

Taxation of Consumption, Wealth and Not-for-Profit Organisations

Excise—A hateful tax levied on commodities.

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Taxation of Consumption ♦ Taxation of Wealth ♦ Australian Taxation of Land and Housing ♦ Tax Treatment of Not-for-Profit Organisations

In this chapter we turn to the taxation of the other two major tax bases, namely consumption and wealth. Both tax bases are important contributors to tax revenue, but generally less so than the income tax base. In both cases we examine the nature of the tax bases, applications in Australia and elsewhere and efficiency and equity implications of taxing these bases. We also discuss the tax treatment of not-for-profit organisations. In Australia, not-for-profit organisations provide substantial services and may indeed make large profits, but many also receive substantial tax concessions. We discuss the characteristics of these organisations and the economic implications of the various tax exemptions.

Taxation of Consumption

The term ‘taxation of consumption’ refers to the taxation of expenditure as distinct from the taxation of income. As an expenditure tax, it may be levied on intermediate goods (business inputs) or on final goods. As a practical matter, expenditure taxes are usually levied on producers rather than consumers, but we know from the study of tax incidence that economic incidence may be different from statutory incidence. In perfectly competitive markets, firms with perfectly elastic supply curves shift taxes forwards fully on to consumers. In imperfectly competitive markets, which are common, firms also shift most taxes forwards to consumers, but they may bear some part of the tax. When the latter occurs, a tax on expenditure becomes a tax on income rather than on consumption.

The main consumption tax in most OECD economies today is the value-added tax (VAT) described in Australia as the goods and services tax (GST), which is levied on producers. But there are many other actual or potential consumption taxes including: customs duties, excise taxes, retail sales taxes, a general expenditure tax and various other indirect taxes.

Customs duty

Tax on an internationally traded good

Customs duties are taxes on internationally traded goods. They are generally levied on selected imports, but sometimes on exports. Customs duties were designed historically to raise revenue. They are also used to protect local capital and labour (see Chapter 21) as well as for preferential trading purposes.

Excise taxes are taxes on consumption of selected goods. They are generally levied on producers because it is easier to collect taxes from a few firms than from millions of consumers. Historically, they were often imposed to match customs duties on imported goods. Hence, customs and excise departments would be combined in one agency. Today, excise duties are usually imposed on only a few selected goods, such as alcohol and tobacco products, partly to raise revenue on goods in inelastic demand and partly to discourage consumption of demerit goods (although these motives are not entirely consistent).

Excise tax
A tax on consumption
of a selected good

Retail sales taxes are taxes levied on retail sales at point of purchase. Government may levy a retail tax on selected goods, possibly at different rates, or a general retail sales tax. Because there are fewer retailers than firms in the economy, a retail tax has lower administrative costs than a general VAT. But retail goods are not readily defined. Some goods may be used as business inputs or for consumption. Whether a good is a retail sale or not depends upon the purpose of the purchase which is hard to test.

Retail sales tax
Tax on retail sales

Value-added taxes are *ad valorem* taxes levied on the value added at each stage of production. Value added (*VA*) is the difference between a firm's sales and the purchased material inputs used in production:

Value-added tax
A tax on value added
at each point in
production

$$VA = V_O - V_I = W + GOS \quad (32.1)$$

where V_O is value of output (sales), V_I is payments for inputs, W = wages and GOS = gross operating surplus. Thus, VAT can be estimated in two ways: by subtracting the value of inputs from sales or by addition of wages and gross operating surplus. The subtraction method is more common. Generally, firms pay a tax on their sales (which is included in the price to purchasers) and obtain credits for taxes paid on inputs.

Although government can levy a single VAT on all goods and services, it usually exempts many goods and services. Because VAT is usually designed with a consumption base, it is generally collected on imports but not on exports. Exporters may also get credit for VAT paid on inputs.

Whether VAT is a tax on consumption or on income depends on the treatment of capital purchases. If capital purchases are treated like other purchases and firms obtain full allowance for any tax paid on capital items at the time of purchase, a general VAT falls wholly on consumption and has no effect on income. This form of VAT is known as the net consumption type of VAT and is the most common kind. A 10 per cent net consumption VAT is equivalent to a 10 per cent retail sales tax. If tax credits are not allowed for taxes paid on capital goods, investment is taxed as well as consumption and the VAT becomes in part a tax on income.

A cash flow tax. This tax concept is very similar to a VAT (or GST). As described by the Henry Tax Review (2010), firms would pay a tax on their net cash flow in any period, which would be equal to VA . Essentially a cash flow tax is GST without invoices. Firms would not have to levy a tax on sales or obtain credits for taxes paid on inputs. Wage payments would count as part of VA and not be a deduction for tax purposes. Capital payments would be included wholly as an expense. Despite its simplicity it does not seem to have been adopted anywhere perhaps because monitoring is harder and evasion easier with a cash flow tax than with a VAT (or GST) system which requires a paper trail of invoices.

Cash flow tax
A tax on the net cash
flow of a firm

A general expenditure tax is a tax on a person's income less savings (i.e. on their consumption) over a period such as a year. An expenditure tax can be varied with the amount of expenditure and with the characteristics of a person's household and so be equitable. Despite its apparent simplicity, an expenditure tax has been employed only briefly in India

**General
expenditure cash**
A tax on an
individual's income
less saving

and Sri Lanka. This may be because of the difficulty of measuring savings (or dissavings) each year or perhaps because it is thought unfair to exempt income from capital.

Other indirect taxes include wholesale taxes, turnover taxes, payments for licences and government user charges in excess of costs. Wholesale taxes are levied on wholesale sales. Although they are usually intended to be a tax on consumption, they may be a tax on income when the tax is selective and cannot be passed on in the domestic or export market.

A turnover tax is a tax on the gross value of sales (V_0) at each level of production. There is no deduction for inputs. This tax is rarely employed these days. It may involve multiple levels of tax on one final good. Also, the yield of a turnover tax depends arbitrarily on the number of stages of production.

Licences are taxes paid for the privilege of producing, owning or using a good or service. Australian examples include licences for provision of gaming services and for owning a motor vehicle. High government user charges relative to costs may also be viewed as an implicit form of excise tax.

Taxation of consumption in practice

As shown in Table 2.4 (page 28), as at 2017-18, revenue from consumption taxes accounted for about 27 per cent of total tax revenue in Australia. Of this nearly half came from the GST and just over a quarter from excise taxes. Taxes on imports, gambling, insurance and motor vehicles contributed most of the balance of consumption taxes.

