Taxing Consumption.

Key points

Consumption is potentially an efficient and sustainable tax base.

Consumption taxes can be levied directly on individuals by taxing only wages or allowing deductions under income tax for savings, or indirectly by taxing sales of goods and services that individuals buy.

While Australia's main consumption tax — the indirect invoice-credit GST — is an efficient tax relative to most other taxes levied in Australia, its design is complex.

Another means of taxing consumption would be to tax the difference between businesses' cash inflows and outflows (excluding wages from outflows; that is, the value-add of labour would be taxed). So long as the tax remains broad and at a single rate, the efficiency, compliance and administrative costs associated with such a cash flow tax would be significantly lower than with other consumption taxes, including those that States levy and that form a significant part of their revenue base but are particularly inefficient, such as insurance duties.

Over time, such a broad-based cash flow tax could be used to finance the abolition of other taxes, including payroll tax and inefficient State consumption taxes. Such a tax would also provide a sustainable revenue base to finance future spending needs.

For the tax system to support Australia in making the most of the opportunities and meeting the challenges of the 21st century, it needs to raise revenue from efficient and sustainable tax bases. One of the most efficient and sustainable tax bases is consumption. A tax on consumption does not tax the normal return to capital, encouraging investment and saving. From a macroeconomic perspective, consumption is generally less volatile than income or wealth, and therefore provides a more stable revenue source. As the population ages, an indirect broad-based consumption tax is likely to become increasingly important, since it taxes the capital income of retirees as it is spent, which might otherwise largely be untaxed under an income tax.

Australia's goods and services tax (GST) is narrow compared to its potential base, taxing only 57 per cent of consumption — in contrast to the New Zealand GST, which taxes consumption on a comprehensive basis (The GST is Australia's principal consumption tax. To improve the operation of the GST there might be opportunities to make greater use of GST-free or reverse charging treatment for some business-to-business transactions. However, cases where the benefits outweigh the additional complexity are likely to be few, given the existing GST base and the GST's invoice-credit architecture). Few, if any, countries have significantly broadened their main consumption tax base after introduction.

Broad-based consumption taxes are efficient

A broad-based consumption tax is one of the most efficient taxes available to governments. For a small open economy, investment is likely to be more mobile than consumption, suggesting economic growth is likely to be higher by shifting away from taxes levied on investment. Further, a single-rate consumption tax does not distort the timing preferences of consumption for individuals. The same tax is paid regardless of whether a person consumes now or in the future, imparting no bias for or against saving.

While consumption taxes are usually levied indirectly on the sale of goods and services, a consumption tax can also be levied as a direct tax. This can be achieved by taxing personal expenditure (that is, exempting income that is saved) or through a pre-paid consumption tax (which taxes only labour income, and exempts earnings from savings).

Nearly all countries pursue consumption taxation through taxes on goods and services. Personal expenditure taxes were implemented briefly in India and Sri Lanka in the 1960s and 1970s, but the worldwide trend since then has been to tax consumption through indirect taxes such as the value added tax. There would be few benefits and significant difficulties in implementing a direct consumption tax in Australia. The rest of this section therefore considers indirect approaches to taxing consumption.

Problems associated with direct consumption taxes

Potential problems with introducing a direct consumption tax include:

- significant vertical and intergenerational shifts in incidence depending on whether the tax applies to consumption only from income earned after the introduction of the tax;
- equity concerns if such a tax replaced the progressive personal income tax;
- economic efficiency costs associated with higher marginal rates of tax on personal incomes, especially if this causes different rates of tax on consumption over a person's lifetime;
- difficulties under pre-paid direct consumption taxes in taxing economic rents. For example, a pre-paid direct consumption tax, such as a broad-based payroll tax, taxes only the returns to labour. If an employee invests their wages and receives a windfall return, this additional economic rent would go untaxed. An indirect tax can capture this economic rent when it is spent on goods and services; and
- Loss of revenue integrity. For example, while it could be easy to understate or avoid declaring cash income on a tax return, it is much more difficult to avoid paying tax-inclusive prices on most purchases.

Consumption is a sustainable and stable base

Total household consumption as a percentage of GDP has been relatively stable for a long time. This suggests that a tax on consumption would provide a relatively sustainable revenue base that grows in line with the broader economy. The GST is slightly less robust because it does not cover the full consumption base. The Productivity Commission found that by 2044–45 GST revenues may decline slightly as a share of GDP because tax-exempt consumption such as health care is expected to grow.

This finding highlights the desirability of having a broad-based consumption tax rather than narrower taxes on specific goods and services. Narrower-based taxes — such as those on the consumption of fuel, alcohol and tobacco — are not stable, as expenditures on such goods have not remained stable over time. Underlying changes in consumption of specific goods and services can be influenced by tax, as well as changing consumer preferences, new technology or government policy. Together, these factors can affect the production and consumption of different goods. Taxes on specific products can be used to deliver desired social or market outcomes, while the broad-based consumption tax provides a sustainable revenue source.

