SPOILT POLICY:

Why we must keep GST simple and free of food carve-outs

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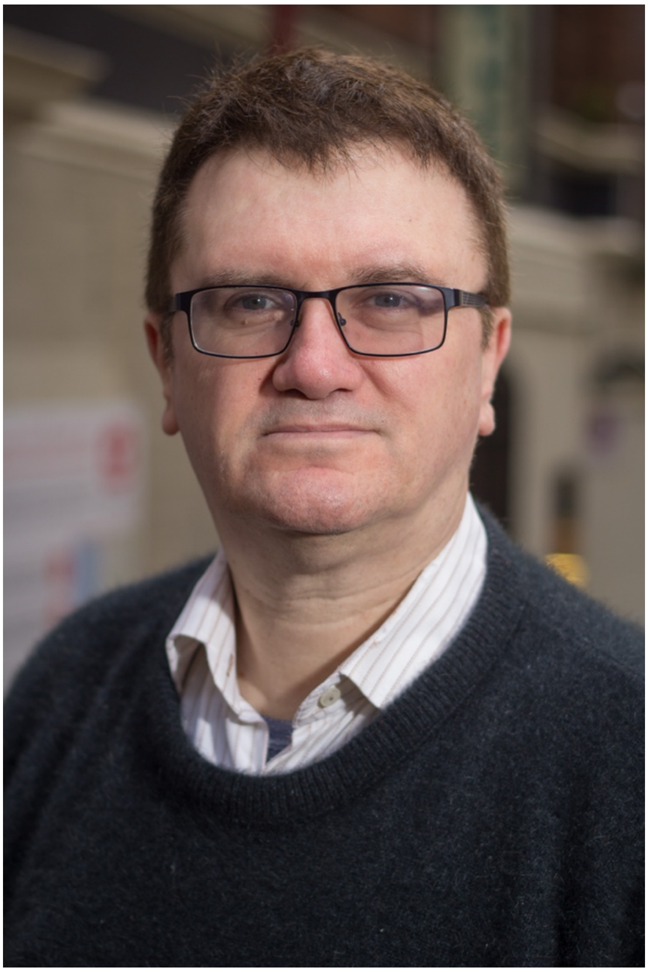

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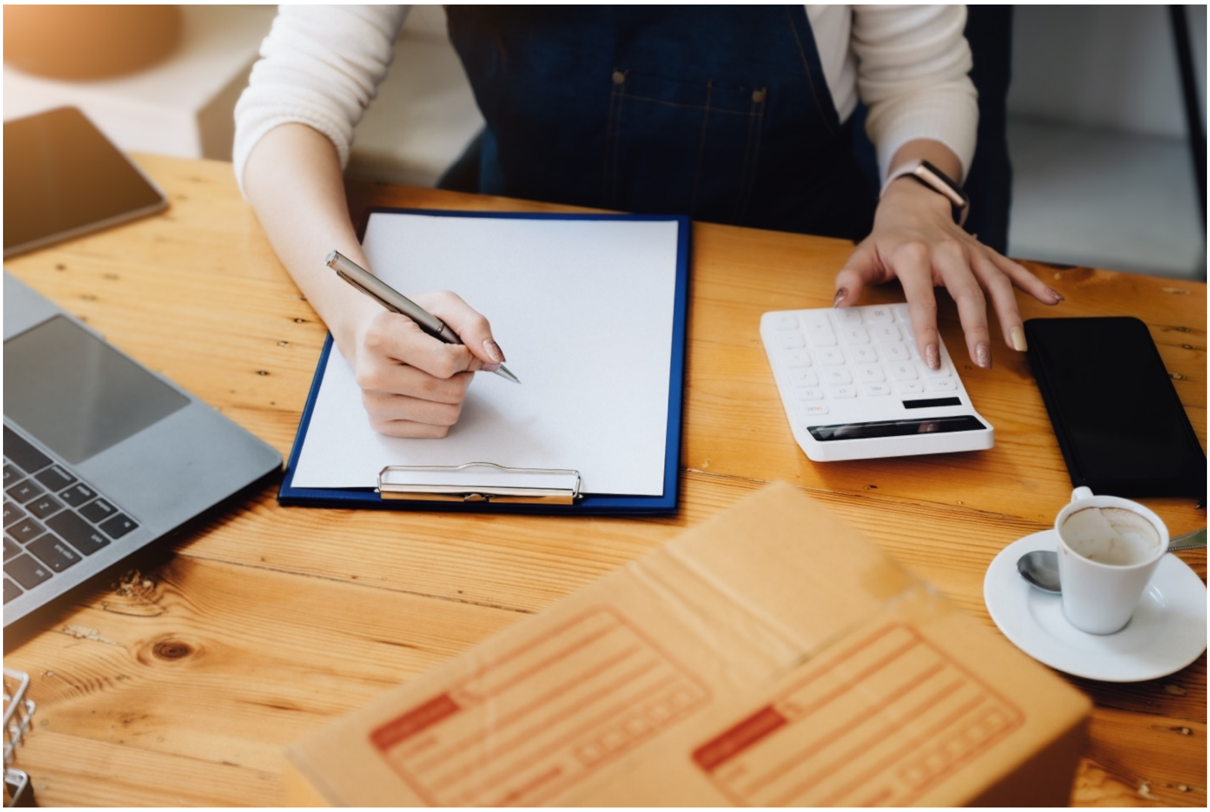
This paper is about proposals by the political parties to zero-rate food. It will be argued that this is a cumbersome, poorly-targeted way of relieving cost of living pressures on ordinary families.

