁷ Ibid, at 450.

⁸ Schenk, Alan, Thuronyi, Victor, and Cui, Wei, *Value Added Tax: A Comparative Approach* (2nd ed, Cambridge University Press, New York, 2015) 1, at 10-11.

⁹ Ibid, at 17.

A value added tax is a type of multistage sales tax imposed on goods and services that is collected in chunks at each stage of production and distribution of goods or the rendition of services in proportion to the value added by each taxpaying firm.

Krever and Walter define VAT/GST as a general, all-stage turnover tax that aims to tax domestic consumption of goods and services.¹⁰ The aim of a VAT/GST is also to tax only final consumption, which is similar to the retail sales tax. What is different from the retail sales tax is that the VAT/GST is a tax levied on all value-adding stages. The VAT/GST delays the actual tax liability to the final stage of consumption by providing input credits¹¹ for tax paid on inputs that can be claimed from tax paid on outputs.¹² Along with the efficiency of reducing of tax evasion, VAT/GST is now the largest source of taxes on general consumption.¹³ Furthermore, economists commonly take the stance that VAT/GST stimulates investment and saving owing to the fact that it is a tax on consumption rather than income.¹⁴

2.2 The Origin of VAT

Prior to the emergence of VAT in the mid-20th Century, imposing tax on business turnover was popular when firms were organised to manufacture goods and trade them via distributors to retailers.¹⁵ The major defect of this

¹⁰ Krever and van der Corput, above n 1, at 452.

¹¹ The input credit is a credit that the taxpayer may claim against outputs for the value added tax that was paid (or is deemed to have been paid) on the purchases that qualify for credit under that type of VAT. Schenk, Thuronyi, and Cui, above n 8, at 16.

¹² Krever and van der Corput, above n 1, at 450.

¹³ OECD, above n 2, at 16.

¹⁴ Charlet, Alain and Owens, Jeffrey, "An international perspective on VAT" (2010) 20 *Tax Notes International* 943, at 944.

¹⁵ Schenk, Thuronyi, and Cui, above n 8, at 3.

type of tax is the impact of its cascading effect.¹⁶ Before the emergence of VAT, this type of cascading turnover tax was levied every time when goods were traded in the process of production and distribution to the final consumer.¹⁷ In these kinds of situations, the business purchaser, who could not reclaim the tax, would raise the price of goods to cover the tax. Therefore, the price of goods would increase due to the greater the number of stages between the manufacturer and consumer, which caused obvious distortionary effects between highly integrated enterprises and other non-integrated or less-integrated enterprises.¹⁸

In 1918,¹⁹ Dr. Wilhelm Von Siemens, who was a German businessman and governmental consultant, noticed the problems of the general turnover tax, and proposed a new approach for tax on goods, which he called the "improved turnover tax" or "the refined turnover tax."²⁰ This improved turnover tax was seen as a technical innovation that brought a crucial improvement to the general turnover tax.²¹ The improved turnover tax avoided the cascading effect by allowing an input credit.²² Another source of the origin of VAT can be found in American economist Thomas S. Adams writings between 1910 and 1921.²³ Adams discussed a Value Added concept²⁴ and thought that VAT would be an

¹⁶ Jin, Dongsheng and Jin, Weifu, "On the development strategy of China's Value Added Tax (VAT) reform" (2013) 3 *Journal of Chinese Tax and Policy* 226, at 230.

¹⁷ Schenk, Thuronyi, and Cui, above n 8, at 3.

¹⁸ Ibid, at 3.

¹⁹ James, Kathryn, "Exploring the origins and global rise of VAT" (2011) 33 *The VAT Reader (Tax Analysts)* 15, at 15.

²⁰ Sullivan, Clara, *The Tax on Value Added* (Columbia University Press, New York and London, 1965) 1, at 12.

²¹ James, above n 19, at 15.

²² Ibid, at 16.

²³ Ibid, at 15.

²⁴ Schenk, Thuronyi, and Cui, above n 8, at 4.

alternative to the business income tax.²⁵ The basic principle for VAT for these two pioneers is to claim the tax paid on business inputs to prevent the cascading effect, which can also remove the incentive to vertically integrate a business.

The idea of the VAT was not put into practice until 1954 by the so-called father of VAT - Maurice Lauré - who was the joint director of the French tax authorities.²⁶ In the beginning, the tax base²⁷ of the VAT implemented in France was narrow. However, the tax base was enlarged to cover the broader retail sector in 1968.²⁸ Côte d'Ivoire and Senegal introduced a VAT at the manufacturing level after France in the 1960s.²⁹ Through a tax regime reform in 1965, Brazil introduced a VAT which was imposed at all stages of production and distribution.³⁰ In 1967, Denmark introduced a VAT which was applied at all stages of production and distribution, and is regarded as the first full VAT in Europe.³¹ Due to the fact that the most common consumption tax at that time was the retail sales tax,³² less than 10 countries had implemented the VAT system by the late 1960s.³³

²⁵ James, above n 19, at 16.

²⁶ Charlet and Owens, above n 14, at 943.

²⁷ The tax base covered only the manufacturing level. Le, Tuan Minh, "Value-added taxation: Mechanism, design, and policy issues" (2003) *Course on Practical Issues of Tax Policy in Developing Countries* 1, at 2.

²⁸ James, above n 19, at 16.

²⁹ Charlet and Owens, above n 14, at 943.

³⁰ Ibid, at 943.

³¹ The full VAT here refers to a VAT that applied at all stages of production. James, above n 19, at 16.

³² Charlet and Owens, above n 14, at 943.

³³ Owens, Jeffrey, "Improving performance of VAT systems" (2011) 5 *World Commerce Review* 8, at 8.

The first expansion of VAT was in Western Europe and Latin America during the late 1960s and 1970s.³⁴ The rise of the VAT in Europe was accelerated by the fact that a series of European Economic Community (EEC) Directives required its Member States to adopt the VAT as a prerequisite for membership of the European Union (EU, previously the EEC).³⁵

The second period of the adoption of VAT started from the late 1980s. Countries outside the EU, such as Australia, Canada, Japan, Switzerland, and New Zealand, began to introduce their own VAT/GST regimes. In particular, New Zealand introduced its GST in the mid-1980s, which made considerable improvements compared with the European model.³⁶ The New Zealand VAT model is called a Goods and Services Tax, which is different from the general VATs at that time.³⁷ New Zealand's GST model is often recommended when countries seek to introduce a VAT/GST system.³⁸ In addition, the second expansion of VAT extended to countries in Africa and Asia.³⁹ By 1989, there were 48 countries who had adopted a VAT.⁴⁰ With strong support from the International Monetary Fund (IMF),⁴¹ VAT/GST has been implemented in more than 160 countries in over just half a century.⁴²

³⁴ James, above n 19, at 16.

³⁵ Charlet and Owens, above n 14, at 943.

³⁶ Dickson, Ian and White, David, "Tax design insights from the New Zealand Goods and Services Tax (GST) model" (2008) *Victoria University of Wellington CAGTR Working Paper Series, Working Paper No. 60* 1, at 2.

³⁷ New Zealand's GST model is introduced in Section 4.3 of this thesis.

³⁸ Dickson and White, above n 36, at 2.

³⁹ James, above n 19, at 17.

⁴⁰ Norregaard, John and Khan, Tehmina, *Tax Policy: Recent Trends and Coming Challenges* (International Monetary Fund, Washington, D.C., 2007) 1, at 37.

⁴¹ Charlet and Owens, above n 14, at 943.

⁴² OECD, above n 2, at 18.

2.3 VAT in Theory

2.3.1 Five methods of calculating VAT liability

Before embarking further into the theory of VAT, it is essential to establish what is meant by "value added." According to Tait value added is interpreted as follows:⁴³

Value added is the value that a producer (whether a manufacturer, distributor, advertising agent, hairdresser, farmer, race horse trainer, or circus owner) adds to his [sic] raw materials or purchases (other than labour) before selling the new or improved product or service. That is, the inputs (the raw materials, transport, rent, advertising, and so on) are bought, people are paid wages to work on these inputs and, when the final good or service is sold, some profit is left.

From the definition above, value added can be viewed from two approaches: the additive way (wages plus profits) and the subtractive way (output minus input).⁴⁴ Similarly, from the perspective of economics, VAT means to tax the labour compensation value and surplus product value, which is imposed as a tax on wages and profits.⁴⁵ Also, according to the definition above, value added can be represented by the following formula:⁴⁶

$$\text{Value added} = \text{wages} + \text{profits} = \text{output} - \text{input}$$

⁴³ Tait, Alan, *Value-Added Tax: International Practice and Problems* (International Monetary Fund, Washington, D.C., 1988) 1, at 4.

⁴⁴ Ibid, at 4.

⁴⁵ Liao, Shaogang and Pan, Ying, "Analysis on the policy effect of replacing Business Tax with Added-Value Tax" (2015) 3 *International Journal of Economics, Finance and Management Sciences* 162, at 162.

⁴⁶ Tait, above n 43, at 4.

Basically, there are four methods of calculating VAT liability: the additive-direct method (or accounts methods), additive-indirect method,⁴⁷ sales-subtraction method, and the credit-subtraction method.⁴⁸ The credit-subtraction method is further divided into two methods: the credit-invoice method and the credit-subtraction method without invoices.⁴⁹

2.3.1.1 The additive-direct method

Under the additive-direct method, a taxable enterprise computes its tax liability for each tax period by means of summing the enterprise's economic components of production for the period, such as wages, interest and rent costs, and profit for VAT purposes.⁵⁰ Then, the taxable enterprise calculates its tax payable through multiplying the total amount by a certain tax rate.

2.3.1.2 The additive-indirect method

While the additive-direct method calculates the total amount of value added before multiplying the tax rate, the additive-indirect method computes tax payable of each component of value added separately.

The problem of using the additive-direct and additive-indirect methods is that multiple tax rates cannot be adopted because the company accounts do not usually separate sales from different product items in accordance with different tax rates.⁵¹

⁴⁷ Ibid, at 4.

⁴⁸ Schenk, Alan and Oldman, Oliver, *Value Added Tax: A comparative Approach in Theory and Practice* (Transnational Publishers, New York, 2001) 1, at 30.

⁴⁹ Ibid, at 36-38.

⁵⁰ Schenk, Thuronyi, and Cui, above n 8, at 33.

⁵¹ Tait, above n 43, at 5.

2.3.1.3 The sales-subtraction method

Under the sales-subtraction method, a VAT taxable enterprise computes its net VAT liability by means of multiplying the total taxable sales after subtracting total taxable purchases from other enterprises by the tax rate.⁵² The calculation of the difference is based on purchase and sales data from each tax period rather than each taxable sale.⁵³ Therefore, under this method, the prices of taxable goods are inclusive of VAT; hence, the data in the financial accounts are recorded at tax-inclusive prices.⁵⁴ This means the VAT under the sales-subtraction method is levied on tax-inclusive prices.⁵⁵

The sales-subtraction method causes an issue for VAT; that is, should the tax rate be levied on a price inclusive or exclusive of the tax liability? Theoretically, there is no significant difference whichever method is used.⁵⁶ By changing the tax rate, these two methods can achieve the same goal of producing fiscal revenue.⁵⁷ For example, a 10 per cent tax rate imposed on tax-exclusive price is approximately equivalent to an effective 9.0909 per cent tax rate imposed on a tax-inclusive price. To date, most of countries in the world choose to levy VAT on a price exclusive of the tax liability.⁵⁸

⁵² Schenk, Thuronyi, and Cui, above n 8, at 31.

⁵³ Schenk and Oldman, above n 48, at 39.

⁵⁴ Schenk, Thuronyi, and Cui, above n 8, at 31.

⁵⁵ Schenk and Oldman, above n 48, at 39.

⁵⁶ Tait, above n 43, at 8.

⁵⁷ Ibid, at 8.

⁵⁸ In practice, although France originally adopted that, only Finland and Sweden have persistently used the tax-inclusive base. Tait, above n 43, at 8.

2.3.1.4 The credit-invoice method

The credit-invoice method was devised in Europe, and is based on a tax-against-a-tax methodology.⁵⁹ Under the credit-invoice method, a VAT taxable enterprise computes its net VAT liability for each tax period as the difference between the tax paid on taxable sales (output tax) and the tax paid on purchases from other VAT taxable enterprises (input tax).⁶⁰ The input tax can be claimed against the output tax on condition that the business inputs are used in making taxable sales.⁶¹ The input tax⁶² is equal to taxable purchases⁶³ multiplied by the tax rate, which is normally listed on the suppliers' tax invoices. The output tax is equal to taxable sales multiplied by the tax rate, which is generally listed on the sellers' tax invoices.

The mechanism of the credit-invoice is analogous to the withholding at source concept in income tax.⁶⁴ Part of the final amount of the VAT is collected at each stage in the process of production and distribution. At the same time, the input tax is claimable unless the purchaser is the ultimate consumer.⁶⁵

2.3.1.5 The credit-subtraction method without invoices

The credit-subtraction method without invoices was introduced by the Japanese Consumption Tax (JCT) in 1989.⁶⁶ Under the credit-subtraction method without invoices, a VAT taxable enterprise computes the net tax liability the

⁵⁹ Schenk, Thuronyi, and Cui, above n 8, at 28.

⁶⁰ Ibid, at 28.

⁶¹ Ibid, at 29.

⁶² The input tax is also called the input credit.

⁶³ The taxable purchases include both taxable imports and taxable domestic purchases.

⁶⁴ Schenk, Thuronyi, and Cui, above n 8, at 29.

⁶⁵ Ibid, at 29-30.

⁶⁶ Ibid, at 30.

same way as under the credit-invoice method. However, this method differs from the credit-invoice method which requires the tax invoices as vouchers in order to reclaim the input tax.⁶⁷ The credit-subtraction method without invoices relies on the financial account records to calculate the input tax and the output tax.⁶⁸

2.3.1.6 Summary

As a visual aid, the five methods of calculating net tax liability are summarised in Table 2.1.

Table 2.1 Five basic methods of calculating the net tax liability

The additive-direct method	$t^{69} (\text{wages} + \text{profit})$
The additive-indirect method	$t (\text{wages}) + t (\text{profit})$
The sales-subtraction method	$t (\text{output} - \text{input})$
The credit-invoice method	$t (\text{output}) - t (\text{input})$
The credit-subtraction method without invoices	$t (\text{output}) - t (\text{input})$

The additive-direct method and the additive-indirect method are not used by countries at the national level; and the sales-subtraction method has never been put into practice.⁷⁰ Japan is the only country using the credit-subtraction method without invoices.⁷¹ Therefore, the credit-invoice method is the most

⁶⁷ Schenk and Oldman, above n 48, at 38.

⁶⁸ Ibid, at 38.

⁶⁹ Here, t refers to a tax rate of VAT/GST.

⁷⁰ Schenk, Thuronyi, and Cui, above n 8, at 28.

⁷¹ Schenk and Oldman, above n 48, at 38.

prevalent method used worldwide to calculate the net VAT liability.⁷² There are at least three advantages of the credit-invoice method:⁷³

- (1) The credit-invoice method links the tax liability to the transaction, making it legally and technically superior than other methods. This is because the invoice is an important evidence of the trade and the tax liability. In addition to this, the credit-invoice method builds a document trail for auditing purposes.
- (2) Compared with the additive-direct method and the additive-indirect method, under which companies find it difficult to calculate their value added by adding wages and profits monthly, the credit-invoice method relies on invoices, which means the tax liability can be computed conveniently. Under the credit-invoice method, the tax liability can also be computed annually, quarterly, monthly, and even weekly.
- (3) As mentioned above, under the additive-direct method and the additive-indirect method, company accounts do not usually separate sales from different product items in accordance with different tax rates; therefore, multiple tax rates cannot be used under these two methods. In contrast, a multiple tax rate VAT is applicable under the credit-invoice method.

⁷² Schenk, Thuronyi, and Cui, above n 8, at 28.

⁷³ Tait, above n 43, at 5-6.

2.3.2 Capital purchases

Shoup interprets "inputs purchased" as follows:⁷⁴

The items that a firm purchases from other firms consist of raw materials, semi-manufactured goods, supplies used up in the process of manufacture or handling, services (e.g., banking, insurance, advertising), finished goods ready for resale to consumers (in the case of a retailer), and finally machinery, equipment, and other capital goods.

According to the theory of VAT explained above, taxes paid on inputs, including capital goods⁷⁵ from other VAT taxable enterprises, would be claimable. However, the substantial purchases of capital goods can cause considerable fluctuation in tax liability.⁷⁶ Three types of VAT can be classified in terms of the varied treatments of capital goods.⁷⁷ They are the gross product type of VAT, income type of VAT, and the consumption type of VAT.⁷⁸ In China, these three types of VATs are called the production-based VAT, revenue (income)-based VAT, and the consumption-based VAT, respectively.⁷⁹

⁷⁴ Shoup, Carl, *Public Finance*, (Weidenfeld and Nicolson, London, 1969) 1, at 251.

⁷⁵ Capital goods refer to any asset that will not be used up entirely within the tax year of purchase. Ibid, at 251.

⁷⁶ Tait, above n 43, at 6.

⁷⁷ Schenk and Oldman, above n 48, at 34.

⁷⁸ Shoup, above n 74, at 251-253.

⁷⁹ Lin, Zhijun, "Value Added Tax in China and its reform" (2009) 35 *International Tax Journal* 65, at 66.

2.3.2.1 The gross product type of VAT

Under the gross product VAT, the input tax is claimable only on the condition that the VAT paid for purchasing business inputs excludes capital goods.⁸⁰ The input tax paid to acquire capital goods cannot be claimed from the output tax for the calculation of VAT payable.

2.3.2.2 The income type of VAT

Similar to the gross product type of VAT, the input tax paid on capital goods cannot be claimed in the year of purchase. However, the amount of depreciation of capital goods, which occurs during the year, can be regarded as a reduction against the output tax.⁸¹

2.3.2.3 The consumption type of VAT

Under the consumption type of VAT, the input tax paid on capital goods can be fully claimed in the current tax period.⁸² Most VATs used today are a consumption type of VAT; a few countries are still in the process of changing their VAT to a consumption type of VAT.⁸³ It is easy to conclude that when there are capital goods purchased, the consumption type of VAT generates the least fiscal revenue, and the gross product type of VAT generates the most fiscal revenue.

⁸⁰ Shoup, above n 74, at 251.

⁸¹ Ibid, at 252.

⁸² Ibid, at 253.

⁸³ Schenk, Thuronyi, and Cui, above n 8, at 28.

2.4 Principles of Taxation

In 1776, economist Adam Smith published his landmark work *An Inquiry into the Nature and Causes of the Wealth of Nations*.⁸⁴ In a chapter entitled "Of the Sources of the General or Public Revenue of the Society," Smith outlined four principles of an optimal framework for a tax system. The four principles of taxation include equity, certainty, convenience, and efficiency.⁸⁵ Alley and Bentley point out that:⁸⁶

These principles are important to the creation of tax policy, because it is only when these principles are upheld that effective taxes are implemented in a manner which satisfies the stated purposes of a tax system.

In addition to these four principles, economists and other researchers have added further principles to this list. Two common additions are neutrality and simplicity, which have been adopted by the *Carter Report - Canada*,⁸⁷ the Organisation for Economic Co-operation and Development (OECD),⁸⁸ and the American Institute of Certified Public Accountants (AICPA).⁸⁹

⁸⁴ Smith, Adam and Cannan, Edwin, *An Inquiry into the Nature and Causes of the Wealth of Nations* (6th ed, Methuen, London, 1950) vol 2. This is a reprint of the original work.

⁸⁵ Ibid, at 310-312.

⁸⁶ Alley, Clinton and Bentley, Duncan, "A remodelling of Adam Smith's tax design principles" (2005) 20 *Australian Tax Forum* 579, at 586.

⁸⁷ See Canada, *Report of the Royal Commission on Taxation (Carter Report)* "The use of the tax system to achieve economic and social objectives" (1966), Ch 1.

⁸⁸ OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (OECD Publishing, France, 2001) 1, at 50.

⁸⁹ The American Institute of Certified Public Accountants, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (AICPA, New York, 2001) 1, at 8.

Therefore, Adam Smith's four principles of taxation, and the principles of neutrality and simplicity, are considered for this research. The following discussing elaborates on each principle.

2.4.1 Equity

The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.⁹⁰

According to the quotation above, Smith believed that the tax paid by a person should be in accordance with their ability to pay and the benefits received. The Carter Commission took equity as the main objective of a tax system due to the fact that the fundamental aim of taxation is lost when a tax system is commonly accepted as unfair.⁹¹

From the taxpayers' point of view, equity or fairness generally refers to an equitable distribution of the tax burden.⁹² There are at least seven dimensions of fairness.⁹³ Two most commonly referred to are horizontal and vertical equity:⁹⁴

⁹⁰ Smith and Cannan, above n 84, at 310.

⁹¹ Carter Report, above n 87, at 27.

⁹² Ibid, at 27.

⁹³ These dimensions are: general fairness; exchange fairness; horizontal fairness; vertical fairness (measured by ability to pay); retributive fairness; personal fairness; and administrative fairness. See Saad, Natrah, *Fairness Perceptions and Compliance Behaviour: Taxpayers' Judgments in Self-Assessment Environments* (Unpublished PhD thesis at the University of Canterbury, New Zealand, 2011), <<http://ir.canterbury.ac.nz/handle/10092/5065>>. See also Richardson, Grant, "A preliminary study of the impact of tax fairness perception dimensions on tax compliance behaviour in Australia" (2005) 20 *Australian Tax Forum* 407; Richardson,

- (1) Horizontal equity requires that taxpayers who are in similar situations should receive similar tax treatment, eg taxpayers who earn the same amount of income or capital should be treated in the same way.
- (2) Vertical equity means that taxpayers in different situations should be treated differently, eg taxpayers with more income and/or capital should pay more tax.

It seems that researchers have a common understanding of horizontal and vertical equity.⁹⁵ However, this does not mean that there are no issues when these principles are put into practice. For example, these issues include:

- (1) How does one know if two people are in the same or similar situations (horizontal equity) or in different situations (vertical equity)?⁹⁶

Grant, "An exploratory cross-cultural study of tax fairness perceptions and tax compliance behaviour in Australia and Hong Kong" (2005) 31 *International Tax Journal* 11; Tan, Lin Mei, "Taxpayers' perceptions of fairness of the tax system: A preliminary study" (1998) 4 *New Zealand Journal of Taxation Law and Policy* 59.

⁹⁴ Maples, Andrew, "Chapter 1 The Tax Environment" in Vosslander, Robert (eds) *New Zealand Taxation 2015 Principles, Cases and Questions* (Thomson Brookers, Wellington 2015) 1, at 13.

⁹⁵ For example, James and Nobes believe that horizontal equity is the most obvious important aspect of equity or fairness, which "is to treat equal people in equal circumstances in an equal way." In contrast, "different treatment of people in different circumstances would be used to preserve vertical equity." James, Simon and Nobes, Christopher, *The Economics of Taxation: Principles, Policy and Practice* (Fiscal Publications, Birmingham, 2012) 1, at 78. Greenheld believes that "horizontal equity is when individuals earning the same amount of income pay the same amount of tax," and vertical equity means "an individual with the greater ability to pay should be paying more tax proportionately." Alley and Bentley, above n 86, at 603-604.

⁹⁶ Maples, above n 94, at 13.

- (2) Does equality mean equality of income, expenditure, wealth, total utility, benefit gained from the expenditure of the tax-raising authority, or some combination of these and other factors?⁹⁷

From the works of Smith, two key concepts can be adopted to measure equity: the ability to pay and the benefits received.

Veseth suggests that Adam Smith saw equity in terms of the ability to pay.⁹⁸ Therefore, those who have a greater ability to pay should pay proportionately more taxes than those who have a lower ability to pay, and the same taxes should be levied on those with the same ability to pay. This measure raises another issue; that is, how to determine the basis of the ability to pay. Should it be according to income, expenditure, or wealth? Basically, an increment in any of income, expenditure, or wealth, indicates an increasing ability to pay.⁹⁹ Amongst these measures, income may be the most obvious one to show an increasing ability to pay.¹⁰⁰ However, critical arguments are put forward against adopting income as the basic measure. These arguments are mainly from those who support either using expenditure or wealth as the basis. For example, some researchers who support using expenditure, claim that if "income includes capital gains, gifts received, and gambling wins," they should be included in the tax base.¹⁰¹ Other researchers suggest that taxation should be

⁹⁷ James and Nobes, above n 95, at 78.

