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THE EVOLUTION OF CONSUMPTION TAXES AND THEIR IMPACT ON THE ECONOMY: VAT VS SALES TAX

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Abstract

The evolution of consumption taxes, particularly Value Added Tax (VAT) and Sales Tax, has played an important role in the country's revenue structure and its impact on the economy. VAT, where tax is levied on value added at every stage of production and distribution, is different from Sales Tax which is levied only at the final stage of sale to consumers. While both taxes aim to generate revenue, they have different mechanisms, administrative efficiency, and economic effects. VAT is considered more effective in generating revenue without disrupting significant economic activity, while Sales Tax is often criticised for its regressive and potentially distortive nature. The study conducted in this research uses literature research method. The results show that while consumption tax provides a stable source of revenue and increases taxpayer compliance, its structure can have a negative impact, particularly on low-income families, due to its regressive nature. Further investigations address the impact of consumption taxes on consumer behaviour and market dynamics, highlighting how the structure of tax rates affects the affordability of goods and consumer choice. Finally, this study offers suggestions for policy formulation with a balanced approach to ensure that the social and economic benefits of consumption taxes are maximised, while mitigating potential unintended consequences that could hamper overall economic growth.

Keywords: Evolution, Consumption Tax, Economy, Vat Vs Sales Tax.

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Introduction

Consumption taxes are an important part of many countries' taxation systems. As a major source of revenue for the government, consumption taxes also play a role in directing the country's economic and social policies. Sales Tax and Value Added Tax (VAT) are two of the most common forms of consumption taxes applied worldwide (Acosta-Ormaechea & Morozumi, 2021).

Sales Tax is a type of direct tax imposed by the government on the sale of goods and services. This tax rate is applied as a percentage of the selling price of goods or services purchased by consumers. Sales Tax is a single-stage tax that is only levied on transactions at the final level of sale to the final consumer (Adandohoin, 2021). The nature of this tax makes it relatively simple to collect and administer by merchants or companies selling goods and services. Its implementation creates transparency for consumers, as they can see the amount of tax they have to pay at the time of the transaction. However, the one-stage nature of Sales Tax is often criticised for encouraging tax evasion and price gouging at the consumer level (Adegbie et al., 2020).

Value Added Tax (VAT) is a tax system imposed on the added value generated at each stage of production and distribution of goods or services. Unlike Sales Tax, VAT allows the deduction of input tax from output tax, so that tax is only levied on the added value of the product at each stage (Afonso et al., 2021). In this way, VAT avoids the double taxation problem that often occurs in the Sales Tax system. The VAT system is considered one of the most efficient methods of collecting consumption tax revenue as it reduces incentives for tax evasion and ensures tax collection at every stage of the production and distribution cycle. However, the complexity of managing and administering VAT is a challenge, requiring strict record-keeping and reporting systems from businesses (Agrawal & Fox, 2021).

Both have different characteristics, collection mechanisms, and effects on the economy. VAT, which is a multi-stage tax system, is considered more efficient and reduces the potential for tax evasion. On the other hand, Sales Tax, as a single-stage tax levied at the final point of sale, is often considered simpler and easier to implement (Ahmad, 2021).

The diversity of opinions and findings from research on the effectiveness and economic impact of these two types of consumption taxes has led to an ongoing debate on which one is superior. There are countries that have successfully increased revenue and economic growth with the implementation of VAT, while some others have prospered by using Sales Tax (Alshira'h et al., 2020). While some economists propose VAT because of its broader tax base and low likelihood of tax evasion, others highlight the transparency and manageability of Sales Tax as reasons to retain it (Anderson & Rees, 2023).

In Indonesia, the implementation of VAT has been ongoing for decades and continues to undergo various reforms to improve efficiency in its collection and administration. However, there are still criticisms and difficulties that arise, especially in terms of implementation and its impact on small and medium-sized businesses and its effect on the consumption level of the general public (Andrejovská et al., 2020).

