SOUTHMOD – simulating tax and benefit policies for development

Integration of indirect taxation to GHAMOD

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Abstract: This note, with emphasis on VAT and excise taxes, illustrates how indirect taxes are modelled in the context of GHAMOD, a tax-benefit microsimulation model for Ghana. GHAMOD is similar to the EUROMOD base platform, and its built-in Statistics Presenter Tool supports simple analyses of ex-ante policy (reform) on distributional outcomes. GHAMOD has been developed in the context of the SOUTHMOD project, under which various tax-benefit microsimulation models have been elaborated and maintained for selected developing countries. The indirect tax incorporation approach discussed for GHAMOD is a template for future models and will be reflected in existing country models under the SOUTHMOD umbrella. The models are available free of charge for non-commercial research purposes by researchers, government officials, policy-makers, and the interested public.

Key words: indirect taxes, microsimulation, VAT, excise taxes

JEL classification: H20, H30
1 Introduction

Indirect taxes are an important component of tax systems across the world. In developing countries, the share of tax receipts through indirect taxes such as the value-added tax (VAT) has seen a pronounced increase at the expense of the revenue share of trade tax in the last decades. Therefore, modelling indirect taxes coherently and transparently in tax-benefit microsimulation models is key.

This note, with emphasis on VAT and excise taxes, illustrates how indirect taxes are modelled in the context of GHAMOD, a tax-benefit microsimulation model for Ghana. GHAMOD is similar to the EUROMOD base platform, and its built-in Statistics Presenter Tool supports simple analyses of ex-ante policy (reform) on distributional outcomes. GHAMOD has been developed in the context of the SOUTHMOD project, under which tax-benefit microsimulation models have been elaborated and maintained for selected developing countries. The indirect tax incorporation approach discussed for GHAMOD is a template for future models and is or will be reflected in existing country models under the SOUTHMOD umbrella. The models are available free of charge for non-commercial research purposes by researchers, government officials, policy-makers, and the interested public.

The implementation of indirect taxation in GHAMOD needs to address how changes of the indirect tax burden affect poverty and inequality. Different approaches imply different assumptions and implementation regarding, for example, whether poverty and inequality are based on consumption or disposable income. At the same time, GHAMOD shall offer simple and efficient options to modify existing indirect tax policies and implement reform scenarios. Given the often complex and highly fine-grained distinction of goods and services subject to full, reduced, or no indirect tax in many countries, a concise presentation of different goods and services in relevant groupings is necessary.

This technical note is based on GHAMOD v1.5. Screenshots and results are shown for 2013 which was the latest available year of the underlying survey, the Ghana Living Standards Survey (GLSS), at the time of writing. Although there are current versions of GHAMOD, the screenshots describing the approach remain the same.

In the following, this note will first set out how expenditure data are introduced into the model in a way that allows easy composition of alternative lists of expenditure items subject to VAT and/or excises (or not) using the example of Ghana and GHAMOD (Section 2). Section 3 shows how the VAT and excise taxes of Ghana are implemented in GHAMOD. Section 4 presents the respective choices the user can make when running the Statistics Presenter Tool in GHAMOD.

2 Introduction of expenditure items to the model

The various expenditure items are introduced to the model according to the Classification of Individual Consumption by Purpose (COICOP). Thirteen income lists collect expenditure items in the respective 13 COICOP lists for individual consumption expenditure at the household level.
Figure 1: COICOP lists for individual consumption expenditure at the household level in GHAMOD

Each COICOP list is then composed by all the respective goods and services that fall into this group (see Figure 2 for an example of a selection of goods that are part of COICOP 01 income list).

Figure 2: Excerpt of income list ils_vat_coicop01 that collects expenditures included in the COICOP 01 income list in GHAMOD

The goods and services subject to the current VAT policy are in turn collected in the income list ils_vat_std (see Figure 3).

Figure 3: Excerpt of income list ils_vat_std that collects goods and services subject to standard VAT rates in GHAMOD
If a user wants to modify the list of expenditures subject to VAT, they can thus simply add an item to income list $ils_{vat\_std}$ or take an item out. Should the hypothetical reform be of larger size, they can simply compose $ils_{vat\_std}$ using the COICOP based income lists and adding or taking out specific items that shall or shall not be subject to the hypothetical reform VAT policy.

3 Modelling of VAT and excise policies

In this section we present a quick and easy way to modelling indirect taxes. This is underpinned theoretically by De Agostini et al. (2017). Two approaches allow consistent modelling. The first approach assumes that households consume a fixed share of their disposable income (constant budget shares), whereas the second approach assumes that households consume a fixed quantity of goods and services, irrespective of the consumer price (constant quantities). Both methods require observed information or data on expenditures.

In GHAMOD, we model indirect taxes using the constant budget shares approach. We assume that a household always spends the same share of its budget on a certain commodity or service, irrespective of increases or decreases in its overall budget. In case of a reform scenario that changes the budget available to the household, the absolute expenditure on a good and service is thus scaled proportionally to the budget change.

Let $E^{obs}$ denote the household’s observed budget, $\omega_k^{obs}$ the expenditure share spent on good or service $k$, $x^{obs}_k$ the observed expenditure on good or service $k$, $ils_{disp}^{obs}$ the observed income, and $ils_{disp}$ the new disposable income under the reform scenario on the household level. Under the assumption of constant budget shares, expenditure on commodity $k$, ($e_k$) can be written as:

$$
e_k = \frac{ils_{disp}}{ils_{disp}^{obs}} \omega_k^{obs} E^{obs} = \frac{ils_{disp}}{ils_{disp}^{obs}} x^{obs}_k$$

(1)

At the aggregate level, this entails that total expenditures, $E$, equal the observed total expenditures multiplied by the growth in disposable income with respect to the observed disposable income.

