When an estimate is not good enough: Taxing the consumption of housing

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Words such as “consumption” and “consumer” are readily used today. Consumption is a part of our daily lives. The society that we live in is often referred to as a “consumer” society. Increasingly more goods and also services are being made available for us to consume. New and better prototypes are released, and there is a human tendency to want more goods and services than what we need. A whole discipline has developed around marketing products to consumers, and studies are undertaken as to what consumers really want. The words “consumption” and also “consumer” are referred to today in many disciplines. So much so that to survey the use of these words across the disciplines would result in a long list of variations in the ways that these words are used, and the means which are attributed to them.

At the same time that we as a society become more interested in purchasing more and more goods and services, consumption is increasingly being used as a tax base by countries around the world. While once the consumption of a small range of luxury items was sometimes taxed at a fairly low rate, now over 150 countries have a VAT/GST system which functions as a broad tax system, taxing the consumption of most goods and services.

Given that the word “consumption” has become such a readily used term in society it could easily be assumed that now it must not be difficult to measure consumption and also to tax the consumption of a wide range of goods and services. However in this paper I will explain that sometimes there are situations where the VAT/GST charged on a good or service is reflective of an estimate only of the value of the consumption of that good or service. In these situations the estimate produced will not necessarily equate to an accurate reflection of the value of consumption.

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2 For example, the Treasury has written that ‘[a]t federation, the Commonwealth levied excises (taxes) on domestic production and tariffs on imported goods. These were typically commodities with clearly identifiable and easily controlled sources, such as alcohol and tobacco. Many of these commodities were also everyday consumption goods including starch and sugar.’: Australia’s future tax system, Architecture of Australia’s tax and transfer system (2008), 277. For a fuller history of the use of excise taxes around the world see Cnossen Sijbren, Excise systems: A Global study of the selective taxation of goods and services (1977), 1.
The main problem that I will explore in this paper is that it is not clear how to treat goods or services which are used both for consumption purposes as well as for savings and investment. It is the conceptual basis of the VAT/GST to only tax consumption. However, in this paper I refer to existing economic literature which makes it clear that savings and also investment are not consumption. Instead, these are other uses which can be made of a good. It is also clear from this literature that over the life of a good it may be used not just for consumption purposes, but also for savings as well as investment purposes. However, it is not clear how to treat goods for VAT/GST purposes which are used for more than one of these three purposes. This confusion can result in under or over taxation. Here there is a clear role for the law to play in developing rules to clarify how to tax the consumption of goods which can be used for more than one of these three purposes.

Related to the problem that we cannot precisely value the consumption of goods which are used both for consumption as well as for non-consumption related purposes, a more specific issue that I will discuss in this paper is the approach which is used to tax the consumption of durable goods at the time of sale. This approach may not result in an accurate amount of tax being charged on the consumption of these goods or the related services which are provided. At the time that goods are purchased it can be difficult to determine how long particular consumers may consume these goods. To address this issue which relates to taxing the consumption of durable goods, legal rules have been put in place so that the first consumer is said to “prepay” the VAT/GST which is chargeable on future consumption. These rules also ensure that later sales of goods from consumer to consumer are not subject to VAT/GST, although theoretically later consumers bear VAT/GST on their consumption, as future consumption is supposed by economists to be built into the price at which second hand goods are sold. However, the problem is that the price which is paid by the first consumer for a good cannot be perfectly predictive of the price at which future consumers will purchase the good, i.e., the price at which future consumers will value their own consumption. The “prepayment” system is a simple way in which to charge VAT/GST. However, it is not necessarily the most accurate way in which to tax consumption.

In this paper I will discuss how both of these situations can lead to consumption not being taxed accurately. I will also discuss whether there might be a better way to tax consumption. In discussing these issues I have chosen to refer to the VAT/GST treatment of housing as an interesting case study. This is because the VAT/GST treatment of housing is affected by the two problems which are mentioned above, which I will discuss in detail as they affect whether consumption can be taxed accurately. Housing is a particularly important supply to discuss for three main reasons. First, there
are many supplies of housing. Second, housing is a high value good. Third, it is generally a long-lived good, and the value of housing can change over time. These three reasons mean that it is particularly important to question whether the current VAT/GST treatment of housing can lead to accurate amounts of tax being charged.