GST in a nutshell

Up until now, New Zealand has had a broad-based tax on consumption at a single rate of 15% with few exceptions. The two main exemptions from GST are residential accommodation and financial services. Residential accommodation suppliers and the financial services sector don't pay GST, but they cannot claim back any GST charged on goods and services they use as inputs in their businesses. In 2022, GST revenue was $24.7 billion which accounted for 25% of New Zealand's taxation revenue.



What the political parties plan for GST and food

Many proposals to remove GST from food have occurred over the years in New Zealand. In 2010, for example, there was a private member's bill by Māori Party MP Rahui Katene to exempt healthy foods from GST. At the time, one MP noted that fish and chips could be considered a healthy meal because it was made of fish and vegetables. Both ingredients were exempt from GST under the Bill.

The Māori Party, now in 2023, wants to remove GST from all food sales in New Zealand while New Zealand First has proposed exempting basic foods from GST. Food and drink, according to the Tax Working Group in 2018, contributed $2.6 billion in GST revenue.

Labour is planning to remove GST from fresh and frozen fruit and vegetables as a response to the cost-of-living crisis. The annual foregone revenue would be about $500 million. In the 2011 election, the opposition Labour Party proposed to zero-rate fresh fruit and vegetables from GST. It dropped this policy a few years later.

Zero-rating for food is not uncommon overseas. As the Labour Party summarised the situation:

> *Five other OECD member countries – Australia, Canada, Mexico, Ireland and the United Kingdom – apply a zero-rating exemption to a broad range of food items. Moreover, most European countries apply exemptions or reduced rates to various food items in their GST/VAT systems (Labour Party 2023 p. 5).*

The zero-rate for GST on many types of food such as basic groceries were last-minute compromises to soften the blow to political support for the introduction of GST such as in Canada in 1991 and Australia recently in 2000 (van Klink and Huang 2013). VAT zero-rates for many foods in the UK is a holdover from the purchase tax introduced in 1940 (van Klink and Huang 2013).

What is kai?

The Māori Party wants to remove GST from all food. They are unclear whether this removal of GST from kai is just for supermarket food sales or for all food sales such as from restaurants, cafeterias, and sandwich bars. The Māori Party may not have thought matters through because as it stands, they might be zero-rating restaurants, cafeterias, and less healthy food options such as fast food.

Are fresh fruit and fresh vegetables cheaper?

The proposal by the Labour Party to remove GST from fresh and frozen fruits and vegetables is a response to the cost-of-living crisis. Does the GST removal help or not? Does GST removal encourage consumers to switch to a more expensive option? Does the zero-rating for GST on fresh and frozen fruit and vegetables target the value for money items in the budgets of ordinary families?

