Taxation – Lecture 5

INDIRECT TAX SYSTEM: INTRODUCTION

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Taxation of spending

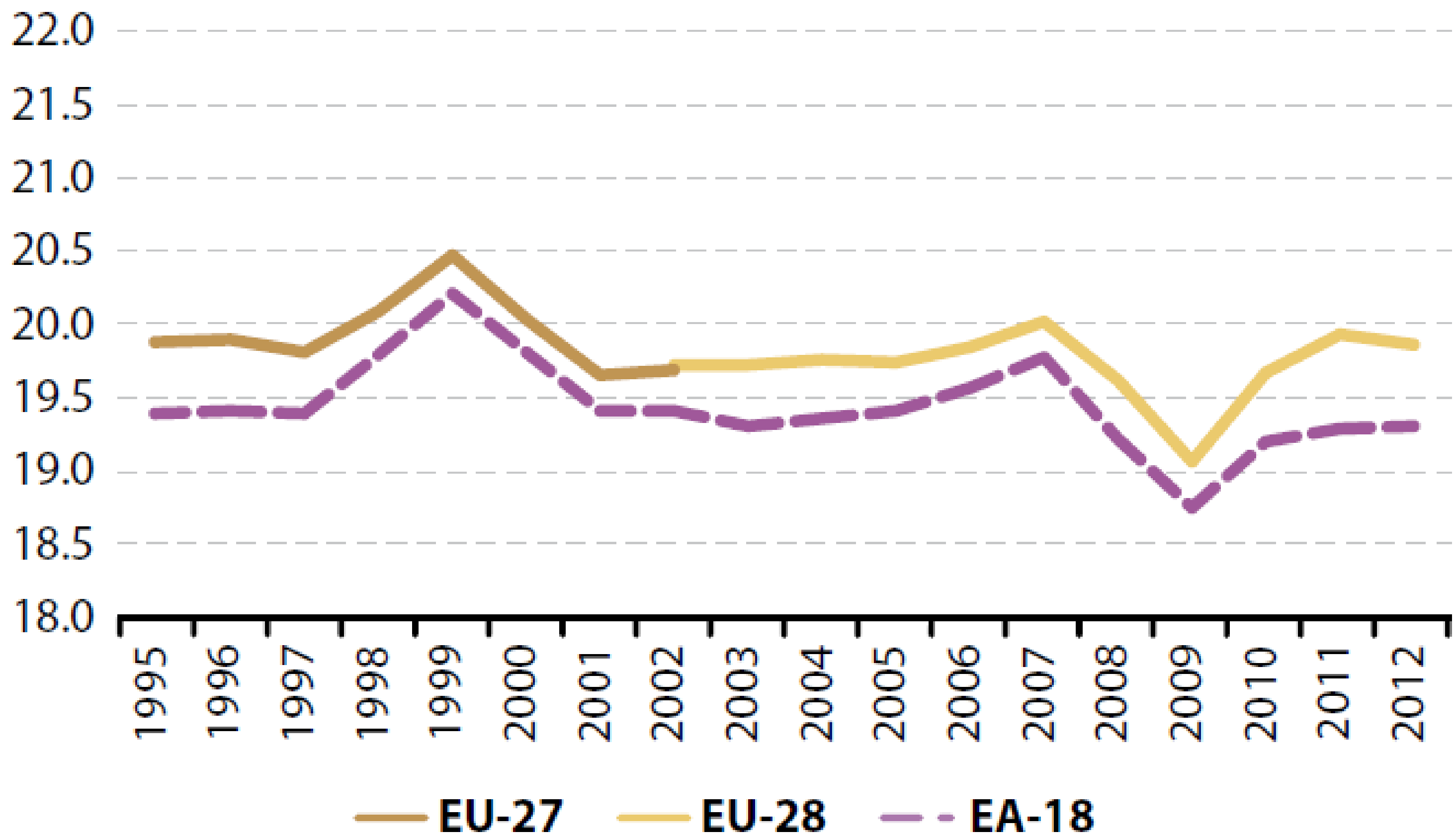
- **Indirect taxes or taxes on spending are those on turnover, production or consumption of goods and services** - regarded as **components of cost prices and selling prices** - which are **collected without regard to the realization of profits, or indeed income, but which are deductible when determining profits**. In most countries, taxes on spending include **most or all items of consumer spending**, and also some additional taxes, or **excise duties**, on certain individual categories of spending, especially **motor fuels, motor vehicles, alcoholic drinks, and tobacco products**.
- **Indirect taxes are collected by an intermediary** (such as a retail store) **from the person who bears the ultimate economic burden of the tax, that is, ultimate consumer. <u>It does not respect the personal situation of the consumer.</u>**
- **Four trends** that shape the global indirect tax landscape **today:**
    - **Indirect taxes continues to grow, while direct taxes stagnate**.

