



Taxing Consumption

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Domestic consumption in most countries is taxed through general sales taxes, excise taxes on specific commodities, and a variety of miscellaneous taxes on such services as hotels and transfers of property. This note considers only the first two of these categories, with particular attention to general sales taxes.¹

Consumption taxes are obviously related both to customs duties and other taxes on imports and also to production taxes like those often imposed on agricultural output. In some countries elements of both import and production taxation remain. These aspects are not further explored in this note—other than to note that the original form of general sales taxes often consisted of a sales tax imposed on imported and domestic manufactured goods.

Most countries have now replaced such “pre-retail” sales taxes by taxes that fall primarily on consumption rather than on production and, it is hoped, are both more responsive to revenue needs and easier to collect effectively and efficiently. However, excise taxes on specific commodities are often still imposed at the production stage.

Why VAT is the Sales Tax of Choice²

There are essentially only three types of general sales taxes: a turnover tax, a single-stage sales tax, and a VAT. A *turnover tax* is in some ways the easiest to administer. Tell me your turnover, and I’ll tax you on it. The basic administrative problem is to determine and verify the turnover (sales) of a taxpayer and to collect the tax. The idea is simple but its execution can be difficult. The basic way to evade such a tax is also simple: hide (under-report) sales. The easiest way legally to avoid the tax is by integrating vertically with one’s suppliers since ‘within-firm’ sales are not taxed. The other side of this coin, however, is that a turnover tax is by far the economically most distorting form of sales tax. Only in the unlikely event that one wishes to discourage exports and investment and to induce firms to integrate up and down the chain of distribution and production are the allocative effects of such a tax likely to be welcomed. Moreover, since the final tax burden borne by any particular transaction depends essentially on how many prior taxed transactions are

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embodied in its sales price, its distributional impact is indeterminate. Governments that impose turnover taxes have little idea of the effects of such taxes on either allocation or distribution.

To avoid all these problems, one obvious solution is to impose a *single-stage sales tax*—commonly called a retail sales tax (RST)—on the final sale to consumers (households or nonregistered firms).³ Investment goods purchased by registered firms, like other inputs purchased for business purposes, are in principle freed from tax, as are exports. The allocative and distributional effects of such a tax are much clearer than those of a turnover tax. The government can figure out what it is doing. Unfortunately, experience with RSTs even in countries with good tax administrations demonstrates that this approach has two fatal flaws. First, it is extremely difficult to ensure that inter-firm purchases used to produce taxable goods and services—and only those purchases—are exempt from tax. The ‘ring’ (or suspension) system used to achieve this result—under which tax is ‘suspended’ on sales by one registered firm to another and so on and on until there is a sale to someone outside the ring of registrants—is both cumbersome to police and easy to abuse. Second, the entire tax collection process rests on the least dependable link in the chain—the final sale to a consumer (someone outside the ‘ring’ of licensed firms). The fragmented and usually small-business-dominated retail trade sector is notoriously difficult to police in any country.

Hence the dilemma: turnover taxes are easier to administer but have bad economic effects; single-stage retail sales

taxes in theory avoid the bad effects (though in practice they are unlikely to do so very cleanly) but they are difficult to administer well.

Enter the *VAT*. In principle—and, when properly set up and run, in practice—VAT combines the good features of both its competitors while avoiding the bad features for the most part. It does this through two features: *First*, VAT collects the equivalent of a single-stage retail sales tax through a multi-stage collection process that collects tax at each stage of the chain of production and distribution preceding the final sale to households. By doing so, in the end it achieves the (presumed) goal of taxing only consumption. Moreover, even if evasion occurs at the final retail stage only that part of the potential tax base consisting of the retail margin escapes tax. *Second*, by crediting taxes on inputs including capital goods, VAT avoids distorting economic choices with respect to production technology. It also eliminates taxes on exports by crediting taxes paid on inputs at prior stages.

With an RST as with a turnover tax the basic way to evade is simply to avoid reporting sales. This can be done by remaining in the shadow economy, by not keeping proper books, or by not reporting correctly to the tax authority. It takes only one to evade. With VAT, however, there are two ways to evade: by under-reporting sales or by over-reporting taxable purchases (thus claiming excess input tax credits and, in some cases, even refunds). On the other hand, with VAT it also takes two to evade—a seller and a buyer. Moreover, since the two sides of the transaction are recorded in two sets of books the task of the admin-

istration in detecting evasion should be easier with VAT.

