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VALUE ADDED TAX EFFICIENCY IN THE WESTERN BALKAN COUNTRIES

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Abstract

An important feature of the tax systems of the Western Balkan countries is the large share of consumption taxes in total tax revenue. Despite its relatively short existence, VAT in particular has proven to be an important fiscal tool, due to its many advantages. The aim of the article is to outline the main developments in VAT in these countries in the past two decades and to analyse its efficiency. The main result of the article is that the tax has good overall revenue performance in the Western Balkans, as measured with the C-efficiency ratio.

Key words: Western Balkans, consumption taxes, value added tax, Vat efficiency

JEL: H20, H21, H25, H26

Introduction

The tax systems of Western Balkan countries exhibit many of the features that are typical for all transition economies from Central and Eastern Europe. An outstanding feature of all these countries is the predominant share of consumption taxes in fiscal revenue. However, the tax mix of the Western Balkan countries has changed over the years. Customs duties revenue has declined due to trade liberalization. On the other hand, value added tax (VAT) was introduced in these countries at the beginning of the new century and it soon became the most important fiscal tool. Against this background, the aim of the present article is to outline the most important changes in the field of VAT over the past years and to analyze the efficiency of revenue collection, given the important role of this tax to fiscal sustainability of these countries. The article is structured as follows: the second part presents a short overview of the tax mix of the Western Balkan countries and the arguments in favour of a large share of consumption taxes; the third part focuses on the main changes in VAT since its introduction; the fourth part presents the results of the analysis of the C-efficiency ratio in the observed countries; and the fifth part concludes.

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Tax mix of the Western Balkan countries

The tax systems of the Western Balkan countries resemble in many respects those of the other transition economies of Central and Eastern Europe insofar as they have been influenced by the same driving forces. At the beginning of the 1990s these countries faced the challenge to restructure their economies and to establish new institutional and legislative frameworks. An integral part of this transformation was the introduction of modern tax systems capable of accumulating sufficient financial resources.

Since 2000 the fiscal reforms in the Western Balkan economies have been largely driven by their integration into the European and global markets. This opened new opportunities for their development, but also implied strong pressure to attract investments and boost growth. Additionally, the prospect for accession into the European Union has led these countries to start harmonizing their consumption taxes with the requirements of the EU. Therefore, the structure of consumption taxes in the Western Balkans has changed over time. In the initial years, a large portion of fiscal revenue was coming from taxes related to international trade (Peci, 2013, p. 73). Later, these countries introduced value added taxes and modern-type excise duties as part of their integration into the European Union. On the other hand, they lowered the rates of customs duties, due to trade liberalization. The process of foreign trade liberalization created continuous pressure on the fiscal authorities to compensate for the losses in customs duties by increasing excise and VAT collection (Antic, 2014, p. 330).

The most important characteristic of the modern-day tax systems of the Western Balkan countries is the predominant share of consumption taxes, which in most of them amount to around half of total tax revenue (see Table 1). Kosovo stands out with its extremely high share of indirect taxes in total tax receipts (over 80%). According to the IMF (2013, p. 8), the country's reliance on indirect taxes is compatible with the strong openness of its economy, as measured with the high share of imports in GDP.

Table 1: Structure of general government tax revenue in 2019 (as a share of total tax revenue)

	Direct taxes	**Indirect taxes**	**Social security contributions**	**Other taxes**
	1	2	3	4
Albania	21.1	54.4	24.5	n/a
Bosnia and Herzegovina	10.4	49.2	40.0	0.3

Continued

	1	2	3	4
Kosovo	17.1	82.9	n/a	n/a
Montenegro	19.7	50.7	28.9	0.7
North Macedonia*	17.1	47.1	34.5	1.2
Serbia	16.6	45.4	33.9	4.1
Balkan countries average	17.0	55.0	27.0	1.1
EU average	32.4	33.0	34.6	0.0

* *Note*: The data for North Macedonia are from January to September 2019.

Source: Ministry of Finance and Economy of the Republic of Albania (2021), Central Bank of Bosnia and Herzegovina (2021), Ministry of Finance and Transfers of the Republic of Kosovo (2021), Ministry of Finance and Social Welfare of Montenegro (2021), Ministry of Finance of the Republic of North Macedonia (2021), Ministry of Finance of the Republic of Serbia (2021), Eurostat (2021).

The tax mix in the Western Balkan countries, based mainly on indirect taxes, can be attributed to several factors. The most important argument in favour of a consumption-based tax design found in the economic literature is related to economic efficiency. Indirect taxes are considered more favourable to economic growth because of their neutrality towards labour and investment decisions. This argument becomes even stronger in the context of globalization and high capital mobility. Consumption is relatively immobile, which combined with the broad tax base, is an important advantage in terms of fiscal revenue.

