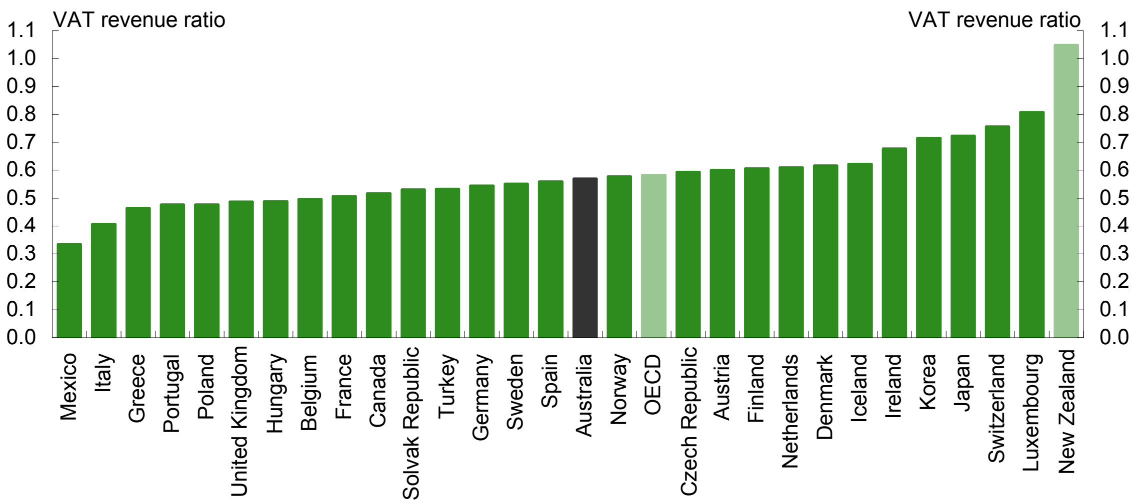
7. Taxing consumption

Consumption is potentially one of the most efficient and sustainable tax bases available to governments. Empirical evidence indicates that a broad-based tax on consumption is one of the least damaging taxes to economic growth. Many countries rely heavily on consumption taxes, levying them at rates well above Australia's 10 per cent GST rate.

The introduction of the GST made Australia's consumption tax base more efficient because it replaced a range of narrowly based Commonwealth and State taxes. While the GST is an efficient tax relative to most other taxes levied in Australia, it is less efficient than it could be because of its failure to tax consumption on a truly comprehensive basis (see Chart 7.1).

Moreover, complying with the GST is costly for business — particularly small businesses. It is an operationally complex tax, designed on tax invoice concepts more suited to the documentary standards of the 1960s than the digital potential of the 21st century.

Chart 7.1: VAT revenue ratio, 2005[(a)]



(a) Unweighted average used for OECD. The VAT revenue ratio = (VAT or GST revenue)/([consumption (including government consumption) — VAT or GST revenue] x standard VAT or GST rate). An 'ideal' value added tax, which would apply at a single rate on all domestic consumption, would have a VAT revenue ratio of 1. A VAT revenue ratio above 1 can reflect investment in residential housing that is taxed on a prepaid basis (and rents are input taxed) but is not included in national accounts as consumption, or cascading effects of input taxation in the value chain.
Source: OECD (2008a).

Australia retains a range of additional inefficient taxes on consumption (such as insurance taxes and the luxury car tax) and narrow payroll taxes. It would be possible to replace these taxes with a low-rate broad-based cash flow tax that more effectively utilised the consumption base. Exports would be exempt and imports subject to the tax, to ensure that it taxes consumption in Australia. The tax could be designed so that returns from labour would be taxed, making an additional payroll tax unnecessary. It would be highly efficient, because it would cover most of the consumption tax base. It would also be a relatively simple tax if it could be added to the existing tax reporting obligations of businesses.

Taxing the consumption of financial services, where value is generated through interest rate spreads rather than prices for products, is problematic for both the GST and a simple cash flow tax. The use of input taxation as a proxy for GST potentially biases production and consumption decisions, despite additional complex rules designed to mitigate the inefficiency. This is because it over-taxes business by around $500 million while under-taxing consumption by around $2.5 billion (see Table 7.1).

Table 7.1: GST with input taxation of financial services

	Non-financial goods and services Explicit price = wages + economic rent	Financial services Implicit price in interest margin
Households	10% tax on price	10% tax on some inputs into financial services
Business	GST refunded, except for embedded tax	10% tax on some inputs into financial services
Exports	GST free - some embedded tax	GST free - some embedded tax

Financial services should be taxed equivalently to other forms of consumption. That is, the consumption of financial services by Australian households should be fully taxed. There are a range of options for how this could be done, although the actual design of the tax would need to be informed by extensive consultation with the financial services industry.