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Options for Reforming Australia's Indirect Taxes

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AUSTRALIA'S Commonwealth and State governments collect a number of different taxes on the sale of goods and services. In some cases, and in part, such taxes are crude forms of user charges for government services, and some are justified as taxes on external adverse effects of production and consumption. But most indirect taxes are designed to raise general revenue. In total, indirect taxes collect a third of all taxation revenue, and are more important for the States than the Commonwealth. On the assumption that they mostly are passed forward to consumers, indirect taxes add an average of 13.5 per cent to the purchase cost of final consumption expenditure.

Indirect taxes in Australia are vulnerable to many criticisms. They have narrow bases with many consumption items exempt; rates are high and variable; they have a high incidence on some (but not all) business inputs; they are highly regressive and offend principles of horizontal equity; and in many cases they are complex and costly to comply with. Australia is far from having a broad-based consumption tax of the type found in most other developed countries. Non-neutrality of indirect taxation of different economic choice options distorts choices on the goods and services produced and consumed and also on production methods.

Major reform of the indirect tax system should proceed from first principles. Here, three reform contexts are relevant. First, where indirect taxation is used as a means of charging users or of countering externalities, the base and the rate should directly and explicitly reflect the user charge or externality. Second, insofar as indirect taxes serve to raise general revenue, the use of a single-rate tax on a broad base of consumption expenditure has strong appeal; as well, technical and political feasibility is achieved most easily if indirect tax reform is presented as a revenue-neutral rationalisation.

A third and more complex economic and political context for considering indirect tax reform is the use of an expanded revenue-raising broad-based consumption tax as part of a change in the tax mix. Australia in 1985 and 1993 considered using revenue from an expanded indirect tax to replace part of the present income tax. A tax mix change involves transition adjustment problems and large changes in the distribution of the tax burden.

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Current Indirect Taxation

Table 1 provides a list of indirect taxes collected by the Commonwealth and State governments and the revenue yielded in 1995-96. Inevitably, there is scope for legitimate debate over which taxes should be included and which excluded. For example, the table does not include tariff revenues or land taxes.

Table 1

Indirect taxes collected on expenditure of goods and services, Australia, 1995-96 ($m)

Type of tax	*Commonwealth*	*States*
General		
Wholesale sales tax	12,792	
Payroll tax		7,088
Financial and capital taxes		
Financial institutions duty		1,904
Stamp duties		4,165
Excise and franchise fees		
Petroleum products	10,224	1,531
Tobacco	1,585	2,621
Alcohol products	1,026	735
Gambling	10	
Lotteries		958
Poker machines		1,256
Race betting		643
Casinos and other		450
Motor vehicle taxes	35	
Registration, licences, other		2,382
stamp duties		1,050
Third party		225
Insurance contributions		1,505
Others		
Departures taxes, broad-cast licences	362	
Total	26,034	26,513

Constructed from: ABS (1996a); Commonwealth of Australia (1996).

The most important general revenue-raising indirect taxes are the wholesale sales tax levied by the Commonwealth and the payroll tax levied by the States. The wholesale sales tax has a narrow tax base: all services are tax exempt, as are some goods, including clothing and food. Currently there are five rates of tax: 12, 22, 26, 32 and 45 per cent. Ostensibly, the higher rates apply to luxury goods, but much of the classification reflects views that were current in 1930, when the tax was introduced. More than a half of the initial incidence of the wholesale sales tax falls on business-input purchases of cars, furniture, appliances, paper, and so forth, rather than final consumer sales (Chisholm, 1993). The multiple rates and taxable categories give rise to uncertainty and some litigation.

Payroll taxes levied by the States apply to firms with annual salary bills above a threshold of around half a million dollars (from a low of $456,000 in South Australia to a high of $750,000 in Queensland) with marginal tax rates of 5 per cent in Queensland, 6 per cent in Western Australia and South Australia, and 7 per cent in other States. There are exemptions for decentralised industry, some classes of special industry assistance, and some employment schemes (see New South Wales Treasury, 1996). Wages and salaries, and some fringe benefits including superannuation in two States, are taxable. In effect, just over a half of employees are subject to payroll tax. Grouping provisions and exemptions, together with separate State administrations, give rise to some complaints about tax compliance.