There is plenty of evidence that fresh fruits and fresh vegetables are more expensive than their frozen competitors such as shown in the graphic below about basic vegetables at Countdown. Out of the six vegetables sampled, only fresh carrots and cauliflower were cheaper. On the other hand, frozen peas were much cheaper than the fresh variety. Beans were nearly a third cheaper if frozen.

FRESH				FROZEN			
Vegetable	**Cost – Fresh**	**Weight**	**Cost per 100g**	**Cost – Frozen**	**Weight**	**Cost per 100g**	**Saving per 100g**
Broccoli	$2.79 (per head)	250g	$1.12	$2.49	500g	$0.50	$0.62
Cauliflower	$4.99 (per head)	1kg	$0.50	$3.50	500g	$0.70	-$0.20
Peas	$3.99 (pre-packaged)	100g	$3.99	$2.29	1kg	$0.23	$3.76
Beans	$3.00 (pre-packaged)	250g	$1.20	$2.29	1kg	$0.23	$0.97
Spinach	$4.99 (pre-packaged)	400g	$1.25	$3.00	500g	$0.60	$0.65
Carrots	$2.99 (loose)	1kg	$0.30	$3.29	500g	$0.66	-$0.36
TOTAL	**$22.75**	**2.1kg**	$8.35	**$16.86**	**4kg**	$2.91	$5.44

https://lovefoodhatewaste.co.nz/fresh-vs-frozen-save-time-and-money-by-buying-frozen-vegetables/

Using frozen vegetables instead of fresh vegetables also minimises food wastage, therefore saving consumers' money in the long run. In addition, frozen vegetables can also be bought in bulk meaning reduced transportation costs for consumers from fewer trips to the store.

Frozen vegetables are cheaper because they can be frozen in bulk at harvest and then shipped to the supermarket in bulk. There is no evidence of loss in quality from snap freezing. In contrast, fresh fruit and vegetables have a wastage factor because some are thrown out because it is not of presentation standard at supermarkets. Tinned fruits and vegetables also have advantages in storage and price.

Household budgets are unlikely to stretch further by the government removing GST from the more expensive food options at the supermarket. Because they are the cheaper option, it would make more sense to only remove GST from frozen fruits and frozen vegetables. That doesn't have much mojo as a political slogan or soundbite. This lack of mojo indicates the shallowness of the public policy-making around proposals to remove GST from fruit and vegetables.

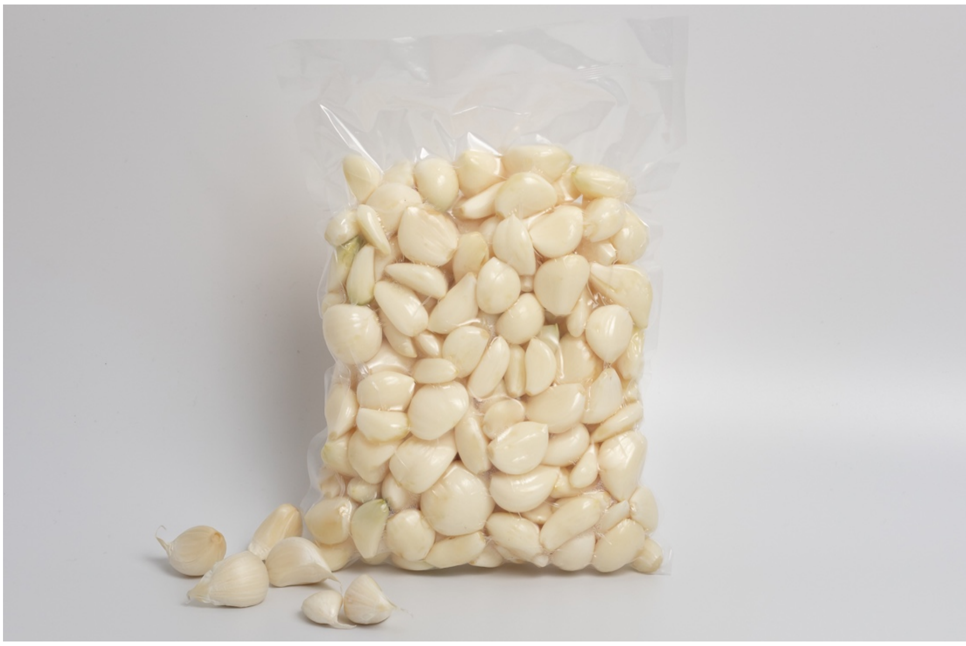
What is fresh fruit and vegetables?