⁹⁸ Veseth, Michael, *Public Finance* (Reston Publishing Company Inc, United States, 1984) 1, at 176.

⁹⁹ James and Nobes, above n 95, at 80.

¹⁰⁰ Ibid, at 80.

¹⁰¹ Ibid, at 80.

based on consumption rather than income, due to the fact that "saving and investment are regarded as beneficial, whereas consumption is anti-social."¹⁰²

James and Nobes argue that saving is just a choice to delay consumption on economic grounds, and by accumulating capital, benefits of status and economic power are obtained.¹⁰³ They claim that wealth can arise from an individual's savings out of income, and other means, such as inheritance, gifts, and gambling. All of these means would cause inequity. For example, in the case of savings, both income and capital that has been accumulated out of taxed income have been taxed. In contrast, in the case of inheritance, gifts and gambling, a wealth tax would amount to double taxation.¹⁰⁴ In practice, using income as the basis of ability to pay is the most prevalent approach.¹⁰⁵ Therefore, regardless of the challenges, James and Nobes prefer using income as the basic measure of the ability to pay.

An alternative approach to measure equity or fairness is related to the public benefits received. According to this approach, those who obtain the most benefits from the government should pay the most tax for their benefits.¹⁰⁶ Researchers who support this view advocate that taxpayers' will only pay tax voluntarily on condition that there is a relationship between what they pay (e.g., taxes) and what they receive (e.g., the benefits provided by the government).¹⁰⁷ James and Nobes agree that "the main attraction of the benefit approach is that

¹⁰² Ibid, at 81.

¹⁰³ Ibid, at 81.

¹⁰⁴ Ibid, at 81-82.

¹⁰⁵ Ibid, at 81.

¹⁰⁶ Lymer, Andrew and Hancock, Dora, *Taxation: Policy & Practice* (Thomson Learning, London, 2001) 1, Ch 3, at 10.

¹⁰⁷ Maples, above n 94, at 14.

it can include both the taxation and the resulting government expenditure."¹⁰⁸ However, due to the nature of government expenses, the benefits are difficult to identify and assess, especially for individual recipients.¹⁰⁹ Lymer and Hancock believe that the benefit approach is a crude measure owing to the fact it is hard to evaluate how much benefit a taxpayer gains from the services provided by the government.¹¹⁰

Additionally, taxpayers' perceptions towards the equity or fairness of a tax system can influence tax compliance. Maples claims that taxpayers tend to avoid or evade their tax liabilities when they perceive the tax system to be inequitable or unfair.¹¹¹ Furthermore, Ross, Burgess, and Krever suggest that policymakers should take into consideration administrative and compliance problems to achieve the principle of equity when designing a tax system.¹¹² The AICPA also suggests when evaluating the principle of equity, the whole range of taxes borne by a taxpayer, namely the entire taxes of a state, should be considered, instead of just one type of tax.¹¹³

2.4.2 *Certainty*

The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be

¹⁰⁸ James and Nobes, above n 95, at 80.

¹⁰⁹ Ibid, at 79.

¹¹⁰ Lymer and Hancock, above n 106, Ch 3, at 10.

¹¹¹ Maples, above n 94, at 14.

¹¹² Ross, Ysaiah, Burgess, Philip, and Krever, Richard, *Income Tax: A Critical Analysis* (2nd ed, LBC Information Services, North Ryde, 1996) 1, at 26.

¹¹³ AICPA, above n 89, at 9.

paid, ought all to be clear and plain to the contributor, and to every other person.¹¹⁴

According to this quotation by Adam Smith, a tax system should clarify when and how the tax is to be paid, which enables taxpayers to determine what is subject to tax (the tax base), and at what tax rate(s).¹¹⁵ Maples points out that uncertain tax legislation creates dissension between taxpayers and tax authorities because uncertainty gives both taxpayers and tax authorities an opportunity to interpret the ambiguous tax legislation.¹¹⁶

Alley and Bentley believe that certainty derives from the clear tax legislation, and it is difficult to accomplish this goal owing to the complexity of tax law (i.e., its content).¹¹⁷ Also, the AICPA states that the principle of certainty is closely connected with the principle of simplicity, owing to the fact that the more complex the tax legislation, the more likely the tax rules or regulations will lack certainty.¹¹⁸ In contrast, James, Sawyer, and Wallschutzky hold a different view, where they state that ambiguous or unclear legislation leads to new provisions in the law or new authorities, which may clarify but also cause the tax system to be more complex.¹¹⁹ This is because that both taxpayers and officials need instructions when legislation is ambiguous or unclear.¹²⁰

¹¹⁴ Smith and Cannan, above n 84, at 310-311.

¹¹⁵ AICPA, above n 89, at 9.

¹¹⁶ Maples, above n 94, at 16.

¹¹⁷ See Alley and Bentley, above n 86.

¹¹⁸ AICPA, above n 89, at 10.

¹¹⁹ James, Simon, Sawyer, Adrian, and Wallschutzky, Ian, "Tax simplification: A review of initiatives in Australia, New Zealand and the United Kingdom" (2015) 13 *eJournal of Tax Research* 1, at 10.

¹²⁰ *Ibid*, at 10.

2.4.3 Convenience

Every tax ought to be levied at the time, or in the manner in which it is most likely to be convenient for the contributor to pay it.¹²¹

This principle means that the tax should be imposed in a most convenient method with respect to both time and manner. Greenheld believes that the level of convenience of tax collection varies depending on the different types of taxes.¹²² Withholding and periodic payments of estimated tax liability are typical approaches to facilitate tax payment.¹²³

There are a number of views related to the relationship between convenience and tax compliance. For example, the AICPA states that the more inconvenient a tax is to pay, the more probable it will not be paid due to the fact that convenience is crucial in helping to ensure tax compliance.¹²⁴ Alley and Bentley also believe that compliance costs can lower the convenience of a tax system. A study by Sawyer and Hite in 1997 estimated that taxpayers incurred between NZ\$1.5 and NZ\$2 billion in compliance costs each year.¹²⁵ This suggests that overall the tax system in New Zealand was not convenient for taxpayers at that time.¹²⁶ However, since then, the Inland Revenue Department (IRD) in New Zealand has made some efforts to simplify its tax system, especially the income tax system.¹²⁷ The effect can be evidenced from the data

¹²¹ Smith and Cannan, above n 84, at 311.

¹²² Alley and Bentley, above n 86, at 610.

¹²³ AICPA, above n 89, at 10.

¹²⁴ Ibid, at 10.

¹²⁵ Alley and Bentley, above n 86, at 610. See also Sawyer, Adrian and Hite, Peggy, "A comparison of compliance cost estimates for tax systems in the United States and New Zealand" (1997) 51 *Bulletin for International Fiscal Documentation* 93.

¹²⁶ Alley and Bentley, above n 86, at 610.

¹²⁷ Ibid, at 610.

from the IRD's *SME tax compliance costs 2004 to 2013: Evaluation Report 2*, which show that the average annual compliance costs for all small and medium sized businesses is NZ\$5,861.00, decreasing by 11.7 per cent compared with NZ\$6,640.00 in 2004.¹²⁸

2.4.4 Efficiency

Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.¹²⁹

On efficiency, the OECD in the *Ottawa Taxation Framework Conditions*, comments that "compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible."¹³⁰ Similarly, the AICPA states in, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, that "the costs to collect a tax should be kept to a minimum for both the government and taxpayers."¹³¹ Alley and Bentley believe that both the OECD and the AICPA define efficiency narrowly, being limited to minimising compliance and administration costs by enhancing taxpayer service and tax administration.¹³² However, they argue that this

¹²⁸ Inland Revenue, "*SME tax compliance costs 2004 to 2013: Evaluation Report 2*" (15 April 2015) Inland Revenue
<http://www.ird.govt.nz/resources/4/a/4a31ee11-4a0e-4a77-9e7b-86f5144e2820/sme-tax-compliance-costs-2004-2013-evaluation-report-2.pdf> at 17. However, contrary evidence can be found in Gupta and Sawyer's recent research, which indicates in fact the compliance costs for small and medium sized businesses increased. See Gupta, Ranjana and Sawyer, Adrian, "Tax compliance costs for small businesses in New Zealand: Some recent findings" (2015) 30 *Australian Tax Forum* 135.

¹²⁹ Smith and Cannan, above n 84, at 311.

¹³⁰ OECD, above n 88, at 18.

¹³¹ AICPA, above n 89, at 10.

¹³² Alley and Bentley, above n 86, at 596.

narrow definition of efficiency could have the most influence on the widest number of taxpayers, due to the fact that minimising taxpayers' compliance costs and reducing administrative costs mainly focuses on the tax authorities, and most improvements can be done in the short-term in these areas.¹³³

There are two concepts that need to be clarified, namely compliance costs and administrative costs. According to Sandford and Hasseldine,¹³⁴ compliance costs are defined to be "those costs incurred by taxpayers in meeting the requirements laid on them by tax law, over and above the payment of tax, and over and above any distortion costs inherent in the nature of the tax."¹³⁵ Compliance costs may include monetary costs, time costs, and psychic/psychological costs that derive from stress and anxiety related to understanding tax laws or preparation for paying tax.¹³⁶ On the other hand, administrative costs are defined as "the cost incurred by the public sector to collect tax, and essentially are the costs of running the tax system."¹³⁷

The AICPA states that administrative costs for the government and compliance costs for taxpayers are proportional to the complexity of the tax regime.¹³⁸ Therefore, the principle of efficiency is also closely associated with the principle of simplicity.¹³⁹

¹³³ Ibid, at 596.

¹³⁴ Sandford, Cedric and Hasseldine, John, *The Compliance Costs of Business Taxes in New Zealand* (Institute of Policy Studies, Wellington, 1992) 1, at 5.

¹³⁵ Maples, above n 94, at 19.

¹³⁶ Ibid, at 19.

¹³⁷ Ibid, at 19.

¹³⁸ AICPA, above n 89, at 10.

¹³⁹ Ibid, at 10.

2.4.5 Neutrality

The principle of neutrality is derived from, and is a further extension of, the notion of efficiency, which is sometimes termed economic efficiency.¹⁴⁰ The AICPA offers a definition of neutrality, that is:¹⁴¹

The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

This means taxpayers' business or personal activities should not be unduly influenced by the tax law due to the fact that raising fiscal revenue for government is the main objective of the taxation system, rather than affecting taxpayers' economic behaviours.¹⁴² Therefore, the AICPA take the stance that "the effect of the tax law on business and personal decisions should be kept to a minimum."¹⁴³

However, Alley and Bentley believe the assumption that raising revenue is the main objective for governmental activities is not always the case.¹⁴⁴ This is because "taxation can also be used to further social and economic objectives and as such certain types of taxes are designed not to be neutral."¹⁴⁵ For example, most countries such as New Zealand and China, levy a tax on tobacco to reduce consumption for the purpose of health.

¹⁴⁰ Frecknall-Hughes, Jane, *The Theory, Principles and Management of Taxation: An Introduction* (Routledge, New York, 2015) 1, at 33.

¹⁴¹ AICPA, above n 89, at 10-11.

¹⁴² Ibid, at 10-11.

¹⁴³ Ibid, at 10.

¹⁴⁴ Alley and Bentley, above n 86, at 616.

¹⁴⁵ Ibid, at 616.

Similarly, Veseth believes that "neutral taxes collect revenue without disturbing the market's invisible hand; they don't alter choices among goods, between spending and saving, or between work and leisure."¹⁴⁶ The Haig-Simons model claims that "all net accretions to wealth should be taxed."¹⁴⁷ This theory means that a unified taxation should be imposed comprehensively on the tax base; therefore distortionary effects of taxation will be minimised, and as a result, the principle of equity and efficiency can be achieved.¹⁴⁸ Ross, Burgess, and Krever¹⁴⁹ believe that tax considerations should not be taken into account when deciding to purchase one supply as over another.¹⁵⁰ From this perspective, Alley and Bentley point out that the GST system in New Zealand can be regarded as neutral since it applies to almost all supplies, with limited exemptions.¹⁵¹

The OECD provides six guidelines to achieve the principle of neutrality in practice. These guidelines are produced especially for the implementation of the international VAT, and designed for the implementation of VAT on cross-border trade. However, some of these guidelines, such as Guidelines 2 and 3, are still suitable for the general tax system in terms of the principle of neutrality. These guidelines are:¹⁵²

¹⁴⁶ Veseth, above n 98, at 181.

¹⁴⁷ Alley and Bentley, above n 86, at 592.

¹⁴⁸ Ibid, at 592. See also, Head, John, "Capital gains taxation - An economic perspective" (1984) 1 *Australian Tax Forum* 148.

¹⁴⁹ Ross, Burgess, and Krever, above n 112, at 26.

¹⁵⁰ Alley and Bentley, above n 86, at 615.

¹⁵¹ Ibid, at 615.

¹⁵² OECD, *OECD International VAT/GST Guidelines Draft Commentary on the International VAT Neutrality Guidelines* (OECD Publishing, Paris, 2012) 1, at 4 (emphasis added).

- (1) Guideline 1, the burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.
- (2) **Guideline 2, businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.**
- (3) **Guideline 3, VAT rules should be framed in such a way that they are not the primary influence on business decisions.**
- (4) Guideline 4, with respect to the level of taxation, foreign business should not be disadvantaged nor advantaged compared to domestic businesses in the jurisdiction where the tax may be due or paid.
- (5) Guideline 5, to ensure foreign businesses do not incur irrecoverable VAT, governments may choose from a number of approaches.
- (6) Guideline 6, where specific administrative requirements for foreign businesses are deemed necessary, they should not create a disproportionate or inappropriate compliance burden for the businesses.

2.4.6 Simplicity

Cooper concludes that the term "simplicity" has at least seven features:¹⁵³

- (1) Predictability. In this context, a rule would be simple if that rule and its scope were easily and accurately understood by taxpayers and their advisers.

¹⁵³ Cooper, Graeme, "Themes and issues in tax simplification" (1993) 10 *Australian Tax Forum* 417, at 424.

- (2) Proportionality. A rule would be simple if the complexity of the solution were no more than reasonably necessary to achieve the intended aim.
- (3) Consistency. This would apply where a rule deals with similar issues in the same way and without the need to make arbitrary distinctions.
- (4) Compliance. A rule would be simple if it were easy for taxpayers to comply without incurring excessive costs.
- (5) Administration. A rule would be simple if it were easy for a revenue authority to administer.
- (6) Co-ordination. A rule would be simple if it fitted appropriately with other tax rules; it would be complicated if its relationships with other rules were obscure.
- (7) Expression. A rule would be simple if it were clearly expressed.

Cooper also points out that there are three levels of simplification:¹⁵⁴

- (1) The first level is the choice of the tax base, whatever that may be.
- (2) The second is the design of the rules to be applied to the tax base.
- (3) The third is in the expression of those rules and the final level of complexity is the administrative requirements imposed on taxpayers.

It is easier for taxpayers to understand their obligations and entitlements when faced with a simple tax system.¹⁵⁵ MiHu claims that a tax system should be

¹⁵⁴ James, Sawyer, and Wallschutzky, above n 119, at 6.

simple so taxpayers easily abide by it, which helps in promoting better and effective administration of taxes and fees.¹⁵⁶ Kabinga believes that a tax system should not be too intricate in order to understand how to compute and ultimately ascertain tax.¹⁵⁷ Further Kabinga argues that a tax system should be plain and simple for taxpayers to follow, which in turn, increases the likelihood of tax compliance.¹⁵⁸

Tran-Nam suggests that there are two types of simplicity: legal simplicity and effective simplicity.¹⁵⁹ Sawyer provides a simple way to explain Tran-Nam's two concepts, that is, legal simplicity refers to "how difficult is a tax law to read and understand," whereas, effective simplicity refers to "how easy is it to determine the correct tax liability."¹⁶⁰ James, Sawyer, and Wallschutzky believe that with advances in technology, it is possible to keep the administration simple for taxpayers in spite of a very complex tax system overall.¹⁶¹ Therefore, "achieving simplicity in a tax system does not stop with legislation but extends to tax administration."¹⁶²

On the other hand, while James, Sawyer, and Wallschutzky suggest that simplicity is one of the factors used to assess a particular tax or proposed tax

¹⁵⁵ OECD, "Fundamental principles of taxation" in OECD (ed) *Addressing the Tax Challenges of the Digital Economy* (OECD Publishing, Paris, 2014) 1, at 30.

¹⁵⁶ Mihiu, Stefan, "Reforming the tax code: Modern principles of taxation" (2011) 6 *Economics, Management, and Financial Markets* 942, at 947-948.

¹⁵⁷ Kabinga, Musonda, "Principles of taxation" (2015) *Paper 5 of the Introduction to the Project "Tax Justice & Poverty"* 1, at 11.

¹⁵⁸ *Ibid*, at 11.

¹⁵⁹ Tran-Nam, Binh, "Tax reform and tax simplification: Some conceptual issues and a preliminary assessment" (1999) 21 *Sydney Law Review* 500, at 505.

¹⁶⁰ Sawyer, Adrian, "Rewriting tax legislation - Can polishing silver really turn it into gold?" (2013) 15 *Journal of Australian Taxation* 1, at 25.

¹⁶¹ James, Sawyer, and Wallschutzky, above n 119, at 14.

¹⁶² Kabinga, above n 157, at 11.

reform, it is not always the most important one.¹⁶³ They point out that there are other important considerations, such as equity.¹⁶⁴ Generally, complexity often wins over simplicity when taking into account fairness in taxation, namely in that when it comes to fairness a simple tax may be not acceptable.¹⁶⁵ A celebrated example¹⁶⁶ of sacrificing simplicity for fairness can be found in exemptions in the United Kingdom's (UK) VAT system, for example whether cakes with chocolate coverings are exempt from VAT. Essentially, food is VAT zero-rated in the UK, but confectionery is one of the exceptions. However, there is an exception to the exception (confectionery), that is, cakes are zero-rated. Furthermore, there is another exception to the exception (cakes), which is cakes partly or wholly covered with chocolate are taxed at a standard rate. Therefore, fairness may lead to a complex tax system, and as a result, complexity will arise, with simplicity the trade-off for fairness in taxation.

Sawyer points out that simplifying the tax law is one of the means to encourage voluntary compliance.¹⁶⁷ In a similar manner, Alley and Bentley also comment that:¹⁶⁸

if tax law is simple it will be more certain, which will improve the compliance process and enable taxpayers to better understand the tax consequences of transactions in which they engage in or plan to engage.

¹⁶³ James, Sawyer, and Wallschutzky, above n 119, at 7.

¹⁶⁴ Ibid, at 7.

¹⁶⁵ Ibid, at 8-9.

¹⁶⁶ James, Sawyer, and Wallschutzky, above n 119, at 9.

¹⁶⁷ Sawyer, Adrian, "Enhancing compliance through improved readability: Evidence from New Zealand's rewrite 'experiment'" in Eller, Martha and Plumley, Alan (eds) *Recent Research on Tax Administration and Compliance* (IRS Research Bulletin, Washington, D.C., 2010) 225, at 227.

¹⁶⁸ Alley and Bentley, above n 86, at 612.

Therefore, simplicity can also increase tax compliance.

2.4.7 Summary

Maples points out that a trade-off is necessary when applying these principles in practice due to the conflicts between them.¹⁶⁹ For example, vertical equity is often regarded as a sacrifice for considering other principles.¹⁷⁰ Alley and Bentley also state that these principles are invariably contradictory and overlap each other. Therefore, to accomplish the intended goal, it is important to balance these principles in the most effective way.¹⁷¹ When it comes to simplification, James, Sawyer, and Wallschutzky believe that "there is a trade-off between simplification and other policy goals which requires a careful balancing of competing priorities that might ultimately be determined by the ruling political party at the relevant time."¹⁷²

2.5 Basic Elements of a VAT/GST System

2.5.1 Tax base of VAT/GST

Krever and van der Corput differentiate that there are three types of supplies in a VAT/GST regime:¹⁷³

- (1) Taxable supplies, which refers to those supplies on which VAT/GST is taxed at a positive or a zero rate;

¹⁶⁹ Maples, above n 94, at 22.

¹⁷⁰ Alley and Bentley, above n 86, at 623.

¹⁷¹ Ibid, at 623.

¹⁷² James, Sawyer, and Wallschutzky, above n 119, at 20.

¹⁷³ Krever and van der Corput, above n 1, at 460.

- (2) Exempt supplies, being supplies which should be taxed by VAT/GST but are not due to an explicit exemption in the VAT/GST legislation;
- (3) "Out-of-scope" supplies, which are supplies that fall outside the VAT/GST legislation.

Due to political and socio-economic considerations, technical difficulties, or administrative complexity,¹⁷⁴ Krever further articulates that there are also three types of supplies on which no effective tax is imposed in a VAT/GST system. The first is where supplies are taxed at a tax rate of zero;¹⁷⁵ the second relates to supplies that belong to the category of "out-of-scope" supplies.¹⁷⁶ The third type of supply is those supplies that are classified in the category of exempt supplies in a VAT/GST system.¹⁷⁷

De la Feria and Krever believe that there are three categories of supplies that may be classified in "out-of-scope" supplies:¹⁷⁸

- (1) The first are businesses that would otherwise be subjective to VAT but with turnover below the compulsory VAT threshold.
- (2) The second are entities that fall outside the scope of the tax as a result of judicial interpretations of legislative exclusions.

¹⁷⁴ Jenkins, Glenn and Kuo, Chun-Yan, "VAT revenue simulation model for tax reform in developing countries" (1995) 522 *Harvard Institute for International Development, Harvard University* 1 at 2.

¹⁷⁵ Krever and van der Corput, above n 1, at 460.

¹⁷⁶ *Ibid*, at 461.

¹⁷⁷ *Ibid*, at 461.

¹⁷⁸ de la Feria, Rita and Krever, Richard, "Ending VAT exemptions: Towards a post-modern VAT" in de la Feria, Rita (ed) *VAT Exemptions: Consequences and Design Alternatives* (Kluwer Law, The Netherlands, 2013) 3, at 14.

- (3) The third are entities explicitly prevented from registering by legislative exclusions.

De la Feria and Krever claim that the first type mentioned above is common to both the traditional VAT model and the modern GST model, whereas the second and third categories are found most often in the traditional VAT model.¹⁷⁹ Furthermore, Ebrill et al believe that exemptions in a VAT/GST system may be classified either in terms of particular commodities or in terms of particular traders.¹⁸⁰

When a supply is classified as a zero-rated supply, it is considered to be taxable. Hence, the input tax on the supply, which was paid at the preceding stages, is claimable. Consequently, zero-rated supplies are excluded from VAT/GST.¹⁸¹ In contrast, when a supply is treated as being an exempt supply, the VAT/GST is not applied at the current stage. However, the input tax of the supply paid at preceding stages is not eligible to be claimed. This means the non-claimable input tax paid at preceding stages increases the production cost, although the value added of the exempt stage escapes the VAT/GST.¹⁸² When exemptions occur at an intermediate stage rather than the retail stage, the supply made by the subsequent businesses is over-taxed owing to the fact that the input tax prior to the exempt stage is still included in the price.¹⁸³ As a consequence, the cascading effect will be induced under this situation.

¹⁷⁹ Ibid, at 14.

¹⁸⁰ Ebrill, Liam, Keen, Michael, Bodin, Jean-Paul, and Summers, Victoria, *The Modern VAT* (International Monetary Fund, Washington, D.C., 2001), at 83, footnote 76.

¹⁸¹ Krever and van der Corput, above n 1, at 488.

¹⁸² Jenkins and Kuo, above n 174, at 3.

¹⁸³ Ibid, at 3.