Financial and capital taxes are general revenue-raising taxes. The financial institutions duty is payable on receipts (credits) of financial institutions at a general rate of 0.06 per cent (except Queensland, where it is zero, and the ACT, where it is 0.1 per cent) with a maximum per transaction ($1,200 in most cases) and a special lower rate for the short-term money market. Stamp duties are levied on contracts and conveyances, the sale of motor vehicles, life insurance, share transfers, hiring arrangements, leases of land, and mortgage and loan security. The rate structure varies: some are progressive, others have flat rates. Rates vary from item to item and across States, and sometimes there are exemptions and special rates. This hotch-potch of taxable and non-taxable items and different tax rates results in narrow tax bases and different rates on different forms of capital items and financial transactions. Like the wholesale sales tax, distortions associated with stamp duties apply to business-choice options as well as to household consumption-choice options.

The other indirect taxes listed in Table 1 are, in part, user charges or taxes on externalities as well as raisers of general revenue. Insurance contributions and departure taxes are entirely fees for services provided.

In aggregate, revenue collected from excise and franchise fees on petroleum products, motor vehicle taxes, and the wholesale sales tax on vehicles amounts to roughly twice the level of government expenditure on road construction and maintenance (Docwra & Kolsen, 1993). Further, debate persists on the relationship between these charges and actual road service usage by different categories of vehicles (see for example IAC, 1986).

Some of the revenue collected from excise and franchise fees on petroleum products is available for meeting externality effects, including pollution and congestion. However, the present tax arrangements are poor indicators or measures of the externalities involved. If taxation of petroleum products is designed to deal with greenhouse-gas pollution, why are off-road uses of diesel, the burning of coal for electricity generation and other purposes, and liquid petroleum gas tax-exempt? But if it is designed to curb traffic congestion, why does it apply in rural and suburban areas, and for fuel consumption around the clock in urban areas where congestion occurs mainly during peak hours? The combination of a specific tax per litre, the Commonwealth excise on petroleum products and the *ad valorem* State franchise fees appears to be inspired by expediency and revenue-raising opportunities rather than a rational estimate of the marginal externality effects of the consumption of selected petroleum products.

Relatively high indirect tax burdens are levied on alcohol products through the Commonwealth wholesale sale tax and excise and the State franchise fees (see Scales, Croser & Freebairn, 1995). As well, the tax burden differs widely from product to product (it is highest for spirits, lower for beer, and lowest for cask wine) and it varies according to whether the wine is sold at the cellar door or elsewhere. And here too there is a mixture of specific taxes per litre of alcohol (excise), which probably comes closer to the source of any externality, and *ad valorem* (wholesale sales and franchise) taxes. The particular tax burdens on alcohol products do not systematically reflect the pattern and magnitude of externality effects.

Gambling taxes are an increasingly significant source of State revenue (for details of the different gambling taxes, see New South Wales Treasury, 1996). No case has been made to the effect that gambling may have some negative externality effects, let alone any attempt to quantify these. Moreover, the differences between the tax rates on different forms of gambling, and even between win/place and trifecta bets on races, lack justification in terms of efficiency, equity or simplicity.

General Assessment

In terms of economic efficiency, the present indirect tax system has many deficiencies (Freebairn, 1993; Albon, 1996). A case can be made for levying special taxes, or applying relatively high tax rates, on goods and services that generate external effects. However, the existing higher tax burdens on some petroleum products, the different taxes on different alcohol products and on different gambling activities, and the very high tax burden on tobacco are not supported by logical and realistic estimates of net marginal externality effects. Similar, though weaker, criticisms can be made of the use of indirect taxes as user charges for government-provided road, insurance and other services.

As a general revenue raiser, the indirect tax system with its different tax rates on different choice options distorts consumer decisions. It also distorts producer decisions, both on what to produce and on how it should be produced. Many critics of the system (such as Chisholm, 1993; Albon, 1996) ignore its effects on the latter type of producer choice. For example, the heavy taxation of transport distorts loca-

tion decisions; payroll tax favours small business enterprises over large business enterprises; and the heavy taxation of motor vehicles favours rail and air over road transport.

As for vertical equity, the current system is regressive in terms of tax paid as a share of disposable income, and approximately proportional in terms of tax paid as a share of household expenditure. Table 2 reports ABS data for about a half of the indirect taxes, prepared on the conventional (though debatable) assumption that such taxes are fully passed forward as higher prices. Because of life-cycle effects and temporary periods of above- and below-normal income, a more useful measure of the distributional burden is indirect tax as a share of expenditure. While the exemption of food from most taxes initially favours those on low incomes, in reality food prices include some taxation because of the taxation of fuel, motor vehicles, and other inputs used in its production. The exclusion of most services from current indirect taxation is highly regressive.