Indeed, in principle, the task of the taxman is made even simpler because the two parties involved in any potentially taxable transaction (buyer and seller) have conflicting incentives. Buyers want to overstate purchase prices to inflate credits, while sellers want to understate sales to reduce output taxes. For this reason, some early writers even claimed that VAT was at least to some extent 'self-enforcing'. In practice, in some instances, this apparent strength of VAT has proven to be a weakness in the sense that it perhaps induced some countries to rely too heavily on tax design (the VAT approach to sales taxation) to do the work that only good tax administration can really do. A major form of VAT evasion in many developing and transitional countries plays on this feature of VAT: a firm creates a 'shell' company and then 'sells' inputs to itself at a false price that then serves as the basis for an input tax credit or refund claim. It is easier to get away with this dodge when the alleged supplier is in another country (as in the case of the so-called 'carousel' frauds in the EU). But when the tax administration is as weak as it is in many developing and transitional countries it is not hard to create and register fictitious firms domestically in order to operate such frauds.

Nonetheless, despite such problems, both in principle and practice it remains simpler to enforce a sales tax applied in an incremental 'value-added' form to a chain of transactions than when all stands or falls on honest reporting of a single transaction (the final sale). Countries that have VATs, as most now

do, should keep them and improve them as necessary; countries that do not have VATs should consider adopting them.

Some Key Issues in VAT Design

The key design issues in any general consumption tax include such matters as rates, exemptions, the treatment of small businesses, the treatment of excise goods, and the appropriate treatment of imports and exports. Only a few critical points about sales tax design are noted here.⁴ For example, the best sales tax with respect to both efficiency and administration is undoubtedly one with a *single uniform rate applied to all taxable transactions*. The usual reason for imposing more than one rate is that it is more 'equitable' to do so, but this conclusion is disputable for a number of reasons: more rates make it harder to administer a sales tax, differentiated rates mean that a higher average rate is required to raise a given amount of revenue (thus increasing the economic costs of imposing the tax), higher rates on 'luxury' goods are an ineffective means of increasing the progressivity of the fiscal system, and, most importantly, lower tax rates on 'necessities' are generally poorly targeted and ineffective. The rich may spend relatively less of their income on 'basic food', but they are likely to spend absolutely more and hence receive more benefit from such concessions.

Although the most broad-based consumption taxes in the world (such as the New Zealand VAT) come close to including most final (private) consumption in the tax base, most VATs in developed countries probably encompass 50-60 percent of such consumption. The general sales taxes found in developing

countries generally do considerably worse in this respect, often tapping little more than 30 percent of the theoretical consumption tax base. The broader the base the better since the rate required for any revenue is obviously lower, which means that the efficiency cost of raising revenue is correspondingly lower. With a broader base, administration is also simpler because there are fewer avenues of escape.

Full taxation of consumption can never be achieved because it is not possible to tax some consumption (such as home-produced consumption). It may also be economically inadvisable to do so, or there may be no net revenue gain from doing so, or it would be too costly to do so. Examples found in most jurisdictions in addition to financial services are public sector consumption, education, health, and agriculture. Most countries simply exempt activities carried out under these headings from tax. This common practice obviously leaves a lot of consumption out of the tax base and creates a number of economic inefficiencies and administrative complexities.

Finally, in part because VAT compliance costs are particularly high for small business, many countries have introduced various forms of special treatment for small traders. Current thinking is that in practice most developing countries should likely have relatively high thresholds—say \$100,000—at which to require firms to register for VAT.⁵ Registrants should, of course, be required to keep at least minimal books—essentially records of sales and purchases. If the VAT is moderately well designed and operated, registrants should come into

the system voluntarily since it will be so clearly in their interests to do so. If they do not, in so far as they deal with the registered sector they will pay a fiscal penalty and the interests of both equity and competitive efficiency should, at least roughly, be served.

