



## Consumption Taxes: the Way of the Future?

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on consumption?**

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### Introduction

All governments raise taxes for public spending, from schools to highways and social security. The question is what kind of taxes to levy, how they are applied and how they affect people. Governments have become increasingly interested in recent years in using taxes on consumption, such as sales tax and value added tax (VAT) to finance a larger share of this spending.

There are two main reasons for this. Some analysts argue that increased international tax competition – different tax rates or provisions in different countries – makes it more difficult for governments to collect corporate and personal income taxes from their citizens, so that taxes on consumption will become a more important source of revenue. Others claim that a move from taxes on income to taxes on consumption would improve economic efficiency and increase the rate of growth, or that it would improve competitiveness and protect employment.

These arguments have moved up the political agenda recently. Germany increased its VAT rate at the beginning of 2007, partly to finance a cut in social security contributions. Even more recently, the election of a new government in France has given new impetus to the debate on the “TVA sociale”, a proposal to increase VAT and reduce employers’ social security contributions. The debates surrounding these developments centre on the extent of the possible advantages outlined above and on their major perceived disadvantage: that increased VAT allegedly also increases inequality and lowers the living standards of the poor.

These debates raise a number of questions. Is a move towards greater use of taxes on consumption, and particularly VAT, inevitable? Would this lead to increased economic growth? Would it improve competitiveness and protect jobs? How much would it widen the gap between rich and poor?

This *Policy Brief* looks at OECD work on these issues, and how governments are having to find a difficult balance between economic efficiency and concern for income inequality. ■

### What are taxes on consumption?

Taxes on consumption are mainly of two types:

- General consumption taxes, which are levied on a broad range of goods and services. These are usually levied in the form of VAT or sales tax.
- Taxes on specific goods and services, such as excise duties on items like vehicle fuels, tobacco and alcoholic drinks as well as import duties on goods coming into the country.

Taxes on consumption are also often referred to as “indirect taxes”, in contrast to “direct taxes” that are levied on income (personal and corporate income taxes, social security contributions and payroll taxes). The choice of how much revenue to raise from taxes on consumption rather than taxes on income can therefore also be described as a choice of the balance between direct and indirect taxation.

It is important to note that there are significant differences in the design and economic effects of different taxes within the general classes of “taxes on consumption” or “taxes on income”. The distinction between the two main types of consumption tax has already been noted. Among taxes on income, personal income taxes are generally progressive (the tax rate rises with higher income levels) while most social security contributions are proportional (a fixed percentage of income) or regressive (taking a higher proportion of lower incomes). ■

### What are the trends in the OECD?

The share of major tax categories in OECD countries has evolved in the past 40 years (see Table 1). The share of tax revenue that comes from taxes on consumption has declined from above 38% in 1965 to below 32% in 2005, with most of the reduction taking place between 1965 and 1975.

This fall in the share of taxes on consumption has been balanced by an increase in the share of taxes on income. This rise has come mainly from a strong increase in the share of social security contributions. Personal plus corporate income taxes show no trend over the period as a whole, although the share of personal income tax rose and then fell. In contrast, the share of property taxes (which are difficult to classify as either taxes on consumption or taxes on income) has suffered a slight fall.

**Table 1.**  
**REVENUE SHARES OF MAJOR TAXES IN THE OECD AREA (UNWEIGHTED AVERAGE)**

	1965	1975	1985	1995	2005
Personal income tax	26.2	29.8	29.7	27.1	24.6
Corporate income tax	8.8	7.6	8.0	8.0	10.3
Social security contributions	17.6	22.0	22.1	24.7	25.6
Payroll taxes	1.0	1.3	1.1	0.9	0.8
Property taxes	7.9	6.3	5.2	5.5	5.6
Taxes on consumption	38.4	32.8	33.7	32.4	31.9
<i>Of which, VAT and sales tax</i>	<i>13.6</i>	<i>14.5</i>	<i>16.4</i>	<i>17.7</i>	<i>18.9</i>

