

## Why the U.S. can learn from New Zealand when it comes to taxes



PHOTO: MARK COOTE/BLOOMBERG

By Dody Tsiantar, contributor

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(Fortune) -- Paul Volcker fired the shot heard around the world--or at least around tax circles--last week when delivered some bad news for anyone paying taxes. It's time, he said, to consider one more: the value-added tax--the consumption tax used widely across the Atlantic.

"If at the end of the day we need to raise taxes, we should raise taxes," said the head of President Obama's Economic Recovery Advisory Board, adding that the VAT, as it's called, is "not as toxic an idea" as we once thought. In fact, the United States is the only developed country that does not have a VAT.

With the \$1.5 trillion federal deficit and a

soaring debt of more than \$12 trillion, it is hardly surprising that pundits and politicians of various political stripes, including House Speaker Nancy Pelosi and N. Gregory Mankiw, economic advisor to President George W. Bush, are **flirting** with the notion of imposing a VAT tax.

"Unless the president revises his spending plans substantially, he will have no choice but to find some major source of government revenue," wrote Mankiw in the New York Times. "A VAT tax may be the best of a bunch of bad alternatives."

It may pack a less potent punch than a hike in income or corporate taxes, economists argue. The value-added tax, invented in 1954 by French tax authority Maurice Lauré, is collected by the government, in stages, as a product moves through the economy.

### How the VAT gets filled

For example, take a wool sweater. With a VAT, the sheep farmer and the clothing shop owner--and everyone along the chain in between--adds the tax to the price of their

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product. But here's the advantage: the price add-on is not cumulative to businesses and producers because everybody only ends up paying their portion of the VAT. At each stage, the buyer receives a tax invoice that is filed with the government tax collectors; the buyer then gets a refund for the tax already paid by the previous person in the chain. The government, of course, gets the entire sales tax; it just receives it in a piecemeal way. (For a good explanation of how it works, see Shawn Tully's [article](#) detailing the process.)

But not all VAT taxes are created equal.

In Europe, rates vary from country to country-and many products, like food and children's clothes, are VAT-tax exempt, leading to some vexing, almost ridiculous, dilemmas. In a recent op-ed in the Wall Street Journal, the Hudson Institute's Irwin Stelzer [pointed out](#) that the UK children's clothing exception means that functionaries were forced to decide which size bra is the cutoff between a girl and a woman (up to and including 34B, is the answer).

Michael Graetz, a professor of tax law at Columbia University and the author of 100 Million Unnecessary Returns points to this example: Is a chocolate Easter bunny a food because you eat it-or is it a toy? "Some countries obviously do it better than others," he says. .

So who does it best? Tax experts and economists point to New Zealand, where a 12.5 percent goods and services tax applies uniformly to nearly everything with very limited exceptions-only rent paid for a private home, charitable contributions and interest earned are exempted. (The

government offers clear details, too, on its website.)

"In New Zeland, it works in a very pure form," says Eric Toder, an economist at the Tax Policy Center and a former consultant to the New Zealand Treasury. Toder analyzed the economic impacts of several different VAT tax models for the center, in this [report](#). "The population likes it. People think it's fair because it doesn't exempt some folks and not others."

### The VAT temptation

Critics fear that an American VAT may invite the creation of an arbitrary morass of tax exemptions. Politicians will no doubt try to protect local businesses and pet causes by excluding them from being taxed. And once the tax is in place, raising it is easier than raising a typical tax because so many in the chain pick up little bits of the overall hike.

Another concern: the VAT, because it taxes consumption, can hurt those with low incomes the most. One solution proposed by tax expert Graetz: debit cards. At the

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register, cardholders would scan their card and get an instant tax credit. The government still reaps the tax benefits along the production chain, but avoids burdening low-income consumers.

What model the United States might use, indeed whether the tax will be imposed at all, will be a furious political debate in the coming months. Conservatives and tax opponents hate it. "There's nothing to love. It will only lead to bigger government," says Daniel Mitchell of the libertarian Cato Institute. "The political establishment is salivating for more revenue. Thinking a VAT is going to cure the deficit is like giving an alcoholic the keys to a liquor store."

But if nothing is done soon, argue proponents of the tax, the nation's huge deficit and debt burden are going to produce a wicked fiscal hangover similar to the one that Greece is experiencing now.

"We're headed for disaster," says Syracuse University public affairs professor Len Burman, the former head of the Tax Policy Center, who favors adapting a value-added tax to cover health-care costs. "Anyone not blinded by ideology knows we are going to need another source of revenue." The value-added tax's record makes it a suitable candidate to fill the hole. "The widespread adoption of the VAT testifies to its advantages," write Simon James and Clinton Alley of the University of Exeter.

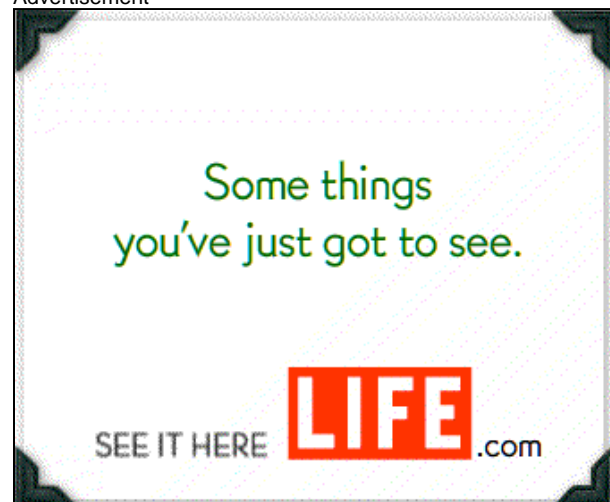
But has it also helped ease fiscal strain? In New Zealand, it contributes about 25 percent to the government's bottom line, and the Tax Policy Center in December [projected](#) that a 5 percent VAT tax here would generate over \$3 trillion in revenue by 2019.

That's not enough to cover America's huge debt obligations, of course, but it's a start.

The big questions will be whether or not politicians here can keep it as pure as New Zealand wool.

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