

9 Taxing goods and services

Outline

This section examines the current Australian system of taxing goods and services.

Key points

- Historically, taxes on goods and services raised revenue relatively simply from narrow bases that are easy to tax, with a shift over time toward more efficient broad-based taxation.
- Some taxes on specific goods and services may reflect a range of non-tax policy objectives, such as reinforcing social policy objectives, or providing assistance to domestic industry.
- Specific taxes can also be levied to help correct market failures. For example, an effectively targeted tax creates incentives in the market for individuals to respond to environmental concerns.
- Improving technology is making it administratively feasible to replace some taxes with more direct user charges.

9.1 Raising revenue for general public expenditure

At federation, the Commonwealth levied excises (taxes) on domestic production and tariffs on imported goods. These were typically commodities with clearly identifiable and easily controlled sources, such as alcohol and tobacco. Many of these commodities were also everyday consumption goods including starch and sugar. Although the administrative costs of collecting excise were quite low, their efficiency costs were likely to be high in many cases. This is because taxing some goods and services and not others changes relative prices. This provides incentives for people to alter consumption from taxed goods to untaxed goods.

Over time, the taxation of goods and services in Australia shifted from selective excise and customs tariffs, to broader-based taxation of goods. The Scullin Government introduced a sales tax at the wholesale level in 1930 at a single rate. The Asprey Committee (1975) noted that exemptions and reclassifications of goods to lower rates since the Second World War had significantly eroded the sales tax base. By 2000, goods were classified at seven different rates, ranging from 0 to 45 per cent. The provision of services was not directly taxed.

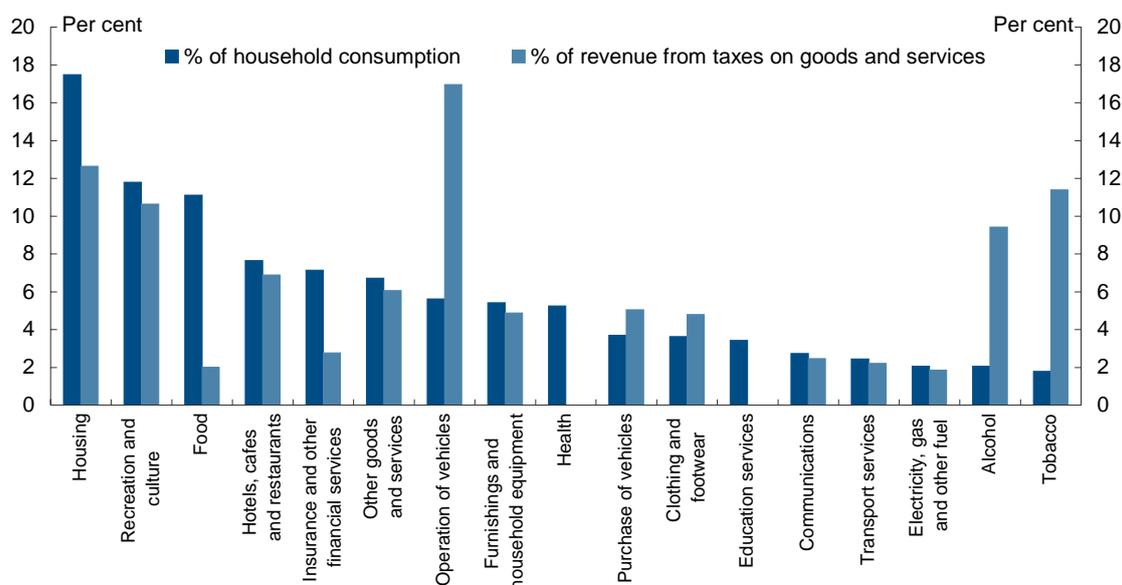
The wholesale sales tax was replaced by the goods and services tax (GST) in 2000. The GST applies at a single rate of 10 per cent to a broad base. By adopting a uniform rate, much of the complexity associated with classifying goods against the multiple-rates of the sales tax was removed. Moreover, the influence of tax considerations on consumer decisions was reduced through fewer tax induced changes to the relative prices of goods and services.

The GST taxes services, which today make up around 70 per cent of Australia's industry output. Some goods and services are GST free, including basic food, health and medical care, education and charitable goods. GST contributes a little more than half of Australian government revenue from indirect taxes.