Taxation of spending

- **Indirect taxes are adapting to the new economic realities.** (**E-commerce and virtual currencies** are on the radar of an increasing number of governments, and they are adapting their tax systems to capture these transactions.)
- **The global trade landscape is changing fast**. (Global trade continues to grow, but still faces trade restrictive measures in many regions of the world.)
- **Tax authorities are focusing on enforcement of indirect taxes**. (New tools and rules are simplifying tax authorities' access to taxpayer data and increasing the frequency, efficiency and effectiveness of tax audits.)

Taxation of spending

Graph 8: Implicit tax rate on consumption, 1995–2012

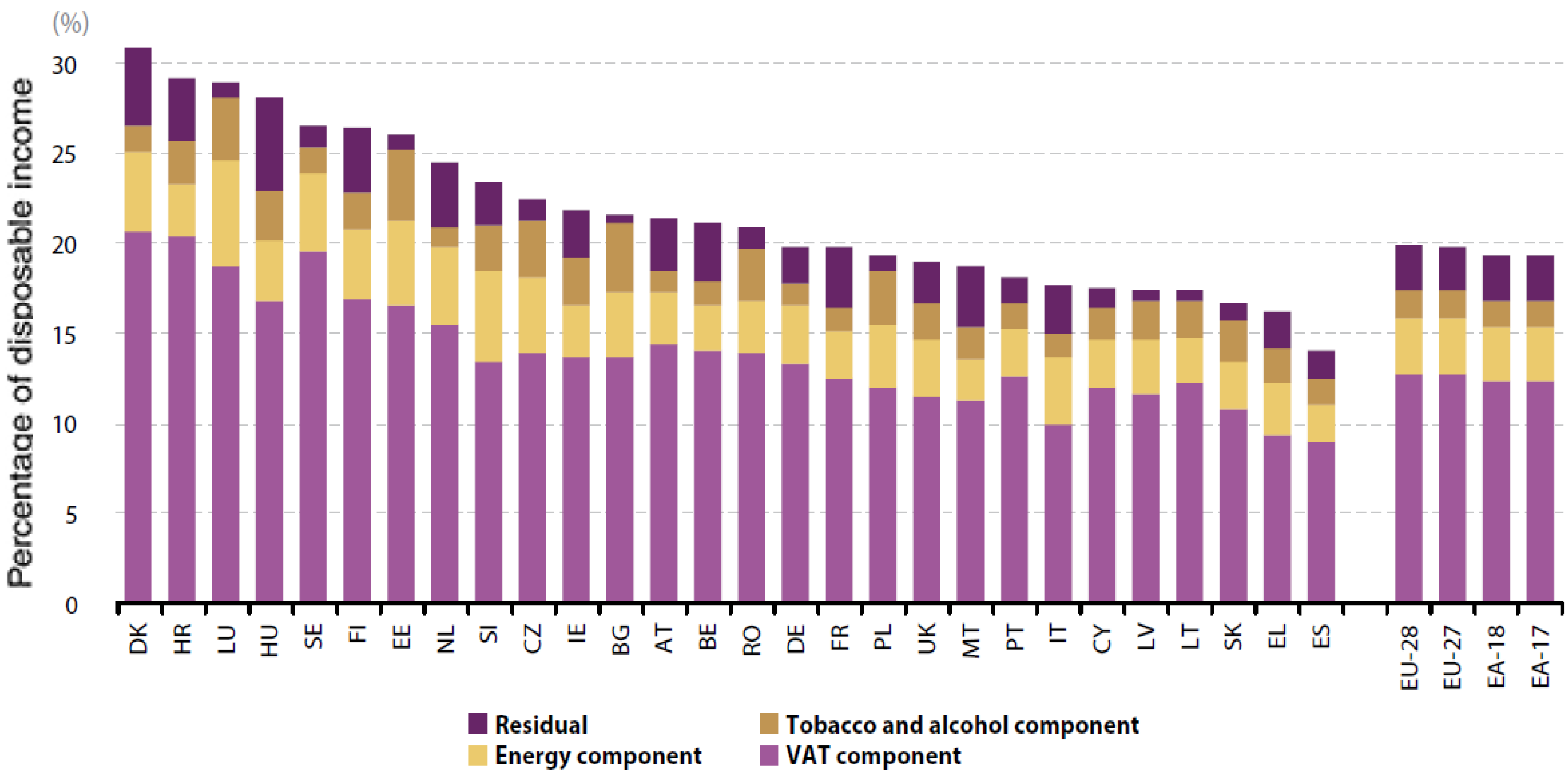


Source: DG Taxation and Customs Union and Eurostat (online data code: gov_a_tax_str)