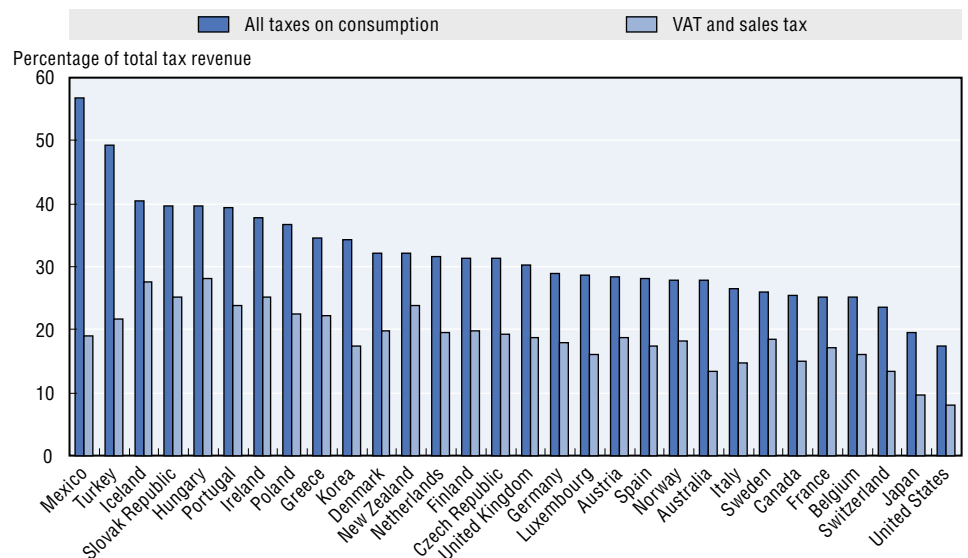
Source: OECD, Revenue Statistics 1965-2006.

Of course, OECD averages do not convey the whole story and a few countries have stood out against the trend, increasing their use of consumption taxes over the period. Mexico increased its share of revenue from consumption taxes by 6 percentage points, while the share in New Zealand, Luxembourg and the Slovak Republic increased by 4 points. The Netherlands (3 points) and Poland (2 points) showed smaller increases. Nonetheless, 24 OECD countries reduced their shares of taxes on consumption, with Iceland experiencing a particularly large fall of 22 points.

It is interesting to look at the role that VAT has played in the development of consumption tax over the past 40 years. VAT is a general consumption tax but is different from the retail sales tax in that it is collected at every stage of production and distribution, not just at the point of final sale. Back in 1965, most general consumption taxes in the OECD were retail sales taxes (only three countries had VAT) but now 29 of the 30 OECD countries have VATs. As VAT was spreading, the revenue share of general consumption taxes was rising but total revenue from all taxes on consumption fell because of a decrease in revenues from excise duties and other specific taxes (see Table 1).

The revenue shares from both taxes on consumption as a whole and those taxes classified as general consumption taxes (now mainly VAT) varies widely between countries (see Figure 1). Countries with low revenue shares of general consumption taxes, such as the United States (with no VAT) and Japan (with a very low VAT), generally have low total revenue shares from taxes on consumption. However, there is not a close relationship across all countries and the two countries with the highest shares from taxes on consumption in the OECD, Mexico and Turkey, do not have a particularly high VAT revenue share; they make heavy use of taxes on specific goods and services.

**Figure 1.**  
REVENUE SHARES OF  
TAXES ON CONSUMPTION,  
2005



Source: OECD, Revenue Statistics 1965-2006.

If, however, we look at changes in the revenue shares of different taxes on consumption over the last ten years, a stronger pattern emerges (see Figure 2). With the exception of Turkey, countries with increased revenue shares from taxes on consumption have all experienced higher revenue shares from general consumption taxes. At the same time, all the countries with reductions in the revenue shares of general consumption taxes have experienced lower tax revenue shares from all taxes on consumption. Some countries have experienced an increased share of revenues from general consumption taxes at the same time as a reduced share from taxes on consumption as a whole. This illustrates the fact that revenues from general consumption taxes (and VAT in particular) have grown faster across the OECD as a whole than all taxes on consumption.

