ANALYSIS of TAX JUSTICE

REPUBLIC OF MACEDONIA

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Short outline of the tax system in Macedonia

Taxes represent the most important form of public revenue and one of the most important means by which the redistribution of the national income to different subjects and in different forms of consumption is being done. The meaning of taxes is rapidly increasing, and in most countries is over 40%, which means great participation, and in some countries half of the GDP.

In the beginning of the 90's, along with the introduction of the new economic system in the Republic of Macedonia, a new fiscal system was introduced based on the principles of market economy, private property, independence of the economic subjects, etc. As Macedonia was leaving the 90s behind; the principle of allocative neutrality was further incorporated in the current fiscal system, with its greatest incorporation in the reformed tax system of 2007.[1] However, this principle was significantly derogated in the recent years, with the very clear example of the incredibly beneficial position of the foreign investments (contrary to the Constitution of the Republic of Macedonia), the large subsidies for agriculture, the different taxation of small and large companies, etc.

The Government of Macedonia introduced a number of supply-side policy measures at the end of 2006 (its implementation started in 2007) aiming to reduce the tax burden and improve the business environment. The main pillars of the tax system reform were the elimination of the progressive system of personal income tax, the reduction and unification of the statutory rates for the personal income and corporate taxes, and introduction of zero tax rates on reinvested profits. The so called flat tax refers to personal income and corporate profits being taxed at one marginal rate (12% in 2007 and 10% in 2008 onwards). Additionally, the Government of Macedonia introduced 1.5% tax on the gross annual income of micro businesses.[2]

When analyzing should the companies pay the same level of taxes regardless of their size, what needs to be clarified first is that basic tax laws are the same for both: large companies and startups. What is different are the type of tax credits and incentives the companies have access to - all of which are based on profits.[3]

Small startups generally do not make the same level of profits as large corporations, and are therefore not usually eligible for credits and incentives. The credits and incentives the larger corporations use to lower their taxes and this is enabled because of many corporate tax loopholes. For example, usually the tax offices in one country do not tax money earned in foreign countries, additionally, many foreign countries (as Republic of Macedonia) have very low corporate tax rates as compared to other high developed countries. This means that large companies can move large parts of their operations

1 Tax system of the Republic of M. Available at: *http://www.ujp.gov.mk/s/vodic?print=1*

2 FLAT TAX POLICY ASSESSMENT IN MACEDONIA, prepared by, CENTER FOR ECONOMIC ANALYSES (CEA) Team: Mr. Aleksandar Stojkov, MSc. Mr. Marjan Nikolov, MSc. Mr. Borce Smilevski, Skopje 2008

3 Taxes: Large Corporations vs Small Businesses and Startups, accessed in February, 2017, available at: *http://tech.co/taxes-large-corporations-vs-small-businesses-startups-2014-12*

abroad, pay much less in taxes than the high taxes they would pay in their native country. The issue here is that small companies and startups often don't have the revenue to set up operations in foreign countries and cannot use these loopholes.

Another issue is that large corporations can take greater deductions on business expenses, including things like executive stock options, private jets, and corporate sponsorships, because they have the financial resources to do so. It may appear that small companies and startups don't stand a chance when it comes to taxes. In fact, large wealthy corporations are the ones that benefit from large number of corporate tax breaks. [4]

When considering the issue of the tax system, and the taxation of individuals, what is interesting to notice is that all but the top-earning 20% of American families pay more in payroll taxes than in federal income taxes, according to a Treasury Department analysis. Still, that analysis confirms that, after all federal taxes are factored in, the U.S. tax system as a whole is progressive. The top 0.1% of families pay the equivalent of 39.2% and the bottom 20% have negative tax rates (that is, they get more money back from the government in the form of refundable tax credits than they pay in taxes).[5] Of course, people can argue and can have different thinking on whether this tax system constitutes a "fair" tax system.

What is crucial at the moment for Macedonia regarding tax policy is that we must make tax reform and introduce the progressive taxation which will be very carefully constructed and supported by serious cost-benefit analyzes. Meaning, the richest companies, banks, insurance companies etc as well as the richest individuals have to be taxed with the highest tax rates of the progressive scale. The small companies and start ups (in the early beginning of development period of 2 years) must not pay the same taxes as the biggest and richest companies and also must be stimulated with state measures. This is also applicable for the poorest people in the country which must be excluded from paying taxes. This certainly implies introducing non taxable minimum for the lowest income groups. The Macedonian tax system, in the way it is constructed now, does not protects the people with lower incomes. In contrary, the tax system puts forward the the economic elite.

What is crucial for Macedonia in terms of tax policy is that a tax reform must be implemented and a progressive taxation introduced which will be very carefully constructed and supported by serious cost-benefit analyzes. This means that the richest companies, banks, insurance companies, etc. as well as the richest individuals should pay the highest tax rates from the progressive scale. Small companies and emerging companies (in the first 2 years of their development) must not pay the same tax rate as the largest and richest companies and at the same time must be supported by the state with appropriate incentive measures. This should also apply to the most vulnerable category of citizens in the country who should be exempted from tax payments or receive appropriate tax exemptions.

On the other hand, when discussing the fairness of the taxation of individuals against the taxation of legal entities, one must be very careful advocating for higher taxes for companies and lower for individuals, because we have to bear in mind the question: who actually ends up paying the higher corporate taxes, meaning that it is very possible the workers in companies pay the tax in the form of lower wages or even the shareholders in lower returns. Nevertheless, one point is for sure: whoever is paying the tax it is not the company. So it is crucial to analyze the proper balance.[6]

4
Taxes: Large Corporations vs Small Businesses and Startups, accessed in February, 2017, available at: *http://tech.co/taxes-large-corporations-vs-small-businesses-startups-2014-12*

5
High-income Americans pay most income taxes, but enough to be 'fair'? accessed on march 2017, available at: *http://www.pewresearch.org/fact-tank/2016/04/13/high-income-americans-pay-most-income-taxes-but-enough-to-be-fair/*