Excise Taxes⁶

In most tax systems around the world selective taxes on consumption, or excises, produce a significant amount of revenue. Excises on alcoholic beverages, tobacco, motor vehicles, and fuels are generally the only items with sufficiently high revenue yields to warrant special attention.⁷ Such taxes have proven to be both administratively feasible—the importation, production, and consumption of excise goods are reasonably identifiable and reachable by the tax administration—and politically acceptable. They produce considerable revenue without giving rise to excessive evasion and resistance. In addition, excises on these items may reduce externalities associated with drinking, smoking, and driving.⁸

On the whole, these products should in principle be taxed at rates set both to offset externalities arising from their consumption and for revenue reasons.⁹ Specific taxes levied as a flat amount per physical unit of the good greatly simplify administration. The tax inspector only needs to be able to count, and does not have to worry about the often troublesome issue of valuation. In addition, to the extent one objective of excise taxation is to discourage the consumption of the taxed good, as in the case of alcohol and tobacco, it seems only sensible to impose the tax on, say,

the alcoholic content of the beverage and not on value. Of course, specific taxes also have problems: for example, they may prove difficult to change in the face of inflation, with the result that real revenues may fall in the face of price increases, and they may discriminate against relatively cheaper products. On the other hand, *ad valorem* taxes raise valuation problems, hence complicating administration, and discriminate in favor of cheaper products. In practice, the choice of specific or *ad valorem* rates usually comes down to how one weighs the administrative advantages of the former against the potential revenue loss in the face of inflation. Although it is seldom done, in principle specific rates should be periodically adjusted to keep real tax rates constant.

On the whole, international experience suggests that the specific tax approach is probably best in administrative terms when one attempts to impose high taxes on a few products that can be fairly tightly controlled. Moreover, to the extent excise tax policy is designed with social objectives in mind, the specific approach is also indicated. Periodic review and revision of specific rates is of course needed in order to maintain both revenue and social objectives in the face of inflation.

The effective administration of a high-rate excise tax fundamentally depends upon establishing an adequate system of control of the physical commodity. Physical control may be costly, and may open the way to corruption (since the tax inspector can be paid off to certify tax payment). Nonetheless, for alcohol, tobacco, and petroleum products, where there are generally few pro-

ducers or commercial importers, such control at the production and import level seems essential in most developing countries. Since vehicles need to be registered and licensed, there is also an opportunity to exercise the high degree of control needed to enforce high rate excise taxes.

Notes

1. For a detailed discussion of service taxes in a specific context, see “The Taxation of Services,” in Roy Bahl, ed., *The Jamaican Tax Reform* (Cambridge, MA: Lincoln Institute of Land Policy, 1991), pp. 433–600. Taxes on property transfers are considered in R.M. Bird and E. Slack, *International Handbook of Land and Property Taxation* (Cheltenham, UK and Northampton, MA: Edward Elgar, 2004). A good recent overview of consumption taxation in developed countries may be found in OECD, *Consumption Tax Trends* (Paris, 2006).

2. The section draws on R.M. Bird and P-P. Gendron, *The VAT in Developing and Transitional Countries* (Cambridge University Press, 2007), chapter 3.

3. Few other forms of single-stage sales taxes (those imposed prior to the retail level) exist, and all suffer to varying extents from the problems of turnover taxes.

4. For detailed discussion of these and other issues, see the book cited in note 2 above.

5. See Michael Keen and Jack Mintz (2004), “The Optimal Threshold for a Value-added Tax,” *Journal of Public Economics*, 88: 559–76.

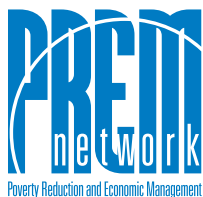
6. For an excellent recent discussion of excise taxation, see S. Cnossen, *Theory and Practice of Excise Taxation* (Oxford: Oxford University Press, 2005). Aspects relevant in developing countries are discussed in

Cnossen, *Excise Tax Policy & Administration in Southern African Countries* (Pretoria: University of South Africa, 2006).

7. Instead of applying differential VAT rates to such products, best practice is to apply the standard VAT rate to the price of the product including excises.

8. The economically relevant externalities arising from these activities are of course not the costs directly imposed on the user but rather the consequences that his actions may impose on other members of society.

9. Motor vehicle taxes are usually progressive in their distributional impact and, both for this reason and because it is administratively not difficult, are often subject to ad valorem rather than specific taxes.



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