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Tax Flight?

An analysis of the 'duty free' system in Australia

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Summary

International travellers can buy 'duty-free' cigarettes and spirits for around half of the normal retail price because they are exempted from excises and GST. Australians in the wealthiest 20 per cent of households spend five times more on overseas holidays than those in the lowest 20 per cent of households.

Although the Federal Government does not publish an official estimate of the costs to the budget of the current duty-free arrangements, the system of 'duty free' and other tax concessions for Australian and international tourists is estimated to result in $300 million in lost revenue each year.

This paper argues that the current 'duty free' arrangements, and the newer Tourism Refund Scheme, are inequitable and open to abuse. They are also inconsistent with the tax simplification objective of the GST package and incompatible with broader health objectives of the tax system.

It is proposed that duty-free concessions be abolished for Australian passport holders and that the Australian Government consider implementing a series of bi-lateral agreements with countries around the world to reduce the extent of duty-free shopping.

1. Background

Nowadays the term 'duty free' is, for the most part, a misnomer. While goods purchased from 'duty free' stores are indeed free of customs duties, the rate of duty imposed on imports in Australia, where it is levied at all, is usually only 5 per cent. The savings that are achievable from duty free stores arise mainly from avoiding large excises on alcohol and tobacco and the GST (levied at 10 per cent). But throughout this paper, the term duty free is used to describe tax-free sales in Australia.

As indirect taxes are now levied primarily to raise revenue or discourage certain kinds of consumption, rather than as a tool of industry policy, the rationale for the existence of duty-free shopping has disappeared.

The current duty-free arrangements came into force in 1985 under sections 96A and 96B of the *Customs Act 1901*. Although some forms of duty-free shopping existed prior to this, legal opinion at the time was that the arrangements at the time were inadequate to prosecute successfully an individual who failed to take goods purchased from a duty-free store out of the country (Hodgman 1982).

A 'duty-free' shop is a licensed warehouse that has obtained permission from Australian Customs to make sales free of customs duty. Goods purchased in duty-free shops are free from domestic taxes (including the GST) and excises, such as those imposed on tobacco and alcohol.

Savings associated with some duty-free purchases can be substantial, particularly for goods on which excise is usually paid. An indication of the extent of savings associated with some common duty-free items is provided in Table 1.

Table 1 Savings associated with duty-free purchases

Product	Retail price	Duty-free price	Percentage saving
Carton of Peter Jackson Extra Mild (10 x 25)	$60.65	$33.50	45%
Carton of Long Beach Super Mild (8 x 30)	$48.95	$30.50	38%
Gordons Special London Gin (1.125 litre bottle)	$55.99	$19.95	64%
Digital Camera	$2365.00	$2150.00	9%
Samsara Eau de Parfum (50 ml)	$150.00	$109.00	27%

Source: Information gathered by authors from duty-free stores and major retailers.

There are two categories of duty-free shops, 'outwards' duty-free shops and 'inwards' duty-free shops. 'Outwards' duty-free shops are allowed to sell tax-free items to Australian and other citizens who are departing Australia. Duty-free goods purchased from 'off-airport' duty-free shops must be sealed in a tamper proof bag which cannot be opened until after the goods have been through Australian customs. Goods purchased from duty-free shops located in the departure area of an international airport, known as on-airport duty-free shops, do not need to be sealed in a bag and can be used immediately after purchase.

'Inwards' duty-free shops are located within international airport terminals between the disembarkation gates and the customs processing areas. These shops, which were established in 1985 (Jones 1985), can only sell duty and tax-free goods to arriving passengers. They are limited in the range of items that they can sell. Similarly, passengers are constrained in the amount of certain goods they can purchase. For example, they can purchase no more than 2.250 litres of alcohol and 250 grams of tobacco or 250 cigarettes. They can also buy non-commercial quantities of perfume, cosmetics, confectionary and photographic film (Australian Customs Service 2002, p. 5).