1 What is consumption, as opposed to savings and investment?

Economists have generally recognised that goods can be used for three purposes. Goods can be consumed. They can be saved. They can also be used for investment purposes. Since the base of the VAT/GST is consumption, the effect of this tax should be that only consumption should be taxed. However we need to have a clear understanding of what is consumption, as opposed to savings and also investment, so as to ensure that it is only consumption which is taxed. After discussing briefly the main economic literature regarding the meaning that is given to these terms I will explain in this section that it is not clear how to tax only the consumption of goods when they can be used both for consumption as well as non-consumption purposes.

One of the key explanations of the relationship between consumption, savings and investment can be found in the writings of American economist Henry Simons, who wrote in 1938 in *Personal income taxation: The definition of income as a problem of fiscal policy* that ‘[i]ncome is not saved or spent; it is rather a measure of saving and consumption together.’ Simons also wrote that ‘[p]ersonal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value in the store of property rights between the beginning and end of the period in question.’ Similarly, Simons also wrote that that ‘[t]he appropriate general consumption of income... may be defined as the algebraic sum of the individual’s consumption expense and accumulation during the accounting period’. So if we were to write Simons’ hypothesis as an equation, we might write it as:

\[ Y = S + C \]

Where \( Y \) = income, \( S \) = saving and \( C \) = consumption

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3 This has been recognised by Randall Schwartz, who has written that ‘real property has a long life, which ranges from infinite in the case of land to decades or centuries for buildings. ...The sheer number of individuals involved making infrequent transactions adds to the complexity of administering the tax.’: Randall Schwartz, ‘The VAT and Housing’ (1989) 47 University of Toronto Faculty of Law Review 718, 724.


5 Ibid, 50.

6 Ibid, 206.
Simons’ explanation of the meaning of income has more recently been reformulated by English economist Nicholas Kaldor in 1955 in his book *Expenditure Tax*. While Simons had written about income being made up of consumption and also savings added together, Kaldor wrote that ‘[i]ncome is consumption less net saving’, which could be written as an equation in this way:

\[ C = Y - S \]

The effect of these formulas is identical. Kaldor has just re-ordered the terms. In both cases the two economists are suggesting that if we take income and subtract any amount that has been put into savings then the remainder must be that which has been consumed. Other scholars have since accepted these formulas.

More recently, in 1993, in an article explaining the potential effect of a tax mix change in Australia, economics professor John Freebairn wrote the formula in the following way:

\[ Y = C + S = C - I \]

where \( Y \) is income, \( C \) is consumption, \( S \) is saving and \( I \) is investment.

Here, Freebairn is pointing out that “savings” and “investment” are two terms which mean the same thing. His analysis appears consistent with earlier economic discussion regarding the meaning of these terms. For instance, it is consistent with the writings of the early twentieth century economists John Maynard Keynes and Irving and Herbert W. Fisher.

In 1936 in *The General Theory of Employment, Interest and Money* Keynes had defined “current investment” as ‘the current addition to the value of capital equipment which has resulted from the productive activity of the period.’ He wrote that “investment” is a concept which is equal to “savings” as savings ‘is equal to that part of the income of the

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8 For instance, American law professor Joseph Dodge recently described the Simons formula as ‘a gold standard of income tax theory and policy discussion.’: Joseph M. Dodge, ‘Deconstructing Haig-Simons income and reconstructing it as objective ability-to-pay income’ (2012) 13(42) Tax law and policy eJournal, 1.
period which has not passed into consumption.’11 Therefore this would suggest that savings and investment are the same thing.

In 1942, in *Constructive income taxation: A proposal for reform*, Irving and Herbert W. Fisher proposed a “yield” or “spend-ings” tax. They suggested that taxable spending could be calculated by adding gross gains from all sources, and then deducting all items of outgo other than “spending”.12 In discussing “items of outgo” the Fishers defined “investments” as ‘all property owned by the taxpayer for the purpose of bringing him cash and not for the purpose of personal use, or “consumption”’.13 This seems to be a broad interpretation of investments. If we were to apply such a broad interpretation to a transaction such as a deposit into a bank account, such an interpretation would mean that the transaction would be regarded as an “investment”, even though we may also regard it as a “saving”.