A question that needs to be considered is the extent to which any zero-rating of fresh fruit and vegetables or a zero-rating of fruit and vegetables extends beyond the supermarket check-out and whether it applies to any processing of fruit and vegetables within the supermarket.

Salads available at the supermarket deli push the boundaries of any GST zero-rating. Will plant-based meat substitutes such as meat free sausages and meat free burgers and so forth be zero-rate rated? Will a salad box prepared by the supermarket constitute fresh vegetables or not?

One British case of relevance for whether fresh fruit and vegetables should be zero-rated is that of Innocent Ltd v The Commissioners for Her Majesty's Revenue and Customs. This was about whether a 100% fruit smoothie was a beverage or a liquefied fruit salad (van Klink and Huang 2013). The latter would be zero-rated in the UK. The smoothie was deemed to be a beverage and therefore subject to the 20% standard VAT rate. This is because the court decided to interpret the ordinary meaning of the word beverage rather than focus on any social policy objectives such as healthy eating (van Klink and Huang 2013).

Preparation of food has long been a bugbear for the zero-rating of food or groceries because then the outputs of restaurants, takeaways and cafeterias might be zero-rated. Supermarket delis provide a lot of prepared or processed food offered in salad form. These delis also provide sandwiches and various other prepared food. Will restaurants, cafés and sandwich bars be zero-rated depending upon whether the food they dispense is hot or cold and is intended to be consumed on the premises or not as is the case in Australia? Great effort is taken in the guidance from Australian Tax Office on what is a premises and what is a takeaway and whether it is hot or cold (van Klink and Huang 2013).



What are processed fruits and vegetables?

The proposals of the Labour Party for zero-rating of GST exclude processed fruits and processed vegetables. That is, canned and dried fruits and vegetables. As the Labour Party explains:

> *Our framework is based on whether the fruit or vegetable has been 'processed' or not. Processed in this context means cooked or combined with other ingredients. This rules out anything canned because of the heating process that accompanies canning (Labour Party 2023, p. 5).*

The Labour Party immediately ties itself in a knot in the next paragraph when explaining the various distinctions that must be made with the zero-rating of food for unprocessed fruit and vegetables:

> *'Processed' does not mean being cut up and wrapped without additives. This means that pre prepared vegetables like fresh spinach in a bag would be zero-rated. The same rules mean that a mix of vegetables frozen together would also be zero-rated for GST. On the other hand, potatoes mashed into chips, coated in canola oil and then frozen would be excluded and would still attract GST (Labour Party p.5).*

It must be noted that canned fruits and vegetables are often cheaper. When giving budget advice to ordinary families, the Consumer Institute said:

> *Frozen and canned produce are just as good for you as fresh. Frozen/canned produce generally maintains nutrition levels because they are usually packaged soon after harvesting. They are often cheaper, plus they last way longer and allow you to eat your favourite produce out of season (Consumer Institute).*

The Dominion Post described canned vegetables as "far, far cheaper than fresh" (Brookes 2022). The Labour Party is leaving out the cheapest food options in its plan to zero-rate fruit and vegetables.

A history of litigation and judicial pedantry overseas

The Labour Party (2023) is confident that overseas experience will help guide a simple administration of its GST carve out. The overseas experience does not justify such confidence.

Australia, Canada, and the UK all zero-rate food but with various exceptions. The UK had the worst experience with the classification of taxable and tax-free food and with the amount of litigation. The UK has had a busy VAT litigation calendar with 49 cases since 1993 (van Klink and Huang 2013).

The UK introduced a value added tax (VAT) in 1973. Food was zero-rated in the purchase tax it replaced. The classifications of foods that were zero-rated in the purchase tax were transplanted into the VAT legislation with few amendments and not much thought (van Klink and Huang 2013). The VAT in the UK zero-rates food with extensive exceptions and then exceptions from these exceptions. This creates a long list of items zero-rated or not and has neither a statute nor legislative history that set out principles to help the courts in interpreting the legislation (van Klink and Huang 2013).