In Australia, the GST is levied at a rate of 10 per cent on around 57 per cent of consumer expenditures. Thus, it is not a general tax. Expenditure on health, education and most basic food is 'GST-free' (zero rated). This means that there is no GST on sales and GST on inputs is refunded. Residential rents and financial services are 'GST exempt'. To be GST exempt means that GST is not levied on sales, but GST on inputs is not refunded.

Given these variations in GST treatments, the classification of commodities has significant implications (and complications) for tax liabilities. For example, GST-free food includes fruit and vegetables, meat, milk and cheese, tea and coffee, breakfast cereals and sugar, among other products. Food that attracts GST includes prepared food such as sandwiches, confectionery, savoury snacks, bakery products, ice-cream and biscuit goods. In the education and health sectors similar demarcation issues arise. For example, some courses in adult and community education colleges attract GST and others do not.

The excise tax in Australia has a narrow tax base. Nearly all the revenue is derived from taxes on beer, spirits, tobacco, petrol and other fuels, which are essentially taxes on drinking, smoking and driving. This excise revenue is in addition to GST revenue from these goods. Unlike the GST, the excise taxes are mainly unit taxes. The taxes on tobacco, beer and spirits are indexed to the consumer price index. The excise on petrol is changed from time to time, not indexed.

International comparisons. The Australian Treasury (2006) review of international taxes showed that revenues from consumption taxes averaged 9.4 per cent of GDP in the 10 largest OECD economies (OECD-10), compared with 9.0 per cent of GDP in Australia.

In the last two decades most OECD countries have shifted towards broad-based consumption taxes. Twenty-nine out of 30 OECD countries levy a VAT. The exception is the United States. But most US states levy a retail sales tax. As at 2006, the unweighted VAT rate in OECD countries was 17.4 per cent. In the European Union, a minimum standard rate of 15 per cent is prescribed. Thirteen OECD countries have no zero-rated goods. Consequently, revenues from VAT in OECD countries currently average 19 per cent of tax revenues compared with 13 per cent in Australia.

On the other hand, Australia has high excise taxes. Australia's reliance on these duties is the third highest in the OECD-10. This reflects mainly the high excise taxes on alcohol and tobacco. Also, Australia has the highest tax burden on use of motor vehicles in the OECD-10. However, Australia has a relatively low excise tax on fuel. As at January 2005, Australia had the fourth lowest excise tax on fuel in the OECD-30 and the third lowest unleaded petrol price (Australian Treasury, 2006).

Efficiency issues in commodity taxation

We have examined commodity taxes in several earlier chapters, notably in the discussions of externalities, efficient taxation and optimal taxation (Chapters 13, 27 and 28). As we have seen, the effects of a commodity tax depend on its characteristics, notably whether it is a broad-based tax or a specific excise tax. In this discussion we focus on the VAT (GST) system.

There are two main principles for efficient commodity taxation. First, to raise a target amount of revenue from selected commodities with least deadweight loss (DWL), there should be an equi-proportionate fall in the consumption of all goods. This implies setting differential tax rates so that the compensated demand for each commodity is reduced in the same proportion. This implies in turn that, other things being held constant, tax rates would be related inversely to the compensated own price elasticities of demand. However, other things are not constant because cross-price elasticities of demand and income effects (as well as administration costs) should be taken into account.

Second, broad tax bases with low tax rates generate a given amount of tax revenue at lower DWL than narrow tax bases with high tax rates. This is because across-the-board increases have less impact on relative prices and the DWL rises with the square of the tax rate. Importantly, if revenue is collected via a general increase in prices of all commodities (rather than by excises on selected commodities) there is no distortion of relative prices. Thus, a broad-based VAT with a low tax rate generally has a lower DWL than do selective excise taxes. However, selective excise taxes may be justified to correct market failures (as a corrective tax) or as a tax on a demerit good. Thus, a tax on fuel consumption may be viewed as a corrective tax and a tax on tobacco consumption as a tax on a demerit good.

A VAT is also more efficient than a wholesale tax levied principally on manufacturers. As the share of services in the economy increases, a wholesale tax becomes increasingly narrowly based. Unless the tax rate is increased this tax yields a declining proportion of GDP as revenue. Also, levying taxes at a single (wholesale) point in the production chain generates arbitrary variations in the effective tax rate depending on the extent to which retail services add value to wholesale goods.

The VAT has smaller efficiency advantages compared with a retail sales tax. The VAT avoids the need to define retail sales or consumption goods, which is hard to do. Also, the double-entry accounting feature of VAT systems helps to reduce tax evasion. On the other hand, VAT systems are compliance intensive. There are far more tax points than with a retail sale tax.

In practice, most VAT systems, including the Australian GST system, have a general VAT rate alongside some VAT-exempt goods and along with some specific excise taxes. On efficiency grounds it is hard to justify narrowing the tax base with the exclusions. On the other hand, a more comprehensive system of differential tax rates would be administratively complicated and difficult to justify given the limitations of the inverse pricing rule theorem.

International tax principles. There are also advantages of a uniform VAT system across countries. Differential commodity tax rates between countries may distort international production or consumption just as differential income taxes do. Moreover, in this case there are no offsetting tax credits. For example, duty-free sales for exports within the European

Union (EU) distorted investment decisions, with major shopping malls built at airports and ferry terminals and operated on passenger ferries across the English Channel. To reduce such distortions, the EU abolished duty-free sales on international trips within the EU in 1999. However, price differences due to variations in the VAT and other costs remained. To reduce these differences, the EU adopted its minimum VAT rate of 15 per cent, though not full harmonisation.

Also, all EU countries adopt the **destination principle** of commodity taxation. Exports are zero rated for VAT purposes on the basis that the taxation rate at destination applies to all goods in that country. This means that consumers in each country can purchase goods from the cheapest source after allowing for transport costs. Therefore, international production is efficient. However, destination taxes may create consumption inefficiency because consumers have an incentive to purchase goods in countries with low VAT rates.

This distortionary consumption effect could be avoided by **source (or origin) taxation**, whereby countries would levy taxes on all goods produced within their country, whether sold at home or exported. Consumers would then have no incentive to purchase locally produced goods outside their home country. However, differential source tax rates could distort the location of international production,

Such distortions of consumption and production can be overcome only by full tax harmonisation. All relevant countries, for example those in the EU, would agree on both a similar basis for taxation (destination or source) and on uniform tax rates. However, where countries have different expenditure preferences, revenue needs or different tax bases, they may prefer different tax rates. Tax harmonisation may prevent a country choosing its preferred tax rates.

Destination taxes
Goods are taxed when consumed at destination

Source taxes
Goods are taxed when produced at source

Equity issues in commodity taxation

Commodity taxes are often regarded as inequitable because they are not based on the ability of individuals to pay tax. For any given taxed purchase, a low-income individual pays the same tax as a high-income individual. Accordingly, commodity taxation is often described as regressive. This means that commodity taxation takes a higher proportion of the income of a low-income earner than of a high-income earner. However, this occurs partly because high-income earners save a greater proportion of their income. Measured against expenditure, consumption taxes tend to be broadly proportional rather than regressive, although this depends on the commodities that are taxed.

