

How Should Consumption Be Taxed?

Spencer Bastani



Summary

IN THE SWEDISH POLICY DEBATE, there is much focus on labor income and capital income taxation, whereas consumption taxation is not given as much weight. When taxes on consumption are discussed, the focus is typically on specific aspects, such as the differentiated VAT rates, without highlighting the role of consumption taxation in the tax system in a broader sense. The purpose of this report is to fill this gap by adopting a holistic approach to consumption taxation and, on the basis of theoretical and practical arguments, discuss the application of consumption taxes in Sweden.

Consumption taxation implies that people are taxed on the basis of how much they consume out of what is produced in the economy. In some sense, this differs from labor income taxation, where the tax base reflects how much people contribute to what is produced in society. Some would argue that consumption taxation is thereby superior in terms of fairness, simultaneously highlighting that consumption taxation to some extent enables people to decide for themselves how much they should be subject to taxation since they more or less control their consumption.

In Sweden and the EU, consumption is primarily taxed through VAT. In normal cases, VAT implies that firms increase the prices of their sales of goods and services with a proportional tax, which is subsequently paid by the firms to the government. Firms are then compensated for the VAT they pay for their production factors. Hence, VAT is not a cost to the firm, instead it is pushed forward until it reaches the final consumers. Apart from VAT, certain goods such as alcohol, tobacco, and energy are taxed using excise taxes. These are taxes paid on each unit sold, rather than on the value of sales. VAT and excise taxes combined constitute almost 30 percent of the total Swedish tax revenues.

How should goods and services be taxed?

An important advantage of consumption taxes is that they can be used to influence the consumption choices of individuals. Most countries use excise taxes to reduce the consumption of goods deemed harmful for people's health and the environment. The purpose of these taxes is to enhance economic efficiency by correcting for so-called externalities. These externalities imply that the prices on goods and services observed in a free market do not fully reflect the societal impact of consumption. In such a situation, research has shown that taxes on forms of consumption having a harmful effect on people's health and the environment should target the underlying environmental or health problem and be set at levels justified by the damage brought on by this consumption rather than being used as general instruments to raise tax revenues.

Sweden violates these principles in different ways; for example, through the aviation tax, which does not target pollution, instead raising the price of each airline ticket. Another example involves energy taxes, which are not justified on the basis of considerations related to environmental economics but rather used to raise tax revenues. These taxes imply distortions when individuals and firms in different ways adapt to avoid them. They also lead to arbitrary redistribution; for example, on the basis of which goods people like to consume, where in the country they live, or which occupational choices they have made. This violates the principle that the ability to pay taxes is what should guide the design of the tax system.

One of the clearest messages in tax research is that, aside from externalities, goods and services in general should be taxed at the same rate and that consumption taxes should not be differentiated due to redistributive considerations. The reason is that it is more effective to use taxes and transfers to achieve redistributive aspirations. The income level of the individual is a better measure of ability to pay than the consumption of specific goods and services. In addition, the income tax does not lead to tax-driven consumption choices. In Sweden, the lower VAT rate on food is motivated based on redistributive grounds. This, however, is an inefficient tax policy. What matters is the redistributive profile of taxes and transfers when considered together.

The problematic implementation of VAT

The Swedish implementation of VAT violates the principle that goods and services should be taxed as uniformly as possible. In Sweden, the VAT is typically 25 percent, but several goods and services are subject to a lower tax rate, such as food, personal transport, and cultural consumption (such as books). This leads

to distorted consumption choices and welfare losses when people do not buy the goods they desire the most but take taxes into account when making their consumption choices.

Many sectors of the economy are also exempt from VAT, such as housing, insurance, and financial services. These exemptions are just as problematic as the reduced tax rates but are discussed more rarely. Firms in sectors with exemptions do not add VAT to their sales but also do not get reimbursed for the VAT paid on their inputs. This means that VAT becomes a cost for the firm, something referred to as hidden VAT. This implies that goods produced by firms in exempt sectors of the economy become less attractive for firms in sectors that are included in the VAT system since these firms do not get compensated for the hidden VAT when purchasing products from exempt firms. Hidden VAT implies distortions in the production decisions made by firms as they are induced not to use the combination of inputs that makes their production the most efficient as, for example, some firms have an incentive to produce inputs themselves instead of purchasing them in the market, thereby avoiding the hidden VAT.