His Majesty's Revenue and Customs provides a 24-page guide to the zero-rating of food that covers basic foods, ingredients and additives, processed foods, bakery products, ice-cream, confectionery, drinks, and savoury snacks (van Klink and Huang 2013). Whether a food is frozen or not has importance. Food is not zero-rated if supplied in the course of catering, when served hot or in some food packaging. Basic biscuits are zero-rated but chocolate covered biscuits are not. Hot takeaway food is taxed at the standard rate, but cold takeaways are zero-rated provided it is not excluded under another exception from exceptions (van Klink and Huang 2013).

The British courts took a literalist approach to interpretation of the VAT law. The Commissioners for His Majesty's Revenue & Customs v Procter & Gamble (UK) was about whether Regular Pringles were made of potatoes or not and whether they were similar to potato crisps (van Klink and Huang 2013).

United Biscuits (UK) Ltd (No. 2) was about whether 'Jaffa cakes' were cakes or biscuits. Issues that influenced the decision of the tribunal included the product name, ingredients, size, texture, packaging, marketing, properties when on sale, how they were eaten, and the proportion of sponge in the product (van Klink and Huang 2013). The tribunal also noted that the texture of a cake is usually soft and crumbling while a biscuit is crisp and could be snapped. Some importance was attached to the fact that a cake goes hard when stale while a biscuit goes soft (van Klink and Huang 2013).

Canada has a GST which the Federal Government introduced in 1991. The Federal GST is levied in addition to the provincial sales taxes.

As a last-minute political deal, basic groceries were zero-rated in Canada when it introduced its Federal GST (van Klink and Huang 2013). Basic groceries were defined as food and beverages for human consumption as well as additives for food and beverage preparation. Nonetheless, 22 categories of food supplies were specifically not zero-rated. These included alcoholic beverages, carbonated beverages, confectionery, snack foods, food prepared for immediate consumption and food sales through vending machines (van Klink and Huang 2013).

The Canada Revenue Agency issued a 35-page guide to GST and basic groceries. There have only been seven court cases since 1998 (van Klink and Huang 2013). In Aliments Koyo Inc. v The Queen, the Canadian court decided that a strawberry flavoured soy beverage was not a milk-based product. Soy milk was not milk in the ordinary sense and was therefore a beverage subject to the standard rate of Federal GST (van Klink and Huang 2013). Again, this seems an arbitrary distinction.

Australia introduced a GST in 2000 with a zero-rating for food. This was at the behest of the crossbench parties in the Senate. Foods that are not GST-free include prepared food, confectionery, snacks, bakery products other than plain breads, ice cream foods and biscuits (van Klink and Huang 2013).

The Australian GST is not without its complications either. The guidance from the Australian Taxation Office contains 87 pages of explanation covering over 1500 types of food (van Klink and Huang 2013). The Australian Taxation Office provides an online search tool that allows the name of a food to be entered to check its tax status (van Klink and Huang 2013). To further simplify matters, businesses with a turnover below $2 million a year can estimate their GST-free sales and purchases using one of five types of accounting methods. Larger businesses can use barcoding to assist in the classification of GST-free food (van Klink and Huang 2013).

There have been few court cases because the Australian Taxation Office issues extensive guidance and tax rulings on particular products and their liability for GST (van Klink and Huang 2013). That did not save Australia from an almost comical court case over whether an "oven baked Italian flat bread" was a bread (so not subject to GST) or a cracker (and subject to GST). A European Union bread certification expert from Italy testified (van Klink and Huang 2013).