The idea of the terms “savings” and also “investment” meaning the same thing is one reason to suggest that the Simons and Kaldor explanations of the relationship between consumption, savings and investment, while simple in theory, may not provide adequate answers to issues which arise in determining the meanings of these terms in practice. For instance, what is the boundary between “consumption”, “savings” and “investment” in relation to a good which displays characteristics of being able to be consumed, as well as being used for savings and/or investment? In his treatise regarding the meaning of income Simons wrote that what is income is important as this term ‘must be conceived as something quantitative and objective. It must be measureable; indeed, definition must clearly imply an actual procedure of measuring.’14 Given the wide use of the concept of consumption as a tax base it would seem logical for these arguments to also apply in respect of measuring consumption.

However academic discussion regarding the meaning of the concepts “consumption”, “savings” and “investment” does not assist us in determining how much VAT/GST should be charged in relation to the consumption of a house, for example. This is the case for two main reasons. First, there is an unanswered question as to whether housing can in fact be consumed. This is because in some ways housing does not fit within traditional ideas of what is consumption. For instance, the economist Kenneth E. Boulding has written about how the traditional understanding of economists was that

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11 Ibid, 33.
13 Ibid, 33.
14 Simons, ‘Personal income taxation: The definition of income as a problem of fiscal policy’, above n 4, 42.
consumption involved the destruction of goods. However, he has written that ‘[n]ot all destruction is consumption, the destruction of a loaf of bread by digestion, or of a suit by abrasion, is presumably somewhat different in character from the destruction of a building by fire’. In this way Boulding suggests that the digestion of a loaf of bread or abrasion of a suit is consumption, but the destruction of a building by fire is not. Therefore he suggests that applying traditional economic thinking to practical situations may not always be an appropriate way to work out whether an activity involves consumption. If our understanding of what is and what is not consumption is uncertain then we cannot be sure that we are accurately taxing this concept when consumption is used as a tax base. This is a big problem as it suggests that our understanding of what is consumption, based on existing economic literature, does not reflect the way that we consume goods and services today.

The second reason why academic discussion regarding the meaning of the concepts “consumption”, “savings” and “investment” does not assist us in determining how much VAT/GST should be charged in relation to the consumption of a house is that looking further at the way in which housing is used it would be fair to say that if housing can be regarded as being used for consumption purposes then it would also be reasonable to say that it can be used for non-consumption related purposes as well. Academic discussion relating to the differences between these terms may not help us in isolating and valuing just the consumption component. American economist Robert F. Conrad, for example, has written that:

Real estate plays a dual role of consumption and investment in any economic system. A significant share of the net worth (or savings) of individuals in any economy is held in the form of housing. Under an ideal VAT a distinction should be made between the “consumption” benefits and the “investment” benefits of real-estate ownership.

Given that it is possible to live in a house for some time, a house would seem to be a good example of a durable good that owners can accrue savings from. Housing can also be regarded as an “investment” good, as housing can be rented out and also owners can benefit from appreciation of the value of housing. However VAT/GST systems are not perfect, and given current understanding regarding what is consumption as opposed to

15 This understanding of consumption is also reflected in the writings of Alvin Warren, who has described “consumption” as meaning the ultimate use or destruction of economic resources ‘as by drinking of a glass of wine’: Alvin Warren, ‘Would a consumption tax be fairer than an income tax?’ (1979) 89 Yale Law Journal 1081, 1084. Irving and Herbert W Fischer also aligned the ideas of consumption and destruction. They wrote that ‘[l]iterally and etymologically, “consumption” should mean destroy-ing goods by use-using them up, wearing them out.’: Fisher and Fisher, ‘Constructive income taxation: A proposal for reform’, above n 12, 24.
investment or savings it is difficult to differentiate between these types of uses of a house, and to ensure that it is only the consumption of a house which is taxed.

