

# Consumption Taxation

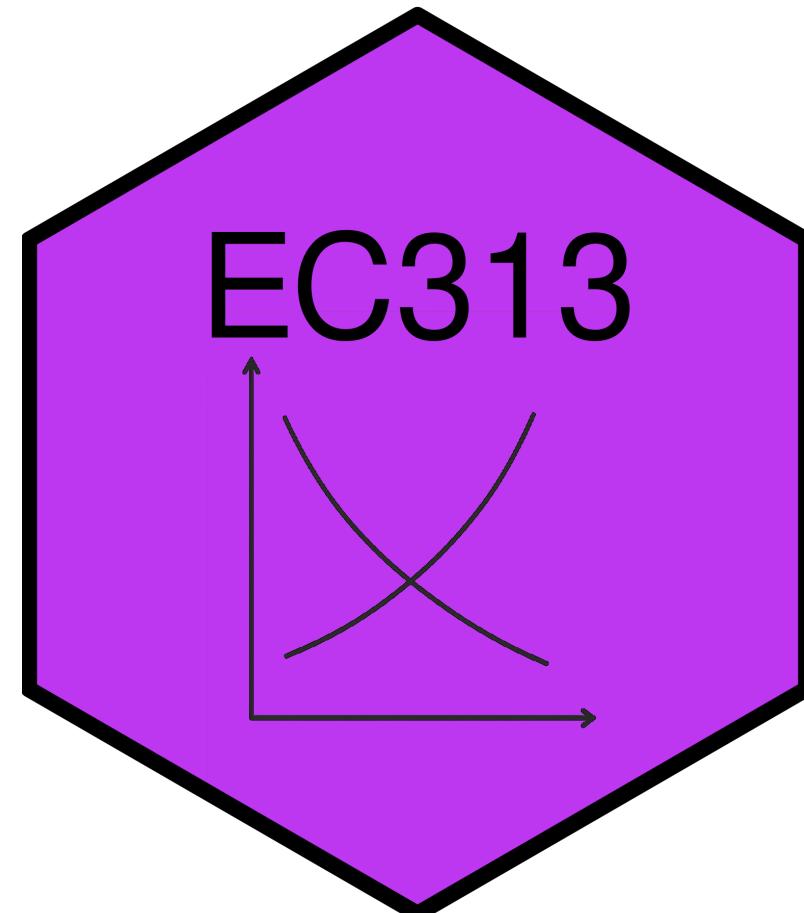
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EC313 - Public Economics: Taxation

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# Goals of This Section



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- Define and discuss types of consumption taxes
- Analyze the efficiency and equity implications of consumption taxes
- Introduce and discuss value added taxes and retail sales taxes
- Summarize Canada's consumption taxation
- Compare consumption taxes to income taxes



# Overview



# Introduction

- As we know, purchases of final goods are taxed
- These taxes are called **consumption taxes**
- There are several types charged depending on province of residence and the type of good or service purchased
  - They have features that distinguish them from each other
- In this section we outline the different types of taxes and discuss their merits