In that context, it is important to understand the origin, evolution, and impact of each consumption tax to help policymakers decide which tax system is more suitable for the current economic conditions, in terms of efficiency, tax fairness, and contribution to economic stability and growth (Aneja et al., 2021). Therefore, this study aims to provide a comparative analysis between VAT and Sales Tax in the context of their impact on the economy.

Research Methods

The study conducted in this research uses the literature research method. The literature research method is an approach used to collect, review, and analyse secondary data sourced from scientific publications such as books, journals, articles, theses, and other text sources. This method aims to gain an in-depth understanding of a topic or research question through a critical review of existing literature. (Abdussamad, 2022); (Adlini et al., 2022); (Afiyanti, 2008).

Results and Discussion

Consumption Tax

Consumption Tax is a type of tax levied on spending on goods or services, usually implemented as an indirect tax imposed on sellers or producers and then passed on to consumers in the form of higher prices. Common forms of consumption taxes include Sales Tax and Value Added Tax (VAT) which work by adding a certain amount to the selling price of goods and services, effectively making consumers pay the tax as part of the purchase price (Artinger, 2020). Their purpose is to generate revenue for the government from consumption activities, and they are often regressive, meaning that they impose more on consumers with lower incomes relative to their expenditure (Ashiedu et al., 2022).

Consumption taxes have existed since ancient civilisations. For example, in Ancient Egypt and Rome, there were taxes levied on goods such as oil and meat. In the Middle Ages, customs duties on goods entering and leaving cities were common. The formation of modern nation-states in the Renaissance brought standardisation to tax systems, including consumption taxes (Baker et al., 2021). In those days, taxes were often imposed as tariffs on imports and exports. However, consumption taxes as we know them today - specifically Sales Tax and Value Added Tax - were introduced in the early and mid-20th century (Benzarti et al., 2020).

The biggest evolution in consumption taxes occurred with the introduction of Value Added Tax (VAT) in France in 1954 by Maurice Lauré. VAT was a conceptual revolution in the consumption taxation system as it allowed companies to credit taxes already paid on purchases, against taxes that had to be collected on sales, reducing the economic distortions generated by previous consumption taxes (Blasco et al., 2023). The VAT system quickly became a popular model worldwide due to the efficiency of its collection and the relatively low difficulty in evading tax payments. Today, consumption tax in its various forms is a major source of revenue for many governments, providing funding for a wide range of public services and infrastructure projects (Buettner & Madzharova, 2021).

In Indonesia, the evolution of consumption tax has gone through various important stages in line with economic development and the country's fiscal needs. The origins of taxation on consumption can be traced back to the colonial era, where the Dutch colonial government imposed various types of indirect taxes, such as import, export, and excise taxes on certain goods (Buettner et al., 2023). At independence, Indonesia inherited this taxation system and continued to develop it to adjust to the country's changing socio-economic conditions. Sales Tax on Luxury Goods was introduced as a form of consumption tax to regulate the consumption of certain goods considered luxurious. However, Indonesia's taxation system underwent a major transformation with the introduction of Value Added Tax (VAT) in 1984, following global practices and aiming to increase state revenue from the consumption sector in a more efficient and structured way (Bunn et al., 2021).

VAT in Indonesia represents a significant step in modernising the country's consumption tax system, providing a framework for transparent and fair taxation of goods and services. Since the introduction of VAT, there have been several changes and adjustments to accommodate economic dynamics and maximise the effectiveness of tax as a fiscal tool (Buterin et al., 2023). These include adjustments to tax rates, expansion and specialisation of tax objects, and improvements to administrative systems to prevent tax evasion and broaden the tax base. Furthermore, with the rise of electronic commerce, Indonesia has also taken steps to adapt its regulations, such as the introduction of rules on Value Added Tax on digital transactions, ensuring the booming digital economy continues to contribute to state revenue (Cashin & Unayama, 2021). These efforts reflect Indonesia's commitment to continuously update and adapt its consumption tax system to suit the changing needs and challenges of the economy (Castelló & Casasnovas, 2020).