In sum, the reduced VAT rates and VAT exemptions imply costs to society in the form of distorted consumption decisions, distortions in the input choices made by firms, distorted competition, administrative hassle, delineation problems, and arbitrary redistribution between sectors of society. These problems are reinforced by the fact that firms adjust their prices to taxes in different sectors differently depending on the specific properties of each market, such as the properties of consumer demand, production technology, and level of competition.

A VAT reform ought to be high on the political agenda – a reform abolishing the reduced tax rates and broadening the VAT base through fewer exemptions, while at the same time compensating individuals and firms for the associated tax increases. Lower taxes on labor incomes for low- and middle-income earners is an important component of such a compensation. A complete transition to a uniform VAT is not possible without changes in the EU VAT directive, but there is room for changes within this directive as well as good reasons for Swedish politicians to advocate changes in the directive.

An important reason why the VAT system looks the way it does today is the political economy of VAT. If one sector becomes subject to a reduced VAT rate, it does not take long until other sectors also express a wish for reduced VAT. Restoring taxes that have been lowered is not easy, not least due to the fact that the affected sectors have adapted to the lower tax rate. Sometimes, a lowered consumption tax is justified by a need to benefit sectors hiring young individuals or individuals facing trouble gaining employment. However, it is more effective to address the root of the employment issue through

lower payroll taxes, which is sector-neutral while also avoiding influencing the consumption choices of individuals.

Subsidies to goods and services encouraging labor supply and effort

The tax system can encourage or subsidize the consumption of certain goods and services, either through a lower tax rate or through a tax credit implying that a certain fraction of the consumption expenditure can be subtracted from the tax. These special rules in the tax legislation are referred to as tax expenditures and imply deviations from the uniform taxation of goods and services.

The main lesson from tax research is that goods and services should be taxed as uniformly as possible, with two exceptions. The first exception, highlighted above, involves excise taxes, which are useful tools for increasing economic efficiency by correcting for externalities. The other exception concerns goods and services that contribute to a high supply of labor, such as household services and childcare. These goods should be subsidized in order to counteract the tax wedge caused by high taxes on labor income having an impact on whether individuals choose to carry out these services themselves or purchase them in the market. Through a reduced tax wedge, the incentives for working in the market in relation to working in the household increase, which can lead to a higher supply of labor and increased specialization in the economy.

In Sweden, household services and various aspects of house maintenance are subsidized through tax credits. Hence, these are well-justified aspects of the tax system by virtue of the link between these subsidized services and labor supply.

The consumption of goods and services is not only subsidized by the tax system, but also by the expenditure side of the public budget. In Sweden, health care and education are provided by the government, either free of charge or in exchange for a low fee. The main difference between subsidies through the tax system and subsidies through the expenditure side of the budget is that there is limited freedom of choice with regard to the latter, since the government typically offers a limited quantity and a given quality. The discussion on whether subsidies should be applied through the tax system or through public expenditure is beyond the scope of this report. However, it is worth noting that that in Sweden, childcare is provided by the public sector, namely subsidized through public expenditure. There are different reasons for this. One is that high-quality childcare is a way of encouraging labor supply and effort among parents with young children. However, for publicly provided childcare to fulfill this goal, it is important that that the quality offered is deemed sufficient.

The balance between taxes on labor and consumption

In tax policy discussions, there is often a significant focus on the differentiation of consumption taxes, whereas the overall balance between labor income taxes and consumption taxes is less frequently discussed.

A common perception is that the tax system could become more efficient if taxes on consumption were raised and taxes on labor income were lowered, as this would make it more attractive to work. This is a weak argument in favor of consumption taxation since the purpose of earning an income is to consume, either today or in the future. However, consumption represents a broader tax base than labor since consumption is not only financed by taxable labor income but also by, for example, wealth, undeclared work, tourism, and border shopping. A switch in taxation from labor income to consumption may thereby imply a more effective way of financing the public sector.

There are also redistributive reasons for preferring such a tax switch that do not seem to have been discussed all that much in the Swedish policy debate. In contrast to labor income taxation, taxing consumption implies taxing consumption financed through certain sources of capital income heavily concentrated among people with high labor incomes. Examples of such capital incomes are leniently taxed dividends received by owners of closely held corporations within the context of the so-called 3:12 rules as well as returns on savings in so-called Investment Savings Accounts (ISK in Swedish) that exceed the imputed return.