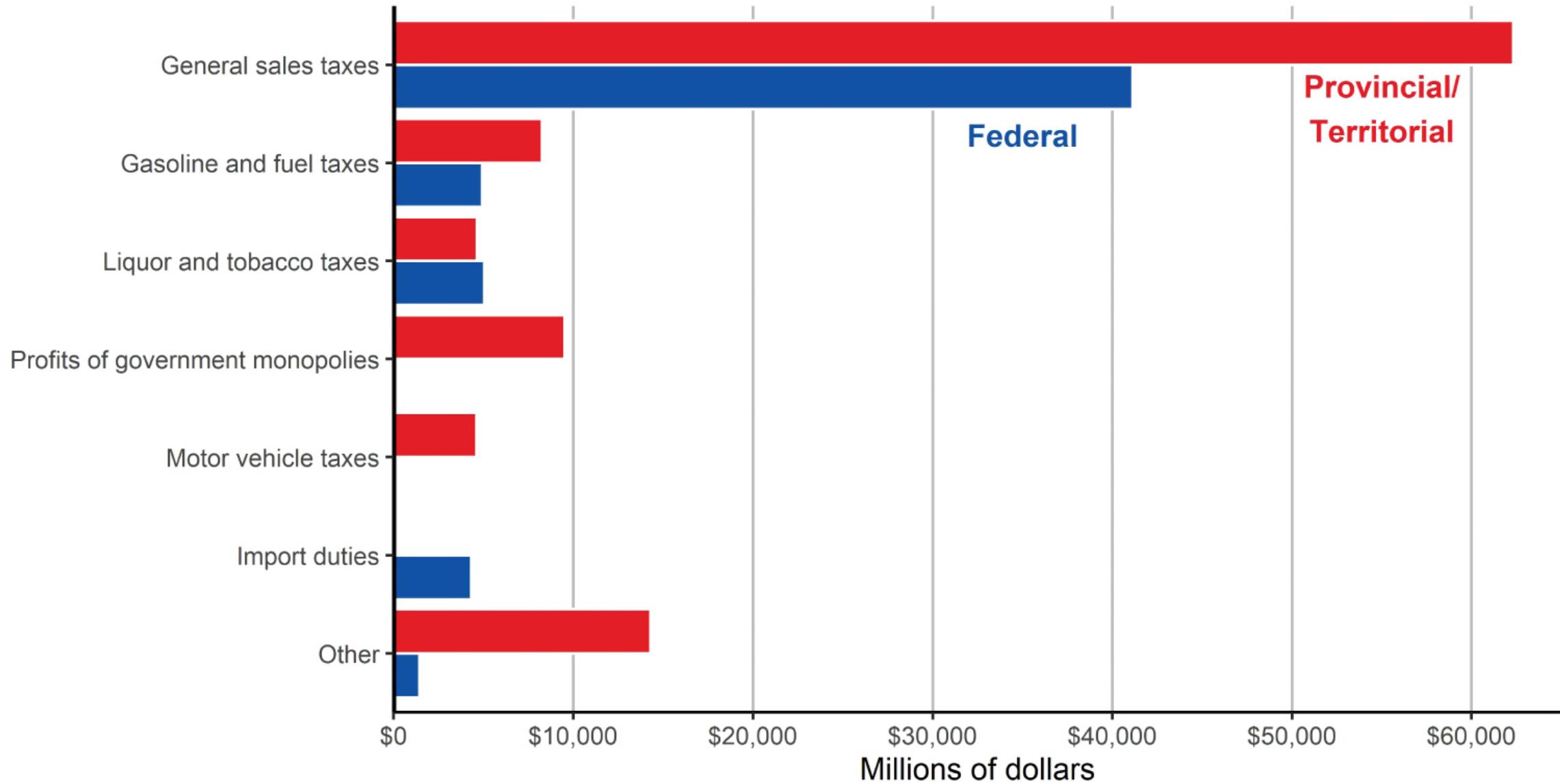


# Types of Consumption Taxes

- Value Added Tax (VAT)
  - Charged at each stage of production based on the value added at that stage
  - Used globally for taxation of consumption
- Retail Sales Tax (RST)
  - Charged only at the point of sale to the final consumer
  - Used in some provinces in Canada
- Excise Taxes
  - Charged on specific goods, often to discourage consumption (e.g., tobacco, alcohol)
  - Used in all provinces in Canada and by federal government
- Custom Duties (tariffs)
  - Charged on goods imported into the country
  - Used by federal government only



# Revenue from Consumption Taxes



# Reasons for Consumption Taxes

# Administrative Ease

- Relative to other taxes, consumption taxes are easy to administer
- Import duties are collected at the time of importation
  - In the past, relatively few items were imported
  - Much more now, but still straightforward to collect
- Sales taxes are collected from retailers
  - Lots of retailers to collect from, but less than for income tax
  - Some complications can arise for taxable and non-taxable goods
    - Example: Less than 6 baked goods at a time are taxable, but 6 or more is non-taxable
    - Some basic groceries are zero rated



# Efficiency

- Economists argue that consumption taxes are more efficient than income taxes
- Because they do not distort savings behaviour
  - Income taxes reduce the return to saving
  - Consumption taxes do not affect the return to saving
- Example on next slide illustrates this using two period model
  - Assume individuals live for two periods
  - One person earns income in period 1 and consumes it all
  - Another person earns income in period 1, saves some, and consumes in period 2
  - Tax rate on income is 50%, tax rate on consumption is 100%, and interest rate is 10%



# Efficiency

	Inc Tax Homer	Inc Tax Marge	Cons Tax Homer	Cons Tax Marge
Item				
Income in period 1	100.00	100.00	100.00	100.00
Taxes in period 1	50.00	50.00	50.00	26.19
Consumption in period 1	50.00	25.61	50.00	26.19
Savings in period 1	0.00	24.39	0.00	47.62
Interest earnings in period 2	0.00	2.44	0.00	4.76
Taxes in period 2	0.00	1.22	0.00	26.19
Consumption in period 2	0.00	25.61	0.00	26.19
PDV of taxes	50.00	51.11	50.00	50.00

# Efficiency

- Under the income tax
  - Saving is discouraged because the return is less
  - Marge pays more in present discounted value of taxes (51.11) than Homer (50.00)
    - So there is a lack of horizontal equity
    - Marge and Homer are not taxed the same for the same lifetime income
- Under the consumption tax
  - Saving is not discouraged because the return is unaffected
  - Marge and Homer pay the same present discounted value of taxes (50.00)
    - So there is horizontal equity
    - Marge and Homer are taxed the same for the same lifetime income

# Efficiency

- There is still an excess burden from the consumption tax
  - Consumption tax distorts choice between consumption and leisure
  - People will substitute towards leisure, creating excess burden
- Studies show that the consumption tax has lower excess burden than income tax



# References



# References

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