Lenoir stated at the Confederation Fiscal European forum (CFE) that "VAT exemptions are a major intellectual error", because in business trades they destroy a fundamental principle of VAT/GST - neutrality.¹⁸⁴ Le points out that exemptions tend to corrode the tax base, decrease the revenue collection, and break the claimable mechanism of VAT/GST, which consequently triggers the cascading effect.¹⁸⁵ Therefore, a non-exemption VAT/GST system would prevent the cascading effect and thus would not distort economic behaviour.¹⁸⁶

The same opinion is held by Valadao, who believes that "basically, under a VAT/GST system, exemptions and zero rates should be avoided, in order to preserve tax neutrality and the cascading problem."¹⁸⁷ This is because a break of the claimable mechanism of VAT/GST means that the input tax on intermediate inputs is not recovered; therefore, the value added in the final consumption is double taxed.¹⁸⁸ Hence, unless the exemption is at the retail stage, the tax burden will increase.¹⁸⁹ However, unlike zero-rated supplies, the input tax of the exempt supply prior to the exempt stage is non-claimable. Accordingly, the supplier may add the non-claimable input tax into the price of the exempt supply. Therefore, even though the exemption is at the retail stage, the ultimate consumer may bear the non-claimable input tax.¹⁹⁰ Cnossen agrees

¹⁸⁴ Vyncke, Kenneth, Axel Cordewener, and De Broe, Luc, "Towards a simpler, more robust and efficient VAT system by levying VAT at EU Level" (2011) 33 *International VAT Monitor* 242, at 245.

¹⁸⁵ Le, above n 27, at 24.

¹⁸⁶ Ibid, at 24.

¹⁸⁷ Valadao, Marcos Aurélio Pereira, "Value Added Tax (VAT) and Retail Sales Tax (RST): A comparative analysis on the two tax methodologies in the U.S." (2012) 1 *Revista de Direito Internacional Económico e Tributário* 1, at 15.

¹⁸⁸ Ebrill, Keen, Bodin, and Summers, above n 180, at 18.

¹⁸⁹ Valadao, above n 187, at 14.

¹⁹⁰ In Australia, "zero-rating" is called "GST-free," and "exemption" is called "input-taxed."

that exemptions distort consumer choices and decrease the fiscal revenue.¹⁹¹ Cnossen also asserts that "the integrity of a VAT is safeguarded best if it applies to all final goods and services."¹⁹²

Despite the disadvantages of VAT exemptions, which deviate from the principle of VAT/GST, exemptions are common practice in EU legislation.¹⁹³ There are justifications for exemptions on practical grounds. The first justification is where the output is difficult to value and therefore to tax.¹⁹⁴ These supplies are also called the difficult-to-tax goods and services.¹⁹⁵ Ideally, the difficult-to-tax supplies should be subject to VAT/GST, but for technical reasons, they are exempted from the VAT/GST. Financial supplies are a typical example of such supplies.¹⁹⁶

¹⁹¹ Cnossen, Sijbren, "Key questions in considering a Value-Added Tax for central and eastern European Countries" (1992) 39 *IMF Staff Papers - International Monetary Fund* 211, at 236.

¹⁹² Ibid, at 236.

¹⁹³ Le, above n 27, at 24.

¹⁹⁴ OECD, above n 2, at 47.

¹⁹⁵ Tait classifies the following categories as the difficult-to-tax goods and services: the construction industry, leasing goods and agents, financial services, services performed abroad, auctioneers and second-hand goods, craftsman, betting, gaming and lotteries, and racing. Tait, above n 43, at 80-107. However, de la Feria and Krever classify three such categories: immovable property, financial services, and pooling services including insurance and gambling. de la Feria and Krever, above 178, at 25.

¹⁹⁶ In 2003, New Zealand enacted legislation zero rating business-to-business (B2B) financial services to tackle the distortionary and cascading effect of exempting B2B transactions. Pallot states that:

New Zealand has been the first country to address the cascading effect of exemption for businesses through an approach that in effect determines the input tax credit entitlement based (as far as possible) on the impact that tax cascades have for individual businesses or their customers.

Pallot, Marie, "GST and financial services - rating zero-rating" in Krever, Richard and White, David (eds) *GST in Retrospect and Prospect* (Thomson Brookers, Wellington, 2007) 163, at 163.

The second justification for exemptions is where the supplies are considered to be "meritorious" that they should not be taxed, such as, food, clothing, education, and public health services.¹⁹⁷ However, de la Feria and Krever argue that the benefits from exempting merit supplies in the traditional VAT model are questionable.¹⁹⁸

- (1) The first concern is that the subsidies of exemptions may increase consumption on merit supplies, and the costs of subsidizing are likely to be considerable.
- (2) The second concern is that exemptions also pose difficulties on computing the net VAT taxable liability and give an incentive to plan aggressive tax strategies, for example, taxpayers may take a risk to avoid the tax by taking advantage of the unclear scope of exemptions, which may lead to substantial and increasing lawsuits. This in turn gives rise to substantial compliance and administrative costs.
- (3) The third concern is that it is unclear whether governments achieve any of the social and distributional objectives that they set out to reach.

Therefore, de la Feria and Krever conclude that the cost of exempting "merit" supplies outweighs the benefits.¹⁹⁹

To justify imposing GST on food and clothing despite its regressive effect,²⁰⁰ Dickson argues that in New Zealand the poorest 20 per cent spent between 23

¹⁹⁷ Le, above n 27, at 24.

¹⁹⁸ de la Feria and Krever, above n 178, at 24.

¹⁹⁹ Ibid, at 24.

²⁰⁰ The regressive nature of VAT/GST is discussed later under Section 2.5.2.1 in this thesis.

per cent and 29 per cent of their expenditure on food every week, and the richest 20 per cent allocated between seven per cent and 10 per cent of their weekly budgets to food.²⁰¹ However, from the perspective of how much is actually spent on food, the richest 20 per cent spent twice as much as the poorest 20 per cent, with every NZ\$100.00 spent on food in New Zealand, the poorest 20 per cent spent NZ\$6.50, whereas the richest 20 per cent spent NZ\$12.00.²⁰² Therefore, requests for exempting or zero rating "merit" supplies were rejected in New Zealand to ensure the GST system was as simple as possible with reasonable compliance costs. Cnossen agrees with Dickson and states "the concessionary treatment of food tends to give twice as much relief to high-income groups than to low-income groups, an odd way of alleviating the plight of the poor."²⁰³

2.5.2 Tax rate of VAT/GST

The term "tax rate" mentioned in this thesis needs to be clarified as follows: a single rate refers to one standard rate excluding the zero rate that is imposed on exports or some supplies; multiple rates refer to at least two tax rates excluding the zero rate.

²⁰¹ Dickson, Ian, "The New Zealand GST policy choice: An historical and policy perspective" in Krever, Richard and White, David (eds) *GST in Retrospect and Prospect* (Thomson Brookers, Wellington, 2007) 45, at 51.

²⁰² Dickson, Ian, "The New Zealand GST policy choice: An historical and policy perspective" in Krever, Richard and White, David (eds) *GST in Retrospect and Prospect* (Thomson Brookers, Wellington, 2007) 45, at 51.

²⁰³ Cnossen, Sijbren, "A VAT primer for lawyers, economists, and accountants" (2009) 124 *Tax Notes International* 319, at 331.

2.5.2.1 Regressive or progressive nature of VAT/GST

Tait believes that all less-than-complete VATs/GSTs²⁰⁴ cause problems.²⁰⁵ However, many arguments are raised on equity grounds to oppose Tait's statement, which is essentially an issue of the regressive nature of consumption taxes, including the VAT/GST.

Krever states regressivity to be "as taxpayers' income rise, spending on current consumption decreases as a proportion of total income and saving as the proportion of total income climbs."²⁰⁶ When the VAT/GST is levied at a single rate, the lower-income households generally spend a greater percentage of their earnings on consumption, than the amount spent by higher-income households. Research conducted in South Africa by the World Bank showed that lower-income households spend a higher portion of their income (61 per cent) on food than that spent by higher-income households (15 per cent).²⁰⁷ This means lower-income households bear more of the fiscal burden of food than higher-income households. As a result, the single rate structure works against the principle of vertical equity, which requires that taxpayers should be treated differently according to their personal situation. Therefore, to achieve the political support needed for introducing the VAT/GST, governments have adopted a number of tax preferences including reduced tax rates and

²⁰⁴ Tait believes that a complete VAT should come with a single tax rate and without exemptions, Tait, above n 43, at 7.

²⁰⁵ Ibid, at 7.

²⁰⁶ Krever, Richard, "Designing and drafting VAT laws for Africa" in Krever, Richard (ed) *VAT in Africa* (Pretoria University Law Press, South Africa, 2008) 9, at 18.

²⁰⁷ Go, Delfin, Marna, Kearney, Sherman, Robinson, and Karen, Thierfelder, "An analysis of South Africa's Value Added Tax" (2005) *World Bank Policy Research Working Paper 3671* 1, at 10.

exemptions, aiming to mitigate the uneven VAT/GST tax burden on lower-income households.²⁰⁸

However, some economists do not agree with the view that VAT/GST is regressive due to the fact that the assessment of income should be on a lifetime basis rather than annual basis.²⁰⁹ Cnossen points out that because many lower-income households situation is temporary, they will become middle-or higher-income households gradually as their income increases. Therefore, if the lifetime income basis is taken in total, the expenditure spent on consumption would be proportional to their income.²¹⁰ Metcalf also believes that from the lifetime income basis point of view, the VAT/GST appears to be only mildly regressive, and in fact, can look quite progressive under different design schemes.²¹¹ However, Cnossen also asserts that politicians often adopt the annual income basis when measuring the burden distribution of the VAT/GST.²¹² Similarly, Poh notes that the VAT/GST is paid out of current income when taking into account the real economic and political situation.²¹³ Furthermore, Charlet and Owens argue that the lifetime income basis has an important assumption, that is, "all individuals have the same life expectancy and earn on average the same income."²¹⁴

²⁰⁸ Krever, above n 206, at 18.

²⁰⁹ Charlet and Owens, above n 14, at 950.

²¹⁰ Cnossen, above n 191, at 222.

²¹¹ Metcalf, Gilbert, "Life cycle versus annual perspectives on the incidence of a value added tax" in Poterba, James (ed) *Tax Policy and the Economy* (MIT Press, Boston, 1994) 45, at 46.

²¹² Cnossen, above n 191, at 222.

²¹³ Poh, Eng-Hin, "Addressing the regressivity of a Value Add Tax (VAT): Lessons from Singapore's experience with the Goods and Services Tax (GST)" in Lymer, Andy and Salter, David (eds) *Contemporary Issues in Taxation Research* (Ashgate Publishing, England, 2003) 209, at 213.

²¹⁴ Charlet and Owens, above n 14, at 9.

2.5.2.2 A single tax rate or multiple tax rates

Le claims that to mitigate the regressive nature of VAT/GST, governments commonly combine various progressivity features into their VAT/GST systems.²¹⁵ For example, multiple exemptions, zero rates, and reduced rates are commonly adopted for supplies consumed mostly by lower-income households. Exemptions and the zero rate have been discussed above. Consequently, this section's focus is on discussing the tax rate.

Tait states that from a politician's point of view, the VAT/GST will be more acceptable to the public if supplies consumed by lower-income households are taxed at lower rates than supplies primarily consumed by higher-income households.²¹⁶ Charlet and Owens point out that the objective for those adopting a multiple rate structure in Europe was to relieve the VAT on supplies that constitute a high percentage of lower-income households' income.²¹⁷

Charlet and Owens also believe that the existence of the reduced rate may result in a high acceptance of a standard rate by the public. However, the effect of the reduced rate may be less significant if the standard rate is relatively low.²¹⁸ Therefore, the arguments above focus on the principle of equity in order to gain wide acceptance by taxpayers.

There are many issues with the multiple rate structure. For example, Krever argues that to address the regressive nature of VAT/GST through using reduced rates may be undesirable from an economic view.²¹⁹ This is because like

²¹⁵ Le, above n 27, at 40.

²¹⁶ Tait, above n 43, at 42.

²¹⁷ Charlet and Owens, above n 14, at 945.

²¹⁸ Ibid, at 953.

²¹⁹ Krever, above n 206, at 19.

lower-income households, high-income households buy these life essential supplies too, but of a higher quality (more expensive). The revenue lost from such concessions from high-income households outweighs the tax benefit for lower-income households. Cnossen points out that "rate graduation is a very blunt and expensive instrument for mitigating regressivity."²²⁰ As mentioned above, high-income households spend twice as much as lower-income households. Therefore, high-income households commonly benefit twice as much as lower-income households in absolute amounts under a VAT/GST system with reduced rates. Furthermore, Cnossen claims that it is difficult to differentiate between expensive, better quality supplies consumed by high-income household from less expensive, ordinary supplies consumed by lower-income household in terms of "life essential supplies."²²¹ As a result, "lower rates become less effective in mitigating the regressivity of the VAT." Similarly, Tait argues as follows:²²²

Favorable treatment creates dissatisfied traders and consumers who argue that their products are at the dividing line of definition; if fresh vegetables are taxed at a low rate, why not frozen vegetables, if frozen, why not canned, and so on.

From another perspective, Valadao believes that the multiple rate structure may cause distortion, and increase administrative costs, especially when different rates are taxed on supplies at the same level of the supply chain.²²³ Charlet and Owens claim that "the existence of multiple VAT/GST rates will affect the efficiency of a VAT/GST system and will increase complexity, which may in

²²⁰ Cnossen, above n 191, at 223.

²²¹ Ibid, at 223.

²²² Tait, above n 43, at 43.

²²³ Valadao, above n 187, at 19.

turn increase administrative and compliance costs."²²⁴ Furthermore, Charlet and Owens also point out that the multiple rate structure may cause legal uncertainty due to the fact that "similar products may be subject to the standard or reduced rate depending on the ingredients."²²⁵ Similarly, Le believes that the multiple rate structure may destroy the efficiency of the VAT/GST system, cause unintended distortions, and increase administrative costs.²²⁶ Also, Tait suggests that adjusting the standard VAT/GST rate to address the issue of equity seems to make more sense than adopting reduced rates.²²⁷

Le states that "tax economists have long suggested that the VAT/GST be designed as a money machine, but not as a primary instrument to target equity issues."²²⁸ Despite the fact that this statement seems to be a little extreme due to its neglect of equity, it sheds light on the issue of whether the regressive nature of VAT/GST should be tackled by the VAT/GST itself or there should be some other approaches to address this problem, such as New Zealand's approach.²²⁹ Cnossen points out that within the VAT/GST system, the multiple rate structure can be used to mitigate the regressivity through a reduced rate or even at a zero rate for life essential supplies consumed by lower-income households, whereas a higher-than-standard rate may be adopted for luxury supplies consumed by high-income households. On the other hand, outside the VAT/GST system, approaches to mitigate regressivity concerns may include higher income tax exemptions or lower basic income tax rates, or increases in

²²⁴ Charlet and Owens, above n 14, at 944.

²²⁵ Ibid, at 951.

²²⁶ Le, above n 27, at 43.

²²⁷ Tait, above n 43, at 43.

²²⁸ Le, above n 27, at 39.

²²⁹ The New Zealand's approach is introduced in Section 4.3 of this thesis.

transfer payments to lower-income households.²³⁰ Tait suggests that "income tax adjustments, transfers, income supplements, or coupon schemes can be better targeted to help the poor."²³¹ Similarly, Charlet and Owens believe that since the VAT/GST is regressive itself, regressivity is an issue that cannot be solved in isolation.²³² Therefore, the issue of regressivity should be addressed within the context of the whole tax system rather than simply looking at the distributional influence of VAT/GST in isolation.²³³

2.5.3 Registration threshold

As mentioned earlier, de la Feria and Krever describe three types of supplier that fall into the category of "out-of-scope" supplies.²³⁴ Amongst these three types, the first is the exclusion of some small businesses from the VAT/GST system because they cannot meet the threshold requirements for VAT/GST registering. The registration threshold is to relieve small businesses from registering to be taxable persons, and hence to exempt them from remitting the tax and reducing compliance costs.²³⁵ Since small businesses that are below the registration threshold are free from the VAT/GST, the input tax paid by small businesses cannot be claimed. Most countries in the world have set their registration thresholds to meet their own needs despite the fact that the registration thresholds vary from countries.²³⁶ However, Diamond and

²³⁰ Cnossen, above n 191, at 222-223.

²³¹ Tait, above n 43, at 42-43.

²³² Charlet and Owens, above n 14, at 951.

²³³ Ibid, at 952.

²³⁴ de la Feria and Krever, above n 178, at 14.

²³⁵ OECD, above n 2, at 49.

²³⁶ de la Feria and Krever, above n 178, at 49.

Mirrlees²³⁷ believe that different treatments, depending on the firms' size, reduce production efficiency.²³⁸ Bird and Gendron²³⁹ also believe that experts recommend that the registration threshold should be set as low as possible since the optimal threshold for the perfect VAT/GST system should be zero.²⁴⁰ As a result, issues related to advantages and disadvantages of the level of registration thresholds are now discussed.

First of all, de la Feria and Krever claim that the registration threshold may cause a distortionary effect on competition between VAT/GST registered businesses and VAT/GST unregistered businesses.²⁴¹ This is because unregistered businesses cannot issue VAT/GST invoices, and reclaim the input tax included in the supplies, whereas, the registered businesses can issue the VAT/GST invoice, and the supplies provided are "free" of the input tax. Hence, when the final consumers are VAT/GST registered businesses, they tend to trade with VAT/GST registered businesses instead of VAT/GST unregistered businesses.²⁴² Therefore, Schenk and Oldman believe that the registration threshold may breach the principle of equity. On the other hand, Turnier asserts that the registration threshold gives a competitive advantage to the unregistered businesses over those registered businesses since registered businesses are subject to VAT/GST compliance costs, and attach them to the price or absorb

²³⁷ See Diamond, Peter and Mirrlees, James, "Optimal taxation and public production: Production efficiency" (1971) 61 *The American Economic Review* 8.

²³⁸ de la Feria and Krever, above n 178, at 14.

²³⁹ See Bird, Richard, and Gendron, Pierre-Pascal, *The VAT in Developing and Transitional Countries* (Cambridge University Press, New York, 2007) 1, Ch 3.

²⁴⁰ de la Feria and Krever, above n 178, at 14.

²⁴¹ Ibid, at 14.

²⁴² Ibid, at 15.

them as expenditures.²⁴³ In order to mitigate this distortionary effect, most VAT/GST regimes provide an opportunity to unregistered businesses to become registered businesses through voluntary registration.²⁴⁴ However, Le states that since unregistered businesses have incentives to be registered businesses, due to the claimable input tax, the result is that the extension to registered businesses may invalidate the effect of exemption, causing an increase in collection costs.²⁴⁵

The second issue is about the trade-off between fiscal revenue and collection costs. Ebrill et al agree with Bird and Gendron's opinion mentioned above, that is, the optimal registration threshold is zero in order to diminish the competitive distortions between registered businesses and unregistered businesses.²⁴⁶ However, Ebrill et al point out that no administration costs incurred by the authorities and no VAT/GST compliance costs incurred by taxpayers are the preconditions of this opinion.²⁴⁷ De la Feria and Krever believe that bringing every small businesses into the VAT [/GST] system increases administrative costs exponentially, and the additional VAT [/GST] collected may be largely absorbed as costs in collecting the tax."²⁴⁸ Turnier also gives three economic reasons for setting a registration threshold. They are:²⁴⁹

- (1) the relatively high compliance costs of small businesses;

²⁴³ Turnier, William, "Accommodating to the small business problem under a VAT" (1994) 47 *The Tax Lawyer* 963, at 972.

²⁴⁴ Ibid, at 15.

²⁴⁵ Le, above n 27, at 29.

²⁴⁶ Ebrill, Keen, Bodin, and Summers, above n 180, at 117.

²⁴⁷ Ibid, at 117.

²⁴⁸ de la Feria and Krever, above n 178, at 12.

²⁴⁹ Turnier, above n 243, at 963.

- (2) the higher costs that taxing authorities incur in administering a VAT on small businesses; and
- (3) the relatively small amount of VAT collected from small businesses.

The reasons why Turnier made these conclusions can be found in Sandford et al's research with respect to administrative costs and compliance costs of taxation generally.²⁵⁰ One of the results of this research is that "compliance costs for the smallest businesses as a percentage of taxable turnovers are 1.94 per cent, more than 600 times the 0.003 figure for the largest businesses."²⁵¹ Ebrill et al also believe that "the largest 10 percent of all firms commonly account for 90 percent or more of all turnover."²⁵² Le points out that including the large number of small businesses in the VAT/GST net may "drain the limited resources of revenue administrations."²⁵³

After conducting research with respect to the optimal threshold for the VAT/GST, Keen and Mintz²⁵⁴ suggest that the VAT/GST "registration threshold should be determined by balancing collection costs against the marginal value of additional tax revenues"²⁵⁵ According to Keen and Mintz,

²⁵⁰ See Sandford, Cedric, Godwin, Michael, Hardwick, Peter, and Collard David, *Administrative and Compliance Costs of Taxation* (Fiscal Press, Bath, 1989).

²⁵¹ Turnier, above n 243, at 964.

²⁵² Ebrill, Keen, Bodin, and Summers, above n 180, at 117.

²⁵³ Le, above n 27, at 28.

²⁵⁴ See Keen, Michael and Mintz, Jack, "The optimal threshold for a Value Added Tax" (2004) 88 *Journal of Public Economics* 559.

²⁵⁵ de la Feria and Krever, above n 178, at 16.

the formula below can be used to describe the benefits and costs of a marginal reduction in the threshold:²⁵⁶

$$Z = \frac{\delta A + \Gamma}{(\delta - 1)\tau(Z)}$$

In this formula, δ denotes the marginal cost of public funds; τ denotes the VAT rate; (Z) denotes the share of Value Added in sales; Z denotes the threshold; A denotes the administrative costs of tax authorities; Γ denotes the compliance costs of taxpayers. Therefore, Krever and van der Corput suggest that to set an appropriate registration threshold, the policymakers should take into account economic data, revenue projections, an evaluation of initial administrative capacity, and the complex political aspects of providing relief for this sector.²⁵⁷

2.6 Summary

In conclusion, VAT is one of numerous consumption taxes, which represents a significant, stable source of revenue for governments around the world.²⁵⁸ VAT has been implemented in more than 160 countries.²⁵⁹ This tax was proposed to address the cascading effect, which was the main feature of the multi-stage turnover tax. Such taxes were widely adopted before the introduction of the VAT.²⁶⁰

There are theoretically five methods to calculate VAT liability. They are the additive-direct method, additive-indirect method, sales-subtraction method,

²⁵⁶ Keen and Mintz, above n 254, at 562.

²⁵⁷ Krever and van der Corput, above n 1, at 474.

²⁵⁸ Ibid, at 449.

²⁵⁹ OECD, above n 2, at 18.

²⁶⁰ Schenk, Thuronyi, and Cui, above n 8, at 3.

credit-invoice method, and the credit-subtraction methods without invoices. The credit-invoice method is most prevalent method used worldwide amongst these five options because the tax liability can be easily calculated under this method.

According to Adam Smith, equity, certainty, convenience, and efficiency are four canons for a good tax system. In addition to these principles, simplicity and neutrality are also used as criteria of a good tax system. Due to the conflicts and overlapping of these principles, it is important to balance them in a most effective way. The way of balancing these principles mainly depends on the ruling political party of a state. For example, the principles of simplicity and efficiency in New Zealand's GST system are based on the trade-off of less equity within the GST system itself, but this was addressed in the wider tax/welfare system.

By discussing the tax base (a narrow tax base or a broad tax base) and the tax rate structure (a single tax rate structure or a multiple tax rate structure), it can be concluded that a VAT/GST system which features a broad tax base with few exemptions and a single tax rate structure, is the ideal VAT/GST system. This is because a narrow tax base and the multiple tax rate structure can cause distortionary and cascading effects. As for the registration threshold, it is important to take into account the trade-off of fiscal revenue, compliance costs, and administration costs when setting the level of registration threshold.

CHAPTER 3 THE BUSINESS TAX TO VALUE ADDED TAX REFORM IN CHINA

This chapter introduces the history of Value Added Tax (VAT) reform in China, starting with the first VAT reform in 1979. In addition to this, China's Business Tax (BT), which is a form of turnover tax, is also introduced in this chapter. The Business Tax to Valued Added Tax (B2V) reform process in China will convert the BT into a VAT. Debates on how to implement the reform are discussed, including the "step-by-step" and the "one-step-to-reach" approach. The features of the new VAT system in China in terms of the tax base, tax rates, and the registration threshold, are introduced in this chapter as well.