The Australian government and the States all levy a range of other taxes on specific goods and services that are mostly consumed by households, and for which there are few substitutes. The demand for these goods and services is generally 'inelastic' (unresponsive to the change in price resulting from the tax). Often, goods subject to specific taxes have only a few, easily monitored, producers. For example, there are fewer than 10 payers of tobacco excise and around 100 payers of fuel excise in Australia. Administration and compliance costs therefore tend to be quite low as a percentage of the revenue collected.

Due to these specific taxes and the exemptions from GST, the share of revenue raised from some goods and services is higher than their share of household consumption expenditure, while for others it is less (Chart 9.1).

Chart 9.1: Household consumption and estimated revenue from Australian government taxes on goods and services in 2006-07



Sources: Consumption shares based on ABS (2007c). GST revenue allocations to consumption categories is estimated from national accounts (not including GST embedded in the price of goods and services that are input taxed), other Australian government tax revenue based on actual 2006-07 Budget outcomes based on estimates for household use.

Chart 9.1 shows the impact of directly imposed taxes on consumer goods and services. It ignores taxes on business inputs that are passed onto consumers through the prices on the goods and services they produce. These taxes are generally less efficient as they also distort production decisions. However, it is possible to limit these distortions by providing relief from the incidence of these taxes to business, such as is intended with fuel tax credits.

9.2 Achieving non-tax policy objectives with indirect taxes

Most taxes result in an efficiency cost to the economy because the production of goods and services subject to tax is less than the level that society would demand if the tax were not imposed (see Box 3.4). However, in some cases taxes and charges can increase market

efficiency. A tax on a specific good may be beneficial if it reflects the external costs the use of the good imposes on others. Such a tax ensures that users or producers of the good take into account the negative effects they have on others when making production or consumption decisions (see Box 9.1).

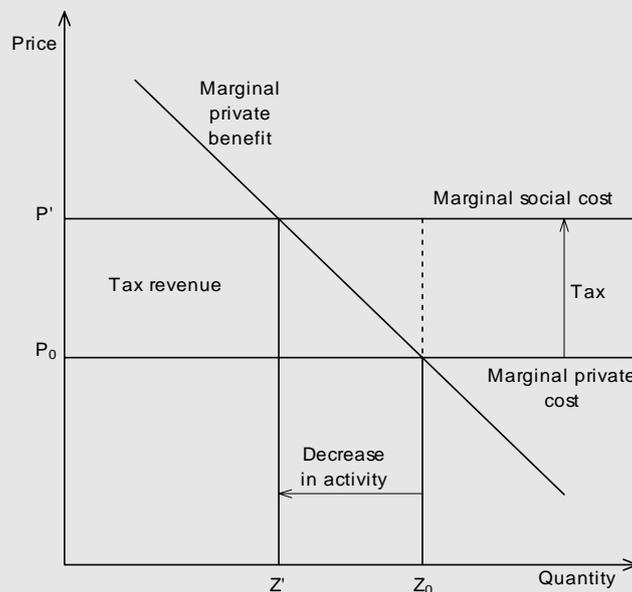
The tax system can also be used to reinforce non-tax policies, including industry assistance, income redistribution, or promoting public health.

Box 9.1: Corrective taxation — paying for the cost imposed on others

For some activities the cost to a private individual or firm is less than the cost to society as a whole. For example, the production of some goods results in environmental pollution. The firm undertaking this production might bear little of the cost of this pollution, with the cost being borne by society as a whole. This can also apply to private consumption decisions. For example, the decision of an individual to smoke tobacco may not only cause harm to their own health, but also affect the health of others and impose a financial cost on society through increased demands on a publicly-funded health system.

One solution is to impose a corrective tax which is shown in Chart 9.2. This tax should equate the private marginal cost (of the polluter) with the social marginal cost (of the public at large). This tax increases the cost of undertaking the damaging activity from P^0 to P' . The polluter then reduces the level of activity from Z^0 to Z' where their marginal benefit from the activity just equals the marginal social cost.

Chart 9.2: Corrective taxation



Corrective taxation is most efficient when the activity that generates the external cost is taxed directly — for example, actual pollution emissions. However, this may not always be administratively feasible. For example, cheap and accurate monitoring may not be possible with existing technology. In such cases a key input (for example, a particular fuel) or output (for example, a particular manufactured product) associated with the activity can be a less efficient, but administratively feasible, means to impose a corrective tax.