Taxation of spending - VAT

- **In nearly all OECD countries the general tax on spending takes the form of a VAT:**

Graph 9: Decomposition of the ITR on consumption, 2012



Source: DG Taxation and Customs Union and Eurostat (online data code: gov_a_tax_str)

Taxation of spending - VAT

- **VAT was introduced in France in the 1950s, and adopted by the member countries of the European Community in the late 1960s.** It has been one of the great success stories of tax policy in recent years, **having now been adopted**, in one form or another, **by all of the major OECD countries with the exception of the USA, and by many developing countries too.**
- **VAT is levied as a percentage of the value of sales of most goods and services by all forms of business**, though in some countries there are exemptions for smaller firms, simply to avoid costs that would be incurred in collecting trivial amounts of tax revenue from a very large number of very small firms. **The distinctive feature of VAT is that it generally applies without distinction to sales made to all categories of customers, including sales made to other businesses as well as retail sales to individual consumers**. However, **businesses which have purchased goods and services from other firms can offset the tax they have paid on these**

Taxation of spending - VAT

purchases against their VAT bill on their own sales.

- If VAT is a tax on the value of sales, why then is it called a ‘value added’ tax? The reason can be seen by considering how the tax accumulates during the course of the production chain - as raw materials are gradually transformed into processed materials, components, and then into final products sold to consumers. If the same rate of tax is charged on all sales and purchases, the additional tax collected at each stage of production will be proportional to the value added by that firm: in other words, **proportional to the difference between the value of the material and components it buys, and the value of the products it sells.**
- **In practice, most VAT systems have different rates of tax for different categories of goods**. Most of the member states of the European Union, for example, have a **‘standard’ rate of VAT, applying to most goods and services**, and **one or more ‘reduced’ rates, applying to particular categories of consumer spending**,

Taxation of spending - VAT

including food, household energy, books, and newspapers:

- **In France** the **standard rate** in 2014 was **20 per cent**. A **reduced rate of 10 per cent** applied to **public transport, hotels and restaurants, and cultural and sporting events**, while **food, water, and books** were subject to VAT at **5.5 per cent**, and **newspapers were taxed at 2.1 per cent.**
- **Denmark**, by contrast, is distinctive in having **a single VAT rate**. It applies its **standard rate of VAT, 25 per cent to all goods and services.**

Taxation of spending – excise duties

- **Excise duties were historically one of the main revenue-raising taxes, but have declined in importance over the past century as more modern and powerful sales taxes have been introduced**. Even now, excise duties and taxes on imported goods **remain crucial for the revenues of many developing countries**, where the organization of economic activity and the limited capacity of government may make complex accounts-based taxes unfeasible.
- **Excise duties are now confined in most developed countries to a small number of products, including motor fuels, vehicles, alcoholic drinks, and tobacco products**. **In many countries, some or all of these products are taxed at very high levels indeed**. For example, **in the UK**, the **taxes charged on cigarettes**, including VAT and the excise duty, **account for around 80 per cent of the retail price**, while the **taxes on petrol** amount to nearly **60 per cent of its retail price.**
- **Such high rates of tax require tight control, of the production**

Taxation of spending – excise duties

and distribution of the commodities concerned, if massive tax evasion is not to take place. Generally, **excise duties are levied at a relatively early stage in the chain of production and distribution to keep to a minimum the number of businesses involved**. It is much easier to charge high levels of tax on whisky by **taxing the distiller** than it would be to charge similar tax rates at the point of **retail sale**. Similarly, the high excise duties charged on motor fuels are levied on the **major producers, refiners, and importers**, and the **fuel is only released for distribution and retail sale once the tax has been charged**. Nevertheless, while it is relatively straightforward to ensure that large brewers, cigarette manufacturers, and petrol companies are monitored and taxed correctly, **the high levels of excise duty can provoke various forms of smuggling, cross-border shopping, and bootleg production**. **This has become a worrying headache for some revenue authorities in Europe, as border controls have been removed to allow a free flow of trade between the EU member states.**

Taxation of spending – environmental taxes

- **A growing awareness of environmental issues has led many countries to introduce tax measures to discourage pollution and environmental damage**. Existing taxes, such as those on **carbon-based fuels and motor vehicles**, have been increased or restructured to discourage the most polluting activities or stimulate the take-up of greener alternatives. In addition, new taxes have been introduced specifically to address particular environmental problems - for example the UK's Landfill Tax on waste dumps, introduced in 1996 with the aim of encouraging greater recycling.