Table 2

Estimated vertical equity distributional effects of Australian indirect taxes, 1993-94

	Households by gross income quintile					
	Lowest 20%	*Second*	*Third*	*Fourth*	*Highest 20%*	*All households*
Disposable income* ($/w)	150	336	512	738	1196	586
Total commodity and services expenditure ($/w)	303	426	573	714	994	602
Selected indirect taxes paid** ($/w)	28.9	43.2	59.0	73.8	96.6	60.3
Indirect taxes as % of disposable income	19.3	12.9	11.5	10.0	8.1	10.3
Indirect taxes as % of expenditure	9.5	10.1	10.3	10.3	9.8	10.0

Notes: *Disposable income is market income (wages, interest, etc) plus government direct payments (pensions, benefits) minus personal income tax paid. **Indirect taxes cover about a half of all indirect taxes. It is assumed they are fully passed forward to consumers.

Sources: ABS (1996b, c).

The mixture of tax-exempt and highly taxed items under current indirect taxes results in horizontal inequity. For example, a family that indulges in luxury expenditure on cars and electronic gadgets pays more indirect tax than a family with similar income that purchases expensive clothing and restaurant meals.

While there have been many criticisms of the allegedly high compliance costs imposed by indirect taxes, available estimates indicate that they are relatively low,

and much lower than those of income tax (Pope, 1993). In part, this arises because a relatively small number of medium and large business enterprises initially pay most of the indirect taxes.

External Costs, User Charges and Indirect Taxes

Levying specific taxes on goods and services whose consumption or production generates external costs on third parties raises the private price to reflect these costs, and so improves economic efficiency as well as generating revenue. To be effective, the tax base should be as close to the direct source of the externality as feasible, and the tax rate should reflect the net external cost caused by the activity.

In principle, a number of Australian goods are candidates for specific indirect taxes that reflect externalities. These include alcohol and tobacco, and transport where it involves congestion. More controversial is the argument that petroleum products for off-road use as well as on-road use, and the burning of fossil fuels for electricity generation and other purposes, should be taxed to mitigate the greenhouse effect. Equally controversial is the claim that gambling should be taxed because it gives rise to large externality effects, especially beyond the family level. Whatever the case, Australia's present indirect tax system is poorly designed to counter externalities. For example, current taxation of alcohol products consists of a mixture of specific taxes (the excise taxes) and *ad valorem* taxes (including the wholesale sales tax and franchise taxes); moreover, effective tax rates vary widely across different products. Generally, one specific tax at a common rate on all sources of the externality would correct the market failure, be equitable, and simplify the taxation system.

The present raft of indirect taxes on road transport includes the wholesale sales tax on motor vehicles, excise and franchise fees on petroleum products, registration and licence fees, stamp duties and third-party insurance. Often they are defended, at least in part, as amounting to a user charge for road construction and maintenance, policing, and so forth. Ideally, there would be a single charge per unit of road services consumed. The present system, relying heavily as it does on indirect taxes on fuel, is poorly correlated with road damage by different users (Industries Assistance Commission, 1986; Docwra & Kolsen, 1993). Given the importance of fixed capital costs in the total costs of providing road services, and the prevalence of decreasing costs, it is likely that an up-front or access charge based on the registration fee would be part of a sensible two-part tariff system for pricing and funding the provision of road services; the other part of the tariff would consist of a user charge reflecting at least some marginal costs.

General Revenue Raising and Indirect Taxes

A broad-based consumption tax. Apart from special externality charges and user fees, the current maze of indirect taxes could be replaced with a broad-based consumption tax levied at a single rate.

A revenue-neutral rationalisation of existing indirect taxes would create a tax base consisting of a comprehensive basket of final consumption of goods and services, including necessities such as food, clothing and housing. This would largely eliminate the distorting taxes on some business inputs. A common tax rate on all consumer items would simplify the tax system. It would remove most of the present distortions to consumption decisions. In addition, the broad base and single rate would achieve horizontal tax equity.

Importantly, such a tax would result in roughly the same level of vertical equity as occurs under the current set of indirect taxes. It would raise the cost of consuming goods and services for all households by the tax rate. It would amount to a proportional tax in terms of household expenditure. This is the same average outcome as occurs with the aggregate effects of the existing indirect taxes, as illustrated in Table 2, although the general revenue-raising wholesale sales tax and payroll tax are slightly less regressive in their effects than the excise, franchise fee and motor vehicle taxes.