Corrective taxes alter relative prices of goods and services to reflect social costs. Provided that a general consumption tax, such as a GST, is also levied on the price that includes the corrective tax, overall consumption should settle at the socially optimal level. These taxes are not designed to eliminate all negative consequences to society. All that is required is that the costs to society of undertaking the activity are reflected in the economic decisions of consumers or producers. Taxation is not the only way to achieve corrective action. For example, licensing restrictions on alcohol and product controls on tobacco aim to affect consumer behaviour, as do public health campaigns. To the extent that the externality is addressed through non-tax means, there is reduced need to apply a corrective tax.

Health and social policy

In some cases, specific taxes apply to consumption of products which may have negative health effects on the consumer and others. For example, alcohol taxation is applied to intoxicating beverages, but alcohol that is not consumed in intoxicating beverages is not subject to excise (such as alcohol used for industrial purposes). This means alcohol taxation is more closely targeting potential public health costs and reinforcing other social policy objectives around alcohol consumption.

Different types of alcoholic beverages are taxed differently. For beer and spirits, the volume of alcohol is taxed through the excise system. A separate wine equalisation tax (WET) taxes wine products based on value, not alcohol content. An additional producer rebate means that the net tax payable on wine products varies according to both the value of the wine produced (with cheaper wines attracting less tax) and the value of the producer's production (a small producer will have no net WET liability).

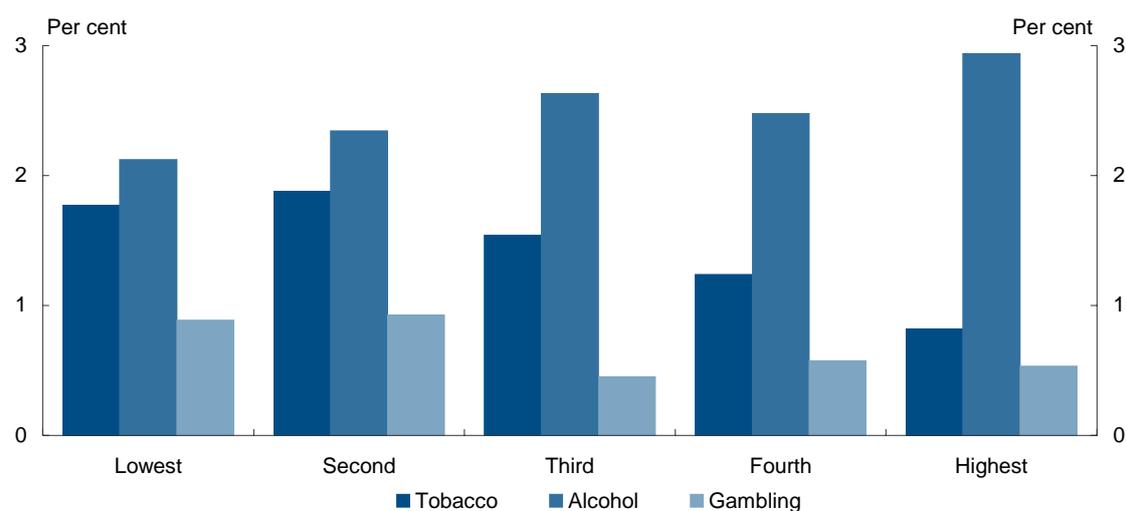
Addressing non-tax policy objectives with taxes on specific goods and services has complex effects. To the degree that there is some substitutability between different forms of consumption, non-uniform tax rates encourage the production and consumption of less taxed goods. Moreover, there may be different impacts on different market segments. For example, academic studies have suggested that increasing the tobacco price lowers the uptake of cigarette smoking, and therefore the prevalence of smoking in the community. However, existing smokers are typically less responsive to price than non-smokers, and are therefore likely to face an increased tax burden.

The States regulate gambling industries to achieve a range of social objectives, including to minimise the costs and risks of problem gambling. Licensed gambling affords the opportunity for licensees to derive supernormal profits, which would be otherwise unavailable in a fully competitive market. State governments apply gambling taxes to ensure that the community derives an appropriate share of these supernormal profits, and so reinforce social policy objectives.