In conclusion, the evolution of consumption tax in Indonesia is a reflection of the country's efforts to adjust to global and local economic dynamics, as well as the need to optimise state revenue sources. From the colonial legacy tax system to the modern Value Added Tax (VAT) adaptation, Indonesia has demonstrated the ability to integrate global consumption tax best practices while customising it to the country's unique context. Changes and adjustments in tax regulations, including adjustments to the digital economy, signify Indonesia's seriousness in ensuring its tax system remains relevant, efficient, and fair. Through this initiative, Indonesia strives to improve tax compliance, broaden the tax base, and effectively leverage consumption tax as a vital tool for revenue mobilisation, supporting development and public services.

Sales Tax

Sales Tax is a type of consumption tax imposed by the government on the sale of goods and services. Typically, this tax is paid by the buyer at the point of sale of the goods or services and then remitted by the seller to the tax authority. Tax rates may vary depending on the jurisdiction and the type of goods or services taxed (Chapagai, 2021). Sales Tax is a major revenue generator for many local and state governments in several countries, including in the United States. Unlike Value Added Tax (VAT) that allows input tax deductions at each level of production or distribution, Sales Tax is charged only once on the final consumer of the product or service (C. Chen et al., 2022).

The general Sales Tax mechanism involves several important steps. First, the government sets a tax rate that must be applied to certain goods and services. The seller of goods or service provider is then obliged to collect this tax from the buyer at the time of the transaction (Z. Chen et al., 2023). Thereafter, the seller is responsible for reporting and remitting the collected tax to the tax authority within a specified time period, usually on a monthly or quarterly basis. In this system, the seller acts as a tax collection agent for the government. This administration and compliance process requires good accounting and record-keeping systems on the part of the seller to ensure that the taxes collected are appropriate and remitted on time, avoiding fines or sanctions (Chica et al., 2021).

The advantages of Sales Tax lie in its simplicity and transparency. It is easily understood by consumers as it is usually displayed separately on the sales receipt, allowing them to directly see the amount of tax charged for the transaction. Moreover, Sales Tax encourages higher compliance as it is easier to monitor and collect at the final point of sale (Conesa et al., 2020). This increases efficiency in tax collection and reduces the possibility of tax evasion. From an administrative perspective, it also tends to be easier for tax authorities to administer and supervise due to its clear tax collection base centred on the final sales transaction (Conrad & Alexeev, 2024).

On the other hand, one of the drawbacks of Sales Tax is its potential to be regressive, meaning that it can impose a greater proportional burden on the incomes of people with lower incomes, as they spend a greater proportion of their income on consumption compared to high-income earners (Dean et al., 2023). In addition, Sales Tax does not cover goods and services that are not sold through official markets, so the informal economy as well as second-hand goods that are usually not taxed after their initial sale may bypass this tax system. This can create market distortions and potentially reduce tax revenue. Sales Tax can also lead to complex and inefficient expenditure planning for businesses, as firms may try to avoid purchases in jurisdictions with higher sales tax rates (Demi et al., 2021).

Value Added Tax (VAT)

Value Added Tax (VAT) is a tax imposed at every level of the production and distribution process of goods and services. Unlike Sales Tax, which is only levied on the final transaction to the consumer, VAT is levied on the value added at each stage, from raw materials, production, distribution, to retail sales. In other words, this tax focuses on the increased value generated at each stage (Diana & Ștefan, 2022). VAT rates vary across countries and may be applied differently depending on the type of goods or services. In many countries, VAT is one of the most important taxes in the national tax system as it is the main source of government revenue (Ducept et al., 2023).

The VAT mechanism consists of collecting taxes at each value-added stage with a tax credit system. When a business sells a product or service, they charge VAT to the buyer. When the business purchases raw materials or services from suppliers, they pay VAT on the purchase. However, businesses can claim a tax credit for the amount of VAT already paid on their purchases, which is called input tax (Efuntade, 2020). In the end, businesses only need to remit the excess VAT they collected from customers (output tax) minus the input tax they have paid. This ensures that tax is only levied on the actual value added that the business has generated on the goods or services, and not on the entire selling price (Etim et al., 2020). This tax credit claim process encourages good reporting and documentation of all business transactions, ensuring that the tax circuit works effectively through the different stages of the supply chain (Feria & Walpole, 2020).

