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Equity aspects of VAT in emerging European countries: A case study of Serbia

Milojko Arsić [a], Nikola Altiparmakov [b,*]

[a] University of Belgrade – Faculty of Economics, Serbia
[b] Fiscal Council, Serbia

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ABSTRACT

A belief that consumption taxation is inherently inequitable has been entrenched in a significant portion of the general public and was supported by early empirical evidence that suggested a highly regressive annual VAT incidence. However, it has been shown that much of the estimated annual VAT regressivity is due to the income under-reporting bias inherent in sample surveys. This bias is particularly important in emerging European countries due to a high shadow economy and the evasion of direct income taxes, which suggests household expenditures as a more meaningful indicator of well-being than registered income. Furthermore, theoretical considerations favor the lifetime incidence approach, whereby VAT is estimated to be proportional or mildly progressive. A micro-simulation analysis of the Serbian expenditure survey data yields incidence estimates in line with the existing literature from other countries. We show that a significant presence of own-source (small) farming production of food in many emerging European countries, including Serbia, presents an important progressivity-enhancing buffer compared to the VAT incidence in developed European countries. We conclude that the common beliefs of inherently inequitable VAT taxation are vastly overstated and poorly founded in the economic reality of emerging European countries such as Serbia, where VAT can be most adequately described as being mildly progressive.

* Corresponding author.
E-mail address: nalti@yahoo.com (N. Altiparmakov).

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1. Introduction

Tax systems around the world are continuously changing in response to economic, political and administrative developments. Rapid globalization during the last couple of decades introduced unprecedented international mobility of capital, goods and services, and to a certain extent labor, consequently causing a world-wide trend of reducing custom duties, corporate income taxes and tax wedges on labor. Faced with reduced revenues from other sources, European Union (EU) countries are increasingly relying on consumption taxation. The European Commission (2009) notes that the reliance on consumption taxes, and on value added tax (VAT) in particular, has increased continually in EU member states in the 2000–2007 period. The recent economic crisis has further increased the reliance on consumption taxation since VAT increases have been the dominant element of revenue-enhancing policy measures in many EU member states.[1]

The policy importance of consumption taxation is also highlighted by the renewed attention to the issue of the optimal tax mix due to strong theoretical and empirical evidence that consumption taxes are less disruptive to economic growth than direct income taxes (Johansson et al., 2008; OECD, 2010). Some European countries have already implemented growth-enhancing tax reforms which shift the burden from income to consumption – Germany in 2007 and Hungary in 2008 being the most obvious examples, and Croatia being the most recent one. Similar growth-enhancing tax reforms are being analyzed in other European countries, both developed (France, Belgium, Netherlands) and emerging ones (Serbia, Czech Republic). The European Commission (2011) notes that in the process of consolidating public finances, one third of euro-zone member states might enhance economic growth by shifting the tax burden from labor to consumption.

Implementing the aforementioned reforms, which shift the burden from income to consumption taxation, is challenging in practice due to political considerations and the common public (mis)belief that VAT is a regressive tax that creates a disproportionate tax burden on poor households. Public perception of regressive consumption taxation has been reinforced by early empirical tax incidence analysis, including the classical work of Pechman (1985). However, more recent research has unambiguously shown that much of the estimated extremely regressive incidence of consumption taxes against annual income originates from measurement errors inherent in expenditure surveys. Furthermore, the theoretical basis for assessing the VAT incidence against annual income instead of annual expenditures or lifetime income is theoretically incorrect (Caspersen and Metcalf, 1994; Creedy, 1998). Recent empirical estimates in EU member states, based on the lifetime tax incidence approach, reveal a slightly progressive VAT incidence (Decoster et al., 2010).

We will use micro-level data for Serbia to investigate equity aspects of value added taxation in a typical emerging European country. Compared to developed European countries, in many emerging European countries, especially Poland, Romania and Serbia, there is a significant presence of own-source small farming production of food and associated in-kind consumption. As we will show, this tangibly enhances VAT progressivity by providing a tax-exempt buffer to poor households. Another distinguishing characteristic of emerging European countries compared to the developed ones is the significant presence of a shadow economy and evasion of direct income taxes. This suggests that, on top of theoretical considerations which favor the lifetime over the annual VAT incidence approach, practical considerations in emerging Europe also favor household expenditures over registered income as a more meaningful indicator of well-being and the ability to pay taxes. We conclude that common beliefs of regressive VAT taxation are vastly overstated and poorly founded in the economic reality of emerging European countries such as Serbia, where we estimate VAT to be mildly progressive.

This paper is organized as follows: Section 2 presents basic results from the existing literature, highlighting the difference between annual and lifetime tax incidence analysis and noting the inherent presence of income measurement errors in expenditure surveys. Section 3 describes the features of the existing Serbian VAT system and explains the estimation methodology used in our

[1] EU member states that have relied on VAT increases to cope with fiscal challenges during the recent economic crisis include the Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Poland, Portugal, Romania, Slovakia, Spain and the United Kingdom.