Between States, there are different regulatory and tax arrangements for different forms of gambling – for example, racing, lotteries, poker machines and casinos are taxed differently. Overall revenue from state taxes on gambling provides around 10 per cent of state tax revenue (see Section 2.5). This is only 3 per cent in Western Australia due to a prohibition on gambling machines outside of Burswood Casino.

In general, especially since the abolition of the wholesale sales tax, the redistribution of wealth in Australia is managed through the broader tax-transfer system, not through differential taxes on specific categories of goods preferred by low-income or high-income households. However, the taxation of specific products does have distributional consequences. For example, low-income households spend a greater share of their income on tobacco (see Chart 9.3). On the other hand, the luxury car tax is aimed at goods that are generally more accessible to high-income consumers.

Chart 9.3: Spending on particular goods and services
By gross household income quintile



Source: ABS (2006b).

Industry policy

A tariff is a tax on products produced overseas and imported into Australia. Although tariffs were a major revenue source for early Australian governments, their importance has diminished following successive tariff reductions and the growth of other taxes. Tariffs have moved from being a primary means of raising revenue to a form of industry assistance.

Tariffs assist some local firms by providing some protection from import competition. In effect, they enable local producers to increase the prices at which they can sell their goods on the Australian market and/or to increase the volume of their sales. As such, tariffs have a redistributive impact, away from consumers and toward the owners and employees of tariff assisted industries. Tariffs also impose costs on firms which use imported products that are subject to tariffs or use domestic products that are produced at a higher cost because of the tariff.

The Productivity Commission (2008b) estimated that tariffs on imports provided \$9.1 billion of assistance to Australian industry in 2006-07 but also cost Australian industry around \$7.7 billion in higher input prices, leaving net assistance of \$1.4 billion. This net assistance comes at a cost to consumers who pay higher prices than in the absence of tariffs. The manufacturing sector enjoys the largest amount of net assistance (\$5.8 billion), with primary production receiving a smaller benefit (\$5.4 million). The services and mining sectors are made worse off by \$4.1 billion and \$253.1 million respectively.

Environmental policy

Australians undertake many activities that cause environmental damage. To the extent that the environment is a public good, then it is likely that these activities make other Australians worse off. There are few examples of environmental taxes in Australia. To be an environmental tax – rather than just a tax – there must be a direct link between the tax and the marginal social cost of the activity damaging the environment. The tax effectively ‘corrects’ for the market under-pricing the loss of social value from a damaged environment (see Box 9.2).

Box 9.2: Aircraft Noise Levy

The Aircraft Noise Levy is targeted at the noise emitted by jet aircraft landing at declared airports. Airlines are charged for the noise pollution caused to those who live near the airports. The levy is calculated so that a relatively noisy aircraft such as a B747 pays some three to four times more than a quieter aircraft such as a B737. Depending on market conditions, airlines may try to pass on the cost of the levy to passengers in the ticket price. Revenue from this levy is used to recover the costs of Australian Government-funded noise amelioration programs. After the full cost of the noise amelioration program is recovered, the noise levy for that airport ceases to apply.

In general, there is no efficiency reason to spend the revenue raised by environmental taxes on additional environmental programs as is the case with the Aircraft Noise Levy. This is because an effectively targeted tax creates incentives in the market for individuals to respond to environmental concerns.

Taxes may also be linked to the environment because they are used to fund environmental programs, but these taxes are not strictly corrective or 'environmental' taxes. The tax and public spending should be assessed independently. An example is the Product Stewardship Oil Levy (see Box 9.3).

Box 9.3: Product Stewardship Oil Levy

Lubricant oils produced or sold in Australia are subject to a levy of 5.449 cents per litre. This is paid by producers and importers of these products. Both imported and domestically-produced oils are subject to the levy, which is collected as an excise by the Australian Taxation Office (ATO) and as customs duty by the Australian Customs Service. Exported oil is not subject to the levy. The levy is intended to off-set the costs of benefits paid under the Product Stewardship for Oil program which provides benefits to oil recyclers to recycle waste oil. In 2006-07 net revenue collected from the levy was \$23.3 million, with \$31.9 million paid as product stewardship benefits.