In principle, it would be possible to design a progressive commodity tax structure (measured against income or expenditure) by levying differential tax rates. Goods that are a high proportion of the budgets of low-income individuals (sometimes described as necessities) would be taxed at a low, or zero, tax rate. Goods consumed mainly by high-income persons (sometimes described as luxuries) would be taxed at a high rate. Basic foods and clothes would attract a low tax rate; large boats and air travel would be taxed more highly.

However, there are strong arguments against such differential tax rates. First, income taxes are a more efficient and better targeted redistributive instrument. They can also be adjusted to deal with any inequities arising from other parts of the tax system, including GST-related inequities. Selective commodity taxes are a clumsy way to achieve distributional goals. Some high-income people would consume low-taxed goods and low-income people consume highly taxed goods. Second, such differential equity taxation could depart significantly from efficient differential tax rates and so create high DWLs. Third, attempts to obtain additional equity by exempting various goods from commodity taxation increase tax complexity and administrative costs.

Final observations on commodity taxation

As we saw in Chapter 28, the aim in designing a tax system is to create an optimal combination of taxes. If income tax deals adequately with distributional issues, consumption taxation should be efficient and not aim to achieve distributional objectives. However, in practice it may be hard to ignore the distributional implications of commodity taxes. The public may not be easily convinced that design of taxation for one tax base will offset tax incidence in another.

Our discussion of efficient commodity taxation above focused on impacts on consumption. Efficiency issues also arise with labour supply and savings. In a world without fiscal illusion, commodity and wage taxes have a similar effect on labour supply. Suppose Anne earns \$100 an hour, is taxed \$20 and takes home \$80. She can buy \$80 worth of goods. Now suppose that Anne can keep all her income, but that the government raises \$20 in every \$100 purchased (with a 25 per cent tax on \$80 of consumption). Anne again consumes goods worth \$80 before the consumption tax is added on. For any given level of revenue collection, a tax on consumption and tax on wages would have a similar deterrent effect on labour supply.

On the other hand, a commodity tax does not tax income from capital and so does not reduce investment or distort inter-temporal consumption choices. However, the net effect on investment may be small as taxation of income from capital appears to have only a small impact on savings.

There are also two practical advantages of consumption taxes. First, there are fewer problems with inflation than with income taxation. With *ad valorem* taxes, inflation is automatically allowed for. Second, it is arguably harder to avoid commodity taxes than income taxes (through trusts, offshore incomes and so on). Therefore, consumption taxes may make payment of taxes more equitable rather than less.

Taxation of Wealth

Wealth is a stock variable. An individual's wealth at any point in time equals the value of assets owned less any liabilities. Assets may include physical assets, most often land and housing, and financial assets such as shares, bonds or term deposits. The assets may be held directly or indirectly via managed funds (including superannuation). A general tax on wealth is a tax on the value of these assets less any liabilities. A selective tax may be imposed on the value of any of these assets and may not allow for any liabilities. As we will see, a tax on the capital value of an asset has a similar effect to a tax on the income from that asset (which is a flow variable).

As shown in Table 32.1, there are five main kinds of tax on wealth: a general wealth tax, taxes on land and housing and on natural resources, taxes on capital transactions and taxes on bequests and other gifts. We examine below Australian and international wealth taxes and the efficiency and equity implications.

Taxation of wealth in Australia and internationally

In 2017-18, Australian taxes on wealth were just over 10 per cent of total tax revenue. As a proportion of total tax revenue, Australia raises slightly more revenue from wealth taxes than most other OECD countries. Also, wealth taxes are raised in different ways. Compared with other OECD countries, Australia has high taxes on financial and capital transactions. Australia raises an average amount from property taxes. However, there are no taxes on bequests of any kind.

Few countries raise a general tax on net wealth. Of the OECD-10, only Switzerland, Canada and Spain raise such a tax, and only Switzerland raises significant revenue from it. Thus, in not raising a general wealth tax, Australia is in the majority.

Table 32.1 Taxonomy of major wealth taxes

<i>A periodic general wealth tax</i>
A tax on an individual's net worth—their assets less their liabilities
<i>Taxation of immovable real property</i>
General taxation of land (possibly with some exemptions)
Taxation of land used for commercial purposes
Taxation of residential land
Taxation of residential housing
Land betterment tax (on unrealised gains)
<i>Taxes on natural resources</i>
Taxes on mineral and petroleum resources
<i>Taxes on property transfers and financial transactions</i>
Taxes (stamp duties) on transfer of property
Taxes (stamp duties) on transfer of equities
Taxes on bank transactions or on credit cards
<i>Taxes on bequests and other gifts</i>
Death duties or inheritance taxes
Taxation of gifts (transfers of wealth)

In Australia, as in most countries, taxes on real residential and commercial property make up around half of all tax income from wealth.¹ In almost all countries these taxes are levied by sub-national governments. These taxes do not include taxes on rental income from ownership of property or taxes on capital gains, which are treated as taxes on income from capital and which normally accrue to central government. At about 1.3 per cent of GDP, tax revenue from immovable property in Australia is close to the OECD average. However, property taxation in Australia differs from most other countries. In Australia, nearly all taxes on property are levied on “improved” land values. These land values include capital improvements to the land, such as provision of water and sewerage services, but not structures. In most other countries, property taxes are based on property values inclusive of building improvements.

Taxes on property transfers and financial transactions may include stamp duties on residential and non-residential conveyances and on mortgages, leases, shares and other products, sometimes on bank or credit card transactions. Australian reliance on these taxes (principally on property transfers) is the highest in the OECD and twice as high as the OECD average (Australian Treasury, 2006). Of the other OECD countries, only Spain and Ireland have similar reliance on these taxes.

On the other hand, Australia is one of only two OECD-10 countries, along with Canada, that does not impose any estate, inheritance or gift taxes.² Also, most other OECD countries impose both inheritance and gift taxes (though New Zealand has only a very small gift tax). However, most of these taxes are levied progressively in relation to the total value of the inheritance or gift, exempt family members or treat them concessionaly and exempt donations to organisations such as charities that are deemed to act in the public interest. Because of these concessions, tax revenue from inheritance and gifts is generally very low and only around 0.3 per cent of GDP even at the high end of the range (in Japan, the Netherlands and the United States).

¹ In Australia, owner-occupied property and land used for primary production are usually exempt from property tax.