The advantage of Value Added Tax (VAT) lies in its design that covers the entire supply chain, minimising the risk of tax evasion and allowing the government to collect tax revenue more effectively. This is because each stage in the production and distribution chain has an incentive to claim tax credits for previously paid taxes (Freytag & Siebrits, 2023). In addition, VAT tends to be less regressive than Sales Tax because it can be designed with various rates and tax breaks for specific goods and services, such as basic necessities and education services, which are often consumed more by lower income groups. VAT also provides advantages in terms of collecting accurate economic data, as the detailed reporting system requires businesses to provide detailed information about their activities (Frieden & Lindholm, 2020).

The advantage of Value Added Tax (VAT) lies in its design to cover the entire supply chain, minimising the risk of tax evasion and allowing the government to collect tax revenue more effectively. This is because each stage in the production and distribution chain has an incentive to claim tax credits for previously paid taxes (Funke & Terasa, 2020). In addition, VAT tends to be less regressive than Sales Tax because it can be designed with various rates and tax breaks for specific goods and services, such as basic necessities and education services, which are often consumed more by lower income groups. VAT also provides advantages in terms of collecting accurate economic data, as the detailed reporting system requires businesses to provide detailed information about their activities (Gale, 2020).

VAT vs Sales Tax Comparison

Value Added Tax (VAT) and Sales Tax are the two forms of taxation most commonly applied to transactions of goods and services. They have different collection bases, which is important to understand in order to distinguish between the two (Ganderson & Limberg, 2021). VAT is collected at each stage of production or distribution, where the tax is only levied on the "additional value" at each stage, not on the total price of the goods or services. This means that if a product or service goes through several stages of production, the tax is only levied on the value added at each stage (Gerbeti, 2021).

Meanwhile, the basis of collection of Sales Tax is different as it is levied only once at the point of final sale to the consumer. All the tax burden falls on the final consumer and there is no mechanism to distribute the tax burden along the supply or production chain as in VAT (Ghosh, 2021). As a result, consumers do not always know how much tax they are paying for each component of the final retail price, increasing the potential for distortion and unfairness in its application. These two tax systems have their own advantages and disadvantages that reflect the complexities in a country's tax structure and how it chooses to mobilise revenue (Gunter et al., 2021).

In terms of administrative efficiency, Value Added Tax (VAT) tends to be more complex as it requires monitoring and documentation at every stage of production and distribution. Businesses must record the taxes they receive from buyers as well as the taxes they pay to sellers. This forms a tax credit deduction system, which requires detailed and often complex accounting administration to ensure that only the additional value at each stage is taxed (Gutiérrez & Mendoza, 2024). While this complexity may increase the administrative burden for businesses, it also helps in reducing the risk of tax evasion, as audits can be conducted at each point where value is added, making it easier for the government to monitor and collect the right taxes (Haffert & Schulz, 2020).

In contrast, Sales Tax is simpler in its administrative operations as the tax is only administered and collected at the final retail point of sale. Entrepreneurs do not have to worry about withholding tax credits or tax reporting at each stage of production, thus reducing the administrative burden (Han et al., 2021). However, this could also be a weak point in terms of combating tax evasion, as there is only one point of collection, so if retailers are dishonest or do not comply with the rules, tax revenue could be lost. In addition, inefficiencies may arise as there is no incentive for retailers to distinguish between costs and true value-added, which may encourage errors or fraud in declaring income and taxes owed (Harpaz, 2021).

The impact on the economy of the Value Added Tax (VAT) tax system needs to be seen from several aspects. VAT allows the government to generate relatively stable and predictable revenue as it is levied at various stages of the economy and is less susceptible to economic fluctuations when compared to Sales Tax which is only applied to the final transaction (Herbain, 2020). These advantages favour public investment and the government's ability to undertake long-term fiscal planning. VAT is also considered competition neutral as it is applied uniformly across all sectors, avoiding distortions to business decisions (Hindriks & Serse, 2022). However, the implementation of VAT may increase the price of goods and services as the tax burden is imposed at every stage of production, potentially raising the cost of living, especially if it is not designed with a mechanism that provides relief for low-income groups (Hoseini & Briand, 2020).