In some cases, environmental taxes may not be the most appropriate way to deal with activities damaging the environment. If property rights are clear and the cost of enforcement is not prohibitive, then people damaging the environment might be required to compensate affected parties for the damage caused, or they could be paid to encourage them to stop their damaging activities by others who care about the environment. Improved environmental regulation, such as clarifying property rights and imposing statutory duties of care can be effective solutions for addressing environmental concerns. See Box 9.4 for a discussion of the Carbon Pollution Reduction Scheme.

Box 9.4: Carbon Pollution Reduction Scheme

The Australian Government has asked the tax review to consider the inter-relationship of the emissions trading scheme for carbon and the tax-transfer system.

To impose a cost on greenhouse gas emissions (to address the externality of climate change) the Australian Government has announced that it will introduce a Carbon Pollution Reduction Scheme by 2010. The scheme will set a total limit on the amount of carbon that can be emitted by those sectors covered by the scheme.¹ The Government will limit the amount of emissions in the economy by issuing 'carbon pollution permits' in line with the scheme cap. These carbon pollution permits can then be traded and purchased. This is why such schemes are called 'cap and trade'.

Cap and trade schemes have two distinct features. The first is the cap (or limit) on greenhouse gas emissions, which delivers the desired environmental outcome. The second is the ability to trade the 'permits'. A cap and trade scheme effectively puts a price on greenhouse gas emissions, and lets emitters make the choice between reducing emissions where it is cost effective to do so, and buying a permit. This ensures that emissions reductions are achieved by firms who can do this in the most cost effective way.

Permit allocations would, over the longer term, progressively move towards 100 per cent auctioning as the scheme matures, subject to the provision of transitional support for emissions-intensive trade-exposed industries and strongly affected industries.

The Australian Government's *Carbon Pollution Reduction Scheme Green Paper* (Australian Government 2008c), released on 16 July 2008, proposes to provide up to around 30 per cent of carbon pollution permits to firms that are deemed emissions-intensive trade-exposed. At the outset of the scheme, if agricultural emissions are excluded from scheme coverage, this would be up to around 20 per cent of permits. The Government indicated that its preference would be the proposed allocation of a limited amount of direct assistance to existing coal-fired electricity generators on a 'once and for all' basis – that is, further allocations of assistance would not be provided after the scheme begins.

The auctioning of permits will provide the Australian Government with a source of revenue and the capacity to help industry and households adjust to the impacts of the scheme.

¹ The design of the Carbon Pollution Reduction Scheme, including coverage, will not be finalised until the end of 2008, after the Australian Government undertakes consultation with interested stakeholders.

Box 9.4: Carbon Pollution Reduction Scheme (continued)

Once the scheme is introduced, the prices of emissions-intensive goods and services will rise relative to those that are less emissions-intensive. The extent of the increase will depend on the emissions embodied in the production of a good or service, the extent to which the threat of imports limits the ability of producers to pass through their cost increases, and the availability of firms and households to substitute away to less emissions-intensive goods. The higher prices associated with the costs of the scheme will require households to spend a greater proportion of their income to obtain the same goods and services purchased before the introduction of a carbon price. Without compensation, this would reduce households' real incomes and purchasing power. The Government has committed to using all revenue raised from the Carbon Pollution Reduction Scheme to help households and businesses adjust to the scheme and to invest in clean energy options. In particular, the Government will provide low-income households with increases in assistance through the tax-transfer system and all households with other assistance to address the impact on their living standards. Importantly, lowering taxes or boosting transfers will not make the Carbon Pollution Reduction Scheme less effective for addressing climate change. This is because the relative price of emissions-intensive goods and services will still increase. While some consumers may use their compensated income to purchase more expensive emissions-intensive goods, others will prefer to purchase products with lower relative prices. Even if some consumers do not change their behaviour (say, by not reducing their electricity use), the change in relative prices will still encourage producers to meet this demand with less emissions-intensive processes (for example, by using more renewable energy).

The Carbon Pollution Reduction Scheme has at least three major implications for the current tax-transfer system. First, a cap and trade scheme is the least cost means of dealing with climate change, reducing the need for other existing or potential measures designed to reduce emissions. Given there is a cap, other measures which aim to reduce carbon in one area of the economy will effectively allow more emissions in another. Second, where the compensation scheme uses the tax system it is likely to involve a reduction in existing inefficiencies to the extent that there is a reduction in (effective) marginal tax rates. Finally, to the extent that the scheme results in a more even economic burden across different types of fuel, this would improve efficiency.