3.1 History of Value Added Tax Reform in China

3.1.1 The pre-1994 VAT system

In 1979, China implemented the first VAT pilot programme for machinery and agricultural equipment in Liuzhou, Changsha, Xiangfan, and Shanghai.¹ In 1981, three types of goods including bicycles, electric fans, and sewing machines were included in the scope of VAT.² The VAT was extended to all jurisdictions in China from 1983.³ In 1984,⁴ the State Council issued the *Regulations of the People's Republic of China on Value Added Tax*, which further regulated the application of the nationwide VAT on 12 types of supplies,

¹ National Accountant Assessment & Certification Centre of Ministry of Finance, *Economic Law* (China Financial & Economic Publishing House, Beijing, 2015) 1, at 322.

² Ibid, at 322.

³ Ibid, at 322.

⁴ Ibid, at 322.

such as machinery, automobiles, and steel.⁵ This indicates that China had taken the first step to develop its VAT regime.⁶ However, from 1984 to 1993, the VAT in China was only imposed on the manufacturing stage, and furthermore only for several selected supplies.⁷ Therefore, to some extent, this was not a real VAT.⁸

3.1.2 The 1994 VAT system

Before 1993, China was experiencing a period during which the Central Government lacked financial resources. The Central Government wanted a tax which would generate considerable tax revenues. At the same time, one of the important influential factors - the overheated investment in fixed assets - had triggered inflation. Furthermore, due to the low level of economic development, the level of tax administration lagged behind other developed countries at that time,⁹ such as, New Zealand and the European Member States. In the light of these factors, China launched comprehensive industrial and commercial tax reform in 1993.¹⁰ Against this background, the *Regulation of the People's Republic of China on Value Added Tax* was promulgated by the State Council. This regulation stipulated that sales, imported goods, the provision of

⁵ Jin, Dongsheng and Jin, Weifu, "On the development strategy of China's Value-Added Tax (VAT) reform" (2013) 3 *Journal of Chinese Tax and Policy* 226, at 231-232.

⁶ Ibid, at 232.

⁷ 毕明波, "我国增值税发展与改革历程" (2008) 12 *交通财会* 70, at 71 (translation: Bi, Mingbo, "The development and the reform of VAT in China" (2008) 12 *Finance & Accounting for Communications* 70, at 71).

⁸ Ibid, at 71.

⁹ 王建聪, "我国增值税改革回顾与发展研究" (2011) 7 *沈阳工程学院学报 (社会科学版)* 218, at 220 (translation: Wang, Jiancong, "Study on value-added tax reformation review and its development" (2011) 7 *Journal of Shenyang Institute of Engineering (Social Sciences)* 218, at 220).

¹⁰ Jin and Jin, above n 5, at 232.

processing, and repairs and replacement services, were included in the scope of the VAT.¹¹

Due to the pressure for fiscal revenue and the overheated investment in fixed assets, China selected an imperfect VAT which is called the production-based VAT.¹² The main feature of this VAT is that the input tax of purchasing capital assets (mainly producing machinery and equipment) cannot be claimed from the output tax. In addition to this, there was another feature of China's VAT system; that is, the scope of the VAT excluded almost all service industries, such as the transportation industry and communication industry. Thus only the provision of processing, repair and replacements services were within the scope of the VAT. Other industries¹³ were subject to the BT.¹⁴

3.1.3 The 2009 VAT system

Due to the adoption of the production-based VAT, the input tax of purchasing fixed assets cannot be claimed. This led to a lack of incentives for investing in fixed assets, which hindered the adoption of high technology, and therefore the development of China's economy.¹⁵ In view of this, the Ministry of Finance and the State Administration of Taxation (SAT) jointly issued the *Provision on Extending Reductive Base of VAT in Northeastern Region* on 20 September

¹¹ Ibid, at 232.

¹² The production-based VAT is introduced in Section 2.3.2.1 of this thesis.

¹³ Other industries refer to the transportation and communications industry, building industry, finance and insurance industry, postal and telecommunications service industry, culture and sports service industry, entertainment industry, and the service trade industry.

¹⁴ The Business Tax is explained later in this chapter at Section 3.2.2.

¹⁵ Lin, Zhijun, "Value Added Tax in China and its reform" (2009) 35 *International Tax Journal* 65, at 68.

2004.¹⁶ This provision allowed the input tax on purchasing fixed assets to be claimed in three northeastern provinces (including Heilongjiang, Jilin, and Liaoning).¹⁷ This pilot programme was further extended to 26 industrial-based cities in six provinces¹⁸ from 1 July 2007.¹⁹

The global financial crisis in 2008 accelerated the transformation of the VAT in China. With an economic rejuvenation plan, China changed its production-based VAT to a consumption-based VAT nationwide in 2009.²⁰ Unlike the production-based VAT, the input tax for acquiring capital assets is now claimable. By doing so, the factories in China have been encouraged to replace their outdated machinery and equipment, and to speed up technological upgrading of such equipment. This has in turn stimulated economic development within China.

3.2 VAT and BT in China before the Reform

Strictly speaking, before the B2V reform, China's VAT system was not a comprehensive VAT due to the fact that the BT, a retail sales tax, applied to most service industries, the transfer of intangible assets between parties, and selling immovable properties.²¹ The existence of the BT can be regarded as a complement to the VAT's tax base. However, as mentioned above, the BT is a

¹⁶ Lin, Kenny and Wong, Pauline, "Recent reform in Chinese VAT policies" (2012) 38 *International Tax Journal* 39, at 42.

¹⁷ Ibid, at 42.

¹⁸ These six provinces are Shanxi, Anhui, Jiangxi, Henan, Hubei, and Hunan. Ibid, at 42.

¹⁹ Ibid, at 42.

²⁰ Jin and Jin, above n 5, at 232.

²¹ Schenk, Alan, Thuronyi, Victor, and Cui, Wei, *Value Added Tax: A Comparative Approach* (2nd ed, Cambridge University Press, New York, 2015) 1, at 442-443.

retail sales tax, which consequently cannot work as a VAT. The following sections briefly introduce the VAT and the BT in China.

3.2.1 The Value Added Tax

3.2.1.1 Tax base

According to the *Provisional Regulations on Value Added Tax of China* enacted in 1993:²²

An institution or individual engaged in marketing goods and/or providing processing, repair and/or replacements services within the territory of the People's Republic of China shall be a payer of value added tax.

From this regulation, it can be seen that the VAT mainly included transactions of tangible commodities. However, there were eight categories free from the VAT, namely:²³

- (1) agricultural products sold by farmers themselves;
- (2) contraceptive medicine and tools;
- (3) old books;
- (4) imported instruments and meters to be used directly in scientific research and experiments and/or teaching;
- (5) imported goods and equipment granted gratis by foreign governments or international organizations;

²² *Provisional Regulations on Value Added Tax of the People's Republic of China* (27 October 2007) China Tax <http://www.ctax.org.cn/qyhy/zcwj/sswj/english/200811/t20081126_558778.shtml>, Article 1.

²³ Above n 22, Article 16.

- (6) equipment needed for processing with supplies provided, assembling with parts provided and other compensation trade;
- (7) goods imported by organizations of the handicapped and to be used only for the handicapped; and
- (8) used articles sold by the user(s).

In addition to these eight exemptions, almost all of the service industries were subjected to the BT; therefore, the tax base of the VAT was very narrow.

3.2.1.2 Registration

There are two types of taxpayers in China's VAT system: the small-scale taxpayer and the general taxpayer.

(a) The small-scale taxpayer

The small-scale taxpayer refers to taxpayers whose annual sales amount is below the standard requirement, without using a sound accounting assessment system, and where they are unable to produce documents.

In terms of the annual sales amount, there were two criteria to determine this in accordance with the *Detailed Rule for the Implementation of the Provisional Regulation of China on Value Added Tax*:²⁴

- (1) Taxpayers engaged in the production of goods or the provision of taxable services, and taxpayers engaged principally in the

²⁴ *Detailed Rule for the Implementation of The Provisional Regulation of China on Value-Added Tax* (11 September 2013) China Law Education <<http://www.chinalawedu.com/new/201309/xuhuijian2013091117074674514166.shtml>>, Article 24.

production of goods or provision of taxable services but also in wholesaling or retailing of goods, the annual sales amount of which is subject to VAT is below 1 million Yuan.²⁵

- (2) Taxpayers engaged in wholesaling or retailing of goods, the annual taxable sales amount of which is below 1.8 million Yuan.²⁶ Regardless whether the annual taxable sales amounts exceed the standards for small-scale taxpayers, individuals, non-enterprise units, and enterprises which do not often have taxable activities, are chargeable as small-scale taxpayers.

In 2009, the criteria of the annual sales amount changed from 1 million Yuan and 1.8 million Yuan, to 0.5 million Yuan and 0.8 million Yuan,²⁷ respectively.²⁸

It should be noted that the input tax for supplies purchased from small-scale taxpayers cannot be claimed, and small-scale taxpayers cannot claim the input tax no matter whether they purchase supplies from small-scale taxpayers or general taxpayers. Therefore, the VAT for small-scale taxpayers is actually levied on the level of turnover instead of value added, which is similar to a retail sales tax.

²⁵ Yuan is the unit of Chinese currency. Yuan is also written as RMB or ¥. The exchange rate between Yuan and New Zealand dollar is RMB439.72 = NZ\$100.00. Therefore, RMB1 million = NZ\$0.227 million. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

²⁶ RMB 1.8 million = NZ\$0.409 million. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

²⁷ RMB 0.5 million = NZ\$0.113 million; RMB 0.8 million = NZ\$0.173 million. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

²⁸ The Chinese Institute of Certified Public Accountants, *Taxation Laws* (Economic Science Press, Beijing, 2010) 1, at 44.

(b) The general taxpayer

The term "general taxpayer" applies to taxpayers whose annual sales amounts exceed the standards mentioned above. There was also another criterion for the application of a general taxpayer; that is, the sound accounting assessment system standard. This standard means the ability to correctly calculate the input tax, output tax, and tax payable.²⁹ Regardless of the fact that the annual sales amount does not reach the standard described above, the taxpayer could apply to be a general taxpayer on the condition that the sound accounting assessment system standard is satisfied.

3.2.1.3 Tax rate

There are three levels of tax rates for the general taxpayers: 17 per cent, 13 per cent and zero per cent. The rate of 17 per cent is the standard tax rate and 13 per cent is the low tax rate, while zero per cent is especially for exported goods. According to the *Provisional Regulations on Value Added Tax of China*, the following items are to be taxed at 13 per cent:³⁰

- (1) cereals, edible vegetable oils;
- (2) running water, central heating, air conditioning, hot water, gas, LPG, natural gas, methane gas, coal/charcoal products for household use;
- (3) books, newspapers, magazines;

²⁹ The Chinese Institute of Certified Public Accountants, *Taxation Laws* (Economic Science Press, Beijing, 2008) 1, at 29.

³⁰ Above n 22, Article 2.

- (4) feed, chemical fertilizer, chemical pesticides, agricultural machinery, and farm-use plastic sheets; and
- (5) other goods stipulated by the State Council.

The tax rate on goods marketed or imported by a taxpayer, and the processing, repair and/or replacements services provided by a taxpayer, are to be 17 per cent except those within the scope of the low tax rate or exported goods which were taxed at zero per cent. The tax rates for small-scale taxpayers were six per cent and four per cent for the manufacturing sectors and the business sectors, respectively, before 1 January 2009. After that, the tax rates have changed to three per cent for all small-scale taxpayers.³¹

3.2.2 *The Business Tax*

3.2.2.1 Tax base

According to the *Provisional Regulations on Business Tax of China* enacted in 1993:³²

An institution or individual engaged in providing services, transferring intangible assets or selling immovable property within the territory of the People's Republic of China as provided in these regulations shall be a taxpayer of business tax.

The tax base of the BT mainly includes services, which covers almost all the service industries. These includes: the transportation and communications

³¹ The Chinese Institute of Certified Public Accountants (2010), above n 28, at 49.

³² *Provisional Regulations on Business Tax of the People's Republic of China* (27 October 2007) China Tax <http://www.ctax.org.cn/qyhy/zcwj/sswj/english/200811/t20081126_558774.shtml>, Article 1.

industry,³³ building industry,³⁴ finance and insurance industry, postal and telecommunications service industry, culture and sports service industry, entertainment industry,³⁵ and the service trade industry.³⁶ The term "transferring intangible assets" refers to the transfer of land rights, patent rights, non-patent technology, trademarks, copyright and goodwill.³⁷ There are some exemptions, for instance, services provided by the handicapped were exempt from the BT.³⁸

3.2.2.2 Tax rate

The tax rates are arranged in accordance with the different industries. The transportation and communications industry, building industry, postal and telecommunications service industry, and the cultural and sports service industry, are taxed at three per cent, while the rates of the tax on the entertainment industry range from five per cent to 20 per cent.³⁹ In addition to this, the rest of the taxable items of the BT are taxed at five per cent.⁴⁰

³³ The transportation and communications industry includes: shipment by land, water, air and/or pipeline, loading and unloading. Above n 32, Appendix.

³⁴ The building industry includes: building, installation, repair, interior decoration and other building works. Above n 32, Appendix.

³⁵ The entertainment industry includes: singsong bars, ballrooms, karaoke lounges, discotheques, music teahouses, billiards clubs, golf clubs, bowling halls, and other amusement and entertainment facilities. Above n 32, Appendix.

³⁶ The service trade industry includes: agencies, hotels, restaurants, travel agencies, warehouses, rentals, advertising agencies, and other service trade businesses. Above n 32, Appendix.

³⁷ Above n 32, Appendix.

³⁸ Above n 32, Article 6.

³⁹ The actual tax rate is determined by the local government of each province. The Chinese Institute of Certified Public Accountants (2010), above n 28, at 169.

⁴⁰ The Chinese Institute of Certified Public Accountants (2010), above n 28, at 169.

3.2.2.3 The basis of calculating the tax payable of the Business Tax

According to the *Provisional Regulations on Business Tax of the People's Republic of China*:⁴¹

The tax amount of taxable services provided, intangible assets transferred and/or immovable property sold by a taxpayer shall be settled on the basis of the business turnover and at the prescribed tax rate.

The businesses' turnover should comprise all the payments and other charges.⁴² However, there are some exceptions, such as: "for transactions in foreign exchange, securities and/or futures, the turnover taxable shall be the balance of the sale[s] minus the purchase[s]".⁴³

3.3 An Academic Debate

Hu points out that the ultimate aim of the B2V reform in China is to establish a modern VAT/GST system with the features of uniformity, modernity and a consumption-base.⁴⁴ Uniformity means that the scope of the tax base needs to be as wide as possible, covering all commodities, services and immovable property. Modernity refers to a simplified system with a low tax rate and few

⁴¹ Above n 32, Article 4.

⁴² Other charges refer to handling fees, subsidies, funds, fund raising fees, profit sharing, incentive bonus, damages on breach of contract (interest on deferred payments), packaging charges, rentals on packaging materials, contingency charges, quality charges, freight and loading and unloading charges, commissioned receipts, commissioned payments and charges of any other nature which is in addition to the price charged to the purchaser. See The Chinese Institute of Certified Public Accountants (2010), above n 28, at 170.

⁴³ Above n 32, Article 5.

⁴⁴ 胡怡建, "我国增值税“扩围”改革面临八大挑战" (2011) 7 *涉外税务* 5, at 6 (translation: Hu, Yijian, "Eight challenges in the reform of vat expansion of levying scope in China" (2011) 7 *International Taxation in China* 5, at 6).

tax preferences in order to keep the neutrality of tax. These goals are undisputed.⁴⁵ However, there are divergent views in academia on how to implement the reform through the way of "step-by-step" or the "one-step-to-reach" approach.

3.3.1 The "step-by-step" approach

Zeng believes that the B2V reform involves various industries, enterprises and individuals which hold different intentions and attitudes to the reform. This means that the reform cannot be undertaken in one step, but must be implemented on a step-by-step basis to differentiated industries.⁴⁶ Even though most academics in China are in favour of this perspective, the following discussion sets out differences on how to carry out the step-by-step approach.

Due to the economic level in China and the relationship of trading goods between different industries, Chen claims that the transportation industry, building industry, agency industry, warehouse industry, rental industry, and the advertising agency industry, should be put within the scope of the VAT in the first place.⁴⁷ Chen further argues that the BT should cover industries such as the finance, insurance, and the consultation industry.⁴⁸

After taking into account the level of tax administration in China, the capability of taxpayers of calculating the tax payable correctly and the tax consciousness

⁴⁵ Ibid, at 6.

⁴⁶ 曾章伟, "扭曲的增值税制及其矫正" (2014) 6 *特区经济* 58, at 60 (translation: Zeng, Zhangwei, "Twisty value added tax system and its correction" (2014) 6 *Special Zone Economy* 58, at 60).

⁴⁷ 陈锋, "增值税征税范围的国际比较与思考" (2002) 1 *中央财经大学学报* 50, at 52 (translation: Chen, Feng, "International comparison and consideration on the tax range of VAT" (2002) 1 *Journal of Central University of Finance & Economics* 50, at 52).

⁴⁸ Ibid, at 52.

of taxpayers generally, Wang suggests that to enlarge the scope of the tax base of the VAT, the process should be divided into three steps:⁴⁹

- (1) The first step is to include the transportation, warehouses, and logistics industries;
- (2) the second step is to cover the construction industry and the transfer of land use rights; and
- (3) the third step is to put the finance, insurance, postal and telecommunications services industries within the scope of the VAT.

Dong advocates that in order to address the problems of the non-claimable freight and the non-claimable inputs of purchasing raw materials of builders, the first step is to bring the transportation, building, and postal and telecommunications services industries within the scope of the VAT. The scope of the VAT can be enlarged to all industries when the time is right.⁵⁰ Zhao asserts that the first choice should be the transportation, and finance and insurance industries rather than the building and the real estate industries. This is because the contribution of the building and the real estate industries to local government fiscal revenues accounts for a substantial percentage. If all these industries⁵¹ are put within the scope of the VAT, there will be a serious impact

⁴⁹ 王金霞, "扩大增值税征税范围的思考" (2009) 8 *税务研究* 48, at 49 (translation: Wang, Jinxia, "A consideration of expansion of the VAT levying scope" (2009) 8 *Taxation Research* 48, at 49).

⁵⁰ 董其文, "加快推进扩大增值税征收范围的改革" (2010) 11 *税务研究* 25, at 27 (translation: Dong, Qiwen, "Reform on acceleration and promotion of expansion of the VAT levying scope" (2010) 11 *Taxation Research* 25, at 27).

⁵¹ Here all these industries refer to the industries that are within the scope of the Business Tax, such as, the transportation and communications industry, building industry, finance and insurance industry, postal and telecommunications service industry, culture and sports service industry, entertainment industry, and the service trade industry.

on local governments. Furthermore, multiple rates should be still applied to different industries to show the support to some special industries from the Central Government.⁵² Sun states that transportation is the first industry which should be put into the VAT as, due to its limited influence on the national economy, this is the best option as a trial target for the B2V reform.⁵³

3.3.2 The "one-step-to-reach" approach

On the other hand, Han asserts that according to the situation of China's economy, the scope of the VAT should be as wide as possible, except for special industries such as the finance and insurance industries, and a single rate should be implemented instead of multiple rates.⁵⁴ Gong suggests that the tertiary sector should be brought into the VAT entirely because the number of taxpayers in the tertiary sector⁵⁵ is vast and the situation of this sector is complex.⁵⁶ The threshold of registration should be aligned with the tax collection and administration level otherwise the cost-effectiveness ratio will be reduced.⁵⁷ In the initial reform the number of general taxpayers should be

⁵² 赵丽萍, "关于增值税的扩围改革" (2010) 11 *税务研究* 34, at 34 (translation: Zhao, Liping, "About expansion of the VAT levying scope" (2010) 11 *Taxation Research* 34, at 34).

⁵³ 孙钢, "增值税扩围的方式选择—基于对行业和体制调整的影响性分析" (2011) 2 *地方财政研究* 56, at 59 (translation: Sun, Gang, "Choice of VAT expansion - based on an analysis the influence of industries and the system" (2011) 2 *Sub National Fiscal Research* 56, at 59).

⁵⁴ 韩绍初, "中国增值税应进行第三次重大改革" (2008) 10 *税务研究* 24, at 26 (translation: Han, Shaochu, "China should launch a third-round reform of VAT" (2008) 10 *Taxation Research* 24, at 26).

⁵⁵ The tertiary sector in China mainly includes the service industries, such as, the transportation and communications industry, building industry, finance and insurance industry, postal and telecommunications service industry, culture and sports service industry, entertainment industry and the service trade industry and so forth.

⁵⁶ 龚辉文, "关于增值税、营业税合并问题的思考" (2010) 5 *税务研究* 41, at 43 (translation: Gong, Huiwen, "A consideration on combining VAT and BT" (2010) 5 *Taxation Research* 41, at 43).

⁵⁷ *Ibid*, at 43.

controlled.⁵⁸ As the tax collection and administration capacity increases, the number of general taxpayers should also increase.⁵⁹ Lun and Jin propose that the "perfect" reform program should address the problems of duplicate taxation and the incomplete tax refund of exported goods.⁶⁰ These problems were brought about by the co-existence of VAT and BT. Accordingly, Lun and Jin argue that it is better to fundamentally tackle these problems by enlarging the scope of the VAT comprehensively.⁶¹

3.4 The New VAT in China

Due to the fact that B2V reform is in progress, the introduction of the new VAT is analysed as at 12 February 2016.

3.4.1 Background of the B2V reform

The co-existence of VAT and BT has become problematic due to the rapid development of China's economy in the last 20 years. There are five major disadvantages associated with the pre-2012 China's turnover tax regime:

- (1) The VAT in China had a narrow base that included only the supply of goods, imported goods, and the supply of limited services, such as the processing, repair, and replacement of movable goods. Most supplies of services and immovable property, including transportation and

⁵⁸ Ibid, at 43.

⁵⁹ Ibid, at 43.

⁶⁰ 伦玉君, 靳东升, "中国与韩国增值税制度要素的比较研究" (2011) 5 *经济社会体制比较* 172, at 174 (translation: Lun, Yujun and Jin, Dongsheng, "A comparative study on VAT system element between China and South Korea" (2011) 5 *Comparative Economic & Social Systems* 172, at 174).

⁶¹ Ibid, at 174.

construction, were outside the scope of VAT and subject to the BT.⁶² This means that the existence of the BT has broken the claimable mechanism of VAT, which inevitably results in a cascading effect.⁶³

- (2) The co-existence of VAT and BT cannot promote the optimisation of industrial structures and business investments.⁶⁴ Since the BT is imposed on the total sales, and it cannot be claimed by sellers, enterprises tend to be vertically integrated to avoid the cascading effect. This has restricted the development of outsourcing and specialisation of service production. Also this often leads to redundant investments.
- (3) The existence of BT has hindered the development of service industries and the transformation of the national economy.⁶⁵ The service industries have expanded rapidly with economic development, and have become the pillar of the national economy.⁶⁶ Due to the non-claimable BT, the real tax burden on service enterprises may be higher than enterprises that are subject to the VAT. This has decreased the operating efficiency of service industries.
- (4) Owing to the non-claimable BT, the services products exported by Chinese enterprises have BT attached to the prices. This has posed a huge disadvantage on exported services products.⁶⁷

⁶² Brys, Bert, Matthews, Stephen, Herd, Richard, and Wang, Xiao, "Tax policy and tax reform in the People's Republic of China" (2013) 18 *OECD Taxation Working Papers*, 1, at 22.

⁶³ Lin, Zhijun, "VAT replacing business tax: A major tax reform in China (Value Added Tax)" (2013) 39 *International Tax Journal* 17, at 18.

⁶⁴ *Ibid*, at 18.

⁶⁵ *Ibid*, at 18.

⁶⁶ *Ibid*, at 19.

⁶⁷ *Ibid*, at 19.

- (5) The co-existence of VAT and BT has brought about considerable administrative and compliance costs.⁶⁸ With the development of information and technology, the boundary of VAT and BT has become increasingly blurred. This has caused difficulty in determining which tax category should apply.⁶⁹

Due to these disadvantages, China launched the B2V reform from 2012, aiming to fully integrate with the VAT and then abolish the BT.