A broad-based consumption tax should be part of a fair tax and transfer system

The principal equity objection to a broad-based consumption tax is that it is regressive — that is, households that spend more of their income (typically households at the lower end of the income distribution) pay more tax as a proportion of their income than households that spend less of their income (typically households at the higher end of the income distribution). This appears to contravene the principle of vertical equity — that those with more capacity to pay (here viewed according to income) should pay relatively more tax.

Viewed from the perspective of lifetime consumption opportunities, consumption taxes are less inequitable. In many cases, a person saves in order to consume more at a later point in time. Provided these savings are spent on taxed commodities, their lifetime tax burden is not reduced by virtue of savings in the earlier periods. Their consumption tax is smoothed over a lifetime, rather than concentrated on the years in which it is earned.

Nonetheless, a single-rate consumption tax can play no part in redistributing income to those who consume a greater proportion of their income (that is, typically households at the lower end of the income distribution) from those who consume less (that is, typically households at the higher end of the income distribution). The transfer system, together with progressive personal taxation, is better suited to this task, and should be the primary means through which the government influences the distribution of income in the economy.

In part, the transfer system responds automatically to changes in consumption taxes that raise prices, because transfer payments linked to the consumer price index will also rise. However, given that consumption patterns do vary across income groups, some changes to the consumption tax system might require more targeted assistance.

A broad base and single rate of tax is simplest

A consumption tax system designed to minimise compliance and administration costs would probably impose high rates of tax on easily measured goods (such as fuel and tobacco) at easily controlled points (for example, a large factory or a national border). However, to raise an amount of revenue sufficient to sustain revenue needs of the 21st century, the rates of tax needed on such a small number of goods would introduce large biases into production and consumption decisions in the economy.

An efficient, broad-based consumption tax necessarily draws in very large numbers of taxpayers. As such, a premium should be placed on simplicity. A single rate of tax that does not require taxpayers to discriminate between different forms of consumption is likely to be the simplest approach, as well as being highly efficient.

Future directions

Over time, a broad-based cash flow tax — applied on a destination basis — could be used to finance the abolition of other taxes, including payroll tax and inefficient State consumption taxes, such as insurance taxes. Such a tax would also provide a sustainable revenue base to finance future spending needs.

Recent reforms of indirect taxes in Australia have seen the GST replace a number of inefficient indirect taxes, such as the wholesale sales tax, financial institutions duty, debits tax and a range of stamp duties. Australia also has a pre-paid consumption tax levied on a narrow base (payroll tax) as well as a number of narrow-based taxes on particular products (such as insurance duties). Many of the indirect taxes levied by the States apply both to businesses and consumers (such as stamp duty on motor vehicles and insurance).

It would be possible to replace the current narrow state taxes base with a low, single-rate, broad tax on the difference between inflows and outflows of cash (excluding wages; that is, the value-add of labour would be taxed) of businesses. In large part this could simply be added to existing tax reporting obligations of businesses. By exempting business export sales, this tax would apply to the consumption base.[1] By using existing tax reporting mechanisms, a new cash flow tax could more readily be based on the automated systems increasingly used by businesses.

A cash flow tax that applies a single rate of tax to the net cash flow position of an entity would perhaps be the simplest possible utilisation of the consumption base, as it does not distinguish between different goods and services, or between different types of taxpayers. Such a cash flow tax could have very low administration and compliance costs if it utilised existing GST systems, such as the business activity statement. One concern is that the cash flow tax does not have the integrity due to the self-enforcement incentives of the invoice-credit method GST.

The introduction of a tax on cash flows would be a significant change to Australia's tax system requiring additional analysis and community consultation.

Efficiency and simplicity

To be efficient, the consumption tax base should be spread across most forms of consumption. Provided that decisions about labour supply are independent of purchase decisions, and provided income tax is set efficiently, a single-rate tax on all goods and services is more efficient than different taxes on different commodities. The earlier rule of setting tax rates for products according to their own-price elasticity of demand does not hold when income effects are taken into account, and the price of one commodity affects demand for others.

The ideal consumption tax would tax all consumption at a single, *ad valorem*, rate. However, in practice not all consumption is derived from goods and services that can be taxed — for example, it is practically impossible to directly tax leisure. In theory this means that a single rate of tax may be less efficient than setting higher tax rates on those goods and services consumed as complements to untaxed goods. In fact, Corlett and Hague first proposed such a tax system for complements to (untaxed) leisure. Another significant untaxed commodity is home production — generally consumption taxes increase the incentive to produce (untaxed) goods and services at home.

However, in practice taxing goods or services on the basis of complementarity with leisure would be difficult to implement. This reflects the fact that most goods and services can be used for leisure or work, so to tax consumption only it would be necessary to know what purpose the person purchasing the product intended to use it for. Further, the need to impose multiple rates would cause significant administration and compliance costs. As any efficiency gains from such an approach are likely to be small, in most cases these would be outweighed by compliance costs.

Rather than moving away from a single tax rate, selective subsidies aimed at redressing work disincentives are likely to be more effective. For example, child care subsidies can ameliorate the tax system's incentive to provide child care at home. Further, additional taxes on specific commodities can still be an effective tool to obtain specific social or market objectives other than revenue-raising.

That is, goods and services are taxed where they are consumed, not where they are produced.