Raising revenue to fund specific programs

In some cases, the costs of particular government programs are offset by imposing a tax on a related good or service. This is different from a user charge – where the government charges directly for the cost of providing a particular good or service. This sort of tax is often perceived to be equitable due to the alignment between those who pay the tax and those who benefit from it.

In practice, the revenue raised from a tax may not be perfectly correlated with the program's funding requirements. For example, excise on aviation fuels used for domestic trips is charged for the purpose of cost recovery for the Civil Aviation Safety Authority. However, a downturn in the aviation industry and the increased use of larger, more fuel efficient aircraft meant that the rate of excise had to be increased in 2003-04 to meet the required funding levels. In these cases, the shortfall is often met out of consolidated revenue.

To the extent that these revenues do not match the benefits received, they involve cross-subsidies to different consumers. In other cases, the revenue raised may exceed the funding needs of the program – which can result in over-spending on that program.

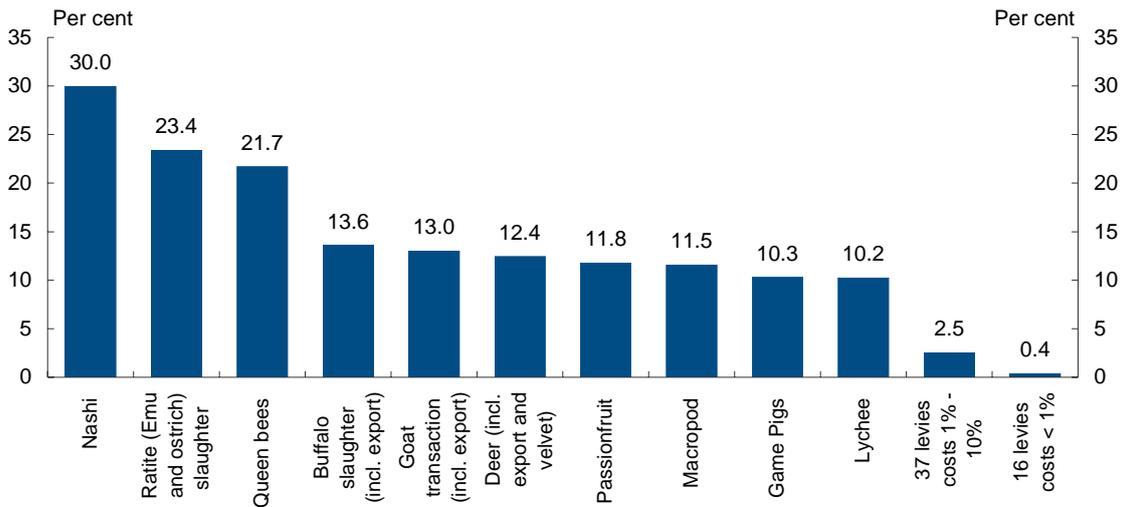
Compared to funding goods out of general revenue, there may be efficiency costs associated with raising revenue in this way. For example, the administration and efficiency costs of collecting an additional \$1 of revenue from a tax on a specific product could be higher than the cost of raising that revenue from a broad-based tax.

The Australian Government's agricultural levies provide another example of narrow-based taxes used to fund specific programs. They are typically implemented at the request of industry to correct market failures that arise from the characteristics of many primary industries – a large number of producers, each accounting for a small share of broadly undifferentiated industry output. This makes it difficult for producers to capture sufficient benefit from research and development for which they might individually pay. By collecting a levy from all producers, they share both the cost of the research and development and the benefit. For example, a single cotton grower is unlikely to realise the benefits from their private research into better sowing methods. The government therefore collects a levy from all cotton growers to fund the Cotton Research and Development Corporation to undertake such research for the benefit of all growers.

These levies are typically charged at very low rates, resulting in very low revenue collection – 28 of these taxes collect, in total, less than \$1 million per year. The smallest, the Queen Bees Levy and Export Charge, collected \$8,000 in 2006-07. The administration costs of collecting the smaller levies can be very high. At the highest end, the collection costs of the Nashi Levy and Export Charge amount to 30 per cent of the revenue collected by it, while the collection cost of the Rice Levy is only 0.09 per cent of the revenue (see Chart 9.4).

