



**BUSINESS ENVIRONMENT
ACTIVITY**

FLAT TAX POLICY ASSESSMENT IN MACEDONIA

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BUSINESS ENVIRONMENT ACTIVITY

This report is prepared with support of the USAID Business Environment Activity. The Business Environment Activity is financed by the US Agency for International Development to sustain the achieved momentum in the economic sector and strengthen the enabling environment for doing business in Macedonia in order to encourage business formation and growth and address the issue of high unemployment.

**Tatjana Lukanovska
Senior Financial Sector Advisor
USAID Business Environment Activity**

Dear Reader,

This report illustrates the main findings from the survey conducted by the Institute for Democracy, Solidarity and Civil Society (IDSCS) – CEA partner in this project. The Questionnaire was developed by CEA, IDSCS and USAID Business Environment Activity (BEA) and the survey was conducted by IDSCS. The first version of the report was developed by the IDSCS. That version of the report was further developed by Mr. Aleksandar Stojkov, Mr. Marjan Nikolov and Mr. Borce Smilevski, all from CEA.

This study draws important conclusions that are sensitive and require immediate action upon which the Government of Macedonia (GoM) should be urged. We suggest a follow up on this study that will be presented at sector level of Macedonian economy.

I hope that the study will meet your expectations and will lay the foundations of our further cooperation.

Yours sincerely,

Marjan Nikolov, MSc

President of CEA



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Table of contents

<i>Executive summary</i>	6
<i>The main policy recommendations</i>	6
<i>Highlights</i>	7
<i>Introduction & Methodology</i>	10
<i>Flat tax policy assessment – Analysis of the survey</i>	12
<i>Concluding remarks</i>	28

Executive summary

- (1) The Government of Macedonia introduced a number of supply-side policy measures at the end of 2006 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 rate 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) The study focuses on: (i) the fiscal implications of the general tax cuts and, (ii) the effects of tax reduction on job creation, investment and production. The present design of tax policy reforms has been accompanied by rather strong economic growth, but to our best knowledge, no comprehensive study has been conducted to assess the growth-conducive effects in the case of Macedonia. Therefore, this research aims at narrowing this empirical gap and providing sound analytical platform for designing a set of policy relevant conclusions for the Macedonian government.
- (3) The questionnaire-based research was conducted on a sample of 100 companies. Cross-tabulations ensure that the responses of the companies take into consideration their size, structure of ownership and industry.
- (4) The main findings are synthesized and organized in several areas: (1) impact on companies' performance; (2) implications for the business environment; (3) impact on tax burden; (4) implications for the size of the shadow economy; (5) tax legislation, and (6) tax collection issues.

The main policy recommendations

- (4) The latest data analyses of the tax declarations submitted to the Tax Administration firmly states about strong performance of the companies' profitability. It is inevitable the impact of the flat tax policy measures implemented and that anchor hit the right place. Flat tax system should continue to be advertised (selling) to potential foreign investors.
- (5) Profitability and liquidity of the companies was to be improved by default having in mind that statutory tax rate was decreased from 15% in 2006 to 12% in 2007 and 10% in 2008. However, no need of further decrease of the tax rate. Going into further reduction of the statutory tax rate could send a different message to foreign investors instead of improvement of the business climate itself.
- (6) Survey results show that the largest gain with the flat rate system is the introduction of the simplicity replacing the complexity of tax calculations that taxpayers have to go through. It also fosters the administering and audits performed by the Tax Administrations decreasing the compliance costs. In return, discipline of the taxpayers increases in payment of the taxes that makes the flat system more efficient. However, further simplifications should be

envisaged in terms of reporting made by taxpayers (tax forms) to the Tax Administration and tax administration procedures to be as much as possible clearly understandable, precise and with less bureaucracy involved.