3.4.2 The process of the B2V reform

There were three stages for implementing this reform. In the first stage the Central Government of China commenced a pilot reform program in Shanghai aiming to bring the transportation and communications industry, and six modern service industries, within the scope of the VAT on 1 January 2012.⁷⁰ These industries were previously subjected to the BT. Then, on 9 September 2012, Beijing and another seven provinces,⁷¹ with two special economic zones,⁷² also began the pilot reform program. From 1 August 2013, the reform was extended to all jurisdictions in China.⁷³ In addition to this, some of the production, broadcasting and publishing of radio, film and television works, were added into the reform.⁷⁴ The State Administration of Taxation of China (SAT) announced that the postal and telecommunications service industry was

⁶⁸ Ibid, at 19.

⁶⁹ Ibid, at 19.

⁷⁰ 李晶, "中国新一轮税制改革的重点与安排" (2015) 1 *宏观经济研究* 18, at 19 (translation: Li, Jin, "Emphasis and arrangements of China's tax regime reform" (2015) 1 *Macroeconomics* 18, at 19).

⁷¹ These seven provinces are Tianjin, Jiangsu, Zhejiang, Anhui, Fujian, Hubei, and Guangdong.

⁷² These two special economic zones are Shenzhen and Xiamen.

⁷³ Li, above n 70, at 19.

⁷⁴ Ibid, at 19.

also involved in the reform from 1 June 2014.⁷⁵ The aim of the B2V reform is to replace the BT with the VAT gradually. Table 3.1 outlines the process of the B2V reform.

Table 3.1 The process of the B2V reform⁷⁶

Date	Region	Industry	
1 January 2012	Shanghai	The transportation industry (excluding railway transportation)	
1 September 2012	Beijing	The six modern service industries	Research, development and technical services
1 October 2012	Jiangsu		Information technology services
1 November 2012	Fujian		Cultural and creative services
	Guangdong		Logistics auxiliary services
1 December 2012	Tianjin		Authentication and consulting services
	Zhejiang		Movable tangible property leasing services (including operating and finance leasing)
	Hubei		
1 August 2013	The whole nation	Adding the radio, film and television services	
1 January 2014		Adding the railway transportation and postal services industries	
1 June 2014		Adding the telecommunications service industry	

⁷⁵ Ibid, at 19.

⁷⁶ Ibid, at 19.

3.4.3 An analysis of the new VAT in China

3.4.3.1 Tax base

After issuing a series of regulations, the tax base of VAT in China now includes the following categories:

- (1) marketing goods;
- (2) providing processing, repair and/or replacements services;
- (3) imported goods;
- (4) providing transportation services;
- (5) providing research, development and technical services;
- (6) providing information technology services;
- (7) providing cultural and creative services;
- (8) providing logistics auxiliary services;
- (9) providing authentication and consulting services;
- (10) providing movable tangible property leasing services (including operating and finance leasing);
- (11) providing radio, film and television services; and
- (12) providing telecommunications service industry.

As at the date of writing, the building industry, finance and insurance industry, sports service industry, entertainment industry, and the service trade industry,

are still subjected to the BT. The SAT in China⁷⁷ has not issued any rules or regulations on when and how to implement the B2V reform to these industries.

Although the B2V reform has included many industries that were previously subject to the BT, there are a number of exemptions in the existing VAT regime. In addition to the eight categories of exemptions existing in the pre-2012 VAT system,⁷⁸ exemptions and tax preferences which were previously regulated under the BT regulations are still applicable for taxpayers who were previously subject to the BT after the B2V reform.⁷⁹ However, these exemptions expired on 31 December 2015.⁸⁰ For now, the tax base of China's VAT regime is still narrow due to a large number of exemptions. This has increased the compliance costs of enterprises and administration costs of the government, which leads to inefficiency.

3.4.3.2 Tax rate

Prior to the B2V reform, there had been two tax rates⁸¹ for general taxpayers plus the zero rate for exported goods and one applicable tax rate (three per cent) for small-scale taxpayers. During the B2V reform, two more reduced rates were added to China's VAT regime. Table 3.2 illustrates the tax rate structure of VAT in China:

⁷⁷ The State Administration of Taxation of China is equivalent to the Inland Revenue Department (IRD) in New Zealand.

⁷⁸ These exemptions are introduced under Section 3.2.1.1 in this thesis.

⁷⁹ 樊其国, "营改增'试点企业原营业税优惠政策如何继续沿用" (2013) 10 *国际商务财会* 59, at 59 (translation: Fan, Qiguo, "How to continue the tax preferences of the BT during the B2V reform" (2013) 10 *Finance and Accounting for International Commerce* 59, at 59).

⁸⁰ The Chinese Institute of Certified Public Accountants, *Taxation Laws* (Economic Science Press, Beijing, 2014), at 105.

⁸¹ The two tax rates include one standard rate (17 per cent) and one reduced rate (13 per cent).

Table 3.2 Tax rates of VAT in China⁸²

Taxable items	Tax rate
Marketing goods	17%
Imported goods	17%
Providing processing, repair and/or replacements services	17%
Movable tangible property leasing services	17%
Agricultural products, grains and oils, and other goods ⁸³	13%
Transportation & telecommunication	11%
The five modern industries ⁸⁴	6%
The small-scale taxpayer	3%
Exported goods	0%

From Table 3.2 above, it can be seen that the tax rate structure of the VAT in China is very complex. In addition to the applicable rate (three per cent) and the zero rate, there is one standard rate plus three reduced rates. The multiple tax rate structure undoubtedly violates the principles of certainty, simplicity, and efficiency.

⁸² These data are from the *Taxation Law* published by the Chinese Institute of Certified Public Accountants (2014), above n 80, at 50-54.

⁸³ These supplies to which the reduced rate (13 per cent) is applied were introduced in Section 3.2.1.3 in this thesis.

⁸⁴ The five modern industries include research, development and technical services, information technology services, cultural and creative services, logistics auxiliary services, and authentication and consulting services.

3.4.3.3 Registration

The registration policy for VAT in China can be summarised as follows:⁸⁵

- (1) Taxpayers engaged in the production of goods or the provision of taxable services, whose annual sales amount which is subject to VAT is above 0.5 million Yuan,⁸⁶ can register as VAT general taxpayers.
- (2) Taxpayers engaged in wholesaling or retailing of goods whose annual taxable sales are above 0.8 million Yuan,⁸⁷ can register as VAT general taxpayers.
- (3) Taxpayers subject to the B2V reform, whose annual sales are above 5 million Yuan,⁸⁸ can register as VAT general taxpayers.
- (4) Taxpayers whose annual sales are below the amount regulated by the categories above, can register as VAT general taxpayers if they can demonstrate that they have a sound accounting system to provide accurate tax information. However, once taxpayers are identified to be VAT general taxpayer by tax authorities, they cannot apply to become small-scale taxpayers.

If taxpayers cannot meet the requirements set out above, they are classified into the category of the small-scale taxpayer. This means their VAT is collected through a simplified method, which is similar to the BT. Small-scale taxpayers

⁸⁵ The Chinese Institute of Certified Public Accountants (2014), above n 80, at 45-50.

⁸⁶ RMB0.5 million = NZ\$0.113 million. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

⁸⁷ RMB0.8 million = NZ\$0.181 million. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

⁸⁸ RMB5 million = NZ\$1.137 million. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

calculate their tax liabilities by multiplying their turnover with the applicable rate (three per cent). Furthermore, the input tax cannot be claimed by small-scale taxpayers.

Research⁸⁹ shows that in China 81.35 per cent⁹⁰ of VAT taxpayers are small-scale taxpayers.⁹¹ However, the amount of revenue generated by small-scale taxpayers is small and has consistently shown a downward trend.⁹² Therefore, Wang⁹³ advocates that to abolish the small-scale taxpayer regime makes eminent sense.⁹⁴

3.4.3.4 Evaluation

The B2V reform in China has brought about certain achievements. First, the reform has allowed enterprises that were previously subject to the BT to claim input tax, which promotes equity amongst the manufacturing, merchandising, and service industries.⁹⁵ More importantly, to some extent, the reform has eliminated the problem of the duplication of tax which, in turn, mitigates the burden of taxpayers.⁹⁶

⁸⁹ See Wang, Haiping, "Jiangsu legislative proposal: Small-scale taxpayer regime should be abolished in reform" (2013) 21 *21st Century Business Herald* 35.

⁹⁰ See the State Administration of Taxation, "The fiscal revenue of the first half of 2015" (27 July 2015) State Administration of Taxation <<http://www.chinatax.gov.cn/n810214/n810631/c1743942/content.html>>.

⁹¹ Schenk, Thuronyi, and Cui, above n 21, at 450.

⁹² Ibid, at 450.

⁹³ See Wang, Haiping, above n 89.

⁹⁴ Schenk, Thuronyi, and Cui, above n 21, at 450.

⁹⁵ Lin, above n 63, at 21.

⁹⁶ Liao, Shaogang and Pan, Ying, "Analysis on the policy of replacing Business Tax with Added-Value Tax" (2015) 3 *International Journal of Economics, Finance and Management Sciences* 162, at 163-164.

Second, the reform has stimulated the development of service industries in China due to the encouragement of technological innovations and the ability to claim the input tax.⁹⁷ This has contributed positively to optimising the industrial structure.⁹⁸ Upon completion of the B2V reform, it is expected that China's VAT regime will be much closer to the modern GST model.⁹⁹

However, the gap between China's VAT regime and the modern GST model is still significant. The problem of the duplication of tax has not been eliminated completely,¹⁰⁰ due to a large number of exemptions and the multiple tax rate structure.¹⁰¹ Apart from many exemptions in the pre-2012 VAT regime, a large number of exemptions under the BT remain exempted under the VAT.¹⁰² These non-exempt enterprises still cannot claim the input tax. Furthermore, the adoption of a simplified method for the large number small-scale taxpayers (81.53 per cent)¹⁰³ is almost similar to the BT, which distorts production decisions.¹⁰⁴ Accordingly, the VAT regime in China can be quite inefficient and complex, which is in breach of a number of principles of taxation.¹⁰⁵ Therefore, when reviewing the B2V reform, Cui has stated that "the 'reform' was in name only."¹⁰⁶ It is too early to judge Cui's statement owing to the fact that the reform is still in progress. However, if China cannot make fundamental changes on the tax rate structure (changing to a single tax rate structure), tax

⁹⁷ Ibid, at 165.

⁹⁸ Lin, above n 63, at 22.

⁹⁹ Jin and Jin, above n 5, at 234.

¹⁰⁰ Lin, above n 63, at 23.

¹⁰¹ Cui, Wei, "China's Business-Tax-to-VAT reform: An interim assessment" (2014) 5 *British Tax Review* 617, at 626-627.

¹⁰² Ibid, at 630-631.

¹⁰³ The State Administration of Taxation, above n 90.

¹⁰⁴ Cui, above n 101, at 637-638.

¹⁰⁵ The principles of taxation are introduced in Section 2.4 of this thesis.

¹⁰⁶ Cui, above n 101, at 637.

base (adopting a broad tax base with few exemptions), and abolition of a simplified method for small-scale taxpayers, the B2V reform will be a "defective product" of China's VAT reform.

3.5 Summary

Since the concept of VAT was introduced in China in 1979,¹⁰⁷ China has started its journey to pursue an effective VAT system through several reforms. However, the existing VAT system in China can still be improved.

Before the B2V reform, the biggest problem that hinders the development of China's economy is the co-existence of the VAT and the BT. Some researchers advocate that the B2V reform should gradually move the industries that are previously subject to the BT into the VAT. This is called the "step-by-step" approach. Other researchers believe that all the industries that were previously subject to the BT should be moved into the VAT at one time, which is called the "one-step-to-reach" approach.

The Central Government of China commenced the B2V reform with a pilot program in Shanghai. This pilot program was to bring the transportation and communications industry, and six modern industries, within the scope of the VAT. More cities and industries were gradually added to the B2V reform. Therefore, a "step-by-step" approach was adopted to implement the B2V reform. To date, the building industry, finance and insurance industry, sports service industry, and the service trade industry, are still subject to the BT, and the B2V reform remains in progress. The SAT of China has not issued any

¹⁰⁷ National Accountant Assessment & Certification Centre of Ministry of Finance, above n 1, at 322.

rules or regulations on when on how to implement the B2V reform to these industries.

Apart from the fact that some of the industries have been included within the scope of the VAT, China's VAT regime still has many exemptions. Some of the exemptions are from the original VAT regime, and the others are from the BT. In addition, two more tax rates have been added to the tax rate structure of China's VAT regime which already has four tax rates. The industries that have not been included in the B2V reform, the exemptions, and the additional tax rates, make the complex VAT regime of China even more complicated. Therefore, China's new VAT regime can be characterised as one that has a narrow tax base with substantial exemptions and a multiple tax rate structure. This means that because the VAT regime in China is quite inefficient and complex, the principles of taxation for a good tax system are breached.

CHAPTER 4 TWO MODELS OF VAT/GST

This chapter gives an introduction to the two models of the Value Added Tax/Goods and Services Tax (VAT/GST) in terms of the tax base, tax rate structure, and the registration threshold. These two models are the traditional VAT model, which is widely used in European countries, and the modern GST model, which was first introduced in New Zealand. In addition, these two models are evaluated in accordance with Adam Smith's four principles of taxation, along with the principles of simplicity and neutrality.

4.1 Introduction of Two Models

Since the term "modern VAT" was first used by Ebrill et al in 2001,¹ numerous studies have been conducted regarding this topic.

Zou claims that there are three types of VAT/GST models worldwide: the imperfect VAT model, the European Union's VAT model and the modern GST model. The imperfect VAT model refers to the VAT with the features of a narrow tax base, inadequate coverage of all industries and many special rules. China is a typical example of utilising the imperfect VAT model. Compared with the imperfect VAT model, the European Union's (EU) VAT model has a relatively broader tax base; the standard tax rates of each Member States fluctuate in a range, with low and zero rates also adopted to relieve the tax burden of taxpayers. The modern GST model refers to the VAT with features embodying the neutrality of the tax, a single standard rate, and limited exemptions and tax preferences. New Zealand's GST is a typical example of the

¹ See Ebrill, Liam, Keen, Michael, Bodin, Jean-Paul, and Summers, Victoria, *The Modern VAT* (International Monetary Fund, Washington, D.C., 2001).

modern GST model.² Like Zou, Jin also believes that there are three types of VAT/GST model: less-than-complete VAT, EU VAT, and modern GST.³ Jin claims the EU VAT is a product of political compromise; therefore, it is not considered to be a good type of VAT from a scientific perspective.⁴

The same conclusion has also been found in Krever's⁵ and Hu's⁶ research. Krever and Hu have both classified the worldwide VAT/GST into two categories: the traditional VAT and the modern GST. Krever elaborated on these two types of VAT/GST in *VAT in Africa*.⁷ Krever articulates that the VAT systems in Europe are typical examples of using the traditional VAT model. The GST system that appeared in 1986 in New Zealand can be called the modern GST model.⁸ Also, Krever indicates that most features of the traditional VAT model and the modern GST model are similar. There are two crucial differences between them: the rate structure and the number of exempt supplies.⁹ Contrary to Krever, Hu shows that there are six differences between the traditional VAT model and the modern GST model. These include: name,

² 邹昱, "欧盟型增值税制: 完善增值税的一种选择" (2013) 5 *地方财政研究* 36, at 37 (translation: Zou, Yu, "European VAT system: A choice of improvement of China's VAT" (2013) 5 *Sub National Fiscal Research* 36, at 37).

³ Jin, Dongsheng and Jin, Weifu, "On the development strategy of China's Value-Added Tax (VAT) reform" (2013) 3 *Journal of Chinese Tax and Policy* 22, at 235.

⁴ Ibid, at 235.

⁵ Krever, Richard, "Designing and drafting VAT laws for Africa" in Richard Krever (ed) *VAT in Africa* (Pretoria University Law Press, South Africa, 2008) 9, at 13-18.

⁶ 胡怡建, "我国增值税“扩围”改革面临八大挑战" (2011) 7 *涉外税务* 5, at 6 (translation: Hu, Yijian, "Eight challenges in the reform of vat expansion of levying scope in China" (2011) 7 *International Taxation in China* 5, at 6).

⁷ See Krever, above n 5.

⁸ Ibid, at 18.

⁹ Ibid, at 14.

tax base, structure of the tax rates, administration of collecting, and tax exemptions and zero rating.¹⁰

4.2 The Traditional VAT Model

In 1962, a recommendation for adopting the VAT as the European Economic Community's (EEC) sales tax was proposed in the *Neumark Report*, which is a study on how the "tax system of the Member States conflicted with the establishment of the a common market."¹¹ Based on the *Neumark Report*, the first two VAT Directives were issued on 11 April 1967; however, the VAT was not implemented in all Member States of the EU until the enactment of the *Sixth VAT Directive* on 17 May 1977.¹² The function of the *Sixth VAT Directive* was to standardise the application of the VAT between Member States. The *Sixth VAT Directive* was refined several times before being replaced by the *Council Directive 2006/112/EU* (the EU Directive)¹³ on 1 January 2007.¹⁴

As mentioned above, all the EU Member States are required to follow the EU Directive. However, it does not require the Member States to apply the same VAT rate. Only a minimum tax rate of 15 per cent is required.¹⁵ The tax rates in different Member States currently vary between 15 per cent and 27 per

¹⁰ Hu, above n 6, at 6.

¹¹ Engel, Charles, "Revisiting the Value Added Tax: A clear solution to the murky United States corporate tax structure" (2012) 22 *Indiana International & Comparative Law Review* 347, at 363.

¹² Ibid, at 364.

¹³ See European Commission, "*Council Directive 2006/112/EU*" (28 November 2006) European Commission <<http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32006L0112>>.

¹⁴ Engel, above n 11, at 364.

¹⁵ Laman, Bert, *European VAT- Business and Taxation Guide* (Praxity, Netherlands, 2013) 1, at 7.

cent.¹⁶ Also, Member States can adopt one or two reduced tax rates, with a minimum of five per cent.¹⁷ Additionally, there are a number of specified goods and services which are exempt under the EU VAT system. These include:¹⁸

certain activities of general interest (such as hospital and medical care, goods and services link to welfare and social security work, school and university education and certain cultural services or the provision of foodstuffs), and certain transactions including insurance, the granting of credit, certain banking services, supplier of postage stamps, lotteries and gambling and certain suppliers of immovable property.

Accordingly, it is important for enterprises to understand local VAT regulations as well as the common VAT regulations among the EU Member States.

As mentioned before, VATs used in the EU are typical examples of the traditional VAT model. These VATs are based on the EU Directive, which is aimed at removing tax obstacles for the free movement of goods.¹⁹ The *Consolidated Treaties Charter of Fundamental Rights*, issued by the EU, defines "Directive" to be:²⁰

¹⁶ Ibid, at 7.

¹⁷ Ibid, at 7.

¹⁸ Engel, above n 11, at 365.

¹⁹ Kubátová, Květa and Pavla Holešovská, "Convergence of VAT rates between 1995 and 2010" (2014) 9 *European Financial and Accounting Journal* 79, at 80.

²⁰ The European Union, *Consolidated Treaties Charter of Fundamental Rights* (European Union, Luxembourg, 2010), Article 288.

A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.

This means that each Member State in the EU has the right to design its own VAT regime and this right is known as derogations from the EU standard.²¹ Therefore, as the basis of VATs in Member States, the EU Directive has essentially introduced the following key requirements.

4.2.1 Tax base

Under the EU Directive, four taxable transactions undertaken by taxable persons in the EU are subject to VAT. There are two terms that need to be clarified at this point. First, the term "taxable person" is defined to be "any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity."²² According to the EU Directive, the economic activities can be all activities of producers,²³ traders, and persons supplying services, including mining and agricultural activities, and activities of the professions. Due to different interpretations, the implementation of the definition of tax person varies between countries.²⁴

Second, the four key taxable transactions are defined as follows:²⁵

- (1) supply of goods;

²¹ Hellerstein, Walter and Gillis, Timothy, "The VAT in the European Union" (2010) 26 *Tax Notes* 461 at 462.

²² European Commission, above n 13, Article 9.

²³ Ibid, Article 9.

²⁴ Lejeune, Ine, "The EU VAT experience: What are the lessons?" (2011) *The VAT Reader: What a Federal Consumption Tax Would Mean for America* 257, at 270.

²⁵ European Commission, above n 13, Title 4.

- (2) intra-Community acquisition of goods;
- (3) supply of services; and
- (4) importation of goods.

According to the EU Directive, "'supply of goods' shall mean the transfer of the right to dispose of tangible property as owner."²⁶ In addition to this, several transactions shall be regarded as supplies of goods, such as "the transfer of goods pursuant to a contract under which commission is payable on purchase or sale."²⁷ Furthermore, "electricity, gas, heat, refrigeration and the like shall be treated as tangible property"²⁸ by the EU Directive. "Intra-Community acquisition of goods" is defined as:²⁹

... the acquisition of the right to dispose as owner of movable tangible property dispatched or transported to the person acquiring the goods, by or on behalf of the vendor or the person acquiring the goods, in a Member State other than in which dispatch or transport of the goods began.

"Supply of services" refers to "any transaction which does not constitute a supply of goods"³⁰ This means that supplies offered by taxable persons for consideration that cannot be classified into the categories of "supply of goods," "intra-Community acquisition of goods," and "importation of goods," are considered to be classified into the category of "supply of services."³¹ As an

²⁶ Ibid, Article 14.

²⁷ Ibid, Article 14.

²⁸ Ibid, Article 15.

²⁹ Ibid, Article 20.

³⁰ Ibid, Article 24.

³¹ Lejeune, above n 24, at 272.

example, "the assignment of intangible property, whether or not the subject of a document establishing title,"³² is regarded as a "supply of services."

The EU Directive stipulates that "'importation of goods' shall mean the entry into the [EU] Community of goods which are not in free circulation within the meaning of Article 24 of the Treaty."³³ However, the importation of services is not included in the taxable transactions. This narrows the tax base of VATs that are used in the EU.

From the four categories of VAT taxable transactions, it can be seen that the EU Directive brings almost all transactions into the scope of the VAT, which creates a broad tax base of VAT.³⁴ However, the Member States generally stipulate a wide range of exemptions. According to the EU Directive, Member States are permitted a number of exemptions when designing their own VAT regimes.³⁵ In the EU Directive, 10 chapters (from Article 131 to 166) provide lists of exemptions to Member States. They are:³⁶

- (1) exemptions for certain activities in the public interest;³⁷

³² European Commission, above n 13, Article 25.

³³ Ibid, Article 30. The term "treaty" refers to the *Treaty on the Functioning of the European Union*.

³⁴ Lejeune, above n 24, at 272.

³⁵ Varga, Katalin, "VAT - Is it really so simple" (2009) 144 *Studia Iuridica Auctoritate Universitatis Pecs Publicata* 311, at 315.

³⁶ European Commission, above n 13, Ch 2-10.

³⁷ These activities mainly include hospital and medical care, the supply of human organs, welfare and social security work, services or goods linked to the protection of children and young persons, children's or young people's education, tuition given privately by teachers, the supply of staff by religious or philosophical institutions, the supply of transport services for sick or injured persons, and the supply of certain cultural services. Ibid, Article 132-134.

- (2) exemptions for other activities;³⁸
- (3) exemptions for intra-Community transactions;
- (4) exemptions on importation;
- (5) exemptions on exportation;
- (6) exemptions related to international transport;
- (7) exemptions related to certain transactions treated as exports;
- (8) exemptions for the supply of services by intermediaries; and
- (9) exemptions for transactions relating to international trade.

These exemptions were introduced to either reduce the regressivity of VAT or the nature of "difficult to tax."

4.2.2 Tax rate

According to the EU Directive, the standard rate and the reduced rates are defined as follows:

- (1) From 1 January 2006 until 31 December 2010, the standard rate may not be less than 15%.³⁹

³⁸ Other activities mainly include insurance and reinsurance, credit guarantees, negotiation concerning deposit and current accounts and so on, postage stamps, betting, lotteries, the supply of a building, and the leasing or letting of immovable property, and so forth. Ibid, Article 135-137.