Exemptions and multiple rates. Arguments for exemptions from a broad-tax base and for multiple rates have serious weaknesses. First, as already observed, the vertical equity argument is unwarranted; further, equity concerns are more directly and efficiently achieved by changes in the personal income-tax and social-security systems. Second, arguments for varying tax rates according to product elasticities of demand and with degrees of product substitution and complementarity with untaxed leisure may make theoretical sense (see Creedy, 1993), but they are questionable in practice: for example, we have inadequate knowledge of the elasticities, and different tax rates create incentives for wasteful lobbying and rent-seeking expenditures. Third, a single rate is simple and transparent.

Varieties of broad-based consumption tax. Serious contenders for a broad-based consumption tax comprise the single-stage retail sales tax (RST), such as is used by the states of the US; and the multi-stage tax known as the valued-added tax (VAT) in the European Union and as the goods and services tax (GST) in New Zealand and Canada.

There is growing support for the view that a broad-based, single-rate multi-stage VAT or GST, best illustrated by New Zealand, is superior to the single-stage RST (Cnossen, 1989). In principle, the two impose the same final tax incidence on domestic consumption expenditure. In practice, the multi-stage system is more effective in exempting business inputs from taxation (thus reducing distortions to production choices and eliminating tax-on-tax cascading causing different effective retail tax rates on different consumer products) and has a broader base and lower tax rate for the same revenue (thus reducing consumption choice distortions). Typically, the RST either involves taxation of business inputs, as would the Option C proposal at the 1985 Tax Summit, or has a relatively small tax base, as in the US. Under the multi-stage system, registered businesses claim a credit for tax paid on business input purchases. In this way, it provides an automatic procedure for distinguishing

between taxation of final consumption, which is desired, and taxation of business inputs, which is undesirable. The degree of additional paperwork required with the multi-stage system easily is exaggerated because the system uses the same records as those kept for income-tax purposes. While all tax systems are subject to some evasion and avoidance, the invoice trail of the VAT and GST provides a good framework for administrative checking. Finally, 21 of the 24 OECD countries have some form of multi-stage system.

Proposals to end the coverage of the wholesale sales tax and/or to add a new tax on services involve a number of deficiencies relative to the broad-based consumption tax options. To remove the input taxing component of the wholesale sales tax, so that it falls only on final consumption purchases, would reduce the current tax base by 60 per cent; and it is not easy to distinguish between business input and final consumption purchases. Retaining input taxation would mean a continuation of distortions to production decisions, tax-on-tax cascading, and differential effective tax rates at the retail level. As well, the base of the wholesale level is very much smaller than the base of a retail tax. Adding a new tax on services involves numerous measurement problems. For example, what part of a new car would be subject to a service tax, especially if the wholesale sales tax still applied to the manufactured good? Again, many services, like goods, are used by business as inputs as well as by households for final consumption: for example, car repairs and legal services. To expand the wholesale sales tax and/or to add a tax on services would mean large changes, with transition costs, and probably also political costs, comparable to those of introducing a VAT or a GST. That is to say, rationalisation of existing indirect taxes for general revenue-raising purposes would be more successful in terms of efficiency, equity and simplicity if effected through a comprehensive multi-stage indirect tax than through the band-aid strategy of modifying the wholesale sales tax and/or introducing a new tax on services.

Operation of a VAT/GST. In practice, a workable VAT or GST would not have a truly comprehensive base (see Bascand, 1989; Chisholm, Freebairn & Porter, 1990). Leisure and non-market goods and services would avoid the tax net, as they do for income tax. Imputed services provided by owner-occupied housing and consumer durables would not be taxed, but the purchase price of new items could and should be taxed as a form of a prepaid consumption tax. No country with a VAT or GST fully taxes financial services; but inputs used by the finance sector typically are taxed. Otherwise, most other goods and services included in private final consumption expenditure would be taxed.

The payroll tax. To achieve tax neutrality, the present payroll tax system should be broadened to encompass all labour income. This would mean removing the small-business and other exemptions, and including employer superannuation contributions. In effect, the present base could be doubled. Such a broad base easily could be built on the existing pay-as-you-earn income tax, fringe benefit tax and superannuation guarantee levy systems operated by the Commonwealth. This also would

significantly reduce compliance costs. More controversial would be an extension of the payroll-tax base to include a deemed labour income component of the income of the self-employed, which includes returns for own labour, management and investment.