The incentive to start a corporation in order to engage in tax avoidance by reclassifying highly taxed labor income into leniently taxed capital income is a commonly discussed issue in the Swedish dual income tax system. A tax switch from labor to consumption implies an increased taxation of consumption financed by such leniently taxed capital income, while also leading to reduced incentives to engage in such income shifting if the tax switch implies a lower marginal tax rate on high labor incomes.

When individuals save money, part of the return is a compensation for delaying consumption. This can be seen as the normal return to savings and can be compared to the government lending rate. This return on investments is not taxed by taxes on labor income or taxes on consumption. However, consumption taxes do tax returns that exceed this normal level, so-called excess returns. This property of consumption taxation is especially relevant in Sweden where a large share of total savings by private individuals occurs in the context of Investment Savings Accounts that solely tax the normal rate of return (the imputed return) and let the excess return be

tax-free (which can be viewed as a form of regressive capital income taxation).

The balance between labor income taxes and consumption taxes has not been studied to a great extent by researchers, but it seems likely that Sweden could benefit from increasing the share of tax revenues originating from consumption taxes through a reform where all goods and services are taxed at a uniform rate of 25 percent, the consumption tax base is broadened, taxes on labor income are reduced for low- and middle-income earners, firms are compensated, and household transfers are adjusted. A more far-reaching reform should also shift part of the tax burden from excise taxes to VAT.

Conclusions and policy recommendations

Based on the above, my conclusions are the following:

1. The taxation of consumption should be as uniform as possible and not be used to achieve redistributive objectives, as these are fulfilled more effectively by using taxes on labor income and household transfers.
2. Goods and services that lead to more effort, more hours worked, and increased specialization should be subsidized to mitigate the distortions associated with high marginal tax rates on labor income. For this reason, the tax credits used in Sweden to subsidize household services and maintenance are, by and large, well-justified aspects of the tax system. The fact that these services are mainly used by high-income individuals is no reason to abolish them, since these individuals are the ones facing the largest tax wedges.
3. Taxes on forms of consumption having a harmful effect on people's health and the environment should target the underlying health or environmental problem and be set at levels justified by the damage caused by this consumption. They should not be used as general tools to raise tax revenues.
4. A uniform consumption tax affects labor supply similarly to a tax on labor income. However, consumption is a broader tax base as it is not only financed by labor income, but also by wealth, undeclared work, tourism, and border shopping. A tax switch from labor to consumption could thus lead to a more efficient financing of the public sector.
5. A tax switch from labor to consumption could also be attractive on redistributive grounds as it leads to an increased taxation of certain types of capital income mainly received by individuals with high labor incomes. Examples of such capital income include leniently taxed dividends received by owners of closely held corporations and returns on saving in Investment Savings Accounts (ISK) that exceed the imputed rate of return.

My recommendations are the following:

1. Investigate how a uniform VAT can be achieved and how the base can be broadened in the context of a larger VAT reform. Such a reform consists of two components.

Step 1: Raise the reduced tax rates of 12 and 6 percent to 25 percent and compensate individuals and firms for the resulting tax increase; for example, by means of reduced payroll taxes, lower labor income taxes for low- and middle-income earners, and increased transfers.

Step 2: Broaden the VAT base through fewer exemptions. VAT exemptions are often perceived as entirely determined by EU rules. However, even without changes in these rules, it is possible to broaden the VAT base at the national level.

Taken together, these proposals imply *a tax switch from labor to consumption*.

2. An excise tax reform

Investigate the possibilities of replacing the taxes on energy with raised VAT and higher taxes on carbon dioxide emissions in a revenue-neutral and climate-neutral fashion.

Avoid symbolic taxes, such as the tax on air travel and the tax on plastic bags, which should instead be replaced by taxes targeting the underlying environmental problems.

About the author

Spencer Bastani is a researcher at the Institute for Evaluation of Labour Market and Education Policy (IFAU) in Uppsala, Sweden. He is also affiliated with the Uppsala Center for Fiscal Studies (UCFS) and the Uppsala Center for Labor Studies (UCLS), Uppsala University, and the Research Institute of Industrial Economics (IFN). For more information about the author, visit www.spencerbastani.com.