

Analysis of effects of announced introduction of differential VAT rate and implemented increase of tax and social contribution rates on citizens' income

Potential losses in income and long-term fiscal weakness that would result from the announced introduction of differential VAT rate would exceed by far the financial relief that could be felt by socially disadvantaged residential groups, if pricing down food products took place. A great number of alternative measures realized through the expenditure section of the budget can offer more direct and better directed form of social welfare with the same goal. Similarly, long-term negative socio-economic effects of the introduced increase of tax and social contribution on income, abolishing the tax-free portion of income and the introduction of tax on dividends and capital profit are significantly greater than the expected positive tax inflow these changes would ensure. Therefore, these fiscal measures can only temporarily postpone inevitable reforms, while, in the meantime, there is danger of additional increase of existing problems.

A recent announcement by the Government of the Republic of Srpska of suggesting the introduction of differential VAT rate with lower rate on selected groceries and possible higher rate on luxurious products represents an announcement of another significant change to the domestic tax system.

This announcement arrived shortly after adopting Law on income tax and changes and amendments to Law on social contributions, by which rates of tax and social contribution on citizens' income, with some other important changes as well, such as abolishing tax-free portion of income and the introduction of tax on dividends and capital profit.

Therefore, we use this opportunity to state our analysis of expected effects of the announced tax policy measures, which are not in favor of differential VAT rate, nor are they in favor of

Category of expenditure on food and beverages (BAM) %	(BAM)	%
Bread and grains	59.07	12.5
Meat	115.95	24.5
Fish	14.07	3.0
Milk, cheese, eggs	66.42	14.0
Oil and fat	18.54	3.9
Fruits	31.86	6.7
Vegetables	46.11	9.7
Sugar, jam, honey and confectionary products	34.16	7.2
Other foods	18.72	4.0
Alcohol-free beverages	44.42	9.4
Alcoholic beverages	23.86	5.0
Totally – food and beverages	473.18	100.0
Consumption of food and beverages produced at home	83.42	17.6

Table: Average monthly expenditure on food and drinks in B&H, 2007
Source: Survey on expenditure per households

already implemented changes in tax and social contribution on income.

Differential VAT rate (pros and cons):

Pros:

- Key motif for introducing differential VAT rate is to cause lowering of prices of basic foods, i.e. products that would be covered by this rate. In short, this means that if the VAT rate for a certain product is decreased from the current 17% to 7%, than it is expected that the price of that product is lowered by the proportionate 10 percent points. Therefore, this measure can be described as primarily social in character, in terms of making it easier for socially disadvantaged residential groups to obtain basic foods.

Cons:

- This tax measure seriously threatens to the amount of income from VAT, bearing in mind that basic foods make high percentage of the entire consumer basket in the Republic of Srpska. For example, an average household spends around 55% of the entire food and drinks house budget on the purchase of bread, milk, cheese, eggs, meat and edible oil (study on households' expenditure, 2007). Therefore, in order to compensate for such decrease in VAT income, it would be necessary to substantially increase VAT rate on luxurious products, which will result in motivating tax payers to conceal sale of these products. For that reason, calculations related to introducing income neutrally VAT reform can be viewed as quite unreliable, because every tax system amendment affects the entire tax basis
- It is known that the decrease in tax rate often does not lead to proportional products' price discount due to traders' efforts to use part of this discount for increasing trading margin, which has proved as being very difficult to control in practice.
- All citizens consume basic foods so this measure will be felt by all, including the richest. Besides, analyses made so far show that a households' monthly amount of money spent on food increases proportionally with income, so it is possible that this measure can actually bring relief in greater extent to rich households rather than to poor ones. On the other hand, social measures realized through the expenditure section of the budget offer possibility of much better directing of aid to those in need and less waste of funds.
- Experiences from other countries show that after the differential VAT rate introduction strong political pressures emerge for supplementing the decreased VAT rate products' list with additional products, which results in gradual extending of the list and further collapse of VAT income potential. The fact that many European countries introduced the differential VAT rate does not mean whatsoever that this is the best solution. It rather confirms the claim that it is very difficult to stop this process once differential VAT rates introduction is initialized.