American law professor Alan Schenk has discussed the VAT/GST treatment of some mixed investment-consumption goods. However Schenk has focused his analysis on the tax treatment of goods which can be moved. In this respect Schenk has recommended that "[i]f the goods are displayed at home, their use may be viewed as predom-antly consumption, and thereby taxable, but... [i]f stored in a vault may be held predominantly for investment and therefore should not be subject to VAT."18 Therefore Schenk has recommended a way for the law to deal with this otherwise problematic issue of how to treat goods for VAT/GST purposes which are used for consumption as well as non-consumption related purposes by recommending the adoption of a predominant use test. However how to treat the consumption of high value goods such as housing, for example, may be more complicated than looking at the predominant use of the good, as applying a predominant use test may result in a large amount of under or over taxation. Housing is described in the Mirrlees Review report as a homeowner’s ‘most valuable asset.’19 Therefore certainty in the appropriate VAT/GST treatment of housing is important to both tax collector as well as taxpayer.

2 How the idea of consumption applies to durable goods

There are two main reasons why the consumption of durable goods such as housing can be difficult to measure. First, there is the fact that consumption can occur over a period of time. For example, Irving and Herbert W. Fisher have written about how ‘[c]ars, dwelling houses, diamonds and clocks may be used for years without being used up.’20 Second, durable goods can be consumed at different times by different consumers. These two facts mean that it is difficult to estimate how much consumption tax a particular consumer should pay. As a result, a legal proxy is used to determine this.

What I mean by a legal proxy is that rules are generally embedded in VAT/GST systems so as to ensure that VAT/GST is charged at the time that goods are first supplied from business to consumer, and not on later supplies between consumers. This means that VAT/GST is charged at a particular point of time, (i.e., the first sale of a good), rather than over a period of time via later sales of the good. This approach to charging VAT/GST is often referred to as the “prepaid method”, and it is the method which is generally used to charge VAT/GST in respect of many goods and also services,

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18 Alan Schenk, ‘Value added tax: Does this consumption tax have a place in the Federal tax system?’ (1987) 7(2) Virginia Tax Review 207, 257.
including in respect of the supply of housing. American economist David F. Bradford described in a chapter about ‘A model tax based on consumption’ that:

- the price paid for a consumer durable should reflect the present value of future services the buyer expects to receive. Including the value of durable goods in the tax base at the time of purchase, in effect a prepayment of the tax on the value of future consumption services.\(^{21}\)

However, taxing consumers on the first sale of a good and then assuming that the appropriate amount of VAT/GST will be passed on in terms of future sales only reflects the value that a consumer may put on a good at a particular time, and the consumer’s willingness to pay this price. Also it is impossible at the time that a good is first supplied from business to consumer to know for how long a good will be used for. For example, American law professor Robin Feldman has written that a sweater that you purchase ‘may never be worn, let alone worn out’\(^ {22}\). Further, the initial amount of VAT/GST that is charged may not reflect the fact that over time the value placed on a good may rise or fall, either due to the market or due to deliberate changes which are made to the good, such as repairs or renovations. If the VAT/GST which is factored into the price which is charged to a consumer does not reflect the consumer’s actual consumption of a good, this can create a “windfall” to consumers.\(^ {23}\) Or it can result in consumers paying too much VAT/GST.

3 Is there a better way to tax consumption?

I have discussed above that the use of the prepayment method in connection with taxing consumption may not result in an accurate amount of consumption being taxed. Problems include that the use of this method can result in a consumer being under or over taxed, as the tax that a consumer pays does not necessarily reflect how long he or she may use a good for. The amount of tax that a consumer pays when this method is used may also not accurately reflect how the value of a good may rise or fall over the time that it is used.