² Australian Treasury (2006) notes that Canada effectively imposes bequest taxes through deemed disposition in income tax legislation. In Australia, from July 2007 capital left in superannuation accounts after the death of the beneficiary is taxed at 15 per cent (except when distributed to spouses).

General effects of taxation of wealth

In principle there is no difference between the taxation of a stock of wealth and the taxation of the flow of income from it. Given appropriate tax rates, the taxation of wealth and of income from wealth is equivalent. Let the value of a stock of capital be K and the pre-tax return from capital be ρ , so that the gross income from capital is $K\rho$. There is a tax rate on the capital (t_k) that produces an equal amount of tax revenue to a tax rate on the income from capital (t_ρ):

$$Kt_k = K\rho t_\rho \quad (32.2)$$

Suppose that capital provides a 6 per cent rate of return and that t_ρ equals 30 per cent. This is equivalent to a tax rate on the stock of capital (or wealth) of 1.8 per cent.

Assuming no fiscal illusions, the taxation of capital would have similar effects to the taxation of income from capital. Given that savings are generally a positive function of the after-tax return on capital, a wealth tax reduces this return and hence reduces savings and capital formation, the capital–labour ratio and productivity. The tax also creates a DWL for individuals who are discouraged from saving (via the substitution effect). The effects on savings are doubled if both the capital stock and the income from it are taxed.

Equity issues are complex. Taxing wealth may be viewed as equitable if wealth is correlated with ability to pay or if it is unearned in the hands of the recipient (a gift of some kind). However, double taxation of capital and of the income from the capital may be viewed as inequitable. Indeed, if income is also taxed when earned, savings would be triply taxed.

However, there are some contrary points. First, some forms of capital provide untaxed, non-monetary benefits. In most OECD economies, households hold over half their capital in their homes and consumer durables. The imputed rent from these assets is rarely taxed. Therefore, taxing some forms of capital, such as property values, may capture some sources of real income that are not captured by income tax. Second, where property prices rise with the provision of local services, some property taxes may be viewed as a benefit tax for the provision of these services, which could make such taxes both efficient and fair. Third, the efficiency effects of a wealth tax depend on the mobility of capital. Taxes on immovable capital, such as land, have less DWL than taxes on mobile capital because the existing fixed capital cannot escape the tax.

In conclusion, there are efficiency and equity arguments for some taxation of capital stock, especially property which does not produce taxable income. The case for taxing wealth is weaker when income from the stock is already taxed. To say more than this, we need to examine the merits or otherwise of each main form of wealth tax.

A general wealth tax. There are strong reasons against a general wealth tax. It is generally easier to tax income from capital which is observable than personal net wealth which requires regular valuations. If the tax rate were to rise with wealth there would be much avoidance activity. In any case, when income from capital is taxed, a general wealth tax would represent double or even triple taxation, which would be inefficient and arguably unfair. Accordingly, few countries levy a general wealth tax. However, selective taxes on assets which are immobile, especially on assets that do not provide an explicit income stream, such as owner-occupied homes, are commonly adopted.

Taxation of immovable real property. Most of the literature on the taxation of property discusses two issues: taxes on the value of unimproved land and taxes on the value of property inclusive of structures. As it happens, neither of these taxes is levied in Australia, where all property taxes are levied on improved land values (improved land but excluding structures). We discuss this form of property taxation in the next main section. Here we discuss taxes on the value of unimproved land and on property values inclusive of structures.

General wealth tax

A tax on the value of an individual's total assets less total liabilities

Unimproved land value

The value of land without any capital improvement

Taxation of unimproved land. The idea of a tax on unimproved land values was popularised by Henry George (1879). Indeed, George proposed that the ‘ground rent’ from land be taxed 100 per cent. By ground rent, George meant the economic surplus from use of the land after payments for any other factors of production including any capital investment in the land. Thus, ground rent did not include any return to investment in the land. The unimproved capital value (UCV) of land is the capital valuation of the ‘ground rents’. Because the supply of land is a gift of nature and fixed, a tax on ground rent is a tax on pure profit and has no effect on land supply. George argued that such a tax it is equitable because land is a gift of nature, not a result of capital or labour.

Despite the attractions of these arguments, there are three significant problems with a 100 per cent tax (or any very high tax rate) on ground rent or UCV. First, unimproved land values have an important role in allocating land to its most productive use, to housing, different types of agriculture and so on. If these land values are reduced to zero after tax, landowners have no incentive to use land in its most productive manner. Without a price mechanism, land would be used most inefficiently. Second, it is difficult to determine how much of the market price of land is pure land value and how much is due to capital improvements to the land. This could result in expensive administrative and judicial procedures. Third, introduction of a tax on pure land values would be retrospective in effect, as many landholders would have paid prices for the land that did not allow for such a tax.

Taxes on property values. Turning to the more common tax on property values, the effects depend on the scope of the tax. Notably, they depend on whether the tax is a small or a large part of the total tax on capital. If it is a small part, the effects can be analysed using partial equilibrium analysis. If it is a large part, a general equilibrium analysis is required. These two approaches (partial and general equilibrium) are sometimes described as the traditional and the new view of the effects of a property tax. This is rather misleading because the partial equilibrium approach still applies in many situations, notably when many local governments levy a property tax (as they do in the United States), and we want to determine the effect of a change in one or a few of these taxes. In such cases, most effects occur in the local area(s) making the tax change and effects elsewhere negligible.

The partial equilibrium approach assumes that a property tax works like an excise tax on the annual income derived from the property. But the tax has a different effect on the land and the housing components of property value because the local supply of land is fixed and the amount of capital spent on it is elastic. As shown in Figure 32.1a, the property tax on the home occupier shifts the demand for land down from D_1 to D_2 . With a perfectly inelastic supply of land (S_L), the tax on the land component reduces the amount received by landowners and is borne entirely by landowners. Of course, the occupier of the property is often also the landowner. If future property rents are capitalised into lower initial land prices, the whole stream of property taxes is borne by the initial landowner.

In panel (b), the property tax reduces the demand for the structural component of the property from D_1 to D_2 , but the supply of capital to build structures (S_B) is assumed to be perfectly elastic, at least in the medium run. If the return on local property is lower than the return on capital elsewhere, the capital will move to another location or sector and the supply of structures falls from B_1 to B_2 . In this case the rents for the built component must rise until the after-tax return to capital is as high in the local housing sector as in other locations or sectors. Accordingly, after an adjustment period, the burden of the property tax is borne partly by the initial landowners and partly by renters in the form of increased rents.