³⁹ Ibid, Article 97. The 15 per cent is due to expire on 31 December 2015. Article 97 was amended by *Council Directive 2010/88/EU* of 7 December 2010 to extend this provision to 31 December 2015. CASE, CAPP, CEPII ETLA, and IFO IHS, "A retrospective evaluation of elements of the EU VAT system" (1 December 2011) European Commission <http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/report_evaluation_vat.pdf>, at 38 footnote 18.

- (2) Member States may apply either one or two reduced rates.⁴⁰
- (3) The reduced rates shall be fixed as a percentage of the taxable amount, which may not be less than 5%.⁴¹

The EU Directive also provides a list which contains supplies of goods and services to which the reduced rates can be applied. There are 21 categories that can apply the reduced rates. These categories include foodstuff, medicines, medical equipments for the disabled, books on all physical, newspapers, passenger transport, domestic care services, hairdressing, etc.⁴²

There are three possible reasons for applying reduced rates to these items:⁴³

- (1) The most important reason is for equity, such as the reduced rates for foodstuffs and water.
- (2) To recognise supplies that have merit, such as intrinsic social or cultural value, or are beneficial to individual health and public health.
- (3) To aid economic efficiency. For example, reduced rates for labour intensive services (domestic cleaning and hairdressing, and so on).

In addition to the standard rate and reduced rates, there are two other types of rates in the EU's VAT system, namely, the "super-reduced rate" and the "parking rate."⁴⁴ According to Article 113 of the EU Directive, the

⁴⁰ Ibid, Article 98.

⁴¹ Ibid, Article 99.

⁴² See Appendix 1 of the list of supplies of goods or services that shall apply the reduced rates in the EU.

⁴³ CASE, CAPP, CEP II ETLA, and IFO IHS, above n 39, at 540-542.

⁴⁴ Gurău, Mariana and Grigore, Maria Zenovia, "EU comparison of VAT" (2012) XIX-1 *Lex ET Scientia International Journal* 170, at 171.

"super-reduced rates" are applied when Member States grant exemptions with the claimable input tax paid at the preceding stage or apply reduced rates lower than the minimum required by the EU Directive (five per cent) on 1 January 1991, and these supplies are not in the list of goods and services to which the reduced rates may be applied.⁴⁵

On the other hand, the "parking rate" (higher than 12 per cent) can be adopted on condition that Member States were applying reduced rates to these supplies on 1 January 1991, the reduced rates must be above five per cent, and the supplies are not on the list of goods and services to which the reduced rates may be applied.⁴⁶ This means that Member States may continue to adopt the super-reduced rates (less than five per cent) or the parking rate (higher than 12 per cent), provided the requirements mentioned above are satisfied. Furthermore, the adoption of super-reduced rates or parking rates must be in line with the EU Community law and "adopted for clearly defined social reasons and for the benefit of the final consumer."⁴⁷

To date, super-reduced rates are adopted only in five countries,⁴⁸ such as food products, pharmaceutical, books, newspapers, and television license fees.⁴⁹

⁴⁵ European Commission, above n 13, Article 113.

⁴⁶ Ibid, Article 118.

⁴⁷ Ibid, Article 110.

⁴⁸ The five countries are Spain (four per cent), France (two point one per cent), Ireland (four point eight per cent), Italy (four per cent), and Luxemburg (three per cent). European Commission, "VAT rates applied in the Member States of the European Union" (1 January 2015) European Commission
<http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf>, at 3.

⁴⁹ Gurău and Grigore, above n 44, at 175.

The parking rates are also adopted in five Member States,⁵⁰ for example, certain energy products, certain wines, tourism publications.⁵¹

4.2.3 Registration

There are three thresholds defined in the EU Directive:⁵²

- (1) the threshold for exempting small enterprises;
- (2) the threshold for application of the special scheme for acquisitions by taxable persons not entitled to claim input tax and by non-taxable legal persons; and
- (3) the threshold for application of the special scheme for distance selling.

Due to fact that the second type of threshold is for intra-Community acquisitions, only the first and third types of threshold are analysed in this research.

The first type of threshold exempts small enterprises. When the turnover of a small enterprise "has not exceeded the threshold in the preceding calendar year, and is not expected to exceed the threshold in the current year,"⁵³ the small enterprise is exempted from the VAT. According to the data released by the European Commission, there are only three countries (Spain, Netherlands, and

⁵⁰ The five countries are Belgium (12 per cent), Austria (12 per cent), Luxemburg (14 per cent), Portugal (13 per cent), and Ireland (13.5 per cent). European Commission, above n 48, at 3.

⁵¹ Gurău and Grigore, above n 44, at 175.

⁵² Ibid, at 175.

⁵³ Ibid, at 176.

Sweden) that do not set a threshold for small enterprises. However, thresholds vary from €6,696.00⁵⁴ (Denmark) to €114,397.00⁵⁵ (the United Kingdom).⁵⁶

With respect to the threshold for application of the special scheme for distance selling, this threshold, according to the EU Directive, should be set between €35,000.00⁵⁷ and €100,000.00,⁵⁸ or the equivalent in national currency.⁵⁹ The special scheme refers to a simple way to collect the VAT, by which a flat-rate is levied on enterprises' turnover rather than on the value added. However, under this special scheme, the input tax cannot be claimed.⁶⁰

4.3 The Modern GST Model

New Zealand's GST system has been in place for nearly thirty years since its introduction in October 1986. The introduction of this GST system was a revolution that changed the landscape of value-added taxation forever.⁶¹ Even in Europe, which is regarded as the home of value added tax, the New Zealand

⁵⁴ The exchange rate between is: NZ\$100 = €58.15. Therefore, €6,696.00 = NZ\$11,515.05. See ANZ, "Foreign Exchange Rates - New Zealand" (12 February 2016) ANZ <<http://www.anz.co.nz/ratefee/forexchange.asp>>.

⁵⁵ €114,397.00 = NZ\$196,727.43. See ANZ, "Foreign Exchange Rates - New Zealand" (12 February 2016) ANZ <<http://www.anz.co.nz/ratefee/forexchange.asp>>.

⁵⁶ See European Commission, "VAT thresholds" (April 2015) European Commission <http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/traders/vat_community/vat_in_ec_annexi.pdf>.

⁵⁷ €35,000.00 = NZ\$60,189.17. See ANZ, "Foreign Exchange Rates - New Zealand" (12 February 2016) ANZ <<http://www.anz.co.nz/ratefee/forexchange.asp>>.

⁵⁸ €100,000.00 = NZ\$171,969.05. See ANZ, "Foreign Exchange Rates - New Zealand" (12 February 2016) ANZ <<http://www.anz.co.nz/ratefee/forexchange.asp>>.

⁵⁹ European Commission, above n 13, Article 34.

⁶⁰ CASE, CAPP, CEPII ETLA, and IFO IHS, above n 39, at 86.

⁶¹ White, David and Krever, Richard, "Preface" in Krever, Richard and White, David (eds) *GST in Retrospect and Prospect* (Thomson Brookers, Wellington, 2007) 1, at 8.

GST model is an international benchmark for indirect tax design, and has since become the starting point for many of the world's modern value-added taxes.⁶²

Due to the financial crisis in 1984 in New Zealand, a radical overhaul was required for the New Zealand economy.⁶³ Importantly, tax reform was an integral part of the overhaul, and a significant component of the tax reform was the GST.⁶⁴ The GST, which was introduced in New Zealand in 1986 at a rate of 10 per cent, was a part of the tax reform package which was combined with reducing the top marginal tax rate on income tax from 66 per cent to 48 per cent, increasing personal rebates, introducing the Family Support Tax Credit for low-income families, and increasing the benefit levels by five per cent.⁶⁵ This tax reform also abolished the Wholesale Sales Tax, which was imposed on an arbitrary selected one-third of total personal consumption, with tax rates that varied from 10 per cent to 60 per cent.⁶⁶

The main features of New Zealand's GST are characterised by four aspects:⁶⁷

- (1) It has a broad tax base with few goods and services exempt from tax.
- (2) It is imposed on a broad category of services rendered by units of government.

⁶² Ibid, at 8.

⁶³ Sawyer, Adrian, "VAT reform in China: Can New Zealand's Goods and Services Tax provide helpful guidance?" (2014) 4 *Journal of Chinese Tax and Policy* 92, at 94.

⁶⁴ Ibid, at 4-5.

⁶⁵ James, Simon and Alley, Clinton, "Reflections on the introduction of value added tax in the United Kingdom and goods and services tax in New Zealand" (2007) *Working Paper Series, Department of Accounting University of Waikato* 1, at 7.

⁶⁶ Ibid, at 7.

⁶⁷ Schenk, Alan, Thuronyi, Victor and Cui, Wei, *Value Added Tax: A Comparative Approach* (2nd ed, Cambridge University Press, New York, 2015) 1, at 55-56.

- (3) It is imposed on casualty and other non-life insurance.
- (4) The jurisdiction to tax is based on the residence of the supplier, not the location of the supply.

In addition to these four aspects, the single tax rate structure is another feature of New Zealand's GST.

According to section 8 (1) of the *Goods and Services Tax Act 1985* (as amended):⁶⁸

Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 15% on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after 1 October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

The tax base, tax rate, and the registration policy of New Zealand's GST system, are outlined below.

4.3.1 Tax base

Any supply of goods and services charged with GST is a taxable supply.⁶⁹

New Zealand's GST is levied on the value of supply, except where the supply is

⁶⁸ CCH, *New Zealand Goods and Services Tax Legislation* (25th ed, CCH, Auckland, 2012) 1, at 99.

⁶⁹ Marshall, Tony, "Chapter 22: Goods and Services Tax" in Vosslander, Robert (ed) *New Zealand Taxation 2015 Principles, Cases and Questions* (Thomson Brookers, Wellington 2015) 868, at 880.

zero-rated.⁷⁰ In addition to the zero-rated supply, an exempt supply is not a taxable supply; hence, it is not charged with GST.⁷¹

Under New Zealand's GST system, the following supplies are exempted from the GST:⁷²

- (1) supplies of financial services (excluding those which are zero-rated or which, between the supplier and the recipient, are not a financial service supply);
- (2) supplies made by a non-profit body of donated goods and services;
- (3) supplies of residential accommodation;
- (4) the letting of leasehold land used for residential accommodation;
- (5) the supply of property which is on-leased as residential accommodation;
- (6) supplies of fine metal (other than those which are zero-rated);
- (7) certain sales of houses, and the free holding of leasehold land, where the residence has been let (or occupied pursuant to a licence) for residential accommodation for at least five years; and
- (8) penalty or default interest (but not a late payment fee).

From the list above, it can be seen that there are only four broad categories exempted from the GST: financial services, donations and non-profit bodies, residential accommodation, and fine metals. As mentioned above, the existence

⁷⁰ Ibid, at 880-881.

⁷¹ Ibid, at 881.

⁷² McKenzie, Alastair, *GST - A Practical Guide* (9th ed, CCH, Auckland, 2012) 1, at 51.

of exemptions may distort economic behaviour. Therefore, New Zealand's GST minimises the number of exemptions.

Under New Zealand's GST system, the zero-rated supplies can be classified into two broad categories: commodities supplied overseas and others (e.g., business-to-business financial services, fine metals and so forth).⁷³ There are two considerations for zero-rating these supplies. First, according to the principle of destination, the GST should not be imposed on exported supplies.⁷⁴ By doing so, the GST will not attach to the price of supplies; and thus, the exported supplies will not lose competitiveness compared with the local supplies in terms of price. The second consideration is to ensure that the GST does not lead to arbitrary results.⁷⁵ For example, the GST will not inflate the price of an internationally priced commodity; hence, zero-rating the supply of newly refined precious metal.⁷⁶ In the light of the purpose of this research, these items are not considered in detail.

Another striking feature of the New Zealand GST system is that all government-provided services are taxed, including, for example, healthcare and education.⁷⁷ The GST is also levied on appropriations to government departments, which is different to most countries VAT/GST systems.⁷⁸ By doing so, the services provided by the state and private sectors are treated in the

⁷³ See Appendix 2 for the list of zero-rated supplies under New Zealand's GST system.

⁷⁴ McKenzie, above n 72, at 14.

⁷⁵ Ibid, at 14.

⁷⁶ Ibid, at 14.

⁷⁷ Dickson, Ian and White, David, "Tax design insights from the New Zealand Goods and Services Tax (GST) model" (2008) *Victoria University of Wellington CAGTR Working Paper Series, Working Paper No. 60*, 1, at 14.

⁷⁸ Benge, Matt, Pallot, Marie, and Slack, Hamish, "Possible lessons for the United States from New Zealand's GST" (2013) 66 *National Tax Journal* 479, at 483.

same way. Therefore, this ensures that there is no competitive advantage for the state or private sectors.⁷⁹

4.3.2 Tax rate

There is only one standard tax rate in the New Zealand GST system, which is currently 15 per cent. The GST rate has increased twice since 1986 when the GST took effect at a 10 per cent rate.⁸⁰ On 1 July 1989, the GST rate increased to 12.5 per cent, eight months after reducing the top personal income tax rate to 33 per cent because of the share market crash in 1987.⁸¹ After a major tax review in 2010, the GST rate was raised to 15 per cent on 1 October 2010.⁸²

4.3.3 Registration

Registering to be a GST taxpayer is available when the following criteria are satisfied, namely, the taxpayer:⁸³

- (1) carries on a taxable activity, or
- (2) intends to carry on a taxable activity from a specific date.

There are three types of registration under New Zealand's GST regime: voluntary registration, compulsory registration, and deemed registration.⁸⁴

Any person who carries on a taxable activity can voluntarily register to be a GST taxpayer.⁸⁵ Furthermore, voluntary registration can be applied before

⁷⁹ Dickson and White, above n 77, at 14.

⁸⁰ McKenzie, above n 72, at 110.

⁸¹ James and Alley, above n 65, at 7.

⁸² Sawyer, above n 63, at 99.

⁸³ McKenzie, above n 72, at 114.

⁸⁴ Marshall, above n 69, at 870-871.

commencement of a taxable activity.⁸⁶ Registering to be a GST taxpayer means that the input tax can be claimed. Therefore, voluntary registration can avoid the distortionary effect on competition between GST registered businesses and unregistered businesses, whose turnover does not reach the threshold.

Compulsory registration will occur when either of the following criteria is satisfied:⁸⁷

- (1) The person's taxable supplies within any 12-month period made in the course of their taxable activity exceeds the \$60,000⁸⁸ threshold and the total value of taxable supplies over the next 12 months is also expected to exceed \$60,000; or
- (2) There are reasonable grounds for believing that the person's taxable supplies over the next 12-month period made in the course of their taxable activity will exceed the \$60,000 threshold.

When a person has satisfied the requirement to be a GST registered taxpayer but has failed to register, the Commissioner of Inland Revenue (CIR) will treat the person as a GST registered taxpayer from the time the requirement has been satisfied.⁸⁹ This is the third type of registration under New Zealand's GST regime, which is called deemed registration. Taxpayers who fail to register for

⁸⁵ Ibid, at 870.

⁸⁶ Ibid, at 870.

⁸⁷ Ibid, at 870.

⁸⁸ The threshold has been changed four times since 1986 (NZ\$40,000 before 1 April 2009, NZ\$30,000 before 1 October 2000, and NZ\$24,000 before 1 October 1990). McKenzie, above n 72, at 141.

⁸⁹ Marshall, above n 69, at 871.

GST when required commit a criminal offence, one may be subject to penalties as well.⁹⁰

4.4 Evaluation of Two Models: Traditional vs. Modern

In this section, the two models are examined in terms of the principles of taxation⁹¹ that were discussed in the literature review in Section 2.4 of this thesis.

4.4.1 The Traditional VAT Model

The EU's VAT model is derived from the French VAT.⁹² VATs in different Member States in the EU are regulated by the EU Directive so that the VAT can be applied relatively uniformly between Member States. However, Member States have the right to design their own VATs, which increases the complexity of the EU's VAT system. Some researchers⁹³ perceive this as an outcome of political compromise. Therefore the traditional VAT model is not considered to be a good type of VAT/GST.⁹⁴

In addition to this, as the general regulator of VATs in the EU, the EU Directive has a significant disadvantage, which violates the principles of taxation, such as simplicity and efficiency. Therefore, more and more

⁹⁰ Ibid, at 871.

⁹¹ These principles are equity, certainty, convenience, efficiency, simplicity, and neutrality.

⁹² Jin, Dongsheng and Jin, Weifu, "On the development strategy of China's Value-Added Tax (VAT) reform" (2013) 3 *Journal of Chinese Tax and Policy* 226, at 235.

⁹³ Ibid, at 235.

⁹⁴ Ibid, at 235.

organisations⁹⁵ support the view that a single rate rather than multiple rates is preferred, and a broad base with minimal exemptions is considered to be ideal.

The first disadvantage of the traditional VAT model is the relatively narrow tax base. In the light of the principle of equity and the issue of supplies that are difficult-to-tax, exemptions are widely adopted in the EU. However, these exemptions can distort the competition between exempt enterprises and non-exempt enterprises.⁹⁶ This is because when selling supplies to final consumers, exempt enterprises have an advantage due to the fact that less tax is attached to the price; whereas, when selling supplies to other enterprises, non-exempt enterprises are favoured due to the fact that the purchasers can claim the input tax.⁹⁷ Furthermore, exemptions can increase tax compliance and administration costs through meeting the requirement of allocating the input tax between taxable and exempt outputs.⁹⁸ Therefore, the exemptions in the traditional VAT model create distortions, which move the traditional VAT model away from the ideal VAT/GST model.

The second disadvantage of the traditional VAT model is the multiple tax rate structure. This is adopted as a tool to alleviate the regressivity of the VAT/GST system, but it has been proven not to be the best way to achieve this.⁹⁹ In addition, the multiple tax rate structure can increase complexity and tax

⁹⁵ For example, the IMF has recommended some best practices to be used for designing a VAT. Lejenue, above n 24, at 267. Also, the OECD has the similar recommendation. Charlet, Alain and Owens, Jeffrey, "An international perspective on VAT" (2010) 20 *Tax Notes International* 943, at 949.

⁹⁶ CASE, CAPP, CEPII ETLA, and IFO IHS, above n 39, at 69.

⁹⁷ Ibid, at 69.

⁹⁸ Ibid, at 69.

⁹⁹ Lejeune, Ine, Daou, Jeanie, and De Maeijer, Stein, "The European Commission's communication on the future of VAT: A recipe of growth?" (2012) 2 *International VAT Monitor* 99, at 101.

compliance costs of enterprises, and cause economic distortions.¹⁰⁰ This can also increase the administration costs of the government due to disputes between the tax authority and enterprises on the correct application of the different rates.¹⁰¹ Furthermore, the application of reduced rates may tax similar people differently due to their preferences.¹⁰² For example,¹⁰³ people who prefer downloading music from the Internet may be free from the tax. In contrast, people who enjoy listening to music CDs are taxed at the standard rate. Therefore, from this perspective, the multiple rate structure can be seen as unfair.¹⁰⁴

These two disadvantages create complexity, uncertainty, and inefficiencies,¹⁰⁵ which breach the principles of taxation. In view of this, the European Commission has started a debate on the future of the EU VAT system through publishing the *Green Paper*,¹⁰⁶ in order to create a simple, more robust, and more efficient VAT system. From the responses to the Green Paper, respondents generally are not satisfied with the current system in the EU due to the fact that the current VAT rules and regulations are not applicable for the single market.¹⁰⁷ To achieve the objective of creating a simple, robust, and

¹⁰⁰ Ibid, at 101.

¹⁰¹ Lejenue, above n 24, at 276-277.

¹⁰² CASE, CAPP, CEPII ETLA, and IFO IHS, above n 39, at 544.

¹⁰³ Ibid, at 544.

¹⁰⁴ Ibid, at 544.

¹⁰⁵ Lejenue, above n 24, at 280.

¹⁰⁶ Vyncke, Kenneth, Axel Cordewener, and De Broe, Luc, "Towards a simpler, more robust and efficient VAT system by levying VAT at EU Level" *International VAT Monitor* (2011) 242, at 242. See European Commission, "Green Paper: On the future of VAT– Towards a simpler, more robust and efficient VAT system" (1 December 2010) European Commission. <[http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/future_vat/com\(2010\)695_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/future_vat/com(2010)695_en.pdf)>.

¹⁰⁷ European Commission, "Summary report of the outcome of the public consultation on the Green Paper on the future of vat towards a simpler, more robust and efficient vat system" (2

efficient VAT system, "the Commission is even aiming at 1 January 2018 as a starting point for such a revised EU VAT system."¹⁰⁸

4.4.2 *The Modern GST Model*

To some degree, New Zealand's GST model is "based" on the UK's VAT regime (the traditional VAT model), with a significant improvement through fewer exemptions and a single standard rate.¹⁰⁹ New Zealand's model is generally regarded as being the benchmark when measured against the principles of simplicity and efficiency,¹¹⁰ which are the main features of the modern GST model. This can be evidenced from the adoption, with some modifications, by other countries of the modern GST model, after studying New Zealand's GST. These countries include Canada, South Africa, Thailand, Fiji, Singapore, and Australia.¹¹¹ However, GST systems in these countries are less "pure" than New Zealand's GST system.

Before introducing the GST in New Zealand, the Advisory Panel on the Goods and Services Tax realised that to ensure the GST would be as simple as possible, a single rate and a broad base were necessary pre-conditions.¹¹² Therefore, when New Zealand started to design its own GST, the objective of the GST system was to create a simple and efficient GST regime, and avoid the

December 2011) European Commission
<http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/future_vat/summary_vat_greenpaper.pdf>.

¹⁰⁸ Lejenue, Daou, and De Maeijer, above n 99, at 104.

¹⁰⁹ McKenzie, above n 72, at 6.

¹¹⁰ Sawyer, above n 63, at 92.

¹¹¹ McKenzie, above n 72, at 10.

¹¹² Green, Richard, "Consulting the public in developing a GST" in Krever, Richard and White, David (eds) *GST in Retrospect and Prospect* (Thomson Brookers, Wellington, 2007) 13, at 19.

"mistakes" and complexities of the European VAT regimes.¹¹³ The original proposal of the UK's VAT regime also aimed to be a simple VAT. However, the actual VAT regime in the UK has deviated from its original intention due to exemptions and different rates.¹¹⁴ A simple and "clean" VAT/GST system, which has only one standard rate and few exemptions, is vital to reduce the compliance costs of enterprises, and administration costs of the government.¹¹⁵ As discussed above, the principle of efficiency is closely associated with the principle of simplicity. The simple nature of New Zealand GST model leads to an efficient GST regime.

On the other hand, the principles of simplicity and efficiency are based on the trade-off of less equity within the GST itself.¹¹⁶ However, the negative impact on equity has been compensated elsewhere in the tax system in New Zealand.¹¹⁷ As mentioned above, the introduction of GST was one of the components of New Zealand's tax reform package in 1986. The package included the reduction of personal income tax, the increase in personal rebates, and the introduction of the Family Support Tax Credit for low-income workers and beneficiaries,¹¹⁸ making the overall tax system in New Zealand less unfair.¹¹⁹ Douglas points out that: "a low income family is not going to

¹¹³ Todd, Jeff, "Implementing GST - information, education, co-ordination" in Krever, Richard and White, David (eds) *GST in Retrospect and Prospect* (Thomson Brookers, Wellington, 2007) 27, at 29.

¹¹⁴ Green, above n 112, at 24.

¹¹⁵ Douglas, Roger, "The New Zealand GST policy choice and its political implications" in Krever, Richard and White, David (eds) *GST in Retrospect and Prospect* (Thomson Brookers, Wellington, 2007) 3, at 9.

¹¹⁶ Sawyer, above n 63, at 92.

¹¹⁷ Ibid, at 1.

¹¹⁸ James and Alley, above n 65, at 7.