The Tourism Refund Scheme (TRS) was introduced at the same time as the GST. The TRS allows Australians and international visitors to claim a refund of GST and the wine equivalent tax on goods purchased in Australia and then taken out of the country. Refunds can be claimed for purchases from any shop that is registered for the GST, has an Australian business number (ABN) and can provide a tax invoice.

This scheme is not widely used or understood. Only 3 percent of departing travellers take advantage of the opportunity to obtain a refund of GST paid on goods being taken out of Australia. During 2000-2001, 246,904 claims were made for a total refund of only $29.7 million (Australian Customs Service 2002b), and in 2001-2002 claims increased to 43.3 million.[1] Based on data for 2000-2001, the average GST refund is $120 per claim.

The Federal Government seems to believe that too few travellers are seeking GST refunds. The Australian Customs Service is currently 'pursuing strategies to promote the scheme and increase passenger take-up rates' (Australian Customs Service 2002b, p. 78). It is unclear why the Australian Government is seeking to spend tax-payers money promoting the avoidance of tax. The low take-up rate indicates that travellers effort involved in making a claim is not worth the refund.

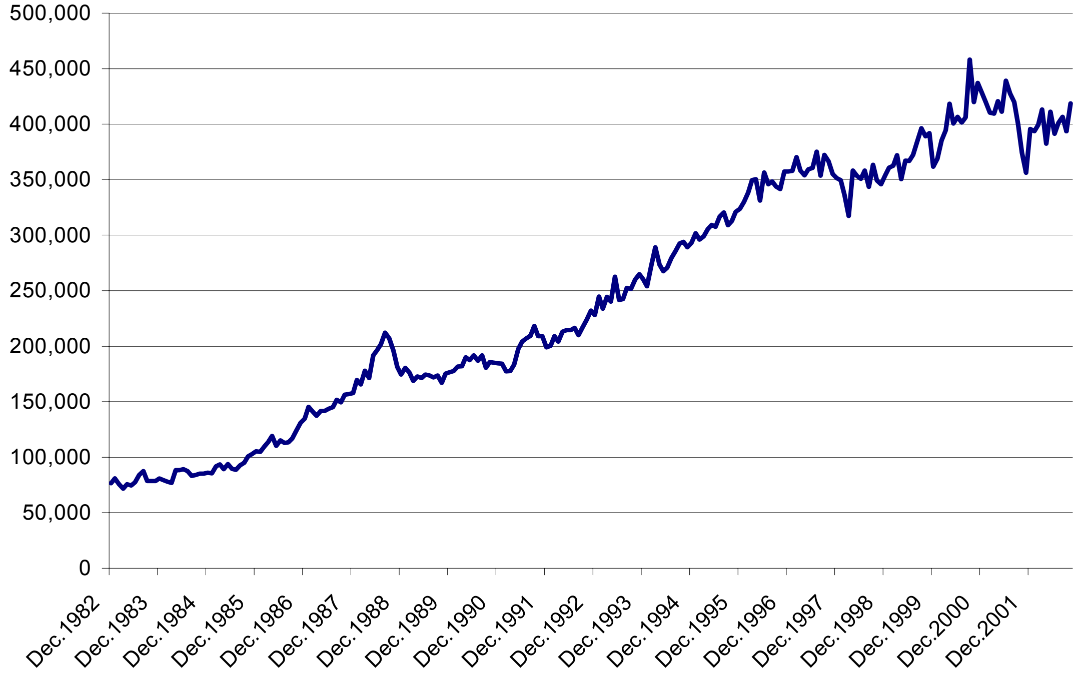
2. Size of the duty-free market

Duty-free stores are estimated to have turnover of between $1.1 billion (IBISworld 2002) and $1.3 billion per year (ADFA 2002). Of this, an estimated 20 percent of turnover is associated with duty-free stores located in airports (IBISworld 2002). There are more than 150 duty-free shops that are affiliated with the Australian Duty Free Association employing around 4,500 people (ADFA 2002). The size of the duty-free industry is directly related to the number of travellers, both to and from Australia. Figures 1 and 2 show that this number is increasing rapidly.