Conclusion

We can conclude that losses of income and long-term fiscal weaknesses brought by this measure multiple times surpass financial relief that would be felt by socially disadvantaged residential categories. Many alternative measures, such as increasing the amount of monthly allowance for socially endangered persons (which currently amounts to 41 BAM per month) would be much more direct and better directed form of help with the same goal.

In our opinion, this reform removes the basic advantage of the existing VAT system, which is its simplicity, and could cause negative effects of former turnover tax that we already know too well. Having in mind that VAT is by far the most important source of tax income for all levels of

Differential VAT rates in Great Britain

“Repeated introduction of lower rate of 8%, followed by further lowering to 5% in 1997, which has been lasting to now, has caused the erosion of income from VAT, increase of frauds and loss of income. According to a survey by the European Commission from 2009, from 200 to 2006 estimated VAT losses in Britain were as high as 17% of the theoretical VAT basis in Britain. These can partially be attributed to the system of differential rates, since a system with several rates is exposed to frauds more than it is the case with a single VAT rate system. Problems in functioning of VAT system in Great Britain are at the same time problems of the Union as well, because VAT is one of sources of funding the Union’s budget.”

Source: Department for macroeconomic analyses of the Steering Board of the Direction for Indirect Taxation of B&H (UINO)

authority in the Republic of Srpska and Bosnia and Herzegovina as well, out of which everyday need of our society are funded, such as schools, hospitals, police and other, we find that it should be “measured well twice before cutting once”, since the introduction of differential rate on basic foods resembles a serious strike with an ax on a branch we are sitting on. Therefore, aside from attracting a lot of attention, we see no other important reasons for choosing particularly this measure for decreasing financial pressure on socially disadvantaged residential categories.

Consolidated projection of tax and non-tax income and inflows of RS for 2011-2013 period (in millions of BAM)

Kind of revenue	Realized 2009	Plan 2010	Projection		
			2011	2012	2013
I Tax revenue	1,471.0	1,522.1	1,614.0	1,764.5	1,900.3
Transfers from the public account of UINO	1129.6	1179.6	1254.7	1342.5	1433.8
Tax on profit (businesses)	137.9	144.5	143.4	170.2	188.5
Personal income tax	152.9	157.5	171.7	206.2	229.5
Other taxes	50.9	40.6	44.2	45.6	48.5
II Non-tax revenue	420.1	313.8	309.0	306.3	307.8
Fees and fines	89.3	97.0	96.5	99.7	103.8
Provisions	137.4	150.7	144.1	153.3	161.0

Other non-tax revenues	193.4	66.1	68.4	53.3	43.0
Total tax and non-tax revenues	1891.1	1835.9	1923.0	2070.9	2208.0
III Grants	130.3	43.2	49.3	38.2	23.2
IV Financing	216.9	311.7	229.2	157.1	98.5
V Non-budgetary funds	1172.6	1265.3	1306.9	1326.9	1346.9
Pension and Disability Fund	651.4	702.9	726.0	737.2	748.3
Children's protection fund	53.6	57.9	59.8	60.7	61.6
Fund for employment	26.8	28.9	29.9	30.4	30.8
Health insurance fund	440.7	475.5	491.1	498.7	506.2
Total revenues	3063.7	3101.2	3229.9	3397.7	3554.9
Total revenues and grants	3194.0	3144.4	3279.1	3435.9	3578.1
Total inflows of consolidated budget	3410.9	3456.1	3508.3	3593.0	3676.6

Source: Document of draft budget of RS for 2011-2013

The increase of tax and social contribution on citizens' personal income, abolishing the tax-free portion of income and introduction of tax on dividends and capital profit (pros and cons):

Pros:

- The aim of these changes is to increase revenues of the budget and funds in the light of growth of budgetary deficit and deficit of the Pension and Disability Fund, Health Insurance Fund and Children's Protection Fund.
- Abolishing the tax-free portion of income mildly simplifies the administration of tax applications of withholding tax.
- By introducing taxation on dividends and capital profit, tax basis lawfully increases, i.e. new kinds of income are brought under income tax.

