



# Weekly Briefing

**Macedonia Economy briefing:**  
**Macedonia's Taxation System: Challenges Ahead**  
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## **Macedonia's Taxation System: Challenges Ahead**

### **Introduction**

While not substantially diverging across a number of policy issues, one of the most significant differences between the two main political parties in Macedonia, SDSM and VMRO-DPMNE, has been the stance on taxation models. SDSM, profiling itself as a center-left party, has historically favored a progressive taxation model. VMRO-DPMNE, profiling itself as a center-right one, has favored a flat taxation model. Their respective times in office have therefore left an imprint on Macedonia's public revenue system and fiscal policy. With the recent change of government, there are impending changes to Macedonia's taxation system; however, it is still unclear how this will unfold. This report takes stock of the recent trajectory of the issue, the current situation and future challenges.

### **Taxation under VMRO-DPMNE**

In its multiple terms in office 2006-2017, VMRO-DPMNE introduced a series of changes in the realm of various economic policies, including taxation. Most notably, in 2007, they have reduced the profit tax rate from 15% to 12%; the following year, they reduced the profit tax rate for additional two percent, down to 10%. This was justified with the belief that lower profit tax for companies will stimulate business operations, thereby stimulating economic growth; and overall, will simplify administration procedures. In 2007, VMRO-DPMNE also amended the personal taxation policy, replacing the previous model of "24-18-15" with a model of flat rate tax of 12% for everyone. The following year, 2008, the new flat rate tax was reduced by two percent, and brought down to 10%. The flat tax and the lowering of the tax rate were justified not only by ideological claims that flat and lower taxes are better for the economy, but also by a rather pragmatic claim that by flattening and lowering the taxes, the state is in a position to ensure more thorough revenue collection

and reducing tax evasion (the logic being that when taxes are higher, people tend to avoid to pay them more frequently).

At the same time, VMRO-DPMNE also changed the statutory rates according to which personal income and revenue are calculated, by introducing a certain range of income (for instance X-Y, where X is the lowest, and Y is the highest possible amount that can be taxed) that can be taxed. If a person earns below the lowest foreseen amount ( $<X$ ), they would still pay revenues based on the nominally lowest statutory amount (X) – making them actually pay more than what they earn. On the other hand, if a person earns more than the highest statutory amount ( $>Y$ ), they would still pay according to that rate (Y) – in practice, this means that they would pay less of what they earn. Hence, financial experts have argued that VMRO-DPMNE introduced a regressive taxation model – the poor people end up having a higher tax rate than the rich, or rather that the state takes from the poor to give to the rich.

VMRO-DPMNE undertook these and other tax reforms as part of a broader set of measures to attract foreign investors. Some of the additional reforms included the reduction of the value-added tax for foreign companies, various tax exemptions for foreign companies, and the establishment of special economic zones (so called Technological and Industrial Development Zones) that have exceptional status characterized by particularly favorable financial conditions. According to a number of authoritative international analyses of business climate, these measures in theory made Macedonia a very attractive destination to foreign companies, at least when it comes to the low tax rates. According to the calculations of the World Economic Forum from 2016, when one takes in account all the different measures to reduce the tax burdens and the various financial concessions, it turns out that foreign companies pay even less than 10% of total tax in Macedonia – world's lowest rate. However, while the tax framework is indeed very favorable for the attraction of foreign investors, other structural circumstances (such as bad infrastructure) prevented a true FDI boom in Macedonia. Once the political crisis started in 2015, Macedonia became a

risky destination and not only investments stopped, but it also faced a threat of capital flight.

Needless to say, the taxation reforms that VMRO-DPMNE introduced, ultimately did not lead to a significant economic progress. Moreover, they have been directly associated with detrimental societal consequences, in particular the meteoric rise of inequality. During VMRO-DPMNE's rule, partially owing to the introduction of the flat tax, and the regressive income taxation measures (but also owing to other factors), Macedonia's Gini coefficient has skyrocketed and the country has become one of the most unequal in Europe. At the same time, the combination of simultaneous overall reduction of taxes happened amidst an era of significant increase of public spending. Having had reduced the tax rates for both companies and individuals, the VMRO-DPMNE government had to diversify its methods of public revenue collection, in order to avoid huge budget deficits and over-indebting the country. In the process, VMRO-DPMNE eventually resorted to extracting more revenue from Macedonian companies and citizens, while maintaining a very favorable climate for foreigners. While taxes remained ever lower, various forms of law enforcement have swarmed Macedonian companies and households. A separate class of executors has emerged, as often companies and individuals had problems with paying the penalties that they owed to the state. The consequence has been the slowing down and even shutting down of a number of companies; while many households have faced an adverse financial situation.