Figure 1 shows that at present, around 400,000 international visitors arrive in Australia each month. The Tourism Forecasting Council (2002) estimates that more than 5 million international visitors will arrive in Australia in 2002. The number of Australians travelling overseas has also grown substantially. Figure 2 shows that the number of Australians departing for overseas increased three-fold over the period 1982–2000, with the total number of short-term departures by Australians estimated to be more than 3.4 million for 2002 (Tourism Forecasting Council 2002).

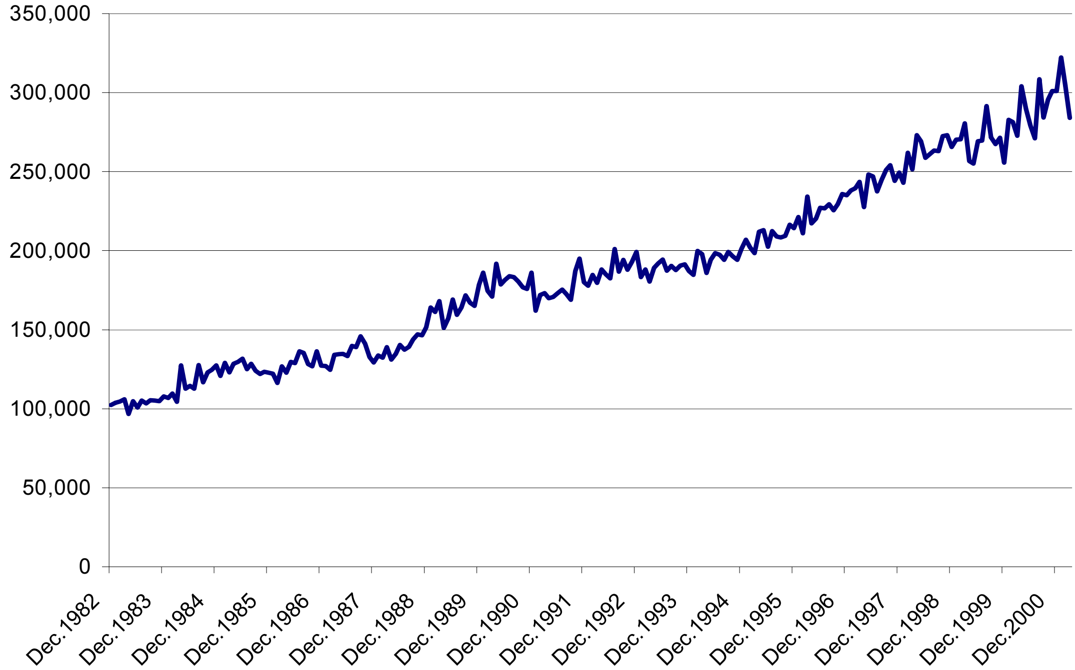
[1] Data from forthcoming Australian Customs Service Annual report was provided in correspondence.

Figure 1 Number of international visitors to Australia (monthly, seasonally adjusted), 1982-2001



Source: ABS 3401.0 Table 1

Figure 2 Short-term overseas departures of Australian residents (monthly, seasonally adjusted), 1982-2000



Source: ABS 3401.0 Table 2

3. The cost of duty-free concessions

There are no systematic Government estimates of the forgone revenue associated with sales through duty-free stores in Australia. Typically the cost of providing exemptions from a Commonwealth tax is provided in the Treasury's annual Tax Expenditure Statement in the Commonwealth Budget. But the tax expenditure arising from the duty-free system is nowhere to be found.

In introducing the legislation that created inbound duty-free shops, the then Minister assisting the Minister for Industry, Barry Jones, stated that '[t]he introduction of inwards duty-free shops is expected to benefit airport concessions revenues by about $5m in a full year. Other revenue effects of the shops are not quantifiable at this stage, nor are the administrative costs' (Jones 1984, p. 2695).

Despite the absence of official figures, it is possible to estimate the amount of revenue currently lost due to the existence of duty-free arrangements in Australia. IBISWorld (2002) estimates that turnover within the duty-free industry in Australia is $1.1 billion per year. Given that the purpose of duty-free shops is to provide goods tax free, it is reasonable to assume that goods sold through them would otherwise be liable for substantial amounts of excise or tax.