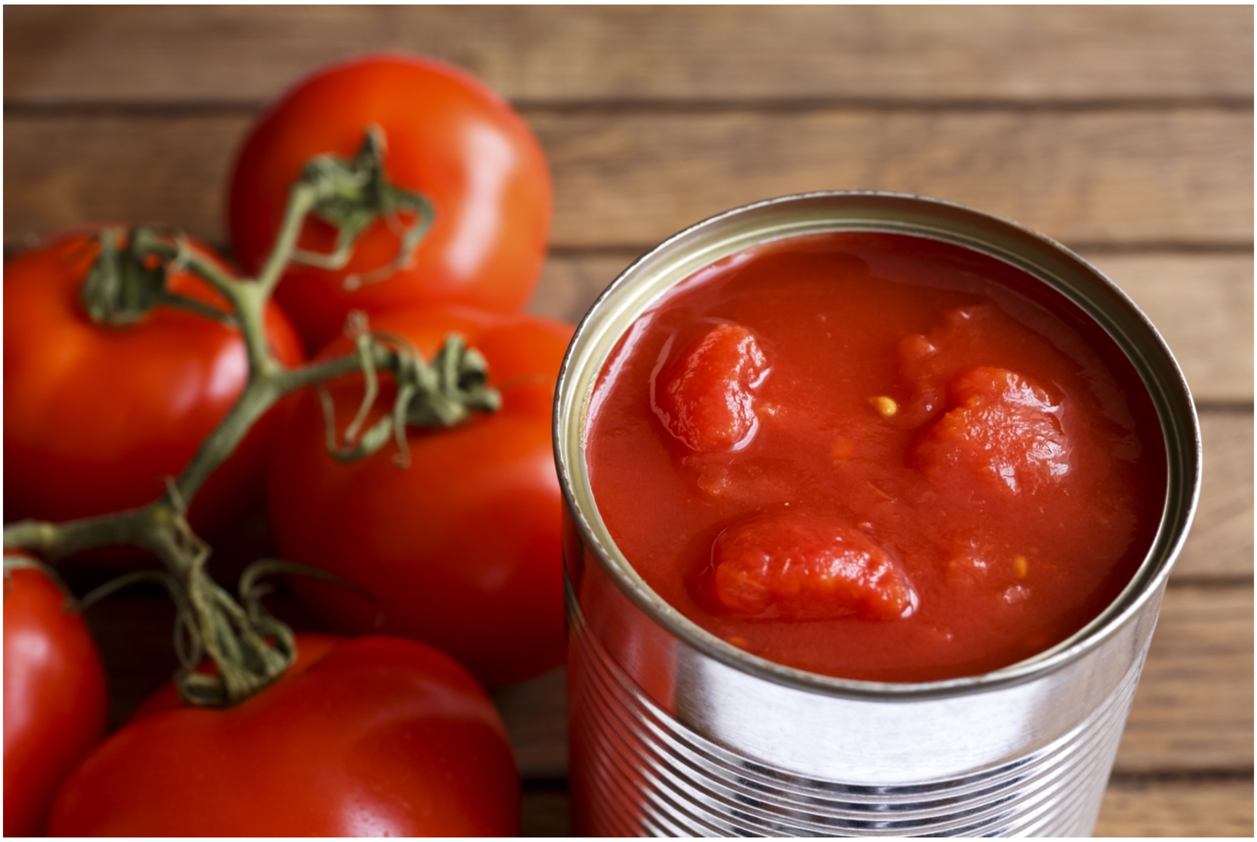
The main lesson for taxpayers from the overseas experience with placing a zero-rate on food for GST is that businesses will have to familiarise themselves with complicated booklets, online tools, and complicate their own internal accounting to take account of the myriad of exceptions.

The Tax Working Group (2018) reported that in 2016 the median annual in-house time devoted to GST in small and medium size enterprises was 14 hours. That's barely 15 minutes a week. This simplicity and ease should be protected against policy proposals that don't help the poor that much and there are far better ways of helping poor families than the zero-rating of food.

How much of the GST cut will be passed through to consumers?

Another cloud over the effectiveness of removing GST from food is the extent to which sellers will pass on the tax cut to consumers in the form of lower prices. Parliament may well decide who writes the cheque to the Inland Revenue Department, but it cannot decide who bears the tax after the forces of supply and demand have taken account of the new cost structure of the industry.

Tax incidence is the study of the effects of tax policies on prices and the distribution of welfare. What happens to market prices when a tax is introduced or changed? Empirical analysis is a big part of the tax incidence literature because theory is itself largely inconclusive about magnitudes, although informative about the direction of changes and the questions to ask.