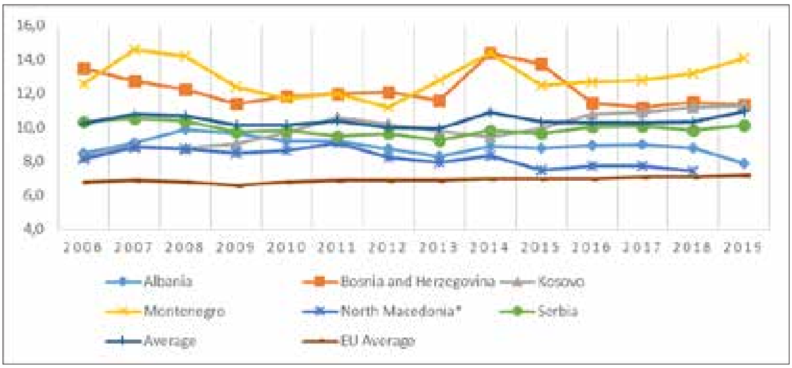
Furthermore, the administration of indirect taxes is simpler (in comparison to direct taxes and social security contributions), especially in the cases when these taxes are collected at the national borders. According to Peci (2013, p. 72), the individual transition economies have chosen different approaches towards tax policy according to their initial circumstances. The countries with higher per capita income and a more developed tax administration had a tax structure resembling more the European Union countries. On the other hand, the transition countries with lower income levels and poorer tax administration have built their tax structure based on indirect taxes.

Gabrisch et al. (2016, p. 7) suggested that the tax mix of the Western Balkan countries can also be related to their currency regimes. As most of these countries have chosen a fixed peg to the euro or adopted the euro unilaterally, nominal depreciation of their currency to improve competitiveness is not available. Therefore, the Western Balkan countries have engaged in fiscal depreciation based on the reduction of income taxes and social security contributions and the increase of VAT.

Main changes in VAT in the Western Balkan economies

Value added tax has become one of the most important fiscal tools in the Western Balkans, although it has been in place in these countries for a relatively short period. Serbia and Bosnia and Herzegovina were the last Western Balkan countries to introduce VAT, in 2005 and 2006, respectively (Tesche, 2005, p. 300). Furthermore, as part of their preparation for accession to the European Union, the Western Balkan countries have harmonized their national legislations with the EU common VAT system.

In 2006 – 2019 VAT revenue as a share of GDP in the Western Balkan countries remained above the EU average level (see Figure 1). At the beginning of the period Bosnia and Herzegovina had the highest VAT revenue-to-GDP ratio, as it stood at 13.5% of GDP. However, this is also the country with the strongest decline over 2 percentage points in VAT receipts in the observed period. A slighter decline in tax receipts was recorded in North Macedonia and Serbia. On the other hand, VAT revenue increased significantly in Kosovo (3 pp.) and also in Montenegro (1.5 pp.). Thus, in 2019 Montenegro was the Western Balkan country with the highest VAT-to-GDP ratio. Throughout the entire period VAT revenue in the Western Balkans was subject to significant short-term fluctuations, which were particularly pronounced in Bosnia and Herzegovina and Montenegro.



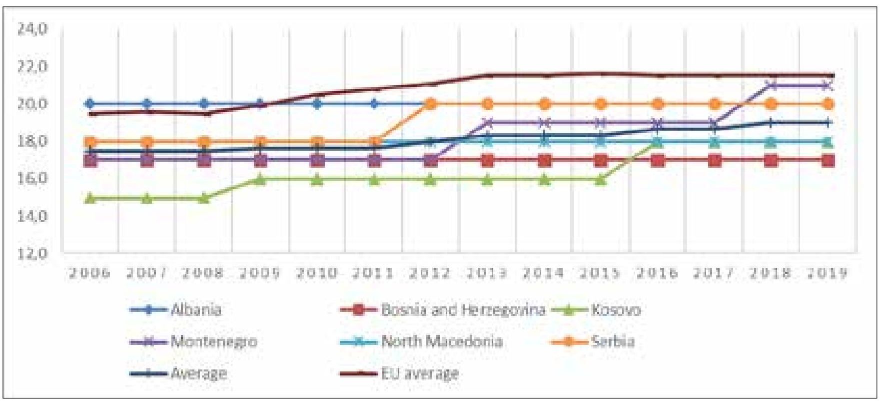
Note: Data for North Macedonia for 2019 are not available.
Source: Ministry of Finance and Economy of the Republic of Albania (2021), Indirect Taxation Authority of Bosnia and Herzegovina (2021), Ministry of Finance and Transfers of the Republic of Kosovo (2021), Ministry of Finance and Social Welfare of Montenegro (2021), Ministry of Finance of the Republic of North Macedonia (2021), Ministry of Finance of the Republic of Serbia (2021), Eurostat (2021).