- (7) As parallel with the flat system in 2007 it was introduced 1.5% taxation on total income for small businesses with annual turnover up to 3 million MKD. Significant percentage of respondents in the survey results relates to low confidence for such tax policy measures. Certain decrease of this tax rate in order to ease the tax burden for micro-businesses should be considered.
- (8) An uncertain result from the survey is related to reinvestment allowance incentive. This uncertainty shows reluctance for such incentive by the companies and more keen to the previous investment allowance. The most probable cause of this is depreciation charges that should be added back in the tax declaration as not recognized expense and of course additional need of record evidence for such depreciation. Consider simplification of such reinvestment incentive and reduce the complexity in administering it; or maybe replacing it with more recognizable allowance for the companies (and more simple) such as accelerated depreciation for equipment and thus avoiding the unnecessary distortions of the depreciation system. In addition, loss carryover rule could be also extended on a longer period instead of only three years.
- (9) Tax legislation is subject to changes too frequently. Consider a rewording of the texts of the tax laws and making it an aggregate, comprehensive and integral texts which could contribute to more precise provisions and avoid further small and partial changes in the laws. Especially, an emphasis should be given to international aspects of the taxation as more and more foreign companies are present in the domestic playfield and tax rules should be reconciled to those internationally recognized rules in order to protect the tax base of erosion (transfer pricing, thin capitalization, permanent establishment, withholding taxes, capital gains etc).
- (10) Further development of the tax administration in terms of human resources and knowledge base in order to improve the audit performance with less political influence or corruptive elements but rather with an independent approach. Such development will contribute to more efficient administering of the tax laws, better revenue collection and capacity to deal with new challenges of taxation, communication with other countries Tax Administrations and decrease of the grey economy.

Highlights

IMPACT ON COMPANIES PERFORMANCE

Impact on liquidity and profitability

- The introduction of flat tax has enabled the companies to improve their liquidity
- Liquidity improvements have mostly been felt by the companies from the metal, furniture, mining and pharmaceutical/ chemical industries
- Flat taxes increased the profitability of companies

- Rising profitability due to the flat tax is accentuated by the managers of medium-sized companies and companies with dominant foreign ownership

Impact on calculation and reporting of fiscal obligations

- Flat tax simplified the calculation and reporting of fiscal obligations, reported 78 percent of the respondents
- The benefits from the simplified tax reporting procedures have been emphasized by the medium-sized companies and companies dominantly owned by domestic residents
- One half of the responding companies reported that the Public Revenue Office has simplified the tax reporting and tax administration procedures
- Additional 21% accentuate that there was substantial progress in this area
- The most satisfied tax payers are the large companies (82% of the large enterprises have expressed positive attitude)

Job creation

- The introduction of flat tax exhibited moderate effects on job creation
- Foreign-owned companies and, in particular, companies from the metal and pharmaceutical/chemical industry reported significant employment growth due to the flat tax introduction

Investment activity

- Flat tax moderately stimulated companies' investment in 2007 compared to 2006

IMPLICATIONS FOR THE BUSINESS ENVIRONMENT

Business climate

- 34% of the respondents contend that the fiscal package has provided a significant improvement of the conditions for doing business in Macedonia
- More than 27% of the large companies (more than 250 employees) consider the flat tax policy as insufficient effort for improving the business climate
- The flat tax adoption improves the business environment, but there are other important aspects to be dealt with

Prospects for attracting FDI

- 28% of the respondents consider the flat tax as a strong impetus for FDI inflows in the Macedonian economy, whereas 46% expect moderate increase in their magnitude
- The largest degree of pessimism is expressed by the managers of the large companies: 36% of them do not find a correlation between the flat tax introduction and the FDI inflows

IMPACT ON THE TAX BURDEN

Overall tax burden

- Large companies believe recent broadening of the tax base has annulled the benefits of the flat tax
- Medium-sized companies did not perceive noticeable increase of the tax burden due to the broadened tax base