The importance of effects of taxation is obvious in new European Strategy "Europe 2020", which has determined the next guideline for all EU countries: "to revise and regularly monitor tax system effectiveness and the system of allowances, in order to accomplish that it pays to work, with special focus on persons having less education..."

Cons:

(increase of tax and social contribution rate on citizens' income)

- This measure has negative effect on sustaining existing and creation of new workplaces. There are many surveys proving that increasing taxation on labor negatively influences employment and that it stimulates unreported employment. In that sense, the timing of introducing this measure is especially unfavorable, bearing in mind negative tendencies at the labor market of the Republic of Srpska during 2010 (fall of the number of employed persons by 9.480 in RS in September 2010 in

comparison with the same period previous year; increase of the number of unemployed persons by 5.807 during 2010).

- In that sense, negative influence of this measure on employment will especially be notable in the case of persons with less paid vocations, in line with their weak negotiation power at the labor market. These persons can expect less chances of finding employment and the decrease of their personal income on the account of elevated taxes and social contributions.
- Speaking in short-term, increasing tax rate on income will provide humble rise of revenues for the government, having in mind that revenues from income tax have relatively small participation (10%) in total revenues. According to the RS Government's projections, revenues from income tax will in 2011 increase by 14 million BAM or around 0.4% of the consolidated budget of RS.
- In mid and long-term, this measure can bring negative effect on tax revenues also, once negative effects in economy on employment and increased unreported employment happen.
- This measure is in contradiction with one of nine key short-term priorities for B&H in the process of accession towards the EU planned by the EU through "European Peace Partnership with B&H". For B&H this priority states as following: "to decrease structural obstacles disturbing the functioning of the labor market, especially labor taxation..., in order to increase inclusion and employment rate."
- Increasing social contribution rate surely is not the solution for existing problems in pension and healthcare system. We fear that this measure would affect repeated postponing or slowing down of the solution of structural problems in these areas. Therefore, one should surely support the implementation of reforms of the first pillar of social security, as well as emphasize the importance of introducing the market principle for a biggest possible number of healthcare services financed from the Health insurance fund.

(abolishing the tax-free portion of income)

- This measure especially negatively affects employment and earnings of persons with less paid vocations, in sectors such as construction works or metal industry. Reason for that is that abolishing the tax-free portion of income, in terms of percentage, has brought made gross wages of less paid vocations more expensive.

(introducing taxation on dividends and capital profit)

Since these measures have already been talked about in media, we will only repeat basic negative effects:

- this measure discourages investment in securities and was introduced in amidst of a great "silence" on the Banjaluka Stock Exchange.
- since income tax does not include revenues from realized interests on savings deposits in banks, the law maker, thereby, additionally favors savings in banks as a form of investment.
- this way domestic companies get less opportunities for ensuring sources of funding at the capital market through emissions of stocks or bonds.

- Realized revenues on this basis will not be significant.
- This measure puts RS in less competitive position for attracting foreign capital in relation to other stock markets in the region that do not have such legislation.

Conclusion

It is obvious that the negative effects of measures above are significantly higher than the positive ones, and that their introduction is mostly motivated by current lack of budgetary revenues. Unemployment represents the key internal imbalance of the economy of RS, so, because of that, it is necessary to ensure that introducing a measure does not act in contradiction with solving this problem.

Solution for the problem of deficit of the budget and public funds should be sought after in its causes, which, besides the economic crisis, consist of structural problems within social security and healthcare system, unsustainably high costs of public administration and poorly directed social transfers. Therefore, measures like these can only temporarily postpone inevitable reforms, while in the meantime the existing problems can only get bigger.

If, on the other hand, a portion of budgetary deficit is wished to be resolved through revenue side, it is apparent that greatest potential lies in increasing the unique VAT rate. In that case, maintaining a single VAT rate and its linear increase by one or 2% would bring more significant revenues without complicating the tax system, while this tax burden would be equally distributed on all consumers. However, this move must be preceded by a thorough evaluation of effects and clear criteria of distribution, in order to ensure the necessary increase of transfers to socially disadvantaged residential categories.