At a minimum, all goods sold through duty-free stores would have otherwise been subject to the 10 per cent GST. This places a lower bound on revenue lost from the sale of duty-free items at around $100 million.

However, a large percentage of turnover in duty-free stores is associated with the purchase of alcohol and tobacco, both of which are subject to high rates of excise. Using an example derived from Australian Customs Service (2002), Table 2 shows that the duty and tax payable on a bottle of spirits can be more than 100 per cent.

Table 2 Duty payable on a 1.125 litre bottle of gin

Variable	Amount
Customs value[a]	$20.00
Volume (litres)	1.125
% alcohol per volume	47.3%
Duty rate = 5% of customs value + $48.99 per litre of alcohol	
5% of customs value	$1.00
$48.99 x volume x alcohol content	$26.07
Total duty payable	$27.07
GST at 10% of customs value + duty payable	$4.71
Total duty and GST payable	$31.78

a. The customs value is the wholesale value of the product plus any freight and insurance costs paid by the importer.
Source: Rates of excise from Australian Customs Service (2002).

The amount of tax revenue forgone due to the duty-free system depends on total duty-free sales, the composition of those sales, and the varying amounts of tax forgone on each type of sale. There are no data available on the composition of sales through duty-free shops. This makes it impossible to calculate the lost revenue by applying the applicable taxes to the amount of different types of goods sold through duty-free stores. Bearing in mind that the payment of excises and GST can approximately double the prices of cigarettes and spirits, an average tax rate of 30 per cent is assumed.

This figure is consistent with a published estimate of the forgone revenue that appeared in a 1997 Auditor General's report (ANAO 1997). In an appendix to that report it was revealed that forgone revenue from Australia's duty-free system in 1997 was $237 million. If the duty-free industry had achieved even the average rate of growth across the economy, then the forgone revenue today would be in excess of $320 million.[2] This is a conservative estimate as the growth in tourist numbers has been far more rapid than the growth in the economy as a whole.

If an average tax rate of 30 per cent is applied to goods sold duty free then the lost revenue associated with duty-free shopping will be in the order of $300 million dollars per year.

4. Equity issues

There is no obvious reason to provide tax-free shopping to some Australians simply because they temporarily leave the country. This is particularly so when it is recognised that those Australians who travel abroad for holidays or on business tend to be wealthier than average. Cheap cigarettes and alcohol are not available to those who cannot afford to travel overseas.

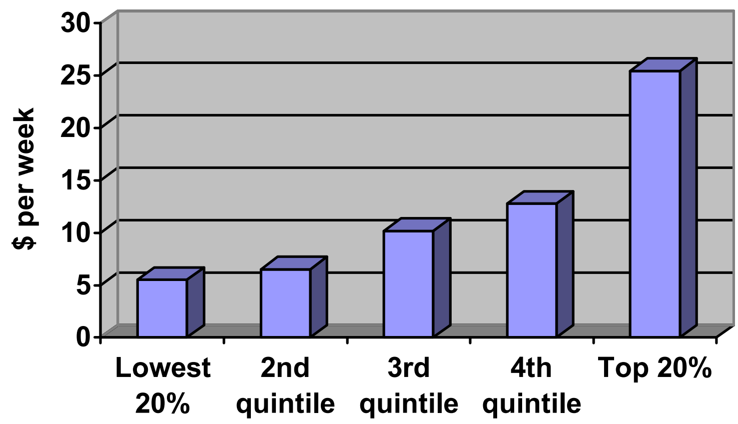
While it is generally believed that international air travel is nowadays available to all, in fact international travel is dominated by wealthy Australians. The ABS household expenditure survey shows that those in the highest income quintile (20 per cent) spend more than five times as much on international holidays as those in the lowest quintile. In fact, people in the top 20 percent of incomes spend almost twice as much on international holidays as those in the next highest income group. Figure 3 shows the distribution of expenditure on overseas holidays for all income groups.