This cost does not include the compliance costs for agricultural producers. Such costs, in addition to the levy, would either be borne by producers or passed on to consumers in higher prices. As producers and consumers of the agricultural products are the most likely beneficiaries of the programs that the levies fund, it is consistent with the beneficiary principle of taxation that programs be financed in this way rather than through general public revenue.

Chart 9.4: Collection costs as a percentage of revenue collected on agricultural levies



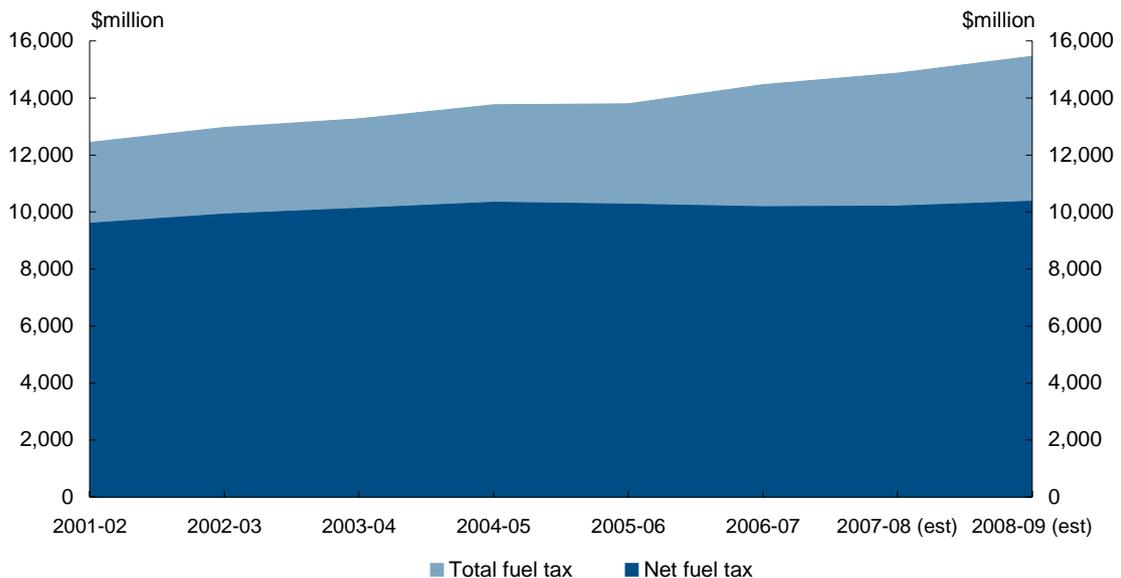
Source: Levies Revenue Service (2007).

9.3 Taxation of fuel

The excise and customs duty on fuel raises the largest amount of revenue of all taxes on specific goods. Fuel is both an input to business as well as making up a significant share of household consumption expenditure. Many of the environmental and social policy arguments already discussed are often raised in relation to fuel taxation.

Fuel excise was reduced by 6.7 cents per litre when the GST was introduced in July 2000. It was reduced further, to its current level of 38.143 cents per litre, in March 2001. These reductions were designed to offset the impact of the GST on fuel prices. Since then, fuel excise has not been indexed. Moreover, when the outlays of programs designed to reduce the incidence of fuel tax are taken into account (for example, fuel tax credits), net revenue from fuel tax has been relatively stable (Chart 9.5).

Chart 9.5: Fuel excise revenue over time



Source: Australian Government (2008a), Australian Treasury estimates.

The Australian Government has made a number of commitments regarding transport fuel in the *Carbon Pollution Reduction Scheme Green Paper*, including cutting fuel taxes on a cent-for-cent basis to offset the initial price impact on fuel associated with the introduction of the scheme. The Australian Government will periodically assess the adequacy of this measure for three years and adjust this offset accordingly. At the end of the three year period the Australian Government will review this adjustment mechanism. For heavy vehicle road users, fuel taxes will be cut on a cent-for-cent basis to offset the initial price impact on fuel associated with the impact of the Carbon Pollution Reduction Scheme. The Government will review this measure after one year.