In contrast, a Sales Tax that is only applied to the final transaction is likely to have a more limited impact on the price structure as the tax burden only arises once. However, this also means that tax revenues can be more volatile, depending heavily on the consumption of goods and services by the public (Jarczok-Guzy, 2021). When the economy slows down and consumers cut back on spending, Sales Tax revenue will also fall, which could make it difficult for the government to finance public spending. Another drawback of Sales Tax is its potential to influence consumers' decisions, where they may choose to purchase in jurisdictions with lower Sales Tax rates or avoid purchasing certain goods that are taxed, which can cause distortions in the market and affect consumer choices and business strategies (Jency & Bharthvajan, 2020).

The Impact of Consumption Tax on the Economy

Consumption taxes, such as Value Added Tax (VAT) and Sales Tax, play a key role in a country's revenue structure and have a real influence on the economy. Consumption taxes are a stable source of revenue for many governments, as they are levied on goods and services purchased by consumers (Joseph et al., 2023). Revenue from consumption taxes can help governments finance essential public services such as education, health, and infrastructure. In addition, consumption taxes are often considered more effective than income taxes in reaching a wider tax base, including informal economic activities and unreported income. This helps in reducing inequality and ensuring all sectors of the economy contribute to the funding of public services (Kiara & Nekesa, 2023).

On the other hand, consumption taxes can have an inflationary impact on the prices of goods and services due to the addition of tax costs to selling prices. This may lead to an increase in the cost of living, especially for low-income families whose proportion of consumption expenditure is larger than that of high-income families (Krzikallová & Tošenovský, 2020). To reduce this burden, some countries implement compensation mechanisms such as tax exemptions or lower tax rates for basic goods. However, these preferential tax treatments can be technically challenging to implement and require careful administration to avoid deviating from the original goal of creating a simple and efficient tax system (Kumar & Kumar, 2020).

Furthermore, consumption taxes can influence consumer behaviour and the allocation of economic resources. For example, high taxes on luxury goods aim to reduce consumption of such goods, while tax exemptions for essential goods aim to ease the financial burden of low-income families (Ganderson & Limberg, 2021). The imposition of consumption taxes may encourage consumers to avoid goods with high taxes, which in turn may stimulate innovation and efficiency among producers in reducing production costs or finding cheaper alternatives to goods. However, its impact should be carefully monitored to avoid negative impacts on consumption that could lead to an economic slowdown. On balance, the introduction of consumption taxes requires a wise policy to maximise the economic benefits while reducing the negative impacts (Liu et al., 2024); (Magalhaens & Sutriswanto, n.d.).

Conclusion

Consumption taxes have several significant impacts on the economy. First, consumption taxes, including Value Added Tax (VAT) and Sales Tax, play an important role in generating stable and reliable revenue for the government. These revenues are essential to finance public services such as education, health, and infrastructure, which in turn support economic growth and social development. The implementation of consumption tax also expands the tax base, covers informal economic activities and encourages greater tax compliance through a relatively simple mechanism.

Secondly, the study shows that consumption taxes can affect economic stratification, particularly towards low-income groups. Given that consumption taxes are levied on consumption expenditure, this group tends to feel a greater economic impact as their proportion of expenditure on consumption is higher than that of higher-income groups. This argues for the importance of a consumption tax structure that is designed with sensitivity to the contents of low-income households, including the use of zero or low tax rates for basic goods, to reduce the regressive impact of such taxes.

Finally, the results suggest that consumption taxes can influence consumer behaviour and the allocation of economic resources. High taxation on certain goods may suppress consumption of those goods, while tax exemptions or lower rates on other goods may stimulate consumption. In this sense, consumption taxes can be a policy tool to promote or curb certain consumption. However, it is important to monitor the socioeconomic impact of such policies so as not to have a negative impact on overall domestic consumption that could lead to an economic slowdown. Thus, this study emphasises the importance of a balanced approach in consumption tax policy formulation to maximise economic benefits while minimising possible unintended consequences.

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