It has generally been recognised that there are two possible ways to tax the consumption of housing. One way is to use the prepayment method as I have discussed in the previous section. Another way is to tax the consumption of housing on an annual basis. The fact that there are these two ways in which to tax consumption has been recognised


\(^{23}\) Schwartz, ‘The VAT and Housing’, above n 3, 725.
in famous tax reviews such as the Mirrlees review in the United Kingdom, and also the report Blueprints for Basic Tax Reform in the United States.\textsuperscript{24}

This second method of taxing the consumption of housing, involving taxing consumption on an annual basis, has become commonly known as the method of taxing “imputed rent”. In a recent Treasury consultation paper regarding Australia’s future tax system, Dr Ken Henry described imputed rent as ‘the value housing provides to an owner-occupier’\textsuperscript{25} and ‘the benefit from not having to pay rent to reside in that dwelling’\textsuperscript{26} Further, imputed rent has been described by Australian law professor Miranda Stewart as ‘[t]he hypothetical rent that a home-owning household would pay to itself if it were treated in the tax law as both a landlord and a tenant.’\textsuperscript{27} This method of taxing imputed rent is therefore a method which reflects the understanding that owning housing is akin to an investment. Stewart describes how if a VAT/GST were to be used to tax imputed rent then it would involve ‘treating the homeowner as simultaneously both ‘landlord’ and ‘tenant’ in the home.’\textsuperscript{28}

The idea of taxing imputed rent is not a new concept. It is a concept which has been written about by economists for a long time. In 1936 in First principles of public finance, Italian economist Antonio De Vito De Marco had considered taxing the annual value of a residence, and he suggested that the annual tax could be calculated on a resident’s ‘direct utility, divided by the number of years the residence lasts.’\textsuperscript{29} De Viti also wrote in regard to “direct goods of repeated utility” that ‘it is technically possible, as a matter of accounting, to distribute the cost, the consumption, and the tax over the period during which such goods last, instead of making these items refer to the initial moment of production.’\textsuperscript{30} In 1938 Simons wrote in relation to income that “[t]he measurement of income implies allocation of consumption and accumulation to specified periods.”\textsuperscript{31} In 1955 Kaldor suggested exempting the original purchase of housing from expenditure tax and imposing an annual charge on the value of the benefit that derived from its possession.\textsuperscript{32} In 1978 the idea of assessing imputed annual values for the purpose of national income was considered in the Meade Report, in the United Kingdom, and it was suggested that this approach could also be used for consumption tax purposes.

\textsuperscript{24} Bradford, ‘Blueprints for Basic Tax Reform’, above n 21, 32.
\textsuperscript{25} Ken Henry, Australia’s future tax system: Consultation paper (2008), 206.
\textsuperscript{26} Ibid.
\textsuperscript{27} M Stewart, ‘Taxation policy and housing’ in International encyclopedia of housing and home (2012) vol. 7, 152.
\textsuperscript{28} Ibid.
\textsuperscript{29} Antonio De Vito De Marco, First principles of public finance (1936).
\textsuperscript{30} Ibid, 257.
\textsuperscript{31} Simons, ‘Personal income taxation: The definition of income as a problem of fiscal policy’, above n 4, 50.
\textsuperscript{32} Nicholas Kaldor, Expenditure Tax (1955), 196.
It was also suggested that ‘in the case of very long-lived goods such as housing, consumption occurs over such long periods that we might prefer to levy a tax as consumption occurs rather than when the house is first built and sold.’ More recently in 2011 in another tax review which occurred in the United Kingdom, the Mirrlees Review, it was written that ‘[i]deally, if a house delivered more (less) valuable services than was originally envisaged and built into the purchase price, we would like to tax (subsidize) this difference.’

However existing examinations regarding the viability of taxing annual imputed values have involved fairly normative propositions. For instance, in the Mirrless review report it was concluded that it may be possible to value land (and presumably buildings) on an annual basis, as forms of land valuation are performed in various countries. However no firm proposition was made about how this should be done. Economists such as Sijbren Cnossen have tended to accept the prepaid method as a ‘second-best solution’.

The potential administrative problems which would occur in collecting tax from imputed rental values on an annual basis seem to be the main reason why as yet there is no country which taxes the consumption of housing in this way. Kaldor, for instance, has explained that there has been:

persistent conviction that studying the merits of such a tax was largely an academic exercise – for it was taken for granted that the administrative difficulties involved in assessing people on their spending was too great for this ‘ideal’ system of taxation to be put in place.