6
Corporations Do Not Pay Taxes: They Can't, They're Not People, accessed in April, available at: *http://www.forbes.com/sites/timworstall/2011/09/22/corporations-do-not-pay-taxes-they-cant-theyre-not-people/#2cc24b7e6a62*

Structure of tax revenues

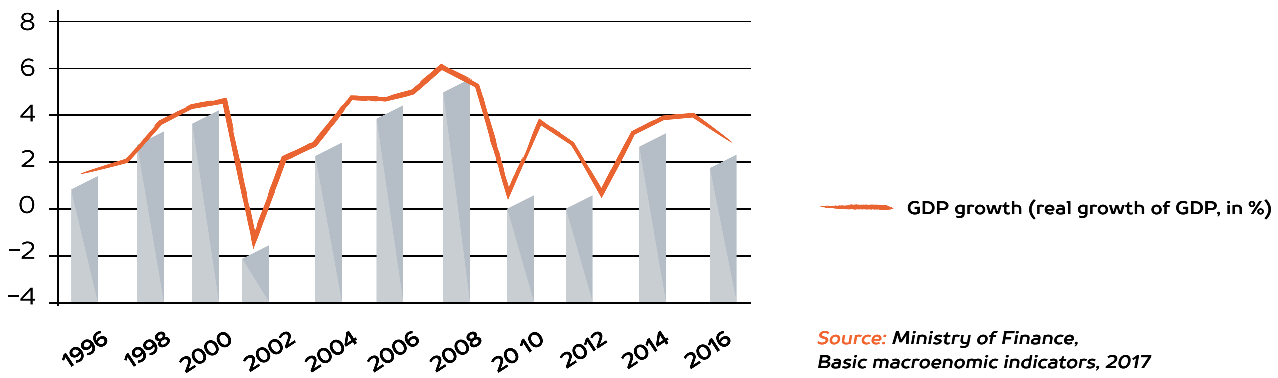
In 2007 the Republic of Macedonia introduced a flat rate system. The previous Government claimed that the introduction of flat tax for corporate and personal income tax will simplify the tax administration for individuals and will stimulate the operations of companies. These were the arguments of the Government of VMRO-DPMNE. The accomplished simplification of the tax administration is not to be argued. But as for the flat tax system and the stimulation of the economic activity, there are no arguments confirming the positive relations between these two variables. Namely, if that was the case, the majority of countries would apply this low and flat tax system.

Regarding the case with Macedonia, in the table bellow are concrete arguments (official numbers) for the suspicion that the flat tax system has "stimulated the operations of companies": the average annual real GDP growth in the period of 1996-1998 was 2 percent; In the period of 1999-2002 = 1.8 %; in the period of 2003-2006 = 4.2 percent; in the period 2007-2016 = 2.8 percent. In the period of 2003-2006, the public debt as a percentage of GDP has declined, and in the last 10 years (2007-2016) the participation of the public debt in GDP was doubled.

Of course, there are various factors that have influenced the economic growth in each period, however, there are certainly no empirical evidence to suggest that the flat tax policy more stimulates the economy. In this period the tax policy of the Republic of Macedonia was oriented towards greater tax burden on consumption and reducing the tax burden on income realized by the economic entities and citizens. In this context was the reduction of the social contribution rates of wedge, which are 27% in the moment, (which has stagnated in recent years at the same level), resulting in a reduction of labor costs.

If we analyze through the years, the introduction of the reforms in the tax system of Macedonia, have brought some positive effects and contributed to the expansion of the tax basis, and together with the enhanced control of the Public Revenue Office, reflected in reducing the informal economy and tax evasion, brought tax administration simplicity and increased the overage and responsiveness of the taxpayers in the country. However, if we want to connect the results of the flat tax system with the positive movements in the economic activity we should again look at the above data for GDP and the date form the table below. According to this data, there was an intense pace of economic activity in the initial period (2006-2008), when the economy continued its momentum before the introduction of a system called flat taxes, while for the entire period (2007-20016) the average real annual economic growth rate is "only" 2.8 percent, ie, it is significantly below the rate (4.2 percent) in the period 2003-2006. However, as regard the tax revenues as a percentage of GDP, the expected results were never achieved. If we look at the table below we could see that the assessment of "permanent annual growth in tax revenues as a percentage of GDP" has no empirical foundation, except perhaps for some individual types of tax - but we need to be interested in the effects of the entire tax system.

Graphic 1: GDP growth (real growth of GDP, in %)



Source: ***Ministry of Finance, Basic macroenomic indicators, 2017***

Table 1: **Tax and contribution revenues (% od GDP)**

	2005	2006	2007	2008	2009
Номинален БДП (мил.денари)	308432	334840	372889	414890	414622
Приходи од даноци (мил.денари)	52321	59774	69761	76854	71023
Приходи од даноци и придонес (мил.денари)	92010	90540	103218	115103	109860
Приходи од даноци и придонеси (% од БДП)	29.8%	27.0%	27.7%	27.7%	26.5%

Source: Ministry of Finance, Basic macroecomic indicators, 2017

From the table above, we can see that participation of both 'taxes', separately, and 'taxes and contributions' together, did not increase the percentage share of GDP, if consider 2005 for base year. This is explained by the obvious fact – the level of 'taxes and contributions' increased by 63 percent, while the nominal GDP growth significantly exceeded the increase of 'taxes and contributions' in the same period and resulted with 97 percent growth. These facts particularly indicate that we need to be careful when we talk about the success of the tax reform introduced in 2007. Simply, it is not enough to consider solely the data for 2007 and 2008, which are the only years in the 10-year series when the structural participation of 'taxes and contributions' together, have slightly increased their share of GDP in those years, while in the remainder of the period we see a decrease in their share of GDP. It should be noted that in the period 2006-2008, the economy registered the highest real and nominal GDP growth as a continuation of the good growth rates from the previous four years (and not due to economic reforms and etc) and the fact that in those three years (2006-2008) the rate of inflation was the highest in the last 11 years – nominal GDP growth of 8.6; 11.4 and 11.3 percent7 compared to each previous year.