- 60% of the responding micro-businesses were unclear with respect to the effects of recently adopted 1.5% tax rate on company's annual income
- 11.4% of them believe that the net effect of the two tax policy measures (flat tax and 1.5% tax rate on annual income) is increased fiscal burden
- 14.3% of micro businesses contend that the benefits of the flat tax shall be partially annulled by the implementation of the 1.5% tax rate

Reinvestment allowance incentive vs. tax relief

- Mixed support for the new policy for stimulating the reinvestment of profits
- Previous tax relief considered a better option by one third of the respondents
- Foreign entities in Macedonia unanimously favour the previous tax policy with respect to reinvestment of profits
- 46% of interviewed companies report that they are planning to use the reinvestment allowance incentive in the following fiscal years
- The recently designed profit reinvestment opportunity is of limited importance for the large companies
- Medium-sized enterprises will take the advantage of the reinvestment allowance incentive in near future

Overall assessment

- There is overwhelming impression that the overall tax burden has been reduced (43% of the companies share the perception it decreased with the introduction of the flat tax and other tax policy measures)
- The perception of unchanged tax burden is mostly shared by the micro businesses and medium-sized companies
- Agriculture, metal, pharmaceutical and textile industries are the sectors that have accentuated the benefits of recently adopted tax measures

IMPLICATIONS FOR THE SHADOW ECONOMY

Main reasons for the tax evasion

- Political party protection of privileged companies, high labour costs and poor quality of the public services highlighted as the main reasons for tax evasion in Macedonia

Reporting of wages

- 31% of the respondents expect moderate progress, whereas 15% believe that there will be substantial improvements in reporting the wages as a consequence of reduced and unified rates of the personal income tax
- The large companies and companies with a dominant foreign ownership are the most sceptical with respect to the expected improvements in the reporting of wages in the Macedonian economy
- Small enterprises are very optimistic in terms of the expected improvements in the wage reporting

Reporting of the number of employees

- 36% of the respondents expect moderate progress in reporting the exact number of employees
- 16% of the companies expect outstanding progress in improving the labour market statistics, whereas 8% of the respondents believe in substantial progress

Expected progress in downsizing the grey economy

- 15% of the respondents expects substantial progress in downsizing the informal economy, whereas one fifth of the respondents do not expect any significant impact of the flat tax on the informal economy
- Micro-businesses are the most optimistic category: nearly a third expects substantial progress in combating the shadow economy, whereas additional third contends there will be a moderate progress
- More than 40% of the responding small companies expect barely noticeable progress in downsizing the Macedonian grey economy
- Companies from the mining, metal and food-processing industries are the ones that expect significant reduction of the underground economy

TAX LEGISLATION

- Nearly half of the companies reported that the changes in Macedonian tax legislation were too frequent
- Around 60% of the micro-businesses and 75% of the large companies believe that tax laws undergo frequent revisions

TAX REVENUE COLLECTION

- Strengthened tax inspections are the most important factor behind the buoyant tax revenue collection in 2007, say 58% of the respondents
- 37% of responding micro businesses consider the decreased incentives to stay in the shadow economy as a significant factor
- The increased economic activity is accentuated as insignificant factor for explaining the surge in the budget revenue collection in 2007

Introduction & Methodology

In recent years the flat-tax revolution became popular among the transition countries. Flat-rate taxes have many merits but they can be applied with low rates, as in Georgia, Russia and the Ukraine, or with high rates as in Lithuania. Therefore, the fact that a country adopts a flat-tax system does not tell us much about the level of taxation in that country or the effective tax burden. It may not even tell us much about the complexity of the system.