Figure 1: VAT revenue as a share of GDP

In the observed period, the Western Balkan countries conducted important reforms in VAT, the most important of which involved changes in the standard rates (see Figure 2). In 2006 – 2008 the average rate in the six countries stood at 17.5%, below the EU average of 19.5%. After 2009 to 2019 the standard rate went up by 1.3 point on average, reflecting the increases in Montenegro, Kosovo, and Serbia. In Montenegro, the rate was raised twice by 2 percentage points (in 2013 and in 2018) and thus reached 21%. In Kosovo, the standard VAT rate went up by 1 percentage point to 16% in 2009 with the aim to compensate for the reduction of CIT and PIT rates (Peci, 2013, p. 79). It was increased again to 18% in 2016. In 2012 Serbia also raised the standard rate to 20%. The main reason for the considerable increases was the necessity for fiscal consolidation after the global crisis. Despite these changes, the average standard VAT rate in the Western Balkans has remained below the EU average. In 2019 it stood at respectively at 19% and 21.5% for the two groups of countries.

Most Western Balkan countries also apply reduced rates and exemptions, although their level and scope vary. In general, rate differentiation aims to achieve various objectives, such as more equitable income redistribution, boosting important sectors of the economy, encouraging the consumption of merit goods, etc. The reduced rates vary from 5% in North Macedonia to 10% in Serbia. Bosnia and Herzegovina is the only Western Balkan country without a reduced VAT rate (Gjokutaj & Gjokutaj, 2020, p. 53). Additionally, the Western Balkan countries apply zero rates to exports. The reduced rates and exemptions create market distortions and narrow the tax base, thus negatively affecting tax revenue.

All six countries have introduced relatively high VAT registration thresholds, varying between EUR 16 000 in Albania and EUR 67 700 in Serbia (Gjokutaj & Gjokutaj, 2020). By setting high registration thresholds the Western Balkan economies have chosen to concentrate their VAT administration capacities on larger businesses (OECD, 2018, p. 180).



Source: Trading Economics (2021), Peci (2013), Tesche (2005), European Commission (2020).

Figure 2: Standard VAT rates

Efficiency of VAT collection in the Western Balkan countries

Given its importance for public revenue, it is worthwhile to analyse the efficiency of VAT performance in the Western Balkan countries. A commonly used indicator in this respect is the C-efficiency index, defined as the ratio of the share of VAT revenues in consumption to the standard rate (Ebrill et al., 2001, p. 41). The benchmark value of the coefficient is 100% (or 1). Generally, when the value of the index is below 1 this reflects the effects of the application of reduced rates and exemptions or a failure to collect all tax due. A C-efficiency ratio above 1 is also possible in case if the entire tax base is covered by the standard rate, but at the same exemptions without right to deduction the input VAT are in place, thus providing additional fiscal revenue that exceeds the cost of exemption (OECD, 2012, p. 112).

Two main determinants are distinguished in the literature (Ebrill et al. 2001, p. 43; OECD, 2012, p. 113; Keen, 2013, p. 14) for the possible deviations of the C-efficiency ratio from 100%, termed as the policy gap and the compliance gap. The policy gap stems from the non-uniform taxation of consumption in an economy through the application of exemptions and differential rates. The compliance gap, on the other hand, is related to the imperfections of its implementation and administration.

C-efficiency of VAT has been the subject of empirical research. Ueda (2017, p. 10) conducted an empirical research of the evolution of C-efficiency ratios in a panel of advanced economies in 2000 – 2014. The results differed significantly across the analysed countries with the ratio in 2014 varying from below 40% (Greece, Italy) to over 100% (Luxembourg).

Empirical studies on VAT revenue performance in the Balkan countries generally suggest good efficiency of this tax. Hodzic and Celebi (2017) conducted an analysis in the EU-28 and Turkey and concluded that in 2013 the highest C-efficiency ratios were recorded in Luxembourg, Croatia and Bulgaria, while the index in Turkey was also relatively high. Durovic-Todorovic et al. (2019) studied C-efficiency in Serbia and the developing EU Member States. The authors found that VAT efficiency in Serbia in 2005 – 2016 was relatively high, but on a downward trend, which they attributed mainly to the standard rate increase in 2012. Antic (2014) conducted an analysis of VAT revenue performance in Bosnia and Herzegovina in the period 2006 – 2013 and confirmed that the revenue performance has remained strong throughout the observed period. However, the empirical results revealed significant fluctuations in the efficiency ratio, which were explained with delays in VAT refunds in some years, resulting in higher value of the index (Antic, 2014, p. 326).