Namely, to conclude: the simplification of the tax system and the reduction of tax rates certainly had an initial effect on the revenue from personal and corporate income tax. However, I think the increased tax revenues in the beginning period were more of a result of the dynamics of the economy in that period; 1.Increased salaries in the administration and the higher pensions (in 2007 and 2008, the Government increased the pensions cumulatively by 23 percent, and the salaries in the administration increased by 10%); 2. Initially improved efficiency of the PRO – the fiscalization and the initial belief of taxpayers that it is better to pay taxes than to be caught in evasion (in that period the shadow economy was shrinking).

If we compare the structure of each of the types of taxes in the total budget revenues in the years after the reform (2007-2015 / 16) to the year before the reform (2006 and / or 2005), we can see clearly what is the structural share of these taxes before and after the reform. So it is clear which tax has given more share to another, when and for what reasons, because, in the end, from year to year, we got a growing gap between incomes and costs, a bad relationship between direct and indirect taxes, high social inequality, duplicated public debt and economic growth that is not particularly praiseworthy.

The highest share of budget revenues is derived through taxes and social contributions and it varies from country to country in the world, but basically, on average ranging from 75-90% of total public revenues. Hence, the important fact for Macedonia is that tax revenues and contributions have the largest share in providing funding for financing the functions of the country, through which are realized 89% (for 2016) of total revenues. Hence, only the tax revenues account for 59% of the budget revenues, whereas VAT revenues are the most important source through which are collected

7 Basic economic indicators for the Republic of Macedonia, available at: *http://nbrm.mk/osnovni_ekonomski_pokazateli.nspx*

2010	2011	2012	2013	2014	2015	2016
437296	464187	466703	501891	527631	558240	607452
73754	78910	76617	78553	85125	92926	99957
112440	118669	117382	121011	129310	140826	150270
25.7%	25.6%	25.2%	24.1%	24.5%	25.2%	24.7%

almost half of the tax revenues. Contributions are also an important source, accounting for 30% of the budget revenues. [8] This confirms the fact that "taxes and social contributions" revenues are very important for the fiscal condition of the country and they must be maintained and even increased form year to year in order to be able to finance the constant growing need for public expenditures.

Nevertheless, the highest share of the budget revenues (for 2016) is spent on current expenditures which represent 89% of total budget expenditures. What is also interesting is that 13% of total budget expenditures were paid for salaries and allowances to the employees of the budget users and social transfers-related expenditures accounted for the most (45%) in the total budget expenditures. The capital expenditures account for only 11% of the total budget expenditures.[9] This suggests that the participation of the so-called 'mandatory expenditures' in the total budget expenditures is huge / excessive and that it constitutes a major obstacle on the so-called 'development component' of the budgets (an issue that has been repeatedly discussed by the previous government, without any arguments, saying that it is adopting development budgets).

Also, when we talk about the structure of the tax revenues, we should also address the current trends in EU and OECD countries. Almost all countries in the EU in response to the economic crisis, in order to reduce the deficit, increased their VAT rates. As regards the labor taxation there was a tendency for increasing this tax rates in almost all countries of the European Union. However, the last available report for Tax reforms in EU member states for 2015 addresses the new trends rising which basically refer to: decreasing tax rates and broadening the tax base in direct taxation, followed by reducing tax exemptions, reducing tax credits, etc,, increasing rates for indirect taxation, primarily VAT rates, reducing the tax burden on workers with low incomes in order to increase the working motivation and initiative.[10]

In 2015, the total taxes and contributions in the EU-28 countries amounted to 40.1% of GDP. In Macedonia, the total taxes and contributions in 2016 amounted to 24,7% of GDP.[11]

8
Bulletin of the Ministry of Finance, available at: *http://finance.gov.mk/files/u9/Bilten_dekemvri_2016_1_5.pdf*

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IBID

10
Tax reforms in EU member states, 2015 Report, Taxation papers, Working paper N.58-2015, ISSN 1725-7565 (PDF) ISSN 1725-7557 (Printed), Directorate General for Taxation and Customs Union Directorate General for Economic and Financial Affairs

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The data for calculation of this percentage were taken from the Bulletin of the Ministry of Finance of the Republic of Macedonia for 2016. This is an estimate based on my own calculations using all the officially available data.

The ratio of taxes to GDP is important factor and signal for the country preference about the size of the public sector. Basically, the level of tax burden is closely related with the level of economic development.[12]

Hence, if Macedonia wants to generate higher economic development, at one point it has to increase the share of tax revenues in GDP, that is, to increase tax revenues, because there is room for it, in order to provide additional funds for financing of capital investments and for the financing high quality public services. Taxes as the bulk of the revenue side must be a priority as a tool for securing additional revenues, bearing in mind that the high level of public debt in the country (47,8% of GDP) limits the mechanisms for securing additional funds for financing public services and capital investments.

The tax structure also differs between EU Member States, whereas that difference is particularly significant among the new Member States compared with the 15 old EU countries. In the old member states the participation of direct and indirect taxes and contributions in GDP is evenly and in the new EU member states the share of direct taxes in GDP is significantly lower in comparison to the EU average (17.9% Bulgaria, Romania 19.1%, Poland 20.5%). Just for comparison, in Macedonia in 2016, the share of directs taxes (PIT and CIT) in GDP is 4,1% and the share of VAT in GDP is 7,6%. [13] . This also presents another fact confirming the weaknesses and poor results of the 2007 reform. This means that Macedonia has real space for increasing the level of taxes, especially for rich individuals and companies.

Tax dodging

As tax dodging is defined like a popular term used by tax justice campaigners and the media to describe situations where it is not clear whether tax is being avoided or evaded, or a combination of both. Hence, we need to make a difference between tax avoidance and tax evasion. Basically, tax avoidance is legal, while tax evasion is not.

Tax avoidance is the legitimate minimizing of taxes, using methods and procedures in accordance with the positive and valid regulations. ***Tax evasion,*** on the other hand, is the illegal practice of not paying taxes, by not reporting income, reporting expenses not legally allowed, or by not paying taxes owed. Whether it is about tax avoidance or tax evasion, it represents avoidance of paying taxes. Considering that tax revenues are part of the total budget revenues, the tax avoidance and tax evasion both impact the decreasing of the total inflows of the budget, hence decreasing the revenues of the state that should be spent in the whole budget year.

Avoiding the legal obligation for paying taxes and social contributions automatically decreases the level of revenues that country should direct into health, education, social protection, infrastructure etc. Namely, the avoidance (legal or illegal) of paying taxes results in lower level of public services from which all citizens will benefit. [14]

One of the ways of fighting tax evasion is the measure the Public revenue office (PRO) applies for years. Each year, on quarterly basis, PRO publishes the black list of debtors. Thus, this year (2017) PRO published the list of debtors No.4/2017 for debt due to 31/12/2016, on the basis of VAT, income tax, personal income tax, contributions for compulsory social insurance, excise and customs duties for which the total amount of debt is: higher than MKD 120,000 for individuals and sole proprietors; and higher than 300.000 legal entities. The list of debtors published on the website of the PRO pursuant to Article 9 of the Law on Tax Procedure. PRO without the consent

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Slavko Lazovski, expert on tax issues, Debt and claim are two palm trees, which if they do not grow side by side do not give fruit, available at: http://www.akademik.mk/slavko-lazovski-ekspert-za-danotsi-dolgot-i-pobaruvaneto-se-dve-palmi-koi-ako-ne-rastat-edna-pokraj-druga-ne-davaat-plodovi-4/

13
Bulletin of the Ministry of Finance, available at: http://finance.gov.mk/mk/node/4105

14
What is tax evasion? Available at: http://bi.mk/shto-e-danochna-evazija/

of the taxpayer on its website may publish data for correction of inaccurate information published in the list of borrowers.[15] However, so far, this is a passive measure which does not produce real effects or they are minor.

On the blacklist are companies and individuals who have failed to pay all they owe in VAT, capital gains taxes and taxes on the profits of real estate sales and concessions. However, the list of debtors for 2015 published by the PRO shows that 3,546 companies failed to pay taxes or contributions. Likewise, there are 1,493 citizens on the black list that did not pay taxes. Together they owe 235 million Euros. The biggest debtors were 8 private companies with a debt of over 46 million Euros, and among the top 10 borrowers are the public enterprises "ЈП Македонија Пат", „ЈП Македонски шуми" and "ЈП МРТ" which together owe 11 million Euros. As regards 2016, the list of debtors published by the PRO shows that 4,251 companies and citizens failed to pay taxes or contributions. Together they owe 228 million Euros. The biggest debtor is the Joint stock company "Oteks" private company with 11 million Euros debt for VAT and CIT. The public enterprise "ЈП Македонија Пат", owns 7 million Euros and "ЈП МРТ" owns 1.4 million Euros.

In everyday life we are witnessing cases when tax authorities were punishing small companies and ordinary citizens for minimal delays in payment of taxes, social contributions or communal services while in the same time there are cases of tax evasion from persons and companies that are privileged and protracted because there are elite close to the previous government and do not bear any consequences even when there are publicly available information for huge tax debts. This just denies the fact that the law is actually enforced and that all the citizens are equal in front of the law. In such way tax discipline is undermined and it is impossible to expect that it will ever be established unless all of the citizens are equal in front of law.

30% of the economy is unregistered activities in which either tax is being evaded or lower contributions are paid. The data for undeclared labor range from 22-47% of GDP. Worrying data is that despite the previous government's measures there is still high percentage (45%) of informal employment among young people. Macedonia is a leader in the region at the rate of informal employment. The undeclared labor leads to tax evasion or failure to report revenue, manipulation with VAT and avoidance or payment of lower taxes. [16] It must also be taken into account that the collection of VAT from the companies is inefficient and there is the largest tax evasion of 30%. In this way citizens are in a completely unfavorable position in relation to companies because they certainly have to pay the VAT with every purchased product or service. There is still a major evasion of the payment of taxes and contributions by firms. Hence, the collection of taxes by the Public Revenue Office has to be improved.

One measure to encourage companies, public enterprises and citizens to pay taxes and thus to reduce the tax evasion is that the Government must establish more efficient, transparent, non-corruptive, more effective economic policy, choosing the most important priorities for citizens, by which companies and citizens will notice the real effect from paying taxes. In simple words, the citizens to see that paying taxes provide high quality, affordable and functional public services. Only then they will clearly know why actually they pay taxes. In this way, the country will start to acquire developed countries tax habits, meaning that taxes must be paid in order for a society and an economy to function normally. This relation raises the awareness that if we pay more taxes will receive better quality public services. [17]

15 LIST OF DEBTORS No. 9/2017 FOR DEBTS REALISED BY 31.05.2017 AND UNPAID BY 31.08.2017, available at: *http://ujp.gov.mk/mk/otvoreni_povici/pogledni/343*

16 Taxes and informal economy. Available at: *http://www.telma.com.mk/vesti/danoci-i-siva-ekonomija*

17 Supporting the Development of More Effective Tax Systems A REPORT TO THE G-20 DEVELOPMENT WORKING GROUP BY THE IMF, OECD, UN AND WORLD BANK. Достапно на: https://www.oecd.org/ctp/48993634.pdf

As for the end, the general thinking of the citizens and CSOs in Macedonia about the tax dodging (tax avoidance and tax evasion) is that this issue is poorly understood. Namely, the issue of tax avoidance and tax evasion of multinational corporations is quite a new topic in Macedonia and these issues are only noticeable when major scandals are reported. Mostly, people in Macedonia are more preoccupied with existential problems. At the end of the day, it is the citizens who are losing the most from the practice of tax avoidance.

Tax competition / Race to the bottom

Tax competition exists when governments are encouraged to lower fiscal burdens to either encourage the inflow of productive resources or discourage the exodus of those resources. Often, this means a governmental strategy of attracting foreign direct investment, foreign financial investment and high value human resources by minimizing the overall taxation level and promoting special tax preferences, creating a comparative advantage.

What is crucial about this phenomenon is to know how negative effects impose tax dodging to one country, in this case Macedonia. Tax competition between countries leads to the well known “race to the bottom”. This consequently means loss of government revenues and loss of funds that can be used for public goods and at the same time limits countries in applying public redistributive policies.

Costs and benefits of tax incentives

It is clearly shown the “tax heaven” policy is not enough for attracting foreign. In relation to this, the flat tax policy introduction and fiscal measures by which domestic and foreign companies are allowed to have cheaper reinvestment of profit and its use for investment leads to loss of tax revenues. If another tax policy was in place, these lost revenues would actually go into the state budget presenting a possibility for realizing investments funded by the state. Nevertheless, this policy for attracting FDI, with all these tax reliefs and exemptions actually favors foreign investors. The numerous subsidies and incentives given to foreign investors, despite the constitutional provision that foreign investors have the same treatment as domestic investors, actually the foreign investors are in far more better position.

Until September 2017 there was no official data on the precise cost-benefit analysis from foreign direct investments. Thus, in September 2017, the new government made a full analysis of the costs of attracting foreign investment and came up with official data. Also, the new Government gave a commitment that in the future all further agreements with foreign investors will be transparent and publicly announced, which is a crucial step forward compared to the situation with FDI in the past 11 years.

Thus, the previous government for period of 10 years, while prime minister was Nikola Gruevski, spent 225 million euros for foreign investors which in turn employed a total of 20,000 people. According to this mathematics, one employee with foreign investors have cost the country 11,000 euros. This sum was spent on 25 foreign companies, for which the country have lost 69 million euros in tax reliefs and customs exemptions. It was noted that there were no negotiating criteria in the agreements with the foreign companies, and all the documents were classified. For some companies the previous government have spent 1,000 euros, for some 11,000 euros. There were no criteria for dividing the money.[18]

Thus, the previous government for period of 10 years, while prime minister was Nikola Gruevski,

18 Costs for foreign investments, For 10 years, 225 million euros were spent on 25 companies which employed 20 thousand people, available at: *https://www.mkd.mk/makedonija/politika/za-10-godini-potrosheni-se-225-milioni-evra-za-25-kompanii-koi-vrabotile-20*

spent 225 million euros for foreign investors which in turn employed a total of 20,000 people. According to this mathematics, one employee with foreign investors have cost the country 11,000 euros. This sum was spent on 25 foreign companies, for which the country have lost 69 million euros in tax reliefs and customs exemptions. It was noted that there were no negotiating criteria in the agreements with the foreign companies, and all the documents were classified. For some companies the previous government have spent 1,000 euros, for some 11,000 euros. There were no criteria for dividing the money.[19]

Professor Branimir Jovanovic[20] in his analysis and BIRN's research on foreign investments[21] gave roughly similar data on the costs from direct government spending intended to attract foreign direct investments, considering that there were no official data regarding this issue.
What is crucial to say is that the actual results of spending huge amounts to attract foreign investment are very weak. Namely, in the period 2007-2016, FDI accounted for 3.6% of GDP, which is lower than the level achieved during the two previous governments. During the previous government from 2002 to 2006, FDIs were on average 3.7% of GDP, and during the government from 1998 to 2002 they accounted for 6.1% of GDP.[22]

All the statistics listed above indicate that this policy to attracting foreign investors that implies spending huge amount of state funds needs to be terminated. Namely, the direct benefit for the Macedonian citizens from these policies is significantly lower than the direct costs. The low-tax policy is not enough to attract foreign investors. Namely, Macedonia still has an unstable political situation, a risk of worsening of the security situation, unresolved bilateral issues and problems with neighbors, a high level of corruption, a failure of the judicial system and a very unstable legislative framework.

Table 2:
Foreign direct investments (% of GDP)

Foreign direct investments (% of GDP)	
1998	4.2
1999	2.4
2000	5.7
2001	12.0
2002	2.6
2003	2.4
2004	5.7
2005	1.5
2006	6.2
2007	8.4
2008	6.1
2009	2.0
2010	2.2
2011	4.5
2012	1.7
2013	2.8
2014	2.3
2015	2.3
2016	3.6

Source:

National bank of the Republic of Macedonia, Basic economic indicators for Republic of Macedonia, 2017

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Costs for foreign investments, For 10 years, 225 million euros were spent on 25 companies which employed 20 thousand people, available at: *https://www.mkd.mk/makedonija/politika/za-10-godini-potrosheni-se-225-milioni-evra-za-25-kompanii-koi-vrabotile-20*

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The real cost of cheap labor, Policies for attracting foreign direct investment in Macedonia, 2007-2015, B. Jovanovic, Skopje 2017.
***The direct costs of the government spent for attracting FDI in the period of 2007-2015 amounted to 160 million Euros. Thus, 26 foreign companies have received state aid, but there are not actual data and contracts from which we can see the value of the state aid for each company. The decisions issued by the Commission for Protection of Competition, are indicated by XXX. These firms (that have gained state aid) at the end of 2015 employed total of 12,600 workers, which means that the state has spent around 12,600 Euros per employed worker. Additionally, the process of granting the foreign investors state aid was not transparent and public.

21
Foreign investors have cost the budget at least 150m euros. Available at: *http://prizma.mk/stranskite-investitori-go-chinea-budhetot-najmalku-150-milioni-evra/*
***It should be noted that the latest analysis of BIRN published on the Prisma Internet portal showed that the previous Macedonian government have spent at least 148.7 million euros in the past 10 years in order to attract foreign investments, also on marketing and promotion, subsidies and also to build technological industrial development zones. The BIRN research showed that 138 foreign investments were announced out of which 51 were actually realized. Regarding employment, there were 62.701 employments announced and only 20.248 were employed. The total investment value that was promoted at the beginning was 1,06 billion Euros and according to the latest data only 492,24 million Euros were invested in the country. The total amount of wages these companies paid to their employees in the analyzed period amounted to EUR 92 million which is significantly less than what the state (the government and other agencies) have spent for attracting foreign companies. During the same period, net profit of these companies totaled 235 million Euros, respectively, two and a half times the wages of the workers.

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Basic economic indicators for Republic of Macedonia, NBRM available at: *http://nbrm.mk/osnovni_ekonomski_pokazateli.nspx*

Inefficient administration, low financial discipline, low levels of personal income, as well as small market, gray economy and tax evasion, budget deficit, high interest rates, poor infrastructure such as roads, telecommunications and energy infrastructure are one of the reasons that impact negativly on foreign investors when considering whether to invest in the country. In such unfavorable conditions there nor its location, skilled and cheap labor force, the flat tax policy and numerous tax reliefs and exemptions for foreign investment are not sufficient to attract FDI, considering the fact that in Macedonia have not recorded a significant amount of foreign capital.[23]

Progressive taxation

A progressive tax is a tax where the tax rate increases as your income increases. The United States currently has a progressive income tax that requires higher income citizens to pay a larger percentage of their income in taxes. Taxpayers are divided into categories based on income levels.

Benefits of Progressive Tax System

Income Equality – This is one of the biggest pros that progressive tax system. A progressive tax system really acts as a tool for redistributing income from the upper class to the lower and middle class. Those individuals who earn more pay more into the federal government. This helps keeps the income gap from growing wider between the rich and the poor.[24]

Social Justice – Some argue that it is morally right that those who can afford to pay more in taxes should do so. Progressive taxes should reduce economic and political inequality in society and they are a prerequisite for a richer, more harmonious and less conflicting society. Those who have very little income should be compensated and helped by those who earn a lot of money on the basis of their privileged position in the society – rent seeking, cronyism etc. Progressive tax system allows governments to collect money from those who have the most and uses it to help create a society that is more just and happier as a result. Those taxes are used to fund education, medical services, housing assistance, and other welfare programs for those people who really need it. [25]

More Government Revenue – A progressive system allows governments to collect more money from higher income earners. These results in more money collected than if everyone paid the same percentage. As a result, the government can provide more programs and services that benefit society.[26]

The flat tax system, and at the same time the policy of huge tax exemptions and incentives to foreign investors, most hurts the poorest, which proportionally pay as much as the wealthiest. In many developed countries, progressive taxation aims to reduce further stratification of citizens.

The latest analysis of the Ministry of Finance showed that Macedonia has a high inequality rate (14%) among the citizens on the basis of income and that there is a tendency for its growth. This inequality is the highest in Europe. The analysis suggests that the highest income realized in 2016 was 2.6 million euros, and 15 persons realized income over one million euros. Also, in 2016, the average personal income was 302 euros per month, the richest 1% in Macedonia had an average income of about 4,200 euros per month. The high

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Administration of public revenues and public expenditures for the purpose of achieving accelerated economic growth and development of Macedonia, doctoral dissertation, V. Joshevska Popovska, 2016 Bitola

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In Favor of Progressive Taxation and a Balance Approach to Budgeting, Available at: *http://www.huffingtonpost.com/andrew-fieldhouse/in-favor-of-progressive-t_b_981868.html*

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income inequality is indicated by the fact that the 775 persons who had over 100 thousand euros of income jointly earned income of 190 million euros, equal to the total income of 210 thousand persons who had the lowest incomes. This analysis, among other things, points to how unjust the tax system in Macedonia is. Namely, the chart shows that the richest 1% in Macedonia have the lowest tax burden.[27]

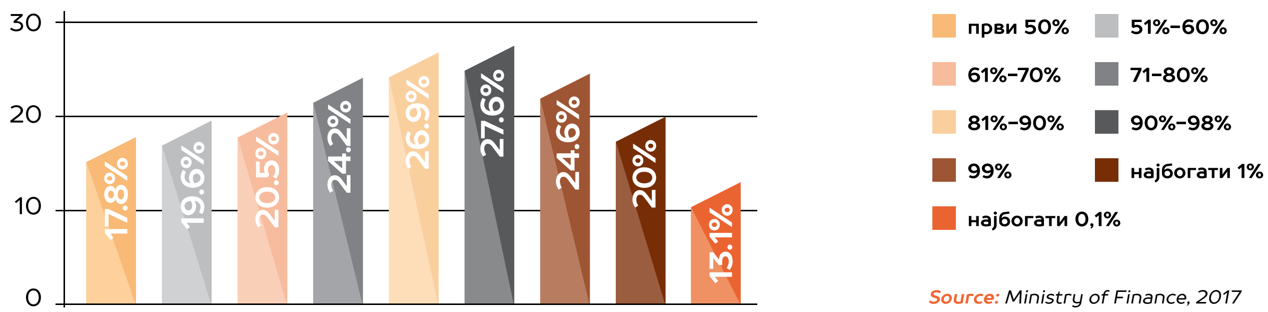
These are disastrous data indicating that the distribution function of taxes does not play its role in Macedonia. Therefore, new economic measures are urgently needed now, and of course, one of these measures is the increasing the non-taxable minimum and tax system reforms aimed at introducing progressive taxation, especially for companies. (In Serbia, the non-taxable minimum is 11000 dinars, in Macedonia is 7500 denars)

Namely, Martin Hudsbund of the world confederation union pointed out that the problem in Macedonia is that direct taxation is low and we are very reliant on indirect taxation, of VAT. He points out that the flat-rate tax is not fair. This income should be taxed on a progressive scale. We cannot have a situation in which the one who earns a lot pays the same with the one who earns a little.[28]

Progressive tax modernization can and should raise significant revenue to finance job creation and public investments, shrink deficits, and ease pressure elsewhere in the budget. It can moderate recent and persistent trends toward widening income inequality and hyper-concentration of wealth, helping to restore a society of shared prosperity. Progressive taxation is a palatable approach to deficit reduction embraced by the public—unlike nearly every other deficit reduction approach. Simply put, progressive taxation is fiscally responsible, economically sensible, and politically viable.[29]

According to Doing business report[30], higher income inequality is associated with a smaller tax base and therefore lower tax collection. Income inequality has been rising in many parts of the world in recent decades. Macedonia is among the ten poorest countries in Europe and the poorest country regarding income inequality in the region and has poverty ratio of 30,4% in 2017. Redistribution of income should be done by the government and it should be done with fiscal instruments that achieve distributional objectives at a minimum cost to economic efficiency. Thus fiscal redistribution can help support growth because it reduces inequality.

Graphic 2: Tax burden (% of GDP)



Source: Ministry of Finance, 2017

27 Ministry of finance: Macedonia with high rate of income inequality, available at: *http://www.akademik.mk/ministerstvo-za-finasii-makedonija-so-visoka-stapka-na-dohodovna-neednakvost/*

28 Taxes and informal economy, available at: *http://www.telma.com.mk/vesti/danoci-i-siva-ekonomija*

29 In Favor of Progressive Taxation and a Balance Approach to Budgeting, available at: *http://www.huffingtonpost.com/andrew-fieldhouse/in-favor-of-progressive-t_b_981868.html*

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What needs to be kept in mind is the careful determination of the progression and the top personal income tax rate, and even more important is the progression of the capital income tax rate. Because if they are too high, taxpayers will find ways to avoid or evade the tax and a higher rate may no longer raise extra revenue. Namely, the proposed progressive model of taxation for personal income tax and capital income tax can increase tax revenues in the budget and will contribute to the achievement of social justice in taxation.

Nevertheless, in the recent years several some of the transition countries are starting to replace the flat rate system with the progressive tax system. Thus, in 2013 two EU countries - Slovakia and the Czech Republic – despite the only one personal income tax rate they introduce a second (additional) personal income tax. Tax progression in Slovenia is 19% and 25%, while the Czech Republic has introduced an additional 7% solidarity tax on the part of the income which four times exceeds the average annual salary. This was introduced as a temporary measure and it is calculated above the rate of 15% so the total is 22%. In Albania in 2014 the personal income tax rate is 10% is replaced with three rates: 10%, 13% and 23%.[31] The authors of the report state that the main reason for the introducing progressive tax system in the mentioned countries is the decision of the leftist governments of correcting the growing inequality. Macedonia has the greatest inequality in income distribution in Europe. Macedonia is the only country in Europe where the value of Gini index exceeds 40. What is worryfying at the moment is that there is a strong and growing of increasing inequality of income distribution. Namely, in the first year (1998) of World Bank's published data on Gini index, the data on Gini index for Macedonia was 28. No other country in Europe has realized such a dramatic increase in inequality in the distribution of income.[32]

The crucial thing is to create such a tax reform which will provide for more equitable and just system, meaning it will equalize opportunities and improve the possibilities for workers, small companies and middle-class families. Nevertheless, the amount of guaranteed minimum income that is not taxable should be increased. The introduction of the progressive taxation to be implemented in a way that highest rates would apply only to individuals who earn a lot and to companies that generate huge profits. The ultimate goal to be: fair, just and equitable system for reducing the poverty in the country. This would revive the labour market and improve the well-being of the most vulnerable categories of citizens and at the same time to middle-class families.

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In this regard and for the matter of collecting more public revenues, one of the key challenges for tax reform, in the report for Supporting the Development of More Effective Tax Systems, written by the working group of IMF, OECD, UN AND WORLD BANK, is that high-income individuals can and must be taxed more effectively, not least to build the wider sense of fairness needed to support compliance more widely — by removing opportunities for avoidance and strengthening detection and enforcement. Also, the report suggests that incentives, including corporate income tax (CIT) exemptions in free trade zones, continue to undermine revenue from the CIT; where governance is poor, they may do little to attract investment — and when they do attract foreign direct investment (FDI), this may well be at the expense of domestic or FDI into some other country. Tax-driven investment may also prove transitory.[33]

31 Reforms for tax justice, П.Гацов, Ѓ. Гоцков, Г. Петревски. Н. Поповски, Д. Тевдовски, В. Узунов и В. Филиповски, февруари 2016

32 Reforms for tax justice. P. Gacov, G. Gockov, G. Petrevski, N. Popovski, D. Tecdovski, V. Uzunov I V. Filipovski, February 2016

33 Supporting the Development of More Effective Tax Systems, REPORT TO THE G-20 DEVELOPMENT WORKING GROUP BY THE IMF, OECD, UN AND WORLD BANK, 2011

As for the value added tax (VAT), the working group suggested that VAT has greater revenue potential than most other instruments, but realizing this in many cases requires expanding the base — by eliminating exemptions, unifying rates, and improving compliance — rather than increasing standard rates. 34

At the same time, we can state other very important reasons for the necessary tax system reforms. Given the public debt in the country (47,6% of GDP), Macedonia needs to increase its budget revenues to pay off accumulated debts and in a relatively satisfactory way to perform public functions, including the constitutional obligation that it is at the same time a welfare state. But fiscal consolidation should not and must not be, realized through the reduction of public expenditures. It is not a reasonable option. Public expenditure must not be reduced, but rationalized and restructured according to the real priorities of citizens and their effect on the GDP growth. 35

Namely, in the past years, due to the need for fiscal consolidation, in the EU member states there is a trend of increasing tax burden. This is because in many countries fiscal consolidation has been made with tax increases rather than with expenditures cuts. This is closely linked to the introduction of progressive taxation. Thus, fiscal policy is the use of government spending and taxation to influence the economy. Governments typically use fiscal policy to promote strong and sustainable growth and poverty reduction.

In relation to the above, there are facts, results and reports from recognized institutions which show that flat tax does not justify the main reasons for its introduction and also emphasize the need for tax reform in the country. The tax system of one country not only serves to finance government expenditure, but also offers ways for redistribution of income. Lately, very important is the fairness of the tax system because inequality can have a negative effect on the growth of economy and political stability.

At the end, in order to make progressive taxation to serve the objective – decreasing income inequalities, the government must commit to the objective. Namely, the taxes must play their distribution function in the society and stimulate the efficiency of the social transfer policy. Hence, what is collected from the rich, through specific measures and programs should be channelled to the poor. The policy measures would be social transfers, increasing the non-taxable minimum, exemption of the poorest people from paying taxes, help programs for single mothers and children with special needs, etc.
Finally, social protection and tax policy are usually considered separately, yet they are strongly linked. If poverty and the reduction of inequality are central problems with a priority of the fiscal policy then careful consideration of taxes and transfers is needed and finding the best ways in which they can jointly deliver the best results. Hence, tax policy reforms need to go hand in hand with social policy reforms.

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Reforms for tax justice. P. Gacov, G. Gockov, G. Petrevski, N. Popovski, D. Tecdovski, V. Uzunov I V. Filipovski, February 2016

Recommendations and conclusions for reforms for fair taxation

- **The era of tax havens should finally end.** Thus, tax havens fuel the inequality crisis which leaves poor countries without the funds they need.
- **Strengthening the technical, administrative and institutional capacity of the Tax Revenue Office in order to improve the collection of revenues,** which will enable a higher level of budget revenues.
- **Introducing solid measures against tax evaders from the corporate sector.** This is also aimed at reducing the tax evasion.
- **Macedonia should leave the existing model of "flat tax system" and to introduce the model of a "fair" (i.e. progressive) taxation.** This applies particularly to the personal income tax and corporate income tax.
- **Increase and guarantee the minimum income that will not be taxed.**
- **Macedonia to stop "race to the bottom" with existing tax incentives, tax subsidies, tax exemptions.** After a preliminary analysis of the costs and benefits of tax exemptions, incentives and subsidies, they should be revised with a further goal for their abolition.
- With regard to the policy of attracting foreign investments, the Government should stop subsidizing jobs for foreign companies that literally exploit workers.
- **Within the fiscal consolidation measures must be taken to collect the evaded taxes,** which will provide higher revenues and reduce the public debt and the budget deficit.
- **Increase the reach and quality of social services.**
- On many occasions, citizens collected money for children with serious health problems, due to lack of state money for this purpose and poor quality of health services. Hence, a system should be introduced in which in the distribution of tax revenues, priority will be given to the costs for such purposes.
- **Macedonia must take the challenge and conduct thorough reforms in the area of public finances, with special emphasis on tax system reforms.** The reforms should be directed to: lower income inequalities, fairer tax system (the poorer will pay less and richer will pay more), increased tax revenues from direct taxes and expansion of social services through increasing tax revenues.
- However, as we mention before, important factor for increasing tax revenues is also the **greater tax discipline in Macedonia. The introduction of greater tax discipline in Macedonia requires increasing tax morality, ie raising awareness of the people about the benefits of paying taxes to the state.** And this is possible only though providing high quality public services funded by the government.

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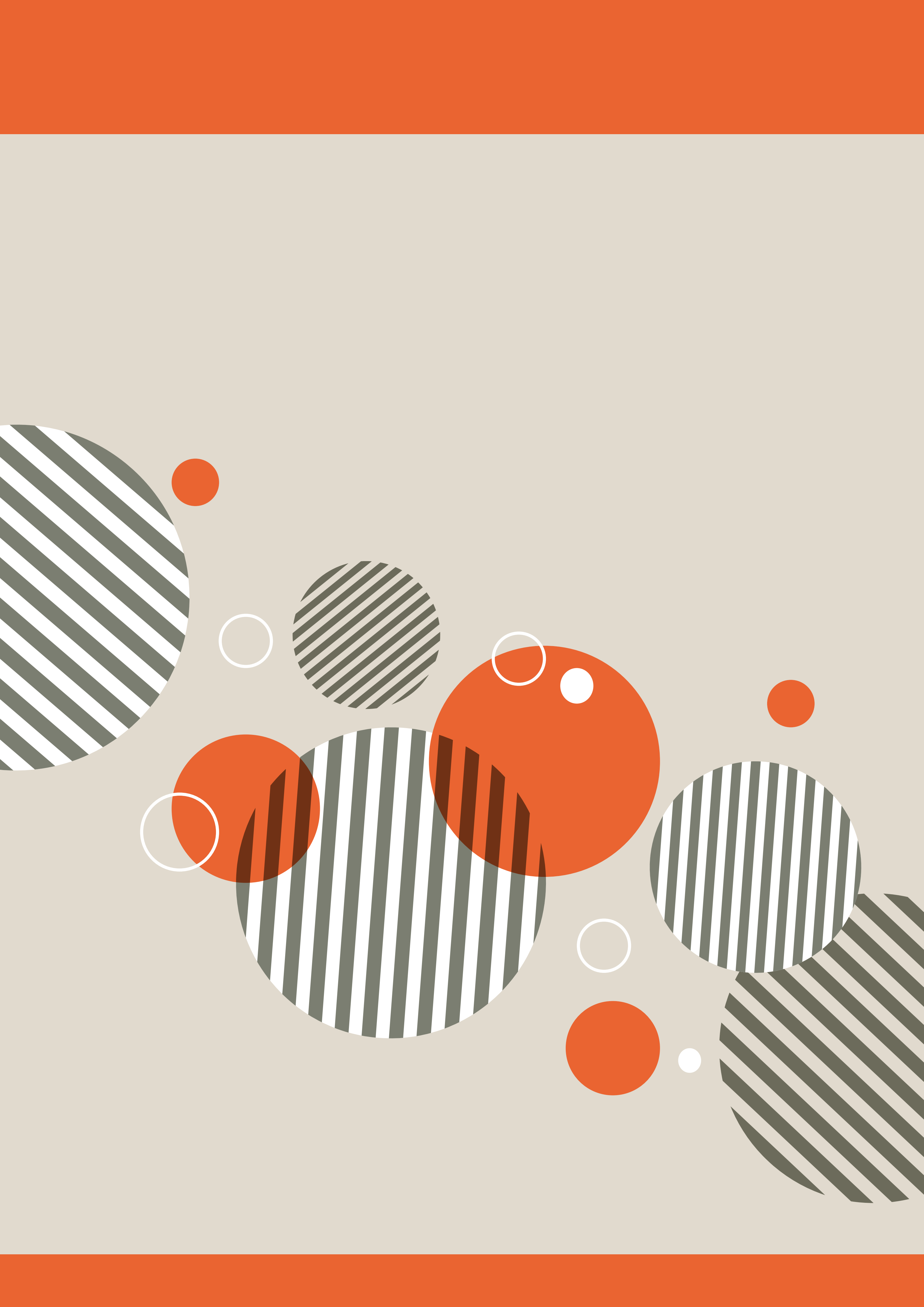


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