When practically implementing this approach in a developing country context, we have to deal with the fact that many households, even after imputing the monetary value of own produce, have zero or very low incomes. Therefore, we replace disposable income by expenditure in formula (1), after which it reads:

$$
e_k = \frac{ils_{con}}{xhh^{obs}} \omega_k^{obs} E^{obs} = \frac{ils_{xhh\_s}}{xhh^{obs}} x^{obs}_k$$

(2)

where $xhh^{obs}$ is the observed expenditure in the base year and $ils_{con}$ captures the household’s expenditure possibilities under a reform scenario. This concept is also referred to as ‘simulated consumption’ and assumes that a hypothetical benefit (tax) adds to (reduces) household consumption by the same amount.\(^2\)

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\(^2\) Refer to the SOUTHMOD modelling conventions (available from the authors upon request) for more details on the definition of the $ils_{con}$. 

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Similar to the case of disposable income, this adjustment implies that the newly simulated expenditure on each good equals the observed expenditure multiplied by the overall rate of expenditure growth, captured by \( \frac{\text{als.com}}{\text{xxhobs}} \).

We can then deduce indirect taxes \( (T_k) \) as functions of these new expenditures calculated above as
\[
T_k \equiv \frac{t_k}{1 + t_k} e_k.
\]
Moreover, specific values for value added taxes \( T_k^v \), specific excises \( T_k^a \), and ad valorem excises \( T_k^p \) can equally be calculated as follows:
\[
\begin{align*}
T_k^v &\equiv v_k e_k \\
T_k^a &\equiv a_k q_k e_k \\
T_k^p &\equiv \frac{t_k}{1 + t_k} e_k
\end{align*}
\]
where \( t_k \) is the VAT rate applicable for good \( k \), \( v_k \) is the ad valorem rate, \( a_k \) the excise, and \( q_k \) the consumer price (in the survey year). In the practical implementation in GHAMOD, this requires stripping off taxes from expenditures as recorded in the survey in the input data for the model, thus basically generating expenditures valued at producer prices.

Practically, for modelling VAT for example, we gather from the previous section the different goods and services subject to the current VAT policy in the income list \( \text{ils.vat_std} \) (see Figure 3). We slightly rewrite equation (2) using the notation of variables names used in GHAMOD model after we have defined our constant VAT rate \( (\text{SVAT_rate}) \), before applying it to income list \( \text{ils.vat_std} \). We collect all simulated VAT into our output variable as \( \text{tva}_s \) (see Figure 4).

Figure 4: Excerpt of VAT calculation based on consumption expenditure

In modelling excise taxes, a similar approach is adopted. Input data for excisable goods are prepared by stripping off excise taxes (and if applicable also other indirect taxes) and calculating where necessary quantities in the input data (variables starting with the letter \( q \)).

In Ghana, excisable goods are not subject to VAT and excise duties on alcohol and most tobacco products are ad valorem, whereas excise duties on petroleum products are per litre. Figure 5 shows the modelling of ad valorem excise duties regarding spirits and Figure 6 the modelling of per litre excise duties for petrol. Excise duties simulated for all goods subject to excise duties are then collected in the end of the policy (not shown in the Figures for brevity).
4 Implementation in the Statistics Presenter Tool

The Statistics Presenter Tool calculates poverty and inequality measures on the basis of either simulated consumption or simulated disposable income by comparing households' consumption or income to the poverty line. When not considering indirect tax, the poverty line is inflated by the CPI and it is based on tax-inclusive consumption. Statistics Presenter also allows the user to compute the so-called post-fiscal concepts of disposable income and consumption. ‘Post-fiscal’ refers to income or consumption minus indirect taxes in this context.

To deduce the corresponding poverty line net of indirect taxes, the monetary value of simulated indirect taxes by households close to the poverty line (+/- 2.5 per cent) is subtracted from the official poverty line. This is done outside of the model based on simulation results for the base year. Then, poverty and inequality numbers are calculated for post-fiscal income (or simulated consumption) using the new, lower, poverty line, denoted in the model as $splpf$. The household is poor, considering indirect taxes, if its disposable income or simulated consumption minus indirect tax payments fall below the new poverty line, $splpf$.

Based on expenditure, using the notation of the model, the household is poor, if its adult-equivalent consumption lies below the poverty line net of indirect taxes ($splpf$):
\[ ils\_con\_pf = ils\_con - ils\_taxind < splpf, \]

where \( ils\_taxind \) is an income list comprised of the household’s indirect tax payments. In the case of income-based welfare measures, one compares \( ils\_dispy\_pf = ils\_dispy - ils\_taxind \) with the post-fiscal poverty line \( splpf \). Similarly, inequality indices are also computed in the space of post-fiscal income or consumption, \( ils\_dispy\_pf \) or \( ils\_con\_pf \).

When opening the Statistics Presenter, in practice, the user thus first has to choose between compiling results for one scenario (‘SOUTHMOD Statistics – Default’) or for comparing scenarios (‘SOUTHMOD Statistics – Baseline/Reform’). After this initial choice, the user is next prompted to choose between poverty and inequality results based on consumption or income and taking into account indirect tax (post-fiscal concept) or not.

References