These figures refer only to holiday travel. While expenditure on business travel is not reflected in these figures it is likely that high-income earners also dominate the international business travel market.

Furthermore, a major objective of placing high taxes on tobacco and alcohol is to discourage its consumption on social and health grounds. It is therefore difficult to understand the rationale behind reducing the tax payable on these substances when purchased at an Australian airport rather than at an Australian bottle shop or supermarket.

[2] This figure was calculated by using GDP at current prices from ABS 5206.0

Figure 3 Average weekly expenditure by Australians on overseas holidays, by income group (1998-99)



Source: ABS Cat. 6535.0, Table 2.

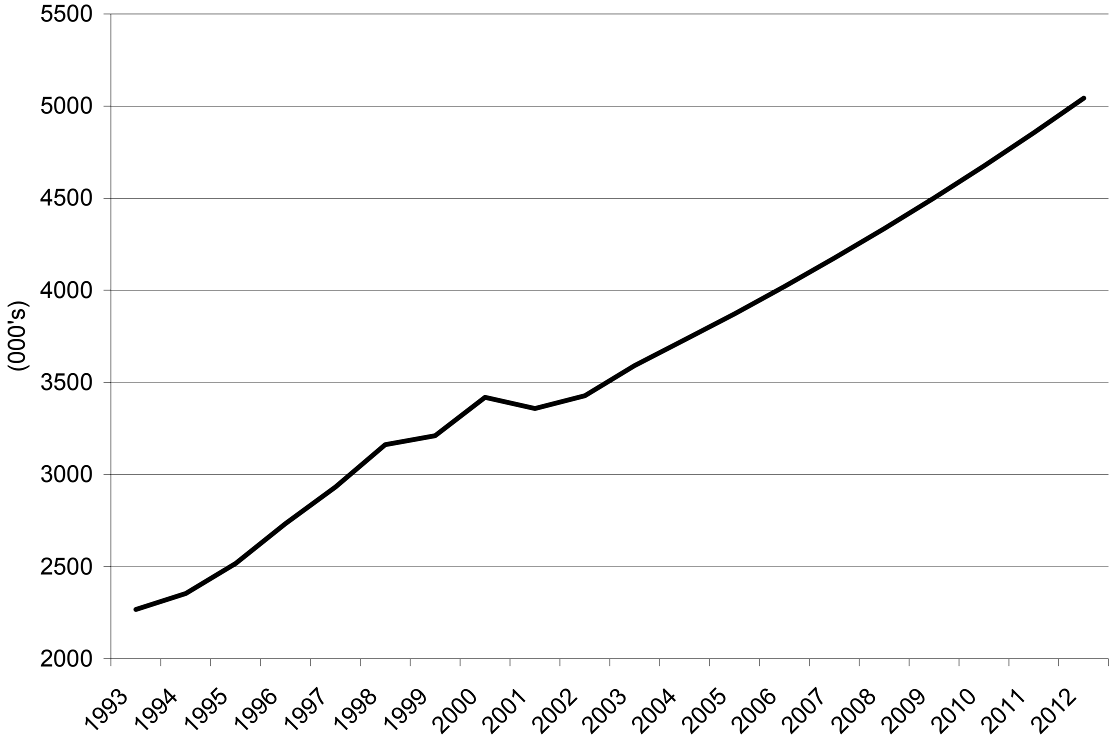
5. Expected growth of the industry

The tourism industry is experiencing rapid growth, both in Australia and internationally. According to the Tourism Forecasting Council (2002), the number of inbound tourists is estimated to increase at over seven percent per annum between 2002 and 2012. The result of such growth is that the number of inbound tourists is expected to double in the next ten years, with more than 10 million arrivals per year expected by 2012.

Similarly, as shown in Figure 4, the number of outbound tourists is likely to increase substantially. The Tourism Forecasting Council (2002) estimates that the annual rate of growth in short-term Australian resident departures will average 3.8 percent over the period 2001-2012. By the year 2012, this will result in an extra 1.5 million departures by Australian residents. If forecast levels of growth in tourism are achieved, then the cost of providing duty-free goods to Australian citizens will increase substantially.