While talking about tax levels, leaving aside the issue of complexity, it is important for Macedonia to have some “reference point” as to the “acceptable” (or growth-conducive) level of taxation at this stage of economic development. This reference point can be provided either by the levels of taxation of other countries at present (cross-section analysis) or by the history of tax burden in Macedonia (time series analysis). Both approaches can be useful but the former is usually the preferred one. As for the latter, the OECD's Revenue Statistics publication reports that in 2003, the latest year for which final data are available, the share of taxes into GDP in all OECD countries averaged 36.3 percent. For the 15 countries of the European Union the tax

level was 40.5 percent of GDP. Thus, a transition country aspiring for EU membership or OECD-member status would have a wide range to choose from.

The study includes qualitative and quantitative approaches in measuring and assessing tax reform in Macedonia in respect to economic growth and private sector development. Developed empirical specifications for a sample of developed and transition economies are tested by using econometric software packages.

Macedonia as a transition economy is at a crossroads in which it has to choose the appropriate tax policy to follow. Policy makers in Macedonia ought to keep in mind that in a market economy the most fundamental role of the state is to make the market work as efficiently as possible. Current tax policy proposals mostly rely on the prescriptions offered by the supply-side economics. The elimination of progressive personal income tax, the reduction of corporate tax, the zero tax rate on reinvested earnings, VAT system restructuring with broadened 5% tax base are primarily focused on increasing corporate and personal income and stimulating saving, investment, job creation and productivity growth.

Hence, the study focuses on:

- (1) fiscal implications of the general tax cuts (empirical assessment of the so called Laffer curve) and,
- (2) effects of tax reduction on job creation, investment and production.

The present design of tax policy reforms has been accompanied by rather strong economic growth, but to our best knowledge, no comprehensive study has been conducted to assess the growth-conducive effects in the case of Macedonia. Therefore, this research aims at narrowing this empirical gap and providing sound analytical platform for designing a large set of policy relevant conclusions for the Macedonian government.

Letter from the IDSCS that conducted the survey

“The research has been divided in two different major topics. The first topic regards the effects of the recent governmental **implementation of flat taxes**, while the second part concerns mostly the **fiscal policies and reform in the country**. Besides the general data (frequencies) gathered on a stratified, representative number of interviewed companies, all of the gathered general information has been cross-tabulated with five different characteristics of the companies i.e.:

- The average number of employees of the company
- The annual income of the company
- The average value of the overall assets of the company
- The type of ownership of the company
- The type of activity of the company (sector)”

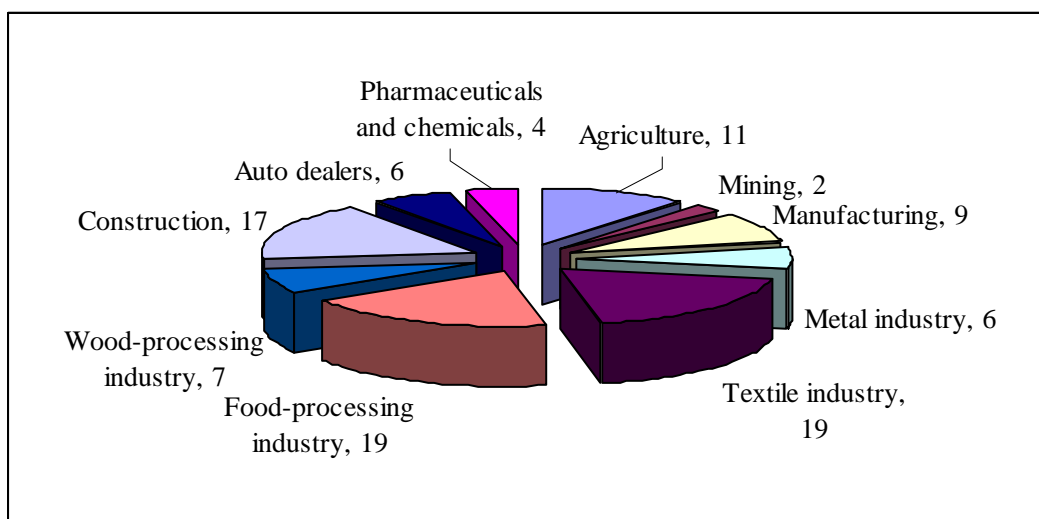
Flat tax policy assessment – Analysis of the survey

- The survey is based on the responses of 35 micro businesses, 31 small enterprises, 23 medium-sized and 11 large companies
- The sample is mostly consisted of firms owned by domestic legal entities or residents (78 out of 100)
- It is mainly consisted of companies from the textile and food-processing industries

Question
1-5

The Survey is conducted on a small sample of 100 observations, consisting of 35 micro businesses, 31 small enterprises, 23 medium-sized and 11 large companies. There are 21 companies with annual turnover less than 50,000 EUR, 49 companies with annual turnover between 50,001 and 2,000,000 EUR, 14 companies with annual turnover between 2 Million and 10 Million EUR and 8 companies with annual turnover above 10 Million EUR, whereas 8 companies did not disclose their turnover. According to the total assets of the firm, the distribution is as follows: 51 enterprises have assets worth less than 2 Million EUR, 19 companies with assets between 2 and 11 Million EUR, 14 companies disclosed assets above 11 Million EUR and 16 companies did not report their assets.

The sample is mostly consisted of firms owned by domestic entities and residents (78), followed by 13 companies dominantly owned by Macedonian residents, 5 companies dominantly owned by foreign nationals and 4 companies exclusively owned by foreign nationals. As presented in Chart 1, the sample is mainly consisted of companies from textile and food-processing industries.



- The introduction of flat tax has enabled the companies to improve

Question

their liquidity

6

- **Liquidity improvements have mostly been felt by the companies from the metal, furniture, mining and pharmaceutical/ chemical industries**

Most of the companies (65%) agree that the flat taxes have improved the liquidity of their company. The introduction of the flat tax was not perceived to have an effect on improving liquidity in 29% of the surveyed companies. Of those 65% with improved liquidity the most satisfied companies are the companies that have between 51 and 250 employees, followed by the micro businesses (with less than 10 employees). Large companies with more than 250 employees are not experiencing a liquidity improvement due to the flat tax introduction. With respect to the type of activity, the perception of improved liquidity is strongly pronounced in the metal industry, furniture industry as well as mining and pharmaceutical/chemical industry.

- **Flat tax simplified the calculation and reporting of fiscal obligations, reported 78 percent of the respondents**
- **The benefits from the simplified tax reporting procedures have been emphasized by the medium-sized companies and those dominantly owned by domestic residents**

Question

7

The introduction of flat tax has substantially or partially eased the calculation and reporting of the tax obligations for 78% of the companies. Nearly 17% of the companies responded that the flat tax introduction has not eased the calculation and reporting of the tax obligation. The cross-tabulations within this question indicate that the introduction of flat taxes have eased the calculation and reporting of the tax obligation substantially or partially for:

- Agricultural, mining and pharmaceutical/chemical companies,
- Companies that have annual income between 50.000€ and 2.000.000€ as well as companies with annual incomes below 50.000€
- Companies that have between 51 and 250 employees,
- Companies owned exclusively by foreign legal or private entities.

The companies reporting no substantial progress in the simplified administration of the tax obligations are mostly concentrated within the production sector, companies with annual income over 10 Million EUR, companies with 11-50 employees, companies with active assets above 11.000.000€ as well as companies with dominant ownership by domestic residents.

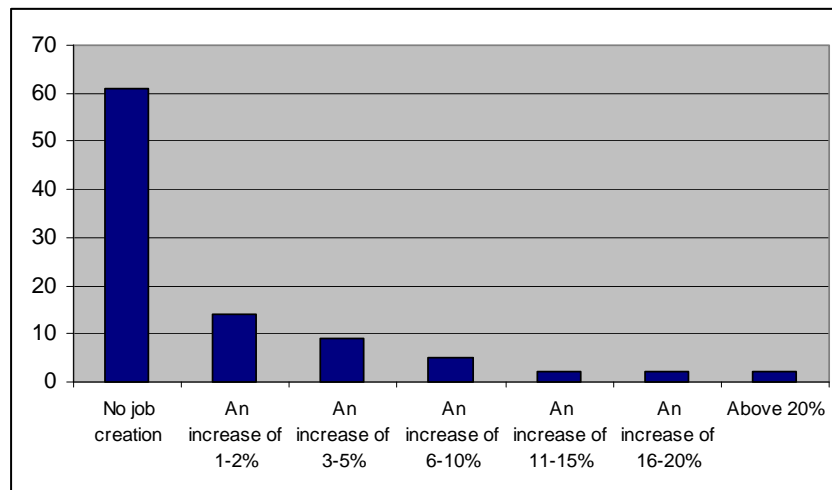
- **The introduction of flat tax exhibited moderate effects on job creation**
- **Foreign-owned companies and, in particular, companies from the metal and pharmaceutical/chemical industry reported significant employment growth due to the flat tax**

Question

8

Most of the companies (61%) emphasize that the introduction of the flat taxes did not boost job creation. On the other side, 32% of the companies answered that they have increased the number of employees by 1% to 20%. Employment growth has been experienced at varying increased a

Table 1 - Percentage of companies that increased the number of employees due to flat tax introduction



Source: Firm-level survey in Macedonia, 2008.

The cross-tabulations demonstrate that companies that increased their number of employees are companies that have between 11 and 250 employees, with annual income of over 10.000.000 € owned exclusively by foreign legal or private entities and companies from the metal and pharmaceutical/chemical industry.

- Flat tax moderately stimulated domestic investment in 2007 compared to 2006

Question
9

Nearly 57% of the respondents report that the flat tax did not provide for any specific opportunities for new investments. In contrast, 38% of the respondents answered that they have increased their investment activity due to the flat taxes introduction.

Table 2 - Percentage of companies that increased their investment activity due to the flat tax introduction (in 2007 compared to 2006)

Increase in investments	In percent
By 1-2%	17%
By 3-5%	8%
By 6-10%	6%
By 11-15%	4%
Over 20%	3%

Cross tabulations demonstrate that the companies for which the introduction of the flat tax did not affect their investment decision are the micro businesses (companies that have less than 10 employees and less than 50.000€in annual profit), companies in dominantly foreign ownership and companies from the food and furniture industry.

- Flat taxes increased the profitability of companies
- Rising profitability due to the flat tax is accentuated by the managers of medium-sized companies and companies with dominantly foreign ownership

Question

10

44% of the respondents report that the flat tax did provide opportunities for increased profitability.

Table 3 - Percentage of companies that have increased their profitability due to flat tax introduction (in 2007 compared to 2006)

Increase in profitability	In percent
By 1-2%	24%
By 3-5%	11%
By 6-10%	3%
By 11-15%	2%
Over 20%	2%

The cross-tabulations demonstrate that the companies for which the introduction of the flat tax enabled higher profitability are those from the metal and pharmaceutical/chemical sector, companies with dominant foreign (private or legal entity) ownership, and mostly medium-sized companies (with overall assets less than 2.000.000€ and between 2.000.000€ and 10.000.000€ and with between 11 and 50 employees).

- Mixed support for the new policy for stimulating the reinvestment of profits
- Previous tax relief considered a better option by one third of the respondents
- Foreign entities in Macedonia unanimously favour the previous tax policy with respect to reinvestment of profits

Question

11

The introduction of flat tax has been accompanied by abandonment of the existing tax relief for investments over 100.000€with the new policy for stimulation of reinvested profit. The incentive allows for a reduction of the company's tax base up to the amount of reinvested profits in the year following that in which the profits were realized. In general, the interviewed companies argue that the new policy (stimulation

to reinvest the profit) is a better solution (56% of the respondents). In particular, 23% of the companies perceive that the new policy is slightly better designed, while 33% believe that the new policy is undoubtedly better than the previous tax relief. In contrast, 33% of the companies report that the previous tax relief policy provided better incentives. Although 11% of the respondents did not answer, there seems to be overwhelming support for the re-investment policy.

The cross-tabs indicate that companies that favour the new policy for stimulation of reinvested profit are small and medium enterprises (companies that have up to 10 employees, companies with an annual profit of between 2.000.000€ and 10.000.000€ and small amount of active assets), companies owned exclusively by domestic foreign or legal entities and companies from the mining and auto industry.

Interestingly, none of the companies exclusively owned by foreign legal or private entities believes that the new incentive for reinvested profit is adequate.

<ul style="list-style-type: none"> • 46% of interviewed companies report that they are planning to use the opportunity to reinvest the profit in the following fiscal years • The recently designed profit reinvestment opportunity is of limited importance for the large companies • Medium-sized enterprises to take the advantage of the reinvestment allowance incentive in near future 	<p>Question 12</p>
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Most of the companies plan on using this opportunity, but a large share of respondents has not done it yet. Some 46% of interviewed companies report that they are planning to use the opportunity to reinvest the profit in the following fiscal years, while only 12% have already taken this advantage. In contrast, 29% of the companies reported that they do not intend to use this reinvestment opportunity any time soon.

The cross-tabulations of companies that plan to use the reinvestment opportunity point to the medium-sized companies (those that have between 51 and 250 employees, annual profit of between 50.000€ and 2.000.000€, overall active assets between 2.000.000€ and 11.000.000€) as well as companies that are owned exclusively by foreign legal or private entities and companies in the agricultural, textile and food industry.

The cross-tabulations of companies that do not plan to use the reinvestment opportunity indicate the large companies (those that have more than 250 employees, a profit over 10.000.000€, and active assets above 11.000.000€), companies with a dominant ownership by domestic legal or private entities as well as companies from the mining, production and pharmaceutical/chemical sector.

<ul style="list-style-type: none"> • Large companies believe recent broadening of the tax base has 	<p>Question</p>
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annulled the benefits of the flat tax

13

- **Medium-sized companies did not perceive noticeable increase of the tax burden due to the broadened tax base**

The question on whether the broadening of the tax base has neutralized the benefits of the implemented flat tax and the significantly reduced statutory tax rates had possibility of scaled answers and thus, many of the companies are rather close in their answers. Most of the respondents (29%) answered that the broadening of the bases for taxation has only partially annulled the benefits of the implemented flat tax. This is the biggest statistical category closely followed by the group of respondents that answered “no” – 23%. Other statistical groups of answers were “so-so” (17%), “largely” (8%) and “fully” – 4%. Some 19% of the respondents did not give an answer to this question.

The cross-tabulations reveal two opposing groups of opinions. The companies that did not agree that the broadening of the bases for taxation has annulled the benefits of the implemented flat tax can be found in the following categories:

- Companies with 11-50 employees,
- Companies with an annual profit between 50.000€ and 2.000.000€
- Companies exclusively owned by foreign legal or private entities,
- Companies in the agricultural and production sector.

On the other hand, companies that accentuate that the broadening of the tax base has annulled the benefits of the implemented flat tax belong to the following categories:

- Companies with 51-250 employees,
- Companies with an annual profit between 2.000.000€ and 10.000.000€
- Companies with overall active assets over 11.000.000€
- Companies exclusively owned by domestic legal or private entities,
- Companies in the food-processing sector.

Hence, the large companies reported that the broadening of the tax base had annulled the benefits of the implemented flat tax, whereas medium-size companies did not perceive noticeable increase of the tax burden due to the broadened tax base.

- **60% of the responding micro-businesses were unclear with respect to the effects of recently adopted 1.5% tax rate on company’s annual income**
- **11.4% of them believe that the net effect of the two tax policy measures (flat tax and 1.5% tax rate on annual income) is increased fiscal burden**
- **14.3% of respondents contend that the benefits of the flat tax shall be partially annulled by the implementation of the 1.5% tax rate**

Question

14

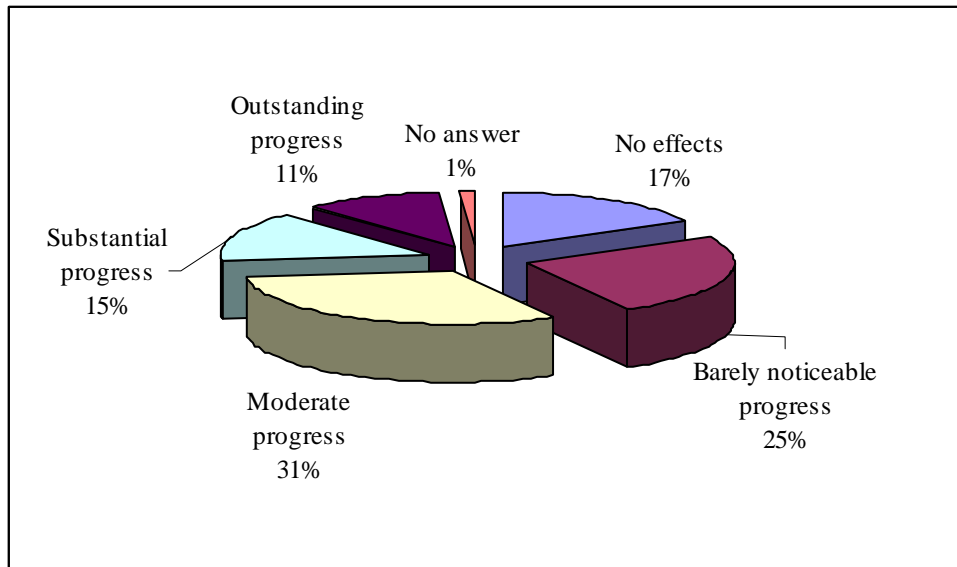
This question was aimed exclusively towards the micro-companies i.e. the ones with less than 10 employees and an annual profit of less than 50.000€ These companies were asked to evaluate the net-effect of the increased tax burden by recently adopted 1.5% tax rate on the annual gross income of the company and the benefits from the flat tax. The large majority of the companies (60%) lacked sufficient time distance and statistical information to express their opinion on this policy issue. Nevertheless, out of the responding micro-companies, 11.4% contend that the net-effect is an increased fiscal burden, 5.7% of respondents argue that the flat tax benefits will be wiped out by the recently adopted tax, whereas 8.6% believe that the benefits of the flat tax shall be largely neutralized by this measure. Additionally, 14.3% of respondents think that the benefits of the flat tax shall be partially annulled by the implementation of the 1.5% tax rate on the annual overall income of the company.

- **31% of the respondents expect moderate progress, whereas 15% believe that there will be substantial improvements in reporting the wages as a consequence of reduced and unified rates of the personal income tax**
- **The large companies and companies with a dominant foreign ownership are the most sceptical with respect to the expected improvements in the reporting of wages in the Macedonian economy**
- **Small enterprises are very optimistic in terms of the expected improvements in the wage reporting**

**Question
15**

Whether the implementation of the reduced and proportional tax rate for the personal income tax (12% in 2007, and 10% in 2008) will motivate the employers to abandon the practice of misreporting the wages seems to be unclear issue. As Chart 1 demonstrates, 17% of the respondents have odium to this question, 25% are still skeptical and believe in barely noticeable progress in this field. Interestingly, 31% expect moderate progress, whereas 15% of the respondents believe that there will be outstanding progress in halting the practices of misreporting the wages.

Chart 1 - Expected progress in improving the reporting of wages due to the simplified and reduced taxes