¹¹⁹ Sawyer, above n 63, at 96.

complain about \$10 taken from them if the government gives \$35 back."¹²⁰ Therefore, addressing the regressive nature of GST by the reform package was seen to be good for New Zealand. As a result, New Zealand's system overall has been perceived to be a relatively fair tax system.¹²¹ This can be evidenced by Alley, Bentley, and James's recent research, in which they comment that New Zealand's GST system that "focuses on achieving economic efficiency together with direct help for the less well-off," has generated the national consensus in New Zealand for a broad based GST.¹²²

When the EU reviewed New Zealand's model for designing its future VAT system, PricewaterhouseCoopers (PwC) commented that "the New Zealand GST model will be at the forefront of study for European policymakers, which is a fascinating dimension."¹²³ Sawyer also suggests that the New Zealand's modern GST model "should be the blueprint that is used by jurisdictions when contemplating a GST/VAT or refining their existing GST/VAT".¹²⁴

4.5 Summary

In conclusion, VATs adopted by the EU Member States are typical examples of the traditional VAT model. The adoption of the VAT that is regulated by the EU Directive is a prerequisite for membership of the EU. Although the EU Directive brings almost all transactions into the scope of the VAT, the Member States still stipulated a wide range of exemptions since they are permitted a

¹²⁰ Douglas, above n 115, at 6.

¹²¹ Todd, above n 113, at 39.

¹²² Alley, Clinton, Bentley, Duncan, and James, Simon, "Politics and tax reform: A comparative analysis of the implementation of a broad-based consumption tax in New Zealand, Australia and the United Kingdom" (2015) 24 *Revenue Law Journal* 1, at 24.

¹²³ Trombitas, Eugen (PwC), "GST: One of our best exports" (28 January 2012) PwC <<http://www.pwc.co.nz/media-centre/opinion-pieces/gst-one-of-our-best-exports/>>.

¹²⁴ Sawyer, above n 63, at 102.

wide range of exemptions when designing their own VAT regime. These exemptions were mainly introduced to reduce the regressivity of VAT. In addition, to achieve the principle of equity, the EU Directive also allows the Member States to have either one or two reduced rates besides a standard rate. Thus, the features of the traditional VAT model are the existence of many exemptions and the multiple tax rate structure, which create distortions and complexity. Therefore, the traditional VAT model breaches the principles of certainty, efficiency, simplicity and neutrality.

By comparison, New Zealand's GST system, which is the benchmark of a simple, efficient, and robust VAT/GST, is the best example of the modern GST model. Under New Zealand's GST system, only financial services (except B2B), donations and non-profit bodies, residential accommodation, and fine metals, are exempted. By doing so, the influence of distortions caused by exemptions has been reduced. Furthermore, the one standard tax rate structure was adopted when the GST was introduced in 1986. New Zealand's GST system is a significant improvement compared with the traditional VAT system. The distinguishing features of the New Zealand model are a broad tax base with few exemptions and a single tax rate structure. Therefore, the New Zealand model is generally regarded as a benchmark of the simple and efficient VAT/GST system. This model is also advocated by both the IMF¹²⁵ and the OCED¹²⁶ as an example of the ideal VAT/GST system.

¹²⁵ Lejenue, above n 24, at 267.

¹²⁶ Charlet and Owens, above n 95, at 949.

CHAPTER 5 FINDINGS

This chapter provides the answers to the two research questions. Apart from answering which model China chose to develop its new Value Added Tax (VAT) system, reasons are provided to explain why China chose that model. The three aspects include an incrementalism strategy, the experience of previous VAT reforms in China, and the impacts of the Business Tax to Value Added Tax (B2V) reform. As for the second research question, suggestions from New Zealand's experience and the author's recommendation for moving China's VAT regime towards the modern GST model are offered in this chapter.

5.1 Which Model did China Choose to Develop its New VAT System? And Why?

According to the discussion in the literature review, the single tax rate and a broad tax base with few exemptions are the main features to differentiate the modern GST model from the traditional VAT model.¹ Despite the fact that the B2V reform is still in progress, the adoption of multiple reduced tax rates and many exemptions, indicates that China chose the traditional VAT model to develop its new VAT regime. It is not clear whether China will adopt a single rate, and abolish as many exemptions as possible at the end of the B2V reform. For now, it seems unlikely that China will achieve the ideal VAT/GST model which features a broad tax base and a single tax rate structure in the short term.

¹ This view is introduced in Section 2.5 of this thesis.

There may be three possible reasons why China chose the traditional VAT model: an incrementalism strategy, experience from previous reforms, and substantial impacts of the B2V reform.

5.1.1 Incrementalism

The first reason is that incrementalism might be the best strategy for tax policymakers.² This is because the incrementalism approach provides a rational action in an uncertain world due to the inherent complexity of tax policy.³ Although all the goals cannot be achieved at one time by incrementalism, this approach avoids unexpected outcomes that might trigger more radical changes.⁴ As a result, incrementalism is a "strategy for a process of limited, gradual tax policymaking."⁵ In China, VAT and BT are two of the most important taxes. This can be evidenced by the proportions of VAT (27 per cent) and BT (15.2 per cent) that account for total fiscal revenue. It is a rational approach to implement the B2V reform gradually, moving ultimately towards the modern GST model. Despite the disadvantages of the VAT regime during the B2V reform, the reform process has at least taken the first step to alter the existing deficient tax system. It has already scored some significant achievements, such as the reduction of the tax burden and the change of China's industry structure. More importantly, the gradual transition of the reform may avoid issues which could result in serious consequences for the whole country, especially for China which has a very large population.

² James, Simon, "The contribution of behavioural economics to tax reform in the United Kingdom" (2012) 41 *The Journal of Socio-Economics* 468, at 470.

³ Ibid, at 470.

⁴ Ibid, at 470.

⁵ Ibid, at 470. See also Pollack, Sheldon David, *The Failure of U.S. Tax Policy: Revenue and Politics* (Pennsylvania State University Press, University Park, 1996).

5.1.2 Experience from previous reforms

The second reason can be found in previous reforms,⁶ namely, the VAT reform in 1984 and the VAT reform in 2009. Before issuing the *Regulations of the People's Republic of China on Value Added Tax* in 1984, the pilot programme had been implemented in four cities in 1979, and then more supplies were added to the scope of the VAT in 1981.⁷ Similarly, the reform in 2009, which was to change the production-based VAT to a consumption-based VAT nationwide, started with a pilot programme in three provinces in 2004.⁸ The scope was extended to 26 cities in 2007,⁹ before implementation nationwide in 2009.¹⁰ It seems that the step-by-step approach is a traditional and accepted approach for VAT reforms in China. Therefore, it is not a surprise that China chose the traditional VAT model for its new VAT regime because the traditional VAT model is potentially an intermediate stage to the modern GST model.

5.1.3 Impacts of the B2V reform

A third possible reason may be that the impacts of the B2V reform are substantial, including micro and macro aspects. The following sections discuss the effects of China's B2V reform with respect to these aspects.

⁶ The history of China's VAT reform is introduced in Section 3.1 of this thesis.

⁷ National Accountant Assessment & Certification Centre of Ministry of Finance, *Economic Law* (China Financial & Economic Publishing House, Beijing, 2015) 1, at 322.

⁸ Ibid, at 322.

⁹ Ibid, at 322.

¹⁰ Ibid, at 322.

5.1.3.1 Micro effects of the B2V reform

The analysis of micro effects focuses mainly on the tax burden and the financial accounting of enterprises that are influenced deeply by the B2V reform in this thesis.

(a) Impact on the tax burden of enterprises

In July 2015, the State Administration of Taxation (SAT) released the relevant data for the B2V reform. According to the data, the amount of overall tax collected and therefore the tax burden of enterprises reduced for the first half of 2015 by 110.00 billion Yuan.¹¹ Also, from the data, the accumulated amount of reduced tax collected since the B2V reform was carried out in 2012 is 484.8 billion Yuan.¹² This accumulated amount accounts for slightly over eight per cent of the entire fiscal revenue (5,937.3 billion Yuan)¹³ for the first half of 2015. For example, before the B2V reform, small businesses in the services industries were taxed at five per cent under the BT. After the B2V reform, the effective tax rate of those small businesses has reduced to 2.92 per cent.¹⁴ This means that the tax burden of small businesses has decreased by 41.6 per cent.¹⁵ The B2V reform is beneficial in reducing the tax burden of small businesses,

¹¹ See the State Administration of Taxation, "The fiscal revenue of the first half of 2015" (27 July 2015) State Administration of Taxation <<http://www.chinatax.gov.cn/n810214/n810631/c1743942/content.html>>. The exchange rate between Yuan and New Zealand dollar is RMB439.72 = NZ\$100. Therefore, RMB110 billion = NZ\$25.02 billion. See Bank of China, "BOC Exchange Rate" (12 February 2015) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

¹² RMB484.8 billion = NZ\$110.25 billion. See Bank of China, "BOC Exchange Rate" (12 February 2015) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

¹³ RMB5, 937.3 billion = NZ\$1, 350.25 billion. See Bank of China, "BOC Exchange Rate" (12 February 2015) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

¹⁴ $2.92\% = 3\% / (1+3\%)$. Three per cent is the tax rate for small-scale taxpayers.

¹⁵ $41.6\% = (5\% - 2.92\%) / 5\%$.

and leaves them with more money to support their development and expansion. Therefore, small businesses in the services industries are the main beneficiaries in the B2V reform in terms of the reduction of the tax burden. This undoubtedly has rebalanced the tax burden of taxpayers in China, which in turn improves the vitality of the markets, and stimulates the development of China's economy.¹⁶ From this perspective, this outcome has reached one of the intended goals set for the B2V reform, the goal which is to implement a reduction in tax collected nationwide.¹⁷

Although, to a certain extent, the B2V reform lessens the tax burden of large or medium-sized manufacturing enterprises and small businesses in the service industries, it also increases the tax burden of large and medium-sized non-manufacturing enterprises.¹⁸ Taking the telecommunications service industry as an example,¹⁹ one feature of this industry is that the amount of investment on fixed assets is substantial at the beginning, but when companies are operating, the investment on fixed assets will be on a much smaller scale. Furthermore, this type of industry was taxed at three per cent under the BT before the B2V reform. After the B2V reform, taxpayers in such an industry were subject to the VAT with the tax rate of 11 per cent. The tax rate gap is

¹⁶ Liao, Shaogang and Pan, Ying, "Analysis on the policy effect of replacing Business Tax with Added-Value Tax" (2015) 3 *International Journal of Economics, Finance and Management Sciences* 162, at 162.

¹⁷ 何代欣, "营改增"最优税率问题: 评估及建议" (2015) 4 *地方财政研究* 4, at 5 (translation: He, Daixin, "The optimal tax rate for the B2V reform: Evaluation and suggestion" (2015) 4 *Sub National Fiscal Research* 4, at 5).

¹⁸ 蔡之仙, "浅谈'营改增'对企业税负的影响" (2013) 20 *财经界(学术版)* 251, at 251 (translation: Cai, Zhixian, "The impact of the B2V reform on the tax burden of enterprises" *Money China (Academic Edition)* 251, at 251).

¹⁹ 侯忠超, "浅析'营改增'对不同行业的税负影响" (2013) 4 *现代经济信息* 104, at 104 (translation: Hou, Zhongchao, "The impact of the B2V reform on the tax burden of enterprises in different industries" (2013) 4 *Modern Economic Information* 104, at 104).

eight per cent, which means the tax burden of this industry was lower than that before the B2V reform, but only when enough output taxes can be generated. If the turnover of a company is NZ\$100.00 billion before the B2V reform, the tax (under the BT) is NZ\$0.3 billion. After the B2V reform, the output tax is NZ\$0.991 billion.²⁰ This means that only when the input tax is more than NZ\$0.691 billion,²¹ will the tax burden be equal to the tax burden before the B2V reform. In other words, the tax burden will not be increased only when purchases are more than NZ\$4.06 billion²² which would generate NZ\$0.691 billion in input taxes. However, as mentioned above, it is difficult for companies in the telecommunications service industry to generate such an amount of input taxes without purchasing fixed assets. Therefore, the B2V reform may increase the tax burden of those companies.

Similar research²³ for the transportation industry shows that whether the tax burden increases or decreases depends on the claimable input tax. This can be demonstrated as follows.²⁴ Assume that the turnover (excluding VAT) of a company in the transportation industry is P, and Q is the proportion of the claimable input tax accounting for the turnover (normally, $0 < Q < 1$). Hence,

²⁰ The output tax $= \frac{10 \text{ billion}}{1+11\%} \times 11\% = 0.991 \text{ billion}$. (11 per cent is the tax rate for the telecommunications service industry).

²¹ $\text{NZ\$}0.691 = \text{NZ\$}0.991 - \text{NZ\$}0.3$.

²² The purchase cost $= \frac{0.691 \text{ billion}}{17\%} = 4.06 \text{ billion}$. (17 per cent is the standard tax rate, which is used for calculating the input tax).

²³ See, 李嘉明, 彭瑾, 刘溢, 张金若, "中国营业税改征增值税试点政策实施效果研究" (2015) 2 *重庆大学学报(社会科学版)* 24 (translation: Li, Jiaming, Peng, Jin, Liu, Yi, and Zhang, Jinruo, "A case study on implementation effects of the pilot policy for substituting the Value-added Tax for Business Tax in China" (2015) 2 *Journal of Chongqing University (Social Science Edition)* 24).

²⁴ Ibid.

the claimable input tax is equal to $P \times Q$. When $P \times 11\% - P \times Q \times 17\% = 0$,²⁵ namely, the input tax ($P \times Q \times 17\%$) is equal to the output tax ($P \times 11\%$), the Q can be calculated to be 64.71 per cent, which is called the critical point of the tax burden of VAT. According to the equation, the outcome can be concluded below:²⁶

- (1) when $Q > 64.71$ per cent, the tax burden will decrease;
- (2) when $Q < 64.71$ per cent, the tax burden will increase.

There are four reasons to explain why the tax burden will increase in large or medium-sized non-manufacturing enterprises:

- (1) Compared with the tax rates under the BT, the tax rates of VAT are too high.²⁷ Before the B2V reform, the tax rates for the telecommunications service industry, transportation industry, and the movable tangible property leasing services were three per cent, three per cent, and five per cent, respectively. Through the B2V reform the tax rates for the telecommunications service industry and the transportation industry have increased to 11 per cent, and 17 per cent for the movable tangible property leasing services. Furthermore, general taxpayers in these industries may not have sufficient input taxes. Therefore, the tax burden increases. On the other hand, for small-scale taxpayers, since the applicable tax rate for them is three

²⁵ 11 per cent is the VAT tax rate for the transportation industry, and 17 per cent is the standard VAT tax rate, which is also used for calculating the input tax.

²⁶ Li, Peng, Liu, and Zhang, above 23 at 28.

²⁷ 潘文轩, "'营改增'试点中部分企业税负'不减反增'现象分析" (2013) 1 *财贸研究* 95, at 97-98 (translation: Pan, Wenxuan, "On phenomenon of tax burden increase in some service industry enterprises during substituting Value-added Tax for Business Tax reform" (2013) 1 *Finance and Trade Research* 95, at 97-98).

per cent, compared to the tax rates under the BT (three per cent or five per cent), the tax burden of small-scale taxpayers in these industries is either the same as before, or decreases.

- (2) The proportion of the claimable input tax is too low.²⁸ In some labour intensive services, such as authentication and consulting services, the labour costs which cannot be claimed, are the main costs. Under the VAT regime in China, the claimable input taxes are mainly from purchasing. Therefore, no input credits arise from the labour costs. This leads to an increase of the tax burden in these labour intensive industries.
- (3) The updating cycle of fixed assets is too long. In fact, many enterprises had replaced their fixed assets before the B2V reform.²⁹ Therefore, the lack of claimable input credits may also increase the tax burden.
- (4) It is difficult to obtain invoices to be used for claiming the input tax. Due to the fact that valid vouchers for claiming the input tax are invoices issued by general taxpayers, when supplies are provided by small-scale taxpayers who cannot issue a VAT invoice, general taxpayers cannot claim their input tax. This phenomenon frequently occurs in the transportation industry. Since most of the enterprises for repairing vehicles are small-scale taxpayers that cannot issue a VAT invoice,³⁰ general taxpayers in the transportation industry cannot get the vouchers for claiming input tax, which increases the tax burden as well.

²⁸ Ibid, at 97.

²⁹ Ibid, at 98. See also Cai, above n 18, at 251.

³⁰ Ibid, at 98. See also Cai, above n 18, at 251.

(b) Impact on financial accounting

This section focuses on the impact of the B2V on financial accounting, especially the impact on annual reports (including the Balance Sheet, Income Statement, and the Cash Flow Statement).³¹ The impacts are illustrated by comparing the accounting methods used before and after the B2V reform.

For the Balance Sheet, there is a slight change, which is the account "Taxes and expenses payable." Before the B2V reform, this account only recorded the BT and other taxes, except the VAT for those enterprises subjected to the B2V reform. However, this account now records the VAT besides the BT and other taxes.

As for the Income Statement, before the B2V reform, the items "Operating income" and "Operating cost" reflected the income and cost that are inclusive of VAT. After the reform, these two items reflect income and cost exclusive of the VAT.

The impact of the B2V reform on the Cash Flow Statement can be explained as follows.³² First, before the B2V reform, the item "Cash from selling commodities or offering labour," recorded the amount of cash and cash equivalents of operating income. Now the item records not only the cash and cash equivalents of operating income, but also the output tax received together with the operating income. Second, before the B2V reform, the item "Cash paid for commodities or labour" recorded the amount of cash and equivalents of

³¹ See Appendix 3, which illustrates an example of the B2V reform's impact on accounting entries.

³² See Appendix 4, which illustrates an example of the B2V reform's impact on the Cash Flow Statement.

operating costs. However, after the B2V reform, the input tax paid by enterprises is added to this item.

5.1.3.2 Macro effects of the B2V reform

This section focuses on the impacts on the industrial structure in China, and the distribution of VAT revenue between the Central Government and the local governments.

(a) Impact on the industrial structure

In the world's major developed countries (for example, the United States, the United Kingdom), the contribution rate of the service industry to economic growth is generally 70 per cent.³³ According to the data from the National Bureau of Statistics of China,³⁴ the contribution rates of the three major industries in China are shown in Table 5.1.

Table 5.1 The contribution rates of three major industries (unit: per cent)

Item	2011	2012	2012	2014
The first industry ³⁵	4.2	5.3	4.4	4.7
The second industry ³⁶	51.5	49.3	48	46.3
The third industry ³⁷	44.3	45.4	47.6	48.9

³³ Liao and Pan, above n 16, at 163.

³⁴ See the National Bureau of Statistics of China "National Data" National Bureau of Statistics of China <<http://data.stats.gov.cn/easyquery.htm?cn=C01&zb=A0209&sj=2014>> (accessed 25 August 2015).

³⁵ In China the first industry mainly includes agriculture and forestry.

³⁶ In China the secondary industry mainly includes manufacturing.

³⁷ In China the third industry mainly includes service industries.

From the table, it can be seen that the contribution rate of the third industry (the service industry) was 44.3 per cent in 2011 before the B2V reform. In 2012 this contribution rate increased to 45.4 per cent. Due to the fact that the reform was implemented only in the pilot cities, the increment of the contribution rate of the service industry is only 1.1 per cent in 2012. However, when analysing the contribution rate from the pilot cities, the effect is clearer. For example, for the first half year after the B2V reform, the Gross Domestic Product (GDP) in Shanghai was 995 billion Yuan,³⁸ which increased by 7.2 per cent when compared with the corresponding period of 2011.³⁹ The first industry decreased by 3.2 per cent, the second industry increased by three per cent, and the third industry increased by 10.3 per cent.⁴⁰ This means that the B2V reform could positively affect the industrial structure. When the B2V reform was extended to all of China in 2013, the contribution rate of the third industry was 48.9 per cent, which increased by 3.3 per cent compared with 44.3 per cent in 2011. As more industries were included in the B2V reform, the contribution rate of the third industry saw an upward trend, which is evidenced by the contribution rate of the third industry in 2014 (48.9 per cent).

³⁸ The exchange rate between Yuan and New Zealand dollar is RMB439.72 = NZ\$100.00. Therefore, RMB 995 billion = NZ\$226.28 billion. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

³⁹ 胡怡建, "上海服务业'营改增'改革试点效应分析" (2013) 1 *科学发展* 55, at 61 (translation: Hu, Yijian, " Shanghai services business change increases the pilot reform effect analysis" (2013) 1 *Scientific Development* 55, at 61).

⁴⁰ *Ibid*, at 61.

(b) Impact on the distribution of tax revenue

Before the B2V reform, according to the *Law of the People's Republic of China on the Administration of Tax Collection*,⁴¹ the local taxation bureaus which report to the local governments are in charge of the collection of the BT. Meanwhile, the state taxation bureaus report to the SAT, which is in charge of collecting the VAT.⁴² In regard to the distribution of the revenues of the VAT and the BT, the following revenues are allocated to the Central Government:⁴³

- (1) the VAT collected from imported goods by China's General Administration of Customs;
- (2) 75 per cent of the whole VAT revenue excluding the VAT collected by China's General Administration of Customs; and
- (3) the BT collected from railway transportation, the headquarters of banks and insurance companies.

In contrast, the following revenues are allocated to the local governments:⁴⁴

- (1) 25 per cent of the whole VAT revenue excluding the VAT collected by China's General Administration of Customs; and
- (2) the whole BT revenue, except revenues collected from the railway transportation, the headquarters of banks and insurance companies.

⁴¹ *Law of the People's Republic of China on the Administration of Tax Collection* (31 August 2005) The Central People's Government of the People's Republic of China <http://www.gov.cn/banshi/2005-08/31/content_146791.htm>.

⁴² The Chinese Institute of Certified Public Accountants, *Taxation Laws* (Economic Science Press, Beijing, 2014), at 24.

⁴³ *Ibid*, at 24-25.

⁴⁴ *Ibid*, at 24-25.

According to a report from the Ministry of Finance, Table 5.2 illustrates the amount of fiscal revenue generated by the different types of taxes before the B2V reform:

Table 5.2 The fiscal revenue of 2011 (unit: billion)⁴⁵

Item	Amount (Yuan)	Amount (NZ\$) ⁴⁶	Per cent
VAT (domestic)	2,426.664	551.866	27.00%
Enterprises Income Tax	1,676.035	381.160	18.68%
Business Tax	1,367.861	311.075	15.25%
VAT and Excise Tax of imported goods	1,356.026	308.384	15.11%
Excise Tax (domestic)	695.593	158.190	7.75%
Individual Income Tax	605.409	137.681	6.75%
Contract Tax	276.361	62.849	3.08%
Custom Duty	255.91	58.198	2.85%
Land Appreciation Tax	206.251	46.905	2.29%
Vehicle Purchase Tax	204.445	46.494	2.27%
Tax on the Use of Urban Land	122.226	27.796	1.36%
Building Tax	110.236	25.070	1.23%
VAT refund of exported goods	-902.47	-205.237	-10.05%
Total fiscal revenue	8,972.031	2,040.396	100.00%

⁴⁵ Not all the items are listed here. See the Ministry of Finance of People's Republic of China, "An analysis of the fiscal revenue of 2011" (February 2012) Ministry of Finance <http://szs.mof.gov.cn/zhengwuxinxi/gongzuodongtai/201202/t20120214_628012.html>.

⁴⁶ The exchange rate between Yuan and New Zealand dollar is RMB439.72 = NZ\$100. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

From the data in Table 5.2, it can be seen that the revenue generated from the VAT accounted for 27 per cent of the entire fiscal revenue, and the BT accounted for 15.25 per cent.⁴⁷

According to the distribution rules mentioned above, when completing the B2V reform, the abolition of the BT will have a huge impact on local government. This can be illustrated by the following example. In 2012,⁴⁸ the national VAT income was about 2.6 trillion Yuan⁴⁹ and the BT income was about 1.5 trillion Yuan.⁵⁰ Therefore, before the B2V reform, the tax revenue of local governments was 2.15 trillion Yuan.⁵¹ After the B2V reform, the tax revenue of local governments was 1.025 trillion Yuan.⁵² The gap is 1.125 trillion Yuan,⁵³ which means that the local governments will lose 1.125 trillion Yuan in fiscal revenue if the Central Government does not change the distribution rules. The scheme of the pilot programme stipulates that the revenue collected from enterprises that were previously subject to the BT is still to be allocated to

⁴⁷ See the Ministry of Finance of People's Republic of China, above n 45.

⁴⁸ Liao and Pan, above n 33, at 166.