Taxation of spending – import duties

- There is one area of taxation which **has declined sharply over the last half century, especially in the industrialized world**. **Tariffs on international trade - taxes on imported goods - have been reduced to very low levels as a result of the successive rounds of multilateral tariff reductions agreed under the auspices of the World Trade Organization (WTO), and its predecessor, the General Agreement on Tariffs and Trade (GATT).** In the United States and in the EU **the revenue from tariffs is now only about 1 per cent of the revenue from other taxes**. Elsewhere, however, and especially **in less developed countries, the significance of tariff revenues can be much greater**. **For countries with limited administrative capacity, frontier formalities provide one of the few reliable points at which taxes can be charged, and import taxes can make a significant and secure contribution to public revenues**. In many countries in Africa, tariffs contribute 20 per cent or more of total tax revenues.

Do consumption taxes harm work incentives less?

- **It is sometimes suggested that damage done to work incentives by high taxes on labor incomes could be reduced by shifting revenue-raising away from income taxes towards consumption taxes such as VAT.** Certainly, VAT has considerable revenue-raising potential, and the revenues it raises could give scope for a substantial reduction in income taxes on wages. But **the idea that this shift in the pattern of taxation avoids the distortionary effects of taxes in the labor market is simply mistaken**. **Taxes levied on spending reduce the quantity of goods and services that can be purchased from the proceeds of an additional hour's work in just the same way as a tax on income does.**
- How much more do consumption taxes add to the burden of tax on labour incomes? In particular, how much do they add to the marginal tax rate? The answer is not straightforward **since it depends on how individual consumption patterns change as workers earn additional income.** However, figures for 2005 from the OECD

Do consumption taxes harm work incentives less?

indicate that **consumption taxes on average added a further 6.7 per cent to the tax wedge on earnings, raising the overall tax wedge in OECD countries from an average of 38.6 per cent to 45.3 per cent.**

- **While the distortionary impact on the labor market of raising a given amount of revenue through an increase in the marginal rate of income tax and an increase in the rate of VAT may be similar, there are two differences of some significance between income tax and a sales tax such as VAT:**
    - The first is that **they affect the interests of different generations differently. Switching from a tax on income to a tax on spending acts to disadvantage older generations relative to younger generations** - in particular, the retired who have saved out of taxed income face an increased tax burden on their spending, while for younger generations the tax change makes little difference.

Do consumption taxes harm work incentives less?

- The second difference arises **when the income tax has a progressive distributional incidence** - for example, **when the income tax schedule begins with a significant allowance of tax-free income.** As a result, **the marginal rate of income tax** (which governs the amount of distortion) **tends to be much higher than the average rate of income tax** (which determines the amount of revenue raised). **Sales taxes, by contrast, tend to apply to all consumption and imply lower marginal rates for a given amount of revenue. As a result, an equal revenue switch from income tax to VAT can reduce the overall marginal tax wedge on earnings. It does so only because the tax on spending is less progressive than the income tax, and therefore marginal tax rates are lower.** Proposals to **shift from income tax to VAT achieve a reduction in the overall marginal tax wedge by making the tax system less redistributive**, **a feature that is rarely stated explicitly by those advocating such a tax shift.**

Indirect tax policies - the future

- **At the start of this course we saw the massive expansion in tax revenues over the past fifty years. Over the OECD area as a whole, tax revenues increased more than fourfold in real terms, as economic growth led to higher revenues, and more tax was raised through higher social contributions and the introduction of VAT**. **At the same time, the revenues from taxes on international trade fell as the result of successive rounds of trade liberalization. What changes might we expect to see in the coming decades?**
- The most powerful force shaping future tax policy is likely to be the increasing **globalization of economic activity**, which means that **countries' economies will be closely interconnected, and their economic policies - including tax policies - increasingly constrained by the pressures of international economic competition. Policy choices in other countries will severely limit the margin for manoeuvre in domestic tax policy.**

Indirect tax policies - the future

Globalization has made tax bases more mobile. Capital and investment, the production of goods and services, and, indeed, employment can move much more freely between countries, and decisions about where to invest and produce are likely to be increasingly influenced by taxation. The effect of this increased mobility is that **countries** will lose - and indeed **have already lost - substantial de facto fiscal sovereignty. Countries that try to set tax rates for capital or other highly mobile tax bases that are higher than the tax rates elsewhere will find that they lose tax base to their competitors as mobile activities move abroad**. In markets such as capital markets with a high level of international integration**, countries may have negligible power to set tax rates that differ from the rates ruling elsewhere**; **if they were to do so they would suffer a substantial capital outflow, which would continue until the net of tax return available to the investor was equalized with the net of tax return available in other locations.** It