The key point of tax incidence is that taxes can be shifted: taxes directly affect the prices of goods, which affect quantities demanded and supplied because of behavioural responses, which affect indirectly the price of other goods. Knowing the tax incidence is incredibly important for policy analysis. If prices are constant after a tax change, economic incidence would be the same as the legislative incidence. If prices change, who pays the tax is different to who makes the payment to the tax office.

A new or increased tax shrinks a market. Buyers pay more and buy less while sellers receive the lower after-tax price and sell less. Buyers and sellers share the tax burden. As Entin puts it:

> *The true measure of the burden of a tax is the change in people's economic situations as a result of the tax. The changes should be measured as the effects on everyone's net-of-tax income after all economic adjustments have run their courses (Entin 2004, p.1).*

The burden of a tax falls more on that side of the market that can respond less easily to the tax by changing the quantity bought or sold. After a tax rise, the side with fewer options to buy elsewhere or supply less pays more of the tax. If consumers can easily switch to another product, the supplier of the more heavily taxed product will have to absorb most of the increase. The price paid by buyers does not rise much, while the price received by sellers falls substantially. On the other hand, if consumers cannot easily switch, sellers can pass on most of the tax rise. As Mankiw observed:

> *A tax burden falls more heavily on the side of the market that is less elastic. Why is this true? In essence, the elasticity measures the willingness of buyers or sellers to leave the market when conditions become unfavourable. A small elasticity of demand means that buyers do not have good alternatives to consuming this particular good. A small elasticity of supply means that sellers do not have good alternatives to producing this particular good. When the good is taxed, the side of the market with fewer good alternatives cannot easily leave the market and must, therefore, bear more of the burden of the tax (Mankiw 2007, p. 130).*

Tax incidence is important because a less than 100% passing through of a zero-rating of food is another reason why GST carve-outs are an ineffectual policy tool. When there is 100% passing through, a tax rise as well as a tax fall is passed on 100% to buyers.

Over the past 15 years or so, there have been temporary cuts in the VAT in Europe that allow econometricians to research the extent to which the cut is passed on to consumers and what happens when the temporary cut comes to an end and prices go back up. As Blundell observed:

> *There is nothing from the economic theory of tax incidence to suggest that a VAT change will always be passed on fully into retail prices. Alternative models of product market competition produce differing degrees of pass-on and the magnitude is largely dependent on the degree of competition in the various good markets (Blundell 2009).*

Faust and others (2021) looked at a temporary reduction in the German VAT for six months starting in July 2020. They studied the price effects using the daily prices of 130,000 supermarket products in the same supermarket chain in Germany and Austria. The German VAT was reduced from 19% to 16% and the reduced rates which apply broadly to basic food and beverages was reduced from 7% to 5%. The Austrian VAT was not changed over this period in its COVID19 stimulus package.

Faust and others (2021) found a large and immediate pass through of the VAT reduction in prices. On average, German supermarket prices decreased by 70% of the VAT reduction. The price increase in response to the return of the VAT rate to its usual level before the temporary reduction was only half the size of the decline. The pass-through of the VAT reduction was strongest in product groups with a large number of competing products. Producers operating in highly competitive markets did not increase product prices fully to the pre-reform level after the VAT rate cut was repealed.

Benzarti and others (2021) likewise found that prices respond significantly more strongly to increases than to decreases in European VATs. Prices respond twice as much to VAT increases as to VAT decreases. In a confounding study, Gaader (2018) found that a sharp reduction in the Norwegian VAT from 24% to 12% on food was fully passed on to consumers. Benedek and others (2015) found that in 17 Eurozone countries for changes in the standard VAT rate, the final pass-through rate was about 100%; but for the reduced VAT rates, pass through was significantly less, at around 30%.

Doyle and Samphantharak (2008) looked at a suspension and reinstatement of a 5% gasoline tax in Indiana and Illinois in 2000. Using data on daily gasoline station level prices, they found that prices dropped by 3% following the suspension of the tax and increased by 4% following the reinstatements. Sellers pocketed some of the tax cut but absorbed some of the tax rise.

The balance of the empirical evidence is that not all of the increase or decrease in GST will be passed-on to consumers. If a number was required, 70% is a candidate maximum pass-through rate. For present purposes, a removal of GST on food will not be fully passed on to consumers and is therefore a less effective social policy tool compared to the alternatives.