⁴⁹ RMB2.6 trillion = NZ\$0.59 trillion. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

⁵⁰ RMB1.5 trillion = NZ\$0.34 trillion. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

⁵¹ RMB2.15 trillion ($= 2.6 \times 25\% + 1.5$) = NZ\$0.48 trillion. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

⁵² RMB1.025 trillion ($= (2.6 + 1.5) \times 25\%$) = NZ\$0.23 trillion. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

⁵³ RMB1.125 trillion ($= 2.15 - 1.025$) = NZ\$0.25 trillion. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

local governments during the pilot programme of the B2V reform.⁵⁴ However, this is effectively only a stalling tactic. It is still unclear how the Central Government will address the problem of the local governments losing tax revenue.

5.2 What Experiences Can Be Drawn from the Modern GST Model?

The single rate structure and a broad tax base are two distinctions between the traditional VAT model and the modern GST model. The distinctions are also disadvantages of the traditional VAT model and advantages of the modern GST model. China's B2V reform should keep away from the disadvantages of the traditional VAT model, and try to incorporate the advantages of the modern GST model.

For the tax base, the suggestion is to continuously enlarge the scope of VAT, putting the building industry, finance and insurance industry, sports service industry, entertainment industry, and the service trade industry, into the VAT. At the same time, China should aim to eliminate as many exemptions as possible. In regard to the tax rate, the suggestion would be to adopt a single tax rate structure. The standard rate in China is 17 per cent, is higher than the tax rate in New Zealand (15 per cent). Furthermore, there is another tax that exists in China, called the City and Rural Area Maintenance and Construction Tax. This tax is a surtax on the VAT, BT, and the Excise Tax.⁵⁵ The tax rates of the City and Rural Area Maintenance and Construction Tax vary depending on the locations of taxpayers. Taxpayers, whose locations are in urban areas, are taxed

⁵⁴ 程瑶, 伍洲, "深化增值税改革研究'课题讨论会观点综述" (2014) 6 *南京财经大学学报* 104, at 105 (translation: Chen, Yao and Wu, Zhou, " Study on deepening the B2V reform" (2014) 6 *Journal of Nanjing University of Finance and Economics* 104, at 105).

⁵⁵ The Chinese Institute of Certified Public Accountants, above n 42, at 176.

at seven per cent, five per cent in towns, and one per cent in other areas.⁵⁶ When the seven per cent surtax is attached to the standard rate of VAT, the effective tax rate is 18.2 per cent.⁵⁷ Through the Computable General Equilibrium Model (CGE), research⁵⁸ suggests that the uniform 11.82 per cent VAT rate should be applied to all the industries in China.

Furthermore, when taking into account the increasing tax burden in some industries, and the regressive nature of VAT/GST, further reductions in the tax rate should be considered elsewhere in the entire tax system. For example, research shows that the Enterprises Income Tax, as a proportion of the entire fiscal revenue, is six per cent higher than the average level of OECD countries.⁵⁹ In addition to this, the highest Individual Income Tax marginal tax rate is 45 per cent.⁶⁰ The Research Group of the State Administration of Taxation (SAT) have recommended that this rate should be 35 per cent or 30 per cent.⁶¹ This is because the high tax rate may discourage the development of

⁵⁶ Ibid, at 177.

⁵⁷ Brys, Bert, Matthews, Stephen, Herd, Richard, and Wang, Xiao, "Tax policy and tax reform in the People's Republic of China" (2013) 18 *OECD Taxation Working Papers* 1, at 20.

⁵⁸ See 王朝才, 许军, 汪昊, "从对经济效率影响的视角谈我国增值税扩围方案的选择" (2012) 7 *财政研究* 28 (translation: See Wang, Chaocai, Xu, Jun, Wang, Hao, "The choice of enlarging the scope of VAT in China from the perspective of economic efficiency" (2012) 7 *Public Finance Research* 28).

⁵⁹ 国家税务总局课题组, 刘佐, 靳东升, 龚辉文, "借鉴国际经验进一步优化中国中长期税制结构" (2009) 5 *财政研究* 8, at 14 (translation: Research group of the State Administration of Taxation, Liu, Zuo, Jin, Dongsheng, and Gong, Huiwen, "Further optimising China's tax regime from international experience" (2009) 5 *Public Finance Research* 8, at 14).

⁶⁰ The Chinese Institute of Certified Public Accountants (2014), above n 42, at 373.

⁶¹ Research group of the State Administration of Taxation, Liu, Jin, and Gong, above n 59, at 15.

human resources.⁶² Therefore, the B2V reform should take advantage of these favourable conditions to overhaul the whole tax regime in China.

Sawyer states that "successful tax reform also requires a package of reform."⁶³ Therefore, implementing reform as a package is a "wise" choice, which can be evidenced by New Zealand's experience of introducing GST in 1986. The Victoria University of Wellington Tax Working Group (TWG) reported in 2010 that "for New Zealand to have a world-class tax system and to ensure that the system is sustainable in the medium-term, significant changes are required to the current tax mix and base."⁶⁴ This is also what China needs to draw experience from.

As for the registration policy, the B2V reform stipulates that taxpayers subject to the B2V reform, whose annual sales are above 5 million Yuan,⁶⁵ can register as VAT general taxpayers. The registration threshold is too high, which means most enterprises do not reach this threshold. Those taxpayers can still register to be general taxpayers if they have a sound accounting system. The "sound accounting system" criterion embodies the flexibility of the good tax policy. However, to stimulate the development of the economy, it would be better for the registration threshold to be reduced further. The extent of the reduction should take into account the administration costs of the government,

⁶² Ibid, at 15.

⁶³ Sawyer, Adrian, "VAT Reform in China: Can New Zealand's Goods and Services Tax Provide Helpful Guidance?" (2014) 4 *Journal of Chinese Tax and Policy* 92, at 115.

⁶⁴ Victoria University of Wellington Tax Working Group, *A Tax System for New Zealand's Future* (Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, Wellington, 2010) 1, at 19.

⁶⁵ 5 million Yuan = NZ\$ 1.137 million. See Bank of China, "BOC Exchange Rate" (12 February 2016) Bank of China <<http://www.boc.cn/sourcedb/whpj/>>.

compliance costs of enterprises, and the marginal value of additional tax revenues.⁶⁶

Since China chose the traditional VAT model to develop its new VAT regime, and the traditional VAT model is potentially an intermediate stage to the modern GST model, the phases of moving China's VAT regime towards a modern GST model are suggested as follows.

- (1) Enlarging continually the scope of the new VAT. All the industries should be included in the scope of the VAT rather than maintaining the co-existence of the VAT and the BT. This is the final stage of the B2V reform, and this is also the first stage of moving towards a modern GST model.
- (2) Reducing the amount of exemptions. A broad tax base with few exemptions is one of the features of the modern GST model. To achieve the aim of moving towards the modern GST model, it is necessary to minimise the amount of exemptions. There are eight categories free from the VAT. China could adopt the incrementalism strategy, which is to reduce the exemptions gradually, starting with the categories of exemptions that have less impact on China's economy, such as "old books" and "used articles sold by user(s)." Then the category of "agricultural products sold by farmers themselves" should be included into the scope of the VAT. In the mean time, the Central Government could give subsidies to those who are influenced by such changes if it is necessary.

⁶⁶ The optimal threshold is discussed in Section 2.5.3 of this thesis.

- (3) Changing the multiple tax rate structure to a single tax rate structure. A single tax rate structure is another feature of the modern GST model. So far, there is one standard tax rate and four reduced rates in China's new VAT regime. In order to move towards a modern GST model, it will be necessary to adopt the single tax rate structure. However, the adoption of the single tax rate structure will be accompanied by an increase in the tax burden of some industries. According to the experience from New Zealand, the increased VAT of those industries could be compensated by a "package" elsewhere in the tax system. For example, some tax preferences (such as a reduced rate, or some exemptions) could be given to those industries subject to the Corporate Income Tax.
- (4) Cancelling the simplified method for small-scale taxpayers. Because the simplified method for the small-scale taxpayer is almost the same with the BT,⁶⁷ China could cancel this simplified method and lower its registration threshold. At the same time, voluntary registration and deemed registration should be also introduced into China's VAT regime. As for the exact level of the registration threshold, VAT revenues, compliance costs, and administration costs should also be taken into account.

5.3 Summary

In conclusion, China chose the traditional VAT model to develop its new VAT regime, which features many exemptions and a multiple tax rate structure. There are three possible reasons to explain this.

⁶⁷ Cui, Wei, "China's Business-Tax-to-VAT reform: An interim assessment" (2014) 5 *British Tax Review* 617, at 638.

- (1) The incrementalism approach adopted may be the best strategy for tax policymakers.
- (2) From the experiences of China's previous VAT reforms, a "step-by-step" approach is a traditional and accepted method for China's VAT reform.
- (3) The substantial impacts of the B2V reform, including both micro and macro effects, require China to implement the B2V reform cautiously.

The successful experience of New Zealand's GST system provides an important lesson to China's B2V reform. Since a broad tax base with few exemptions and a single tax rate structure are the main features of New Zealand's GST system, China should take all the possible opportunities to move its VAT regime to the modern GST model.

An incrementalism strategy can also be adopted to implement such changes, starting with reducing exemptions that have less impact. The multiple tax rate structure could then be changed into a single tax rate structure. Finally, the simplified method for the small-scale taxpayer should be abolished. By doing so, China's VAT regime will gradually move towards the modern GST model.

CHAPTER 6 CONCLUSIONS, LIMITATIONS, AND SUGGESTIONS FOR FUTURE RESEARCH

6.1 Conclusions

The Business Tax to Value Added Tax (B2V) reform in China aims to address the conflict between pursuing economic development and an imperfect tax system. The B2V reform has a substantial influence on China's economy. Whether or not the reform is applicable in China or further improvements should be implemented, requires more research. For models of Value Added Tax/Goods and Services Tax (VAT/GST) worldwide, the traditional VAT model, which is widely adopted in Member States of the European Union, and the modern GST model which was first introduced in New Zealand, are two available models for China to consider.

The first research question that this thesis sought to answer was which model China chose in order to develop its new VAT regime, and an analysis of the reasons why China chose that model. The second research question sought to draw experiences from the model which China is not following. The answer for the second research question is based on analyses of the two VAT/GST models in terms of tax bases, tax rates, and registration thresholds. In addition to these three aspects, Adam Smith's four principles of taxation,¹ as well as the principles of simplicity and neutrality, are adopted to evaluate these VAT/GST models. Comparative law and the legal research methods formed the general guidelines for this research. China's new VAT regime, the traditional VAT model, and the modern GST model are regarded as three case studies. The

¹ These principles are equity, certainty, convenience, and efficiency.

document analysis method was adopted for this research to answer the two research questions.

Three basic elements, including tax bases, tax rates, and registration thresholds, are discussed in this thesis. Due to the regressive nature of a VAT/GST, exemptions and reduced tax rates are often adopted to minimise the negative effect of the regressive nature. Exemptions and reduced tax rates not only relieve the VAT/GST burden on the poor, but also cause distortionary and cascading effects. Due to the fact that the VAT/GST is regressive, the issue of the regressive nature of VAT/GST cannot be addressed in isolation. In order to keep a "pure" VAT/GST system, this thesis recommends using limited exemptions for strict administrative cost-benefit considerations and the adoption of a single tax rate.

The negative effect of increasing the tax burden on the poor of using limited exemptions and a single rate can be compensated in other places through the tax system. This is what New Zealand did for example in order to offset the negative regressive effects on the poor by implementing the Family Support Tax Credit, and increasing personal rebates.

Consideration of the level of the registration threshold, the marginal value of additional tax revenues, the administrative costs of tax authorities, and the compliance costs of taxpayers, should also be taken into account. The trade-off of fiscal revenue, collection costs, and compliance costs is important for countries when setting the level of the registration threshold.

VATs used in Member States of the EU are typical examples of the traditional VAT model. These VATs are generally regulated by the *Council Directive 2006/112/EC* (the EU Directive), under which vast exemptions are widely used. In addition, the multiple tax rate structure is also adopted. The GST system

used in New Zealand is the best example of the modern GST model. A broad tax base with few exemptions and the single tax rate structure are the most distinguishing features of the modern GST model. These features are advocated by the International Monetary Fund (IMF)² and the Organisation for Economic Co-operation and Development (OECD)³ when introducing VAT/GST for their countries. The modern GST model is regarded as being the benchmark of a robust, simple and efficient VAT/GST system. This is based on the trade-off of having less equity within the GST itself. However, the negative influence on equity has been offset elsewhere in the tax system in New Zealand.

Before the B2V reform, the co-existence of the VAT and BT had become problematic due to the rapid development of China's economy. The aim of the B2V reform is to convert the industries subject to the BT to being subject to the VAT. The B2V reform is still in progress, but measures adopted in this reform indicate that China chose the traditional VAT model when modifying its former VAT regime. It is unclear when, or if, China will convert its VAT regime from the traditional VAT model to the modern GST model. The adoption of the modern GST model is emerging as a global trend, which is evidenced by the proposals made by the IMF and the OECD, with recommendations of a single rate and a broad tax base.

As the largest tax in China in terms of the tax revenue, VAT is crucial to China's future, which means the B2V reform should be undertaken cautiously. However, China should keep the ideals of the modern GST model in mind, which requires more research on the advanced VAT/GST systems used

² See Lejeune, Ine, "The EU VAT experience: What are the lessons?" (2011) *The VAT Reader: What a Federal Consumption Tax Would Mean for America* 257.

³ See Charlet, Alain and Owens, Jeffrey, "An international perspective on VAT" (2010) 20 *Tax Notes International* 943.

throughout the world, such as New Zealand's GST system. Also, China should take all possible opportunities to steer its VAT development towards the modern GST model, given that the modern GST model is regarded by many as the ideal model of a VAT/GST in operation anywhere in the world.⁴

Through this study, four phases of moving China's VAT regime towards a modern GST model are suggested. The first phase is to continually enlarge the scope of China's existing VAT until all the supplies of goods and services are subject to the VAT; in other words, to abolish the BT. The second phase is to minimise the amount of the substantial exemptions that exist in China's VAT regime, starting with the categories of exemptions that have less impact on China's economy. At the same time, the Government could give necessary subsidies to those industries that are harmed by such changes. The third phase is to change the multiple tax rate structure to a single tax rate structure. In the light of the fact that the existing VAT tax rates vary from zero per cent to 17 per cent, the adoption of the single tax rate structure will inevitably increase the tax burden of some industries.

Therefore, based on the experience from New Zealand, the increased tax burden could be compensated by a "package" elsewhere in China's entire tax system. The last phase is to abolish the simplified method that was designed for small-taxpayers. To abolish the simplified method would further help China to remove the existence of any remaining forms of the BT. This is because the simplified method is almost the same under the BT. By achieving all these four phases, the China's VAT system would be more close to New Zealand's GST

⁴ Sawyer, Adrian, "VAT reform in China: Can New Zealand's Goods and Services Tax provide helpful guidance?" (2014) 4 *Journal of Chinese Tax and Policy* 92, at 93.

model which is advocated by the IMF and the OECD as a benchmark of the robust, simple, and efficient VAT/GST system.

6.2 Limitations

There are several limitations in this research. These limitations are mainly related to the research methods used.

First, due to the fact that the objects of this research are the three VAT/GST systems in the European Union, New Zealand and China, the most effective way to get information is through document analysis. However, this means that as there is only one method used to conduct this type of research, the findings cannot be verified by triangulation.

The second limitation is that documents may lack sufficient detail.⁵ Since not all documents are produced for the same purpose with this research, some documents may provide insufficient detail to answer the research questions.

The third limitation is that an incomplete collection of documents means bias in selectivity.⁶ Papers from the same journal may reflect the same perspective on certain issues. The existence of authors' bias is also inevitable.

All of the above limitations may be reduced by reading extensive documents and cross-checking them. The selection of documents was as wide as possible so that the influences of insufficient detail and authors' bias could be reduced. However, the methods for collecting the documents posed the biggest challenge to this research.

⁵ Bowen, Glenn, "Document analysis as a qualitative research method" (2009) 9 *Qualitative Research Journal* 27, at 31.

⁶ Bowen, above n 5, at 32.

In addition to these, another limitation is that other methods (such as, interview or survey) were not used in this thesis. Document analysis and the case study method were adopted to conduct this research.

Due to the fact that the China's VAT regime is one of the cases, some of documents are written in Chinese. Since English is not my first language, the translation from Chinese to English may have the possibility of inaccuracy.

As stated in the comparative law section above, each rule and regulation should be released from the context of its own system. Therefore, another limitation is that this research did not take into account the political and economic situation in China when evaluating the system. However, this research examined the impacts of the B2V reform on the society in China in order to provide reasoned recommendations.

6.3 Suggestions for Future Research

Due to the extent of research conducted in relation to New Zealand's GST system, which is regarded by many researchers as the purest and the most effective VAT/GST model worldwide, this study contributes a further insight to the ideal VAT/GST model. It also lays down a foundation for future research of China's VAT regime. Academics in China should seek further information about New Zealand's GST system. They can now take into account the "real" situation in China and the development level of China's economy and society, and they can provide useful and practical suggestions to refine China's VAT system.

This research has investigated China's VAT system in detail. There are two reasons for this. First, it is important to understand China's VAT system; it is an inseparable part of this thesis. The other reason is to provide some information,

in particular, on China's VAT system and the B2V reform, to academics from other countries outside China to encourage cross-country research. Due to different cultures, the different body of knowledge and different thinking patterns, it is expected that these academics can offer suggestions from their perspectives for future reforms in China.

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APPENDICES

Appendix 1

List of supplies of goods or services that shall apply the reduced rates in the EU

- (1) foodstuffs (including beverages but excluding alcoholic beverages) for humans and animals;
- (2) supply of water;
- (3) pharmaceutical products;
- (4) medical equipment intended to alleviate or treat disability, and supply of children's seats;
- (5) transport of passengers and accompanying luggage;
- (6) books (in physical forms), newspapers, and periodicals supplied, and not wholly or predominantly devoted to advertising;
- (7) cultural events and facilities;
- (8) reception of radio and television broadcasting services;
- (9) supply of services by writers ,composers, and performing artists, or of the royalties due to them;
- (10) provision, construction, renovation, and alteration of housing;
- (11) supplies of services and goods to be used in agriculture but excluding capital goods;
- (12) provision of accommodation in hotels, etc;
- (13) admission to sporting events;

- (14) use of sporting facilities;
- (15) supply of goods and services by charities;
- (16) supply of goods and services by undertakers and cremation services;
- (17) medical and dental care;
- (18) supply of services provided in connection with street cleaning, refuse collection and waste treatment;
- (19) minor repairing of bicycles, shoes, leather goods, clothing and household linen;
- (20) domestic care services; and
- (21) hairdressing.

Appendix 2

List of zero-rated supplies under New Zealand's GST system

- (1) exported goods;
- (2) goods shipped by a non-resident purchaser on FOB¹ terms;
- (3) goods due to be exported;
- (4) sealed bag goods;
- (5) goods sold by duty-free shops;
- (6) certain sales of boats and aircraft;
- (7) goods situated overseas;
- (8) goods applied in respect of temporary imports;
- (9) good for consumption on aircraft, yachts or ships outside New Zealand;
- (10) certain taxable activities disposed of as going concerns;
- (11) certain supplies of land between GST-registered persons;
- (12) newly refined precious metal;
- (13) "exported " services;
- (14) most emissions units transactions;
- (15) some "business-to-business" financial services;

¹ FOB refers to Free On Board. FOB is a trade term requiring the seller to deliver goods on board a vessel designated by the buyer. The seller fulfils its obligations to deliver when the goods have passed over the ship's rail.

- (16) certain cross-border telecommunication services;
- (17) certain supplies made or received by territorial and local authorities, where petroleum tax is payable or where there is a land contribution from or to a person who is applying for a resource or development consent; and
- (18) certain supplies of loyalty points.

Appendix 3

Example of the B2V reform's impact on accounting entries

There are two main impacts on the accounting entries. The first impact is the different treatment of the tax. For example, X is a transport company, and generates NZ\$20,000.00 taxable income for the current month.

Before the B2V reform, X was subject to the BT with the tax rate at three per cent. Therefore, X should pay NZ\$200.00 tax for the BT, the accounting entry for this activity is:

	Dr	Cr
Main operation tax & additional expenses	NZ\$200.00	
Taxes and expenses payable - Business Tax		NZ\$200.00

When X remits the tax through the bank, the accounting entry is:

	Dr	Cr
Taxes and expenses payable - Business Tax	NZ\$200.00	
Cash in bank		NZ\$200.00

The item "Main operation tax & additional expenses" is set for all taxes except the VAT in China, and this account is a claimable item when calculating the income tax in the Income Statement in China. This means the VAT is non-claimable for calculating the income tax. The item "Main operation tax & additional expenses" cannot be used for recording the VAT. Therefore, after the B2V reform, the activity of X is subject to the VAT with the tax rate at 11 per cent. Assuming that X is a VAT general taxpayer, and the NZ\$20,000.00 taxable income is exclusive of the VAT, the accounting entry should be:

	Dr	Cr
Accounts receivable (or Cash in bank)	NZ\$22,200.00	
Operating income		NZ\$20,000.00
Taxes and expenses payable - Value Added Tax (the output tax)		NZ\$2,200.00

Assume that X purchased NZ\$10,000.00 (excluding VAT) inventories in the current month, and made the payment through the bank. The accounting entry should be:

	Dr	Cr
Inventories	NZ\$10,000.00	
Taxes and expenses payable - Value Added Tax (the input tax)	NZ\$1,700.00 ²	
Cash in bank		NZ\$11,700.00

At the end of the current month, under the account "Taxes and expenses payable - Value-Added Tax", the tax payable of VAT is calculated in the "T" balance sheet below.

Taxes and expenses payable - Value Added Tax	
Dr	Cr
NZ\$1,700.00	NZ\$2,200.00
	NZ\$500.00

Therefore, X should remit NZ\$500.00 tax to the tax authority.

² NZ\$1,700.00 = NZ\$10,000.00 × 17 %.

Another impact of the B2V reform is the different treatments to purchasing fixed assets. Enterprises previously subject to the BT cannot claim the input tax of fixed assets, but after the B2V, the input tax of fixed assets is claimable. The following example demonstrates the impact. For example, X is a transport company, and purchases a new bus worth NZ\$100,000.00 (excluding VAT) this month. X made the payment through the bank.

Before the B2V reform, the accounting entry for this activity is:

	Dr	Cr
Fixed assets - Bus	NZ\$117,000.00	
Cash in bank		NZ\$117,000.00

However, after the B2V reform, since the input tax is claimable, the accounting entry should be:

	Dr	Cr
Fixed assets - Bus	NZ\$100,000.00	
Taxes and expenses payable - Value Added Tax (the output tax)	NZ\$17,000.00	
Cash in bank		NZ\$117,000.00

Appendix 4

Example of the B2V reform's impact on the Cash Flow Statement

Example 1: Impact on dealing with the item "cash from selling commodities or offering labour"

For example, X is a transport company which received NZ\$100,000.00 freight (excluding VAT) paid by the client. Before the B2V reform, the adjusting entry of preparing the Cash Flow Statement is:

	Dr	Cr
Cash from selling commodities or offering labour	NZ\$100,000.00	
Operating income		NZ\$100,000.00

After the B2V reform, the adjusting entry should be:

	Dr	Cr
Cash from selling commodities or offering labour	NZ\$111,000.00	
Operating income		NZ\$100,000.00
Taxes and expenses payable - Value-Added Tax (the output tax)		NZ\$11,000.00

Example 2: Impact on dealing with the item "cash paid for commodities or labour"

For example, X is a transport company, and makes a payment of NZ\$100,000.00 (excluding VAT) for purchasing inventories to the vendor,

before the B2V reform, the adjusting entry of preparing the Cash Flow Statement is:

	Dr	Cr
Operating cost	NZ\$100,000.00	
Cash paid for commodities or labour		NZ\$100,000.00

After the B2V reform, the adjusting entry should be:

	Dr	Cr
Operating cost	NZ\$100,000.00	
Taxes and expenses payable - Value-Added Tax (the input tax)	NZ\$17,000.00	
Cash paid for commodities or labour		NZ\$117,000.00