Indirect tax policies - the future

is this process that is already thought to **have shifted much of the burden of corporate taxes in smaller economies away from capital and onto less mobile tax bases such as unskilled labor.**

Countries that try to have a tax system that is more redistributive than elsewhere may find that the losers from this redistribution move elsewhere, leaving only those who might have expected to gain. Some pessimists see in this process the end of redistributive public policy altogether, and the end of the welfare state. Even if this exaggerates the severity of the constraint that international competition places on redistributive policies, the reality is that **countries' fiscal choices will be increasingly constrained by competitive pressures. Highly redistributive policies will carry a significant cost in the form of outflows of highly skilled labor and capital, which will increase the cost of redistribution.**

- **The pressures on tax policy from the effects of greater mobility of commodities, firms, and people in the globalized economy will**

Indirect tax policies - the future

be exacerbated by the impact of the internet, which is already reshaping certain areas of the economy, and which creates new difficulties for tax systems which are, in the main, designed to deal with transactions in physical goods. Internet-based retailers have proved adept at exploiting opportunities to have their products taxed in countries offering them the most favourable tax regime, both for the taxes they must charge on sales, and the corporate taxes levied on their profits. **Some of the opportunities that internet-based companies have been able to exploit to reduce the taxes charged on their sales and profits are loopholes that have been exposed in legislation which was not drafted with the internet in mind, and, over time, many of these loopholes are likely to be closed.** However, while the internet may not - as some have feared - spell complete catastrophe for the tax system, **it has undoubtedly amplified the impact of globalization on the fiscal system by reducing the costs of mobility and expanding the range of activities that can be shifted to locations offering a more favourable tax treatment.**

Indirect tax policies - the future

- **Unlike economic competition between firms, which tends to promote efficiency and lower prices to consumers, fiscal competition between countries is not a benign process**. **Tax havens, in particular, exploit their ability to offer a lower tax regime which undercuts the rates of tax elsewhere**; they are not offering any greater efficiency or any other positive advantage, but only the opportunity to sidestep taxes levied elsewhere. **Countries which compete to grab tax base from other countries impose a costly burden on other countries, raising their cost of revenue-raising and limiting the range of tax policy choices that countries can make.**
- A further aspect of globalization **is the growing significance and power of large scale multinational enterprises operating on a transnational basis. Multinationals have the opportunity to shift a significant proportion of their profits into countries where they will be taxed less heavily by manipulating the internal charges** -

Indirect tax policies - the future

the ‘transfer prices’ - at which they book trades between their subsidiaries located in different countries. **Profits can be shifted out of a country where they would be taxed heavily by raising the price which that subsidiary must pay other parts of the group for supplies or the use of intellectual property, such as patents or brand rights, and by undercharging for its own sales within the group**. **The ‘arm’s length’ principle** espoused by the OECD is intended to constrain this, by forcing firms to set their internal charging on a basis that mirrors the prices that would be charged for an equivalent transaction between wholly independent firms. But **it is often very difficult to implement this principle, since there may be no directly equivalent arm’s length transactions to use as a benchmark.** This is a particular problem with **multinationals which earn a substantial proportion of their profits from a brand image or other special advantage that they possess.** Such firms have a considerable degree of latitude in shifting profits to lower tax countries and tax havens. At the very least, the grey area around transfer

Indirect tax policies - the future

pricing offers considerable scope for firms to challenge the tax assessments they receive, and the tax authorities must then decide whether to spend resources on a legal battle to preserve their revenues.

- **One way of restoring some measure of tax sovereignty is, paradoxically, through international coordination and harmonization. If countries collectively agree ground rules that limit the scope for tax competition that could drive tax rates downwards, all may benefit by being able to raise revenues without the erosion of those tax bases most affected by mobility**. **There is nothing equitable about a tax system in which the mobile - and perhaps predominantly rich - can avoid taxation, while the burden of taxation ends up borne by those unable to escape. Nor is there anything efficient about allowing unrestricted international tax competition to erode parts of the tax base.** A continuing feature of tax policy over the coming years is

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likely to be a difficult and protracted international debate over **whether countries are willing to reach some form of agreement to limit the scope for tax competition and the operation of international tax havens.**

Literature

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