It is important to note that when the current duty-free arrangements were formalised in the early 1980s, both the number of tourists and the volume of duty-free sales were substantially lower than they are today. In a 1982 speech given to parliament, W. Hodgman cited estimates that the total sales in the duty-free industry were equal to only $40 million per year (Hodgman 1982), compared to more than one billion dollars today.

Figure 4 Forecast growth in outbound tourism



Source: Tourism Forecasting Council (2002), Table 44.

6. International approaches to duty free

While duty-free arrangements for international travellers are common around the world, in recent years substantial changes have occurred. Increased economic interdependence in the European Community has led to the abolition of duty-free arrangements for travel within the European Union. These changes were opposed by industry advocates.

In considering the likely short and long-term consequences of abolishing tax-free sales for intra-European Community travellers, a Commission inquiry concluded:

> [T]he abolition of duty-free sales will not have a significant lasting negative impact on employment overall. On the contrary, as with the phasing out of any distorting subsidy, short-term negative effects on employment are expected to be more than offset by long-term effects on job creation (Commission of the European Communities 1999, p. 1)

7. Policy response

The rationale for introducing the GST was to improve the simplicity and equity of the indirect tax system. The existence of duty-free shopping for Australian residents creates both increased complexity and reduced fairness. A number of policy responses is available to the Federal Government to reduce or eliminate the problems associated with the current system.

While the simplest solution would be to abolish completely duty-free shopping in Australia, such a move would see foreign visitors to Australia decide to buy certain goods at duty-free shops outside of Australia thus reducing. For this reason, the following amendments to the current arrangements are proposed. They are summarised in Table 3.

1) Pre-departure duty-free tax concessions should be abolished for Australian passport holders. Duty-free shops would still be able to sell goods to foreign passport holders but Australian tourists would be required to pay the same price as all other Australians.

While it is true that such a change may prompt Australian travellers to purchase expensive items overseas, it must be remembered that Australian citizens are only allowed to bring in up to $400 worth of goods without paying duty. For reasons of administrative simplicity the duty-free allowance for goods purchased overseas should be continued. However, tobacco and alcohol should no longer be eligible for exemptions for either Australian or international travellers.

2) Abolish inwards duty-free stores. Inwards duty-free stores are restricted to selling a small range of goods, all of which could be classified as consumables (tobacco, alcohol, perfume). Given that these goods are likely to be consumed in Australia, the economic benefits associated with encouraging tourists to purchase goods in Australia, rather than internationally, are absent. Similarly, if the first recommendation were implemented then there would be no reason for the existence of inwards duty-free stores.

3) Abolish the Tourism Refund Scheme. The fact that only 3 per cent of travellers are claiming GST refunds under the TRS demonstrates that the payment of GST on purchases is not a major determinant of tourist spending behaviour. Rather than attempting to promote a scheme that delivers tax savings that flow mainly to wealthier Australians, the scheme should be abolished.

It is important to note that claims for the TRS can only be made for purchases from any one store with a combined value greater than $300 that are taken out of the country and then brought back in. At the same time, Australian citizens returning from overseas are only entitled to bring in $400 worth of goods duty free. The refund achievable under the TRS for an individual Australian must therefore lie between $30 and $40. This is an absurd situation unless travellers are intending to avoid declaring their purchases on their way back through Australian Customs.

4) Begin negotiations with other countries to implement bi-lateral agreements to abolish duty-free shopping. For example, the Australian and New Zealand governments could agree that people presenting either New Zealand or Australian passports would be ineligible for duty-free concessions in both countries.

Table 3 Proposed changes to current duty-free arrangements

	Australian passport holders	International visitors
Goods purchased in Australia	No duty-free entitlement	Existing arrangements for duty-free stores. Abolition of the Tourism Refund Scheme
Goods purchased abroad	Existing $400 per adult duty-free entitlement but exclude alcohol and tobacco	Existing arrangements except for the abolition of duty-free importation of alcohol and tobacco

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