In respect of liquefied petroleum gas (LPG), the original rationale behind the exemption from excise was security of supply in the context of the oil shocks of the late 1970s. Over time, the number of vehicles using LPG has grown significantly because of the cost differential between LPG and petrol, which is amplified by the excise free status of LPG. LPG is scheduled to begin incurring fuel tax from 1 July 2011 under a policy announced under the previous government. At the time of the 2007 Federal Election, the changes to the law required to tax LPG had not been legislated. As indicated on Budget night, a final decision in relation to this has not been reached.

Arguments for concessional taxation for currently untaxed fuels include environmental and emissions benefits, increased fuel security, together with regional development and infant industry arguments.

Fuel excise is an effective and administratively simple tax for raising revenue. However, it is less effective as a means of meeting additional social or environmental objectives. For example, fuel excise rates do not substantially change the decision to drive in particular vehicles (to reduce road damage), in particular areas (to reduce noise pollution) or at particular times (to reduce congestion). Fuel excise levied for social or environmental objectives also leads to higher burdens on activities where there may be no costs on others. New technologies (such as 'etag' and the global positioning system) are increasing the viability of more efficient direct charging mechanisms.

Relief from the incidence of fuel excise — fuel tax credits

The main avenue for providing relief from fuel tax is through the fuel tax credits system, which provides credits for certain off-road uses to consumers, business users and importers of fuels and for on-road use in heavy vehicles (gross vehicle mass greater than 4.5 tonnes) (Table 9.1).

Fuel tax credits are not a subsidy for the use of fuel. The system is intended to remove or reduce the incidence of fuel tax from business inputs, so that its incidence falls primarily on certain private consumption of fuel. This limits the impact on production decisions. For example, fuel tax credits mean that all electricity generation using liquid fuels is effectively free of fuel tax, in the same way that coal or natural gas inputs to electricity generation are untaxed.

It is difficult to credit business use of all fuels correctly. To the extent that some businesses receive credits while others do not, production decisions are likely to be affected. Similarly, to the extent that credits provided for business use are actually used in consumption, consumption choices will be altered.

Table 9.1: Eligibility for fuel tax credits

	Business use	Private use
Use on road	Gross vehicle mass <4.5 tonnes Full fuel tax payable	Full fuel tax payable
	Gross vehicle mass >4.5 tonnes Fuel tax payable up to the amount of the road user charge, the rest is offset by a fuel tax credit	
Other use	Fuel use fully offset by fuel tax credit	Electricity generation Fuel use fully offset by fuel tax credit
		Burner applications and non-fuel uses Effectively fuel-tax free via a fuel tax credit to business suppliers
		Full fuel tax payable

Source: Adapted from Fuel Tax Bill 2006, Explanatory Memorandum, page 11.

Use of all fuels on-road in heavy vehicles is eligible for a partial fuel tax credit equal to the effective fuel tax paid, less the amount of a non-hypothecated road user charge. The user charge is intended to reflect the damage to roads caused by heavy vehicles. It forms part of the national heavy vehicle charging arrangements.

The road user charge is currently 19.633 cents per litre and the Australian Government has announced its intention to increase it to 21 cents per litre from 1 January 2009 and index the charge according to the National Transport Commission's road funding formula thereafter.

Relief from the incidence of fuel excise — state fuel subsidies

In 1996-97, the States raised \$5.2 billion from business franchise fees on fuel, alcohol and tobacco retailers. However, the 1997 High Court decision in *Ha v New South Wales* (1997) 189 CLR 465 ruled that state franchise fees on tobacco were unconstitutional and, in doing so, cast doubt on the constitutionality of other state franchise fees. At the request of the States, the Australian government implemented safety net arrangements to effectively collect franchise fee revenue on behalf of the States. This revenue was collected through higher rates of excise and wholesale sales tax on the relevant products, and paid to the States. These payments were subsumed into *The New Tax System* package from 1 July 2000.

With respect to fuel, many States had previously levied business franchise fees at different rates. However, for constitutional reasons, the Australian government's increase in fuel excise was uniform throughout the country. The Australian government therefore required some States to introduce subsidy schemes to ensure that motorists in lower-taxing States would not be disadvantaged by the higher rate of Australian government tax.

Over time, some States have withdrawn their subsidy schemes. The largest remaining scheme is the Queensland Fuel Subsidy Scheme, which provides a subsidy of 8.354 cents per litre for eligible fuel purchases, costing the Queensland Government around \$525 million in 2006-07.