CONSUMPTION TAXES ARE REGRESSIVE

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(1) We hereby offer our response to Milojko Arsić and Nikola Altiparmakov (2011) and their critical review of our text “The Effects of Proposed Tax Changes on Poverty and Vulnerable Groups in Serbia” (2011). The latter was a supplement and a comment on their study Tax Policy in Serbia: Looking Forward (2010) in which they advocate in favor of a tax system reform that would shift the tax burden from labor to consumption, i.e. VAT, whilst keeping the total revenues at the same level, which, in their opinion, would help accelerate economic growth. Our text dealt with the quantitative assessment of short-term social effects of such a proposal, using our CLDS microsimulation model, and concluded that the reform would have negative social effects: it would lead to the reduction of household consumption and increase in the poverty rate.

(2) It is true that VAT revenues from our model are below the actual ones. However, the difference is much below the figures claimed by the critics as we model VAT revenues that are collected only from household consumption (being here our primary concern), but not from other forms of consumptions subject to VAT. Also, the remaining shortage in VAT revenues was not caused by an error in the model, but by the fact that the Living Standards Measurement Study states lower consumption figures than the GDP statistics, which is a world phenomenon among similar surveys. Those delving seriously into modelling know that a perfect statistical database does not exist and that certain weaknesses are inevitable. Hence, such flawed microsimulation models are still widely used around the world. Even the leading model from this class – EUROMOD, shows significant shortage in VAT revenues and its authors say: “for VAT rates, the bulk of the countries simulate” using EUROMODE “70 to 85% of VAT revenues in each country. In Ireland and the Netherlands however this rate falls below 70% and in Belgium below 60%.” (O’Donoghue et al., 2004, p. 9), which neither prevents them from analysing the indirect tax regressiveness in these countries nor does it prevent Arsić and Altiparkakov to make a positive reference to their work.

Similarly, the critics claim that the model contains an error in the estimate of revenues from payroll taxes made in the simulation of tax reform effects i.e. that our estimate amounting to RSD 158.4 bn is far too high and should amount to RSD 128.6 billion. Given that the arguments offered by the critics are credible to some degree, we are sorry we cannot examine the simulation procedure of our model more closely for technical reasons (the simulations were conducted over a two-year period in a different firm). All the same, the error, if any, is immaterial in the aggregate: it represents 8.1% of estimated payroll tax and contributions revenues after the tax reform.

Most importantly, the elimination of the potential error would further aggravate the adverse effects on the living standard and poverty referred to in the text. Namely, as the aforementioned increase in revenues from wage taxes partly compensated for the decline in revenues from wage contributions, the lower tax revenues, after allowing for the potential error, would bring down total revenues from payroll taxes and contributions compared to the estimated amount, and increase the necessary VAT rates and VAT revenues for the same amount for compensation purposes.

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In other words, the lower estimate of revenues from payroll taxes would bring an equivalent increase in VAT, which would only intensify the criticism of the tax reform proposal from the social viewpoint.

(3) The statement made by Arsić and Altiparmakov that pensioners should be excluded from the losers’ circle as they will be compensated through the price indexation of pensions (as a result of VAT increase) is incorrect. By taking into account the indexation of pensions (that did not exist in the year 2009 to which our analysis refers), the fundamental methodological principle of their proposal, being the principle of tax reform neutrality, would be impaired. If tax revenues can be kept on the same level before and after the reform, whilst allocating additional cash resources from the budget to increase pensions, then tax neutrality would no longer exist and deficit financing of the tax reform would be introduced. This would not be in line with the methodology, as with additional deficit financing, the effects of any reform could be positive. At that point, the only correct way out would be to eliminate this deficit by increasing VAT rates and revenues, which would additionally aggravate the position of population.

(4) It is entirely untrue what the critics’ claim of our statement provided in the theoretical section that consumption taxes are “usually regressive”. They find it invalid since, in their opinion, such position held by international publications is based on the use of a model unfit to assess regressiveness (based on annual income and not annual consumption).

The theoretical aspect is long known: there is no doubt that regressiveness should be measured in relation to income, as the notion is defined by the entire fiscal theory. For instance, Joseph Stiglitz (2000, page 159), in the textbook used at the Faculty of Economics in Belgrade, says: “A tax system is progressive if tax payments grow more than proportionally to income; a regressive tax system is the system where these payments grow less than proportionally to income”. But the question is which income? In theory, it is more suitable to use life/permanent income than annual income, but the problem is that such income is virtually impossible to assess for different individuals. Hence, annual income is usually used as a substitute for life income. There is a possibility to substitute life income by (annual) consumption, but this solution has its obvious weaknesses (Warren, 2008, page 64), especially for Serbia as it assumes the intertemporal optimization of consumption with an excellent capital market3 which is hardly present here. The use of consumption fully excludes savings from the analysis, which is an artificial way of decreasing the regressiveness assessment, given that richer population has higher savings rates and lower consumption rates than the poor. This renders inaccurate results. In other words, measuring regressiveness through consumption is pointless, unless consumption is assumed to be a valid proxy for income earned during the entire life. Since it is very hard to believe that in Serbia, majority of population balances its consumption over lifetime through credit mechanisms (intertemporal optimization of consumption), this assumption is “too heroic” for our taste. For this reason we believe that the critics’ assessment of VAT in Serbia, presented in table L3-2, is unfair as it excluded household savings from the calculation of permanent income altogether and, therefore, found VAT to be mildly progressive.