A comprehensive payroll tax could be used along with, or instead of, a VAT or GST. In longer-run equilibrium, a broad-based labour tax, such as the proposed payroll tax, has the same economic incidence and effects as a broad-based consumption tax (see Bascand, 1989; Ryan, 1995). Both effectively exempt saving or the income from capital from taxation. The VAT tax base for each business enterprise consists of gross sales, minus expenditure on goods and services purchased and minus cash outlays on gross investment items; the residual consists largely of the labour costs that supply the base for payroll tax.

The payroll tax taxes financial services more effectively than a GST or a VAT. Its disadvantage is the need either to deem a labour component of the income of self-employed persons, or to exempt from taxation this element of the potential tax base. One appeal of payroll tax is that it is a State tax. However, as noted, it could be better administered through existing Commonwealth tax systems. Given these advantages and disadvantages, a case could be made for using a combination of a broad-based single-rate VAT and a broad-based single-rate payroll tax to replace the general revenue-raising component of all existing indirect taxes.

Changing the Tax Mix

Recent attempts to introduce a broad-based consumption tax in Australia, such as Option C at the 1985 Tax Summit (Keating, 1985) and the GST proposed by the Liberal-National Coalition in 1991-93 (Hewson & Fischer, 1991), sought not only to rationalise some existing indirect taxes, as discussed above, but also to use part of the consumption-tax revenue to fund a reduction in the overall level of personal income tax. Such a change in the tax mix, if introduced in an aggregate revenue-neutral way, would reduce the taxation on saving and increase it on consumption. It brings a set of efficiency and equity effects that are additional to those generated by the rationalisation of indirect taxes and that are also more controversial in the minds of analysts, politicians and the public.

Shifting the tax mix away from income to consumption changes the incidence or distribution of the overall tax burden. It reduces the tax level on saving. However, over a half of Australian saving is already wholly or mainly exempt from taxation: the imputed rent from, and capital gains on, owner-occupied dwellings are not taxed, business investments in human capital and research and development are written off in the year of expenditure, and the earnings of superannuation funds are subject to a flat 15 per cent tax; as well, the deferment of tax on real capital gains until realised reduces the effective tax rate. Only those who save in forms that are taxed as income, as are debentures and deposits in financial institutions, would gain from a tax mix change. Even so, those on higher incomes who are responsible for most household saving would predominate among the gainers. Losers under a

change in the tax mix would include many on low incomes and the elderly self-funded retired who are consuming their past savings.

Any attempt to maintain the present distribution of the tax burden under a change in the tax mix would require some form of compensation for the losers. This could be attempted only crudely. It would involve a combination of making the remaining income tax system even more progressive, increasing social security payments, and introducing special rebates.

The efficiency effects of a tax mix change point in different directions, and there is much uncertainty about their magnitude (see for example Goode, 1991; Randolph & Rogers, 1995). By shifting the tax burden away from the returns to saving and investment towards labour income, a revenue-neutral tax mix change would increase distortions in the labour market, including choices between work and leisure. But it reduces the distortions to two key sets of capital-market decisions. First, it reduces disincentives to save and to defer income from present to future consumption. Second, lower income-tax rates would reduce, but not eliminate, the non-neutral taxation of different savings and investment choice options under Australia's present hybrid income tax system, which taxes different forms of saving and investment in different ways (Pender & Ross, 1993). A tax-mix change would in this way raise the productivity of national saving and investment.

Concluding Observations

Discussion of structural reform of the tax system is simplified by assuming that aggregate revenues remain unchanged. Government can be expanded by scaling the tax rates upwards, or reduced by scaling them downwards.

Potential gains in economic efficiency, horizontal equity, transparency and simplicity provide *prima facie* arguments for reform. Further, other countries have in place superior working examples that could be copied.

Rationalisation of the revenue-collecting function of indirect taxes would take two forms. First, broad-based taxes with a single rate should be used as general revenue raisers. Here, a multi-stage VAT or GST, with New Zealand as the preferred prototype, and a broadened payroll tax would replace most existing indirect taxes. These taxes are proportional to consumption expenditure and similar in progressive distributional effect to the taxes they would replace. Second, additional specific taxes would be imposed, both on externalities such as those generated by tobacco and alcohol, and as user charges for government-provided services, such as roads. Further research is needed on the details of the form and level of such taxes.

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