Suppose now that there is a national property tax and that the capital employed in property is a substantial part of the capital employed in the economy. In a closed economy, capital will exit the housing market and be of such a magnitude to cause the after-tax return to capital to fall in all other sectors of the economy. In this general equilibrium analysis, the property tax

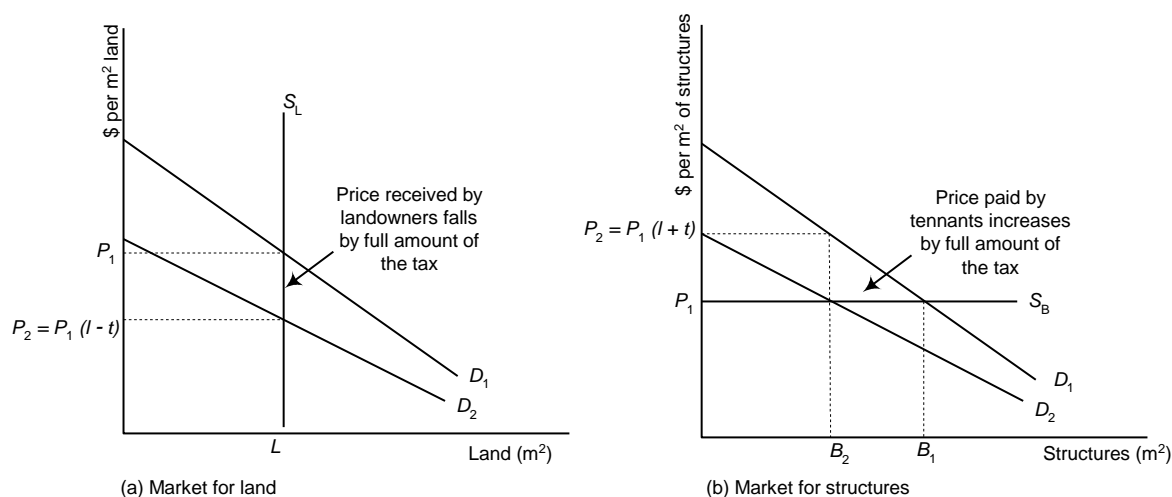


Figure 32.1 Incidence of local property tax on land and structures

is borne by all local owners of capital. Property rents rise, but by less than they would in the partial equilibrium model because the after-tax return to capital required in the housing sector has fallen.

However, in a small open economy the rate of return to capital is determined internationally. In this case the flow of capital out of the local property market will have only a small effect on the rate of return to capital in other parts of the local economy. Rents for structures in the property market will have to rise sufficiently to ensure that the after-tax rate of return in the property sector equals the internationally determined after-tax rate of return prevailing in other sectors.

Another view of property taxes is that they are user fees, not taxes, for the supply of local services to property owners. Studies in the United States by Oates (1969) and Weimer and Wolkoff (2001) found that residential property values are related positively to expenditure on local public services and inversely to municipal tax rates levied on property. Note that, when property values are high, local jurisdictions can have high tax revenues and expenditure along with low tax rates. The relationship between property values and local expenditure implies that local property taxes may be viewed as benefit taxes (i.e. as payments for services). In effect the demand for property schedules in Figure 32.1 would rise. This is also valid for Australia though to a lesser extent as fewer public services are provided locally and funded from local property rates.

These three views of property taxes (the partial and general equilibrium models and the user benefit hypothesis) may be valid in different circumstances. Where local changes in a property tax occur, the partial equilibrium approach is realistic. If national changes in the property tax occur in a closed economy, a general equilibrium model is realistic. And sometimes the property tax is a *de facto* user charge.

Turning to the efficiency effects of a property tax, the distinction between land and structures is again important. A general tax on unimproved land values has little DWL so long as it is low enough to have little or no effect on the total supply or use of land. On the other hand, selective land taxes may distort land ownership and use patterns. Also, a tax on structures is potentially inefficient because it may divert mobile capital away from housing towards lower valued goods.

Taxes on natural resources. In principle, a tax on a natural resource is like a tax on unimproved land. It would not affect the supply of the resource. In a world of certainty, where prices and costs are known, if the tax is less than the value of the resource, a tax on the resource value would have no effect on exploitation of the resource, as a normal return on capital investment can still be achieved (and there is no alternative use for the resource). This is illustrated in Figure 32.2a. Given the international price (P) for a mineral resource and an industry supply curve (S), the industry will produce Q_1 tonnes of output per annum. A tax on economic profit will reduce the return to mining (in Figure 32.2a the tax collects revenue shown by shaded area ABC), but not affect the level of output. Such a tax is described as a tax on economic rent or a pure resource tax.

On the other hand, a tax on the quantity or value of mining output (known as a **royalty tax**) creates a wedge between the sale price and the price collected by miners. As shown in panel (b), a royalty tax shifts the supply curve upwards by the amount of the tax and reduces output from Q_1 to Q_2 . There is then a DWL equal to the shaded area ABC . This loss occurs because the addition to marginal cost may turn otherwise profitable marginal output into unprofitable output and cause firms to reduce output below its efficient level. For marginal mining operations, such royalties can have strong disincentive effects.

This standard analysis suggests that taxes on economic profits (rents) are superior to royalties. This may be the case, but matters are complicated in practice. Consider first the tax on economic rents or its equivalent, a tax on the value of the natural resource. A key problem is that neither economic rent nor the value of the resource is readily observed. Most mining companies are vertically integrated supply chain operations, and sometimes multi-product producers, with joint exploration, management and corporate expenses. Allocating joint costs to parts of the supply chain is often somewhat arbitrary.

Also, entrepreneurship needs to be rewarded as entrepreneurs often accept low incomes for years in the hope of large profits later. In addition, investors in mining require a risk premium and are unlikely to invest unless there is significant economic profit potential to offset the risks. Market valuations of resources usually reflect high discount rates. Moreover, when the total tax rate (on economic rents and corporate income) rises beyond about 50 per cent companies may seek ways to reduce tax, for example by increasing tax-deductible management payout, rather than minimising production costs, which itself is an economic waste.