The truth is the opposite of what the critics claim: as Neil Warren (2008, pp. 25 and 57) says in his detailed review of this area, that “most consumption tax incidence studies continue to focus on a snapshot approach focused on the annual tax burden relative to annual income” and that they “clearly indicated that consumption taxes have a regressive impact on the distribution” of income. This is to say that our statement that consumption taxes are “usually regressive” is commonplace in worldwide sources and references.

(5) We are very disappointed with the way in which Arsić and Altiparmakov, in their observations, distort our text and positions taken over from international sources and references to achieve a semblance of a debate. We have seen an example of that in the previous item and we will add a few more to justify our assessments. It is unusual that the critics corroborate their thesis with references, albeit without quoting any, saying that they support the exclusive use of consumption in the assessment of regressiveness. However, this simply is not true, and we will corroborate this with two texts that they themselves reference. Decoster et al. (2010, p. 326) say that for some EU countries “indirect taxes are regressive with respect to disposable income but proportional or progressive with respect to total expenditures”. O’Donoghue et al. (2004, p. 21) measure regressiveness exclusively in relation to income and say: “indirect taxes were found to be regressive across the countries considered in this study. Although VAT as a percentage of total expenditure rose slightly in most countries along with income, because poorer households were more likely to consume goods with reduced VAT rates, because poorer households were less likely to save and in fact more likely to draw upon savings, as a percentage of income VAT in general fell with income.” As seen herein, income as a measure is not at all rejected, to the contrary, it is used regularly.

3 So as to ensure steady consumption throughout life by borrowing in younger and older age and savings in middle age. The problems are closer described in G. Mankiw (2002, Chapter 16).
What is even worse, the critics present our sentence on “usual regressiveness” to the reader as if we referred to the situation in Serbia, which is not the case given that it is a part of the theoretical section dealing with the reviews of international publications. We do not even deal with regressiveness (redistribution effects) of indirect taxes in Serbia, instead we only analyze changes in the living standard and poverty.

Similarly, the critics placed our sentence from the review of publications that “the decrease in income tax benefits affluent population groups who were much more affected by the previous income tax progression” in the Serbian context, and said that it “is not founded on the existing Serbian reality”. In the first place, it is evident from our text that we are talking about economics in general, and not about Serbia in particular. In the second place, we cannot see the reason for concluding that the sentence is not applicable to Serbia, since at least wage tax is progressive, and there is no other income tax component which would be degenerative and prevent income tax to be progressive on the whole; surely, the issue of the character of income tax on the whole is empirical, given that some of its components do not depend on the amount of current income (return on equity and royalties, capital gains etc.), but we have noticed that the critics not only failed to provide convincing arguments, but any arguments at all, for the alleged lack of grounds.

In other places as well the way the critics use international publications is unusual. They state the positions that are convenient to them, and they attribute it to the supposed Serbian peculiarities, whenever the positions of international publications are not convenient to them ( regressiveness, stabilization effects); they reproach us for not making the quotations as suitable to them (the EU study on the traders’ behavior in certain countries, despite the fact that they have not cited or made references to those cases either) and the like.

(6) The critics’ remark with respect to our opinion that the decrease in household consumption „would probably bring about a decline in economic activity, due to dampened demand of the population and aggregate demand“ is unjustified. We disagree with their firm belief that this dampened demand of population would be automatically compensated by the increase in investments and exports, because it fully relies on the neoclassic model of overall balance that, in our opinion, is not a relevant description of the economic system of modern-day Serbia, especially as the Serbian economy is currently in a deep crisis. Evidently, in times of crisis demand can be lacking, and a part of income may remain unused in the financial reserves accumulated by households, firms and banks. Or, temporarily increased profits of companies may be distributed as dividends, repatriated or used for imports without increasing demand for domestic goods. In other words, as the crisis in Serbia emerged due to the drop in demand, so the new drop in household demand caused by the VAT increase does not have to be compensated by the growth of another component of total demand for domestic goods. Instead it may additionally deepen the crisis.

In our text dealing with the social effects of the possible tax reform, we did not focus on its economic aspect in more depth. Instead, we basically kept the position of natural scepticism to the proposals from the study by Arsić et al. (2010), as they are neither elaborated nor substantiated with reliable arguments – empirical or verbal-economic. The elementary economic logic and a couple of selectively chosen footnotes are insufficient to create a cornerstone for a serious tax reform.

(7) With this we have answered all basic objections raised by Arsić and Altiparmakov and we conclude the debate, at least on our part. The reason for this is that we believe that the debate has entered, as Ljubomir Madžar would say, into the area of seriously diminishing returns, after the discussions we have already had with Messrs. Arsić and Altiparmakov on the same topic at a conference, in the print media, in widely-distributed internet messages and now in the Quarterly Monitor. Sapienti sat.
References