The recent creation of a Groceries Commissioner has highlighted public concern about the level of competition in the sector. To the extent that supermarket competition is weak, the sector is a poor conduit for delivering financial support for working families through GST carve-outs.

There is a better way, a more targeted way

The argument against removing GST from fruit and vegetables or from food generally has always been the same. As the Tax Working Group (2018) led by former Labour Finance Minister Sir Michael Cullen noted, removing GST from food or from fruit and vegetables is a poorly targeted mechanism. This is because in absolute terms higher income households spend more on these goods than low-income households do. For the same revenue loss, the Tax Working Group noted that the government could increase Working for Families to provide help in cash to the low-paid families.

The Tax Working Group (2018) calculated how much could be paid to households in a cash transfer versus how much they saved from removing GST from food. Zero-rating food from GST was estimated to reduce revenues by $2.6 billion. With this amount of revenue, $28.85 per week could be transferred to each household in cash. In comparison, removal of GST from food and drink would provide $24 in weekly benefits to the richest households but less than $14 to a decile one household compared to the lump-sum payment just mentioned. Obviously, a more targeted transfer provides greater benefits to lower income households than the removal of GST on food. An example of this targeting is the increase in the GST rate from 12.5% to 15% in 2010. The Key Government double compensated retirees for any impact of the price rise on their superannuation incomes.

Keep the social safety net targeted

Working for Families is a far more effective tool for assisting low-income families than changes to GST. The Family Tax Credit, the In-work Tax Credit, or the Best Start Tax Credit could be increased to assist ordinary families. About $2.5 billion a year is spent on these family tax credits. The proposal to zero-rate fresh and frozen fruit and vegetables forgoes about $500 million in revenue to deliver savings of $21 per month per family according to the Labour Party fact sheet. The same social policy outcome could be achieved at a lower fiscal cost with small increases in the In-work tax credit, benefits and NZ Superannuation with no spillovers to others.

As for single low-income people, there is the independent earner tax credit which could be increased to help with the cost-of-living crisis. For a New Zealand tax resident earning between $24,000 and $48,000 in a tax year, they receive the independent earner tax credit if they get their income from: salary or wages, ACC compensation payments, paid parental leave, investments, self-employment, and other types of business income. They are ineligible if they or their partner are entitled to Working for Families Tax Credits, an income-tested benefit, New Zealand Superannuation, a Veteran's Pension, or an overseas equivalent of any of the previous. If income (before tax) in the tax year is between $24,000 and $44,000, the credit is $10 per week. Between $44,001 and $48,000, the independent earner tax credit entitlement reduces by 13 cents for every dollar earnt over $44,000.

Beware of slippery slopes

Once we make one carve out, it becomes a lot more difficult to argue against more GST exemptions for other products. For example, children's nappies, bread, pasta, sanitary products etc. Then we end up with other compromises where policy makers decide some products should have less GST than others but not zero, so the system can become even more complex with multiple different rates for different products. Creating exemptions opens the GST system up for further lobbying from special interest groups for GST to be removed from their products.

Conclusions

Introducing a GST zero-rate for fresh and frozen vegetables will lead to administrative complexities and litigation at the boundary as well as a lot of legal and judicial pedantry. There are better options for dealing with the cost-of-living crisis for ordinary families such as increasing Working for Families. Such a move would put as much per week in the hands of ordinary families for less fiscal cost because there is no leakage to other better-off families.

Up until now, there has been a cross-party consensus that an administratively simple GST was in the best interests of all. This cross-party consensus on keeping GST simple to administer was well stated last year by the current Labour Party Minister of Finance, Grant Robertson:

> *GST is a comprehensive tax which makes it very easy to administer and people in the room who've been in other countries with more exemptions will know it becomes an absolute boondoggle to get through, ...*
>
> *If you do it off fresh fruit and vegetables, or even staple products, then you get into an argument of what's the difference between beetroot and canned beetroot, and if you want to make a real impact on the lowest-income people you wouldn't cut the tax off fresh beetroot - that's not what people on low incomes buy (Pearse 2023).*

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