Royalty tax
A tax on the quantity or value of mining or oil sales

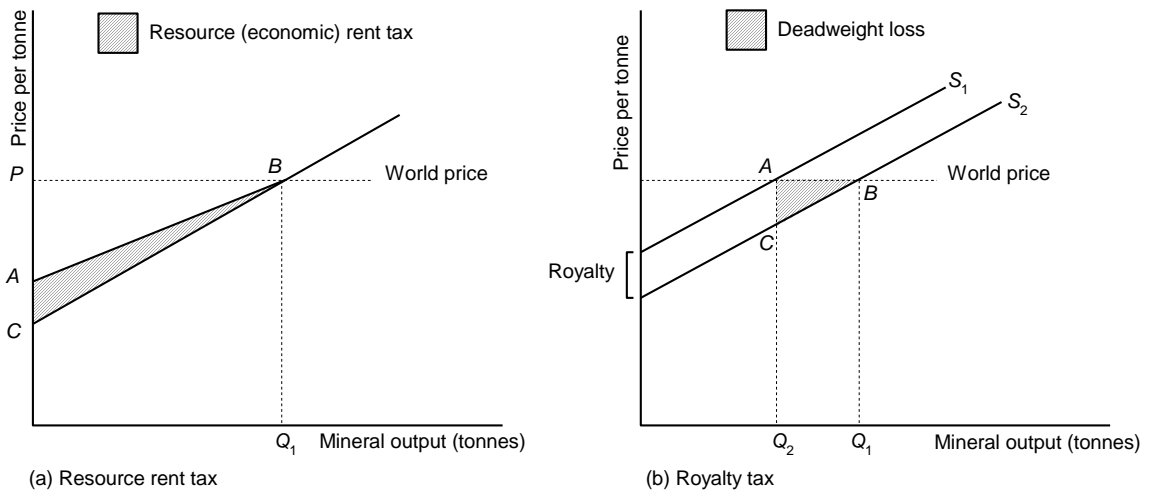


Figure 32.2 Comparison of resource (economic) rent tax and royalty tax

Moreover, the analysis above embodies two critical assumptions. The first is that the level of Australian output has no impact on the world price. This is not realistic for commodities like iron ore and coal. When the demand curve for a country's product is downward sloping, a country can gain by reducing output and increasing the world price (i.e. by exerting monopoly power and choosing quantity where marginal revenue equates to marginal cost). Secondly, we have implicitly assumed no foreign ownership of mining firms. If a mining operation is partly or wholly foreign owned, as many in Australia are, the royalties are not simply a transfer payment within Australia and some of the DWL is borne by foreign entities.

Australian experience exemplifies some of these issues. The Australian government receives around \$1 billion annually from the petroleum resource rent tax (PRRT) and the states receive some \$4 billion annually in royalties on mineral and petroleum production (mainly in Queensland and Western Australia). Under the PRRT introduced in 1987, the Australian government levies a 40 per cent tax on the economic profits of petroleum production *after* a full allowance for (debt and equity) capital costs and *before* corporate income tax. The state governments levy a tax on the production of minerals and petroleum either in the form of a unit tax on output or as a percentage of value realised on output before transport and processing.

The Henry Tax Review (HTR, 2010) proposed that a broadly similar 40 per cent tax should be applied to the economic profits of all mining enterprises in Australia. As a tax on pure profits (rents), this was intended to have no disincentive effect on exploration and investment in mining production. However, when prospects are uncertain investors weigh up whether the spectrum of possible returns after tax is sufficient to compensate for the possibility that they may lose their whole investment if the business is unsuccessful. To deal with this, the HTR proposed that the government would meet 40 per cent of losses (below a normal return on capital) and that this should make investors risk neutral.

In 2011, the (Labour) Australian government introduced a new Minerals Resource Rent Tax (MRRT) whereby excess profits were taxed at a nominal rate of 30 per cent, to apply only to iron ore and coal as from 1 July 2012. Small miners with less than \$50 million profits would be exempt from the MRRT. The MRRT would be assessed on the value of commodity at its first saleable form (at the mine gate) less all costs to that point. However, the effective tax rate was 22.5 per cent because taxable excess profits will be allowed a 25 per cent extraction allowance in recognition of the contributions of the miner's expertise to profits at the mine gate. There were other complex valuation issues. The government also agreed to allow the mining companies to credit any increase in state government royalties against the MRRT. Thus, the MRRT did not displace inefficient royalty taxes. However, three years later the (Liberal) Australian government introduced legislation that repealed the MRRT.

Taxes on property transfers and financial transactions. These taxes can greatly increase the costs of trade and discourage trades. Consequently, productive assets may not be owned by those who can make best use of them and consumption assets may not be owned by those who value them most highly. For example, high stamp duties on property transfers deter households from moving into more suitable housing and result in an inefficient allocation of the housing stock. Abelson and Joyeux (2007) estimated that Australian stamp duties increase the costs of exchanging houses by 33 per cent, deter 7 per cent of housing exchanges and have a DWL of \$375 million per annum.

Taxes on estates and gifts. These taxes may be justified on equity and efficiency grounds. Recipients of large untaxed bequests are strongly advantaged over other individuals. This is inconsistent with the principles of horizontal equity and equality of opportunity. This also suggests that an estate tax might be more equitable if it were taxed in the hands of the recipient rather than on the total size of the estate.

Arguably, the break-up of family holdings in a business may be regarded as efficient in that the assets are more likely to finish in the hands of those who can utilise the assets most productively. In the words of the wealthy American industrialist, Andrew Carnegie: ‘the parent who leaves his son enormous wealth generally deadens the talents and energies of his son’. Rosen and Gayer (2014) cite research that supports this view. On the other hand, those who create wealth may be motivated by a desire to hand some of it on to their families. Therefore, an inheritance tax may discourage investment and savings.

However, a critical issue for estate taxes is tax avoidance. Avoidance may be achieved by designing a complex system of trust companies. A simpler method is to make bequests before death. To reduce this form of tax avoidance, death duties need to be integrated with taxes on transfers between living persons. In the United States estate and gift taxes are integrated through the Unified Transfer Tax. The gross estate includes gifts made during the decedent’s lifetime. But there is a large lifetime exemption amount and spouses are exempt. These exemptions mean that death duties are paid on fewer than 2 per cent of estates in the United States. Administrative difficulties, as well as political constraints, are the major barriers to effective estate and gift taxes in most countries.

The Henry Tax Review (HTR, 2010) noted that most OECD countries impose estate taxes, either through taxes on the whole estate or on inheritances and argued that a bequest tax would be economically efficient. But the HTR also noted the administrative complexities (and political contentiousness) of inheritance taxes and suggested that the issue be discussed thoroughly and publicly before any action should be taken.

Australian Taxation of Land and Housing

Land and housing attracts many taxes because they are easy, immobile targets. In Australia, these taxes include state and local government land taxes (local council rates), stamp duties on property transfers, GST on sales of new dwellings and on renovations of existing ones, and capital gains taxes on rental properties and second homes. There are also charges on land and housing developers for the public provision of economic and social infrastructure—these are essentially user charges although some developers regard them as taxes.

Table 32.2 presents estimates of these tax revenues in absolute terms and in relation to the value of housing in 2004. Abelson and Joyeux (2007) estimated that the taxes amounted to nearly a quarter of annual private housing rents inclusive of imputed rents.