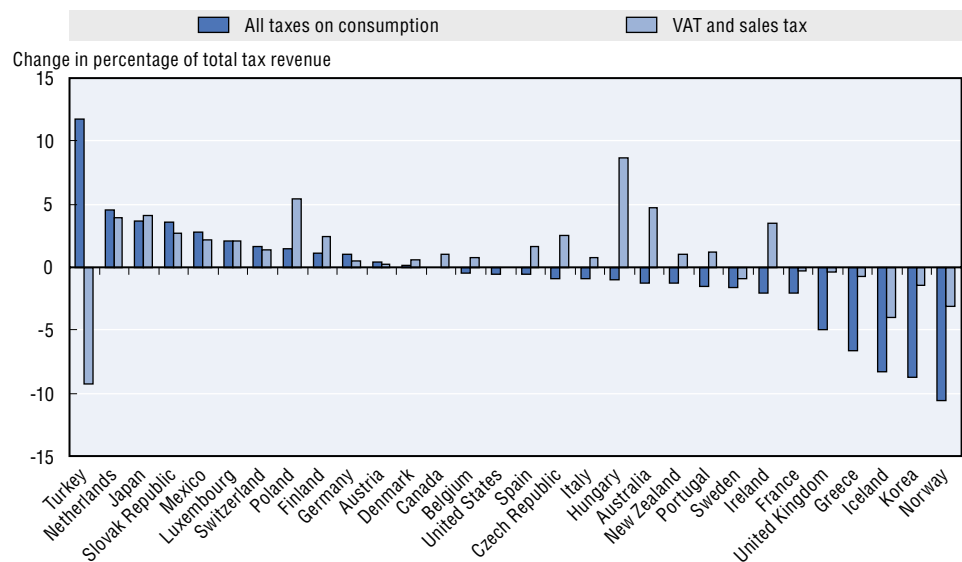
However, these data show that there is not yet any sign that a greater use of taxes on consumption is inevitable. Indeed, the trend over the past 40 years has been away from such taxes, although this trend has virtually stopped over the last decade. In contrast, the share of VAT has grown enormously although some countries have recently shown a reduction in the VAT revenue share, showing that its growth is not inevitable either. It remains to be seen whether a continuing increase in VAT will reverse the historically downward trend in the overall share of taxes on consumption. ■

**Do taxes on consumption promote growth?**

It is often claimed that taxes on consumption are better for growth than taxes on income. The main arguments relate to the way that different taxes affect savings and labour supply decisions.

The different treatment of savings between the two types of taxes is a key element here, with taxes on income subjecting savings to heavier taxation than taxes on consumption. A shift from taxes on income to taxes

**Figure 2.**  
**CHANGES IN REVENUE SHARES, 1995-2005**



Source: OECD, Revenue Statistics 1965-2006.

on consumption that does not change total tax revenue can be expected to encourage savings, leading to increased investment and growth. This arises because taxes on income often include both income that is saved and the income from savings. In contrast, taxes on consumption exclude savings but include the income from savings when it is spent. Of course, not all taxes on income treat savings in the same way: personal income tax systems sometimes give preferential treatment of savings and social security contributions generally exempt capital income.

Turning to the effect of the different types of taxes on labour supply, a “revenue-neutral” shift from taxes on income – particularly personal income tax – to taxes on consumption will not have much effect on the total taxes paid by typical workers and so is unlikely to affect their decisions as to whether or not to work. However, it will reduce their marginal tax rate (the additional tax that they pay when they earn – and spend – more) and thus increase the incentive for them to work additional hours. This is because taxes on income are generally progressive – taxing additional income at higher rates – while taxes on consumption are broadly proportional to income and expenditure. The shift towards taxes on consumption will therefore increase hours worked and thus economic growth.

There is, however, one distortion that is arguably introduced only by taxes on consumption. This is the distortion of the choice between consumption items. Taxes on specific goods and services target particular goods (such as alcoholic drinks) and VAT in most OECD countries is not uniform, often applying lower rates to “necessities”. This gives consumers an incentive to choose those goods and services that are relatively lightly taxed. However, the general view amongst tax economists is that this distortion of consumer choice is not as harmful to growth as the distortion of savings and labour supply. In addition, specific indirect taxes can be used to improve efficiency, for example in the case of taxes on pollution.

So, overall, these arguments provide strong support for the view that a move in the balance of taxation towards taxes on consumption would be likely to improve economic efficiency and increase growth. Additional arguments, based on the link between international competitiveness and economic growth are discussed below. ■

### **What about the gap between rich and poor?**

The efficiency advantages of taxes on consumption are normally associated with a widening of the gap between rich and poor (i.e. the redistributive effect of the tax system). This is clearest in the case of progressive taxes and its effect on labour supply. The difference between the marginal and the average tax rate makes taxes on income discourage labour supply more than taxes on consumption – and produces the redistributive effect of taxation. Therefore, if a move towards taxes on consumption would increase incentives to work, it would also increase inequality.

The situation is similar in the case of savings. In general for OECD countries, both savings and capital income are more highly concentrated at the top of the income distribution than labour income. Thus, while a move towards

taxes on consumption might improve the incentive to save, it would (by reducing the taxation of capital income) increase inequality.

It should be noted that other changes in the tax or benefit system could be used to offset some of these effects on inequality. For example, as mentioned above, many countries apply a reduced rate of VAT to certain “necessities” in order to reduce the tax burden on the poor. However, this is a relatively ineffective way of dealing with the problem as the rich typically consume more of the “necessities” than the poor. It also harms efficiency by distorting consumer choice. It is generally better to use the benefit system to offset any undesirable effects of tax changes on the poor, although these can also reduce efficiency.