In the present paper the C-efficiency ratio has been estimated for the six Western Balkan countries in 2005 - 2019, following the model proposed by Ebrill et al. (2001), OECD (2012) and Keen (2013).

$$Cef = \frac{R}{FC * t}$$

In the formula C_{ef} stands for VAT C-efficiency ratio, R stands for VAT revenue, FC stands for final consumption expenditure, and t stands for standard VAT rate. The statistics for final consumption expenditure were retrieved from the World Development Indicators Database (World Bank, 2021). It should be noted that final consumption expenditure includes both private consumption and government consumption. Moreover, since the data for final consumption expenditure is presented in market prices, including taxes, VAT revenue should be deducted before calculating the C-efficiency ratio (OECD, 2012, p. 106).

As can be seen in Table 2, in the observed period the C-efficiency ratio went up from 0.6 to 0.7 on average, indicating a significant improvement in the collection of VAT revenue. The strongest increase was recorded in Kosovo, Montenegro, and Bosnia and Herzegovina, but C-efficiency improved also in North Macedonia. The ratio declined only in Albania, whereas in Serbia it remained unchanged.

Table 2: C-efficiency ratio of VAT in the Western Balkan countries

	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Albania	0,53	0,55	0,59	0,58	0,57	0,57	0,55	0,50	0,53	0,53	0,54	0,55	0,54	0,47
Bosnia and Herzegovina	0,81	0,79	0,75	0,69	0,72	0,74	0,73	0,71	0,91	0,90	0,76	0,76	0,80	0,80
Kosovo	0,55	0,60	0,59	0,60	0,65	0,74	0,69	0,68	0,63	0,68	0,67	0,70	0,70	0,73
Montenegro	0,74	0,92	0,85	0,80	0,74	0,78	0,71	0,77	0,89	0,77	0,80	0,83	0,80	0,89
North Macedonia	0,52	0,58	0,55	0,54	0,56	0,61	0,54	0,54	0,59	0,53	0,58	0,58	0,57	n/a
Serbia	0,67	0,68	0,68	0,64	0,64	0,62	0,57	0,57	0,60	0,61	0,65	0,65	0,65	0,68
Average	0,60	0,69	0,67	0,64	0,65	0,68	0,63	0,63	0,69	0,67	0,66	0,68	0,68	0,70

Source: Author's calculations

Despite the overall positive trend, there are short-term fluctuations in the indicator's movements in all countries, and particularly in Bosnia and Herzegovina and Montenegro. These fluctuations can be attributed to the impact of the business cycle. Sancak et al. (2010, p. 18) found a positive and significant relationship between C-efficiency and the output gap in a panel of advanced and developing economies. These authors identified the shifts in consumption patterns and tax evasion as additional channels through which the changes in the business cycle affect VAT revenue performance.

The overall high values of the C-efficiency ratio in the Western Balkans are a result of both the tax design (low policy gap) and the relatively good tax collectability (low compliance gap). These countries in general have relatively low standard rates with limited exemptions and reduced rates, especially in the initial years of the observed period. This is the case particularly in Bosnia and Herzegovina, where VAT is levied at a uniform rate on all consumption (the only exception being the zero rate on exports), and few exemptions are in place. In Kosovo and Montenegro, the improvement of the C-efficiency ratio can be partially explained with the standard rate increases which result in more tax revenue. However, the introduction of reduced rates and exemptions in these countries limited the positive effect of the standard rate increases on fiscal revenue due to tax base narrowing (Ebrill et al., 2001, p. 44).

Furthermore, the Western Balkan countries made significant efforts to strengthen their tax administrations (OECD, 2018, p. 167). The good VAT performance in the Western Balkans can also be attributed to the strong openness of their economies, which implies positive effects on tax compliance. Ebrill et al. (2001, p. 45) pointed out that C-efficiency tends to be higher in countries that attach greater importance to trade in the economy, because VAT is collected at the border along with customs duties, thus limiting the possibilities for tax fraud. For example, IMF (2013, p. 8) defines the tax structure of Kosovo as revenue effective, because the import-heavy economy supports tax collection. However, the strong reliance on border control for collecting tax revenue creates risks in the long run given the continuing trade liberalization and the future accession of the Western Balkan countries to the European Union. The participation in the EU customs union implies removal of the border control, thus limiting the possibilities of tax administrations to collect VAT on international transactions.

Conclusion

The present paper has confirmed that in most Western Balkan countries VAT is characterized by a strong revenue-raising capability as measured with the C-efficiency ratio. The main reasons for its good revenue performance include the simple design of the tax, the openness of their economies, and the improving administrative capacity of the observed countries. However, the strong reliance on consumption taxes, and VAT in particular, creates some risks for fiscal stability and sustainability. The significant fluctuations in VAT revenue in the Western Balkans in the past years reveal the pro-cyclical nature of this tax. These fluctuations are reflected in the value of the C-efficiency ratio, which has also been subject to significant short-term changes. Furthermore, the continuing trade liberalization and the removal of the border control after the accession of Western Balkan countries to the EU will possibly limit the capacity of their tax administrations to effectively enforce VAT.

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