As noted above, land taxes in Australia are levied on the value of improved land and are therefore a tax on land and capital. Land taxes on owner-occupied housing are borne by the owner. However, land taxes on rental properties are borne mainly by housing tenants. Investors pass most of the land tax on in higher rents to tenants because capital is mobile and the after-tax return on housing equates approximately to the after-tax rate of return on alternative investments. In other words, the elasticity of rental housing supply is generally greater than the demand elasticity.

The incidence of developer charges and of GST for new houses is more controversial. The housing industry argues that both developer charges and the GST are passed on to consumers via higher house prices. However, new houses are a small part of the total housing market and their prices are set by the value they offer relative to established houses. If a developer has selected the highest possible sale price for a new property, he cannot increase this price because a new tax is imposed. The price of new houses will rise only if their supply is reduced. However, in many parts of Australia, the supply of new housing is determined by planning regulations and is not price sensitive. On the other hand, the price of raw land for housing generally exceeds the value of the land in alternative uses. In this situation, a tax on new housing reduces the price of raw land. It does not increase the price of new housing.

Table 32.2 Estimated value of taxes and subsidies for private housing in Australia in 2004

<i>Subsidy/tax</i>	<i>Owner-occupied housing</i>		<i>Private rental housing</i>		<i>All private housing</i>	
	<i>\$bn</i>	<i>% annual housing value</i>	<i>\$bn</i>	<i>% annual housing value</i>	<i>\$bn</i>	<i>% annual housing value</i>
<i>Taxes</i>						
Land taxes (state governments)	na	na	1.2 ^a	4.6	1.2	1.2
Land taxes (local government)	6.0	8.2	1.2 ^a	4.6	7.2	7.3
Stamp duties	7.0	9.6	2.0	7.7	9.0	9.1
GST on land/new houses	3.0	4.1	0.5	0.5	3.5	3.5
GST on major renovations and additions	1.8	2.4	0.7	0.7	2.5	2.5
Total taxes	17.8	24.3	5.6	21.5	23.4	23.6
<i>Subsidies</i>						
Imputed rent tax concession	8.0	11.0	na	Na	8.0	8.1
No GST on imputed/actual rents	7.3	10.0	2.6	10.0	9.9	10.0
Capital gains tax concession	7.2	9.9	na	Na	7.2	7.3
Asymmetric tax treatment of losses and gains	na	na	1.6	6.2	1.6	1.6
First-home owner grant	1.2	1.6	na	Na	1.2	1.2
Private rent subsidies	na	na	1.8	6.9	1.8	1.8
Total subsidies	23.7	32.4	6.0	23.1	29.7	30.0
Subsidies - Taxes	5.9	8.1	0.4	1.6	6.3	6.4

(a) Estimated net tax for investors after allowing for lower income tax at a marginal tax rate of 40%.

Source: Abelson and Joyeux (2007).

Analysing the effects of taxes on housing is complicated because, trying to make housing more affordable, government also provides numerous subsidies to housing. In Australia there is no capital gains tax for owner-occupied housing. There are also grants to assist first-home buyers and rent subsidies for low-income households in private and public housing. As shown in Table 32.2, Abelson and Joyeux (2007) estimated that owner occupiers receive a gross housing subsidy equivalent to nearly a third of the annual rental value of their housing. Thus, they receive a net housing subsidy valued at just over 8 per cent of imputed rents. On the other hand, the estimated net subsidy for the investor/rental housing sector is about 1.6 per cent of annual housing rents. In Chapter 21 we considered the effects of the subsidy for homeowners on the price and consumption of housing and the associated DWL.

As we have seen, the taxation of pure land, a fixed resource, is efficient. However, land nearly always embodies capital expenditure and taxation of capital inputs to land may increase land and house prices. The Henry Tax Review (2010) pointed out that existing state-based land taxes are inefficient because they have many thresholds and exemptions and are not broadly based and that tax rates vary according to land use and landholding aggregation rules. The HTR proposed that a new land tax should apply to all land regardless of use based on the value per square metre of land above a certain value threshold that would exclude most agricultural land, and that the tax rate would be progressive. This tax would replace existing inefficient taxes including stamp duties on property transfers. However, the HTR proposal would not have a zero DWL because it would not be pure land tax (it would tax capital inputs) and it would have a distortionary tax threshold.

Tax Treatment of Not-for-Profit Organisations

In many countries, including Australia, not-for-profit organisations (NPOs) provide a wide range of services. Some of these are wealthy and receive large revenues and some run essentially commercial services. However, they are generally exempt from income tax and often receive other tax concessions. We describe below the nature of NPOs, their contribution to Australian GDP and the major tax concessions to them. We then discuss some economic and policy implications.

The nature of not-for-profit organisations. A NPO is an organisation that has no external equity interests. A NPO may have internal equity (net assets) and many NPOs do.³ They may make and accumulate profits. However, a NPO must contribute any profit to the purpose for which the organisation was established. A NPO is not allowed to distribute profits to any of its members or to provide profit or financial gain to the individuals who establish or control it. NPOs are involved in a wide range of activities, including churches, church schools, cultural and environmental services, sporting clubs including many wealthy ones, community child care centres and neighbourhood associations. Most NPOs attract substantial tax concessions especially exemption from profit or income taxation.⁴

Charities constitute a high proportion of NPOs and attract the greatest tax concessions. An NPO can be designated as a charity if it has a dominant charitable purpose. However, legislation defines a charitable purpose very widely as provision of a ‘public benefit’. An NPO provides a public benefit if it aims to achieve a common good, has ‘practical utility’ and is directed at a sufficient section of the general community. These are wide goal posts. Examples of charities include religious institutions, aged persons homes, homeless hostels, not-for-profit schools, organisations providing for people with disabilities, not-for-profit child care centres and societies that promote the fine arts (Australian Taxation Office, 2014).

The size of the not-for-profit sector. The Australian Bureau of Statistics (2009) reported that there were just over 41 000 NPOs in Australia at the end of June 2007. These NPOs employed 890 000 persons, including 370 000 full-time employees, and the rest part-time or casual employees, and contributed 3.4 per cent to Australian GDP.⁵ Education and research accounted for 29 per cent of value added by NPOs, social services for 19 per cent, health for 18 per cent and culture and recreation for 12 per cent. These figures did not include not-for-profit public agencies, such as universities or public hospitals operated by religious orders, or mutual organisations (not-for-profits in the financial and insurance industry and trading co-operatives) that operate commercially and permit the distribution of assets to members when they are wound up.

Benefits of not-for-profit institutions. NPOs provide various benefits. Most importantly, they may supply services at lower cost than commercial firms can because they attract labour to work for them as volunteers or at low market rates. Second, members of the community may wish to join together to provide a local public good or service to their members that government is not providing and cannot readily provide. Third, some consumers may prefer to obtain services from NPOs rather than from private firms or government.