Despite the possibilities of offsetting the effects on inequality, it is difficult to ensure that there are no poor people who lose out. It is this concern that causes the greatest opposition to the greater use of taxes on consumption. Indeed, a number of OECD governments have considered the possibility of moving more from direct to indirect taxation in order to promote economic growth but have felt that the effect on income distribution was socially unacceptable. ■

### Do indirect taxes improve competitiveness?

So far, we have ignored international trade and competitiveness, an issue that is much discussed in connection with a move from direct to indirect taxation (particularly VAT). It is argued that using an increase in VAT to reduce taxes on income improves a country’s international competitiveness because of “border tax adjustments” – a process that involves refunding the VAT already paid on exports and applying VAT to imports. This would increase economic growth and employment by increasing exports and reducing imports.

Of course, if all countries had freely floating exchange rates against each other, this would only have short-term effects (except for it favouring some industries over others) because any general competitiveness effect would eventually be offset by exchange rate adjustments. However, the world is not characterised by fully floating exchange rates and some groups of countries (such as the Euro zone) have common currencies.

The argument that taxes on consumption promote international competitiveness is made most strongly in the comparison between VAT and corporate tax. Corporate taxes increase the cost of capital and hence the cost of production, thus making it more difficult for the affected firms to compete in foreign markets. In contrast, VAT is refunded on export and so has no effect on the ability of domestic firms to export.

An argument can also be made in the case of using VAT to reduce employers’ social security contributions, thus reducing the costs of exporting and import-competing firms. This argument probably has considerable validity in the short-run for economies with high levels of unemployment. In this case, it would increase employment and add to the growth effects mentioned above. However, it is less likely to apply for countries with low levels of unemployment as labour shortages would develop and lead to an increase in wages, offsetting the reduction in social security contributions. ■

### Where do we go from here?

There are clear arguments both for and against the greater use of taxes on consumption. Experience shows that it is important for policy-makers to look further than the simple dichotomy between taxes on consumption and taxes on income to analyse the specific features of each tax in the context of their country. For example, the effect that taxes on consumption have on economic efficiency depends on whether they are broadly uniform or target specific goods, while the effect that taxes on income have on labour supply depends on how progressive they are. This means that each country's decision on how to vary its pattern of taxation involves detailed technical analysis but also a difficult political choice between greater economic growth and greater equality.

Several OECD countries have chosen to increase their use of taxes on consumption, and most of them have used VAT as the main instrument of change. However, other OECD countries have chosen to move in the opposite direction, simply using VAT to finance a reduction in taxes on specific goods and services, or even reducing the share of VAT. On average for OECD countries, there has been a decline in the share of taxes on consumption but this decline has almost come to an end, suggesting that countries are more convinced of the advantages of taxing consumption. Whether the trend is now reversed, so that the share of these taxes starts to rise, depends on how individual governments assess the likely effects on economic growth and competitiveness, and on whether they can find ways of reducing any effect of such a change on income distribution to an acceptable level. ■

### For further information

For more information on the OECD's work on the pattern of taxation, please contact:

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### For further reading

See [www.oecd.org/ctp/balance](http://www.oecd.org/ctp/balance) for documents from an OECD meeting in November 2006 on the balance between direct and indirect taxes.

OECD (2007), **Revenue Statistics 1965-2006**, ISBN 978-92-64-03834-9, € 120, 300 pages.

OECD (2006), **Fundamental Reform of Personal Income Tax**, OECD Tax Policy Studies, No. 13, ISBN 978-92-64-02577-4, € 30, 140 pages.

OECD (2006), **Consumption Tax Trends: VAT/GST and Excise Rates, Trends and Administration Issues**, ISBN 92-64-01417-9, € 28, 117 pages.

OECD (2004), **Recent Tax Policy Trends and Reforms in OECD Countries**, OECD Tax Policy Studies, No. 9. ISBN 92-64-01657-0, € 42, 170 pages.

OECD (2001), **Tax and the Economy: A Comparative Assessment of OECD Countries**, OECD Tax Policy Studies, No. 6. ISBN 978-92-64-19544-0, € 30, 75 pages.

For full information on the OECD's work on tax issues, see [www.oecd.org/taxation](http://www.oecd.org/taxation).

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The OECD Policy Briefs are prepared by the Public Affairs Division, Public Affairs and Communications Directorate. They are published under the responsibility of the Secretary-General.