Scepticism about the administrative difficulties that would result from using such a method to tax consumption seems to have arisen from two main sources. One is concern that the use of such a method would give rise to a similar situation experienced when many countries previously charged income tax on imputed values. For example, the United Kingdom had such a system for about half a century until 1963, when the use of this system was terminated because the post-world war surge in homeownership made collection of such a tax far more difficult. Economics professor Paul Merz, for instance, writes that:

[d]ifficulties with the British tax in-creased with intensity with the freezing of valuations for the World War II period and the reluctance of the tax authorities to correct these

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37 Kaldor, ‘Expenditure Tax’, above n 7, 11.
valuations thereafter (reassessment of the late 1930 value did not take place until 1963).  

This leads to the other main argument that is made regarding administrative difficulties that may be experienced if a system of taxing imputed values is used. This is that some goods may be difficult to value. For instance, Simons wrote in this respect that there are few ‘goods or properties which can be valued accurately by recourse to market prices.’ However whilst this may have been true in the 1930s it does not appear to be the case today.

There is one other argument against taxing imputed values and that is the hardship that may result. In Australia’s Asprey review report in 1975 an example that was given was that ‘a widow with young children may have been left the family home, now freed of mortgage by proceeds of an insurance policy taken out by her husband, but she may have only modest cash income and few other assets.’ Taxing imputed values would mean collecting taxes from a wide range of individuals on a yearly basis and may be a system which could be difficult for people whose cash income are low. Also any proposal to tax imputed values would come up against political support for excluding used housing from the tax base, such as arguments about housing affordability and encouraging people to own their own homes. However excluding supplies of used housing from the consumption tax base, as is the case at present, can result in distortion of consumer choices, with consumers preferring to buy used rather than new houses. This means that the understanding held by some consumers is likely to be artificial, as VAT/GST paid for supplies of housing is passed on in the price of used housing.

Potential hardship was also an argument against originally using consumption as a tax base. For instance, American law professor Edward J. McCaffery has written about how policy makers in the early twentieth century:

rejected a wide range of consumption tax alternatives, in part because of the fact that consumption typically forms a higher percent of disposable income for the lower- and middle-income classes than it does for the upper-income class... This led to a “base argument” for income taxation.  

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McCaffery has written about how income tax was generally imposed in the early twentieth century at relatively low tax rates but the need of the Government for funding during war time saw a ‘radically altered… rate schedule’, and the breadth of the application of income tax was expanded ‘enormously once the practical expedient of wage withholding was discovered.’ Now the use of VAT/GST has also increased. The OECD has written that VAT/GST ‘raises 20 per cent of the world’s tax revenue and effects about 4 billion people’. VAT/GST is a considerable source of tax revenue in many countries and we now have more developed skills and ability then we may have had in the past to define tax bases and to develop rules to ensure the accurate taxing of consumption. Therefore it is time to revisit the possibility of using this method of taxing imputed values. Even with the introduction of more taxes and also increasingly complex tax laws the administration of tax has in recent decades become much easier than it was before, partly due to the increasing use of technology. It is time to look further into the idea of taxing annual imputed values. Is it practical for this to be done? Would it result in a more accurate reflection of the true amount of consumption used during a period being taxed? If so, would the end result achieved outweigh the costs involved?

**Conclusion**

In this paper I have raised important questions about how appropriate our current approach is to taxing consumption. Particularly I have suggested that this approach may not result in an accurate amount of consumption being taxed in regards to the use of goods for consumption as well as non-consumption related purposes and also in relation to durable goods. I have questioned whether there may be a more appropriate way to tax the consumption of these goods, and I have suggested that it may be possible to tax consumption more accurately. My overall suggestion offered in this paper is that given the amount of tax revenue affected this issue is worthy of further exploration.

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42 Ibid, 834.
43 Ibid.
44 OECD, Consumption Tax Trends 2012, 50.
45 The OECD had written that ‘[c]onsumption taxes form an important source of revenue for an increasing number of governments. They now account for 30% of all revenue collected by governments across the OECD. Value added taxes... are the principal form of taxing consumption in 33 of the 34 OECD member countries... and account for two thirds of consumption tax revenues.’: Ibid, 8.