³ ‘Not-for-profit’ organisations are often described simply as ‘non-profit’ organisation. The former term is a more accurate description.

⁴ See Australian Taxation Office, 2014, *Tax Basics for Non-Profit Organisations*.

⁵ If the value of free volunteer services is included, the estimated contribution of NPOs rose to 4.7 per cent of GDP.

Tax concessions for the not-for-profit sector. Tax arrangements for NPOs in Australia (Australian Taxation Office, 2018) are complex. Here we outline the major tax concessions.

Most NPOs in Australia are exempt from income tax. Almost the only requirement for tax exemption are that an organisation must be set up for an object other than making a profit and be based in Australia. As we have seen, they can and do often make very large returns on internal equity, often amounting to pure economic profit.

Unless claiming other tax exemptions, NPOs self-assess whether they are income tax exempt. If an NPO is income tax exempt, it is not required to pay income tax on profits from any services provided however incidental they may be to the primary purpose of the organisation. Therefore, profits from gaming machines or business ventures, returns from investments and realised capital gains are all income tax exempt. Of course, employee incomes are taxed and NPOs must deduct pay-as-you-go taxes from employee wages.

NPOs receive several other tax concessions. All NPOs are allowed a higher GST registration threshold than other businesses. Charities also obtain GST-free status for various sales and GST-exempt statuses for various events (that are treated only as input taxed). Charities are exempt from the fringe benefit tax (FBT) on non-cash benefits to employees or eligible for a partial rebate on FBT. Many NPOs are exempt from state payroll and land taxes, and from municipal rates, or receive significant concessions on these taxes. Also, most NPOs receive donations that are income tax deductible. The Henry Tax Review (2010) estimated that the FBT and deductible gifts concessions each had a value of about \$1.0 billion.

Efficiency implications of tax concessions for non-profit organisations. In principle, so long as NPOs aim to maximise their return on capital employed, exemption from income tax should not affect investment or operating decisions. If a charity is operating an unrelated business, it will maximise the contribution to charity by maximising the profits of this business.

However, the incentive to maximise profits is weakened when there is no explicit return on equity, albeit internal equity. Also, income tax exemption increases the after-tax profits retained by NPOs and encourages reinvestment in their own activities and businesses.

The lack of competitive neutrality also encourages inefficient outcomes. There are major competitive advantages in running businesses through an NPO and being GST exempt. NPO clubs that do not have to charge GST and can cross-subsidise meals and drinks from untaxed profits of gaming machines have a competitive advantage over hotels and public bars that must charge GST and pay income tax on profits. Instead of maximising profits by charging their members profit-maximising prices, NPOs may also provide significant indirect returns to members in the form of lower membership fees and service prices. On the other hand, the inability of NPOs to raise equity capital may constrain their capital expenditure, increase labour intensity and be relatively inefficient, and constrain their capacity to expand services.

Tax exemptions on inputs, notably FBT concessions, also distort resource allocation. These exemptions reduce the cost of NPO purchases and provide NPOs with a competitive advantage relative to standard commercial businesses. While these tax-driven cost advantages may be offset by the inefficient capital structures of NPOs, so that the overall size of the NPO sector and resources commanded by NPOs may be similar to what might occur in a neutrally competitive market, there is some inefficiency and a related deadweight loss as more resources are used by organisations with inefficient capital structures and operations.

Equity implications. The concessional tax treatment of NPOs also raises equity issues. The concessions recognise that many NPOs provide services to less well-off members of the community. Indeed, that is a major rationale for many NPOs.

On the other hand, the tax subsidies allow NPOs to provide services at lower prices to their members than commercial firms can provide to the public. Customers of NPOs can receive

cross-subsidised services at lower prices than are available from fully taxed commercial competitors. Church organisations often occupy prime municipal sites without contributing to the costs of municipal services. Employees of some NPOs can receive substantial fringe benefits free of tax. These examples appear to breach the principle of horizontal and vertical equity.

Conclusions. Some NPOs achieve efficiencies in supply that private firms or government cannot. They may also facilitate distributional objectives. However, there is no systemic set of principles underlying the NPO sector and many NPOs exist without clear efficiency or equity objectives. Many tax concessions for NPOs in Australia reflect tradition and political influence more than formal economic justification. Many tax concessions appear to be *ad hoc* decisions and may create significant deadweight losses and inequitable outcomes.

Summary

- This chapter examines the taxation of consumption and wealth and the tax treatment of not-for-profit organisations.
- Value-added taxes are the dominant form of consumption tax. Most countries also levy excise taxes on selected goods, some customs duties and various other indirect taxes.
- Given that income tax can target distributional objectives, consumption taxes should be designed primarily to raise revenue efficiently.
- The most efficient consumption tax system is a broad-based VAT (or cash-flow tax) with basically one tax rate and a few tax rate variations to correct market failures and to address special merit goods.
- International production or consumption is distorted when countries adopt differential VAT rates. Distortions can be removed only if all countries adopt a similar tax principle (by source or destination) and a similar VAT rate.
- The taxation of wealth has similar effects on incentives and savings as a tax on income from capital except that it allows for the taxation of non-monetary returns to capital.
- If tax is levied on earnings, income from capital and wealth, there is triple taxation of savings.
- Taxes on improved land values or full property values are the main form of wealth tax. A tax on land is efficient in that land is not mobile. However, taxes on improvements are taxes on capital. Also, property tax needs to be designed not to make housing unaffordable.
- Taxes on natural resources are also efficient. But valuation of resources, with full allowance for the cost of discovery, exploitation and risk, may be difficult.
- Not-for-profit organisations provide some efficiency and equity benefits. However, the wide range of income and other tax concessions may create deadweight losses and some social inequities.

Questions

1. When is a commodity tax a tax on income rather than a tax on consumption? Give examples. Can the GST be a tax on income and not on consumption?
2. Can commodity taxes improve the allocation of resources?
3. Can and should commodity taxes be progressive?
4. Should the GST be (i) broadened and /or (ii) raised above 10 per cent in line with general international practice for the similar VAT tax systems?
5. What kinds of inefficiencies occur when countries fail to harmonise consumption taxes? Is tax harmonisation always desirable?
6. Are any kinds of wealth taxes desirable? If so, which ones and why?
7. Why are stamp duties on the purchase of housing and insurance considered especially inefficient?
8. What are the current problems with land taxes in Australia? What kind of land tax would be efficient and fair? What might be the disadvantages of land tax?
9. What are key features and merits of a resource rent tax versus a royalty tax? Is a royalty tax ever preferable to a resource rent tax? What issues arise with the Australian Minerals Rent Resource tax?
10. What are the main subsidies for not-for-profit organisations? Do they distort the allocation of resources? Explain your answers.

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