### **SDSM's ideas of tax reforms**

SDSM has consistently argued that Macedonia should abolish the flat tax system, and restore the progressive taxation system. In the years in opposition and during electoral campaigns, SDSM representatives and affiliates have also argued that aside from a tax reform, additional measures are also needed to secure tax justice and social justice in Macedonia. They have continued this discourse after forming the new government in spring 2017. During the remainder of 2017 and in 2018, a number of representatives of the new, SDSM-

led government, including the Prime Minister Mr. Zoran Zaev, the Vice Prime Minister in charge of economic affairs, Mr. Kocho Angjushev, and the Minister of Finance, Mr. Dragan Tevdovski, have expressed their views on the issue of revenue collection – all of them supporting the idea of progressive taxation in principle, with notable differences regarding the details of its implementation. While Mr. Zaev has remained rather vague and reserved on the issue, Mr. Tevdovski and Mr. Angjushev have been more vocal – and have memorably engaged into a debate in which they have voiced disagreements with each other.

According to Mr. Tevdovski, the ideal solution on the short term is two-tiered progressive taxation model. The threshold for distinguishing between the “rich” and the “poor” (based on which they would abide to different tax rate) would be at around 1000 EUR of monthly income. Those who receive below 1000 EUR, would pay 10% income tax; while those who earn more than 1000 EUR, would pay 18% income tax. Based on empirical data, Tevdovski has argued that while the threshold of 1000 EUR may sound too low, it nevertheless applies to only 2% of the population (98% earn less than that). For Tevdovski, the introduction of two-tiered progressive tax would be only the first phase of a longer process, that may as well include introducing an intermediate statutory rate, thereby making a three-tiered taxation structure.

Mr. Angjushev, who hails from the business sector, has surprisingly expressed support for the idea of progressive taxation despite the fact that his constituency has been traditionally opposed to it. However, he has been very cautious about the statutory rates that would separate the different categories of income tax rates. He has opposed Mr. Tevdovski’s idea of having the threshold at the amount of 1000 EUR per month, as according to Mr. Angjushev such move would qualify a large number of the population into the “rich” category (that is supposed to pay the highest rate of taxes), which in turn may be counter-productive.

The government has also proposed changes in the value added taxation. Individuals who are engaged in (entrepreneurial) economic activity (except

regular salary) that generates them more than 1 million MKD of profit (slightly above 16.000 EUR per year, or about 1350 EUR per month), would be obliged to pay VAT for the next five years. In practice, this measure is expected to affect individuals who work as consultants or are in some way contracted by companies, in particular foreign companies, to provide services. The announcement of such reforms has raised concerns and opened debates, in particular among Macedonia's vibrant ICT community. According to some estimates, computer programmers are the most affected group by these measures (as many of them are contracted by foreign companies). Additionally, others have argued that the measure makes little sense, as often, when individuals are contracted, the money they receive involves not only reimbursement for their time and labor, but also for materials, overheads, costs related to the service they provide, etc. In this sense, they may be taxed for something that is essentially not income, but rather work-related costs.

Finally, one common line of a criticism towards the SDSM government is that even though they discuss progressive taxation and promote nominally socialist values, in some ways they still follow the trends set up by VMRO-DPMNE, in the sense that they only regulate the personal taxation, but not the corporate one. While there are impending reforms in the income taxation and the VAT for individual entrepreneurs, companies still have to pay a flat rate tax of only 10%, and foreign companies still enjoy a number of privileges (importantly, the government has announced extending these privileges for domestic companies as well, thereby introducing a principle of equality). In that sense, paradoxically, the workers are supposed to pay taxes for their income at the higher rates than the companies for their profit. While there can be many normative objections to this reality, this also reinforces the challenge of insufficient revenue collection. Macedonia's public spending is significantly increasing under the new government, too. However, an increase in corporate tax is expected to contribute much more significantly to the state budget than an increase in personal income tax. More even so, according to finance experts,

only about two dozen companies in Macedonia generate more than two thirds of all the corporate profits in the country; many of them do not reinvest the profits, and those that are foreign-owned often repatriate the profits abroad. This is increasingly seen as a predicament whose solution would require a lot of political will – as these large companies also enjoy a significant political influence. This perhaps will be the true test for SDSM, as for them demonstrating relative independence from the so called “oligarchs” is not only a matter of proving consistence, conviction and responsibility; but also demonstrating that they are indeed substantially different than VMRO-DPMNE (who maintained political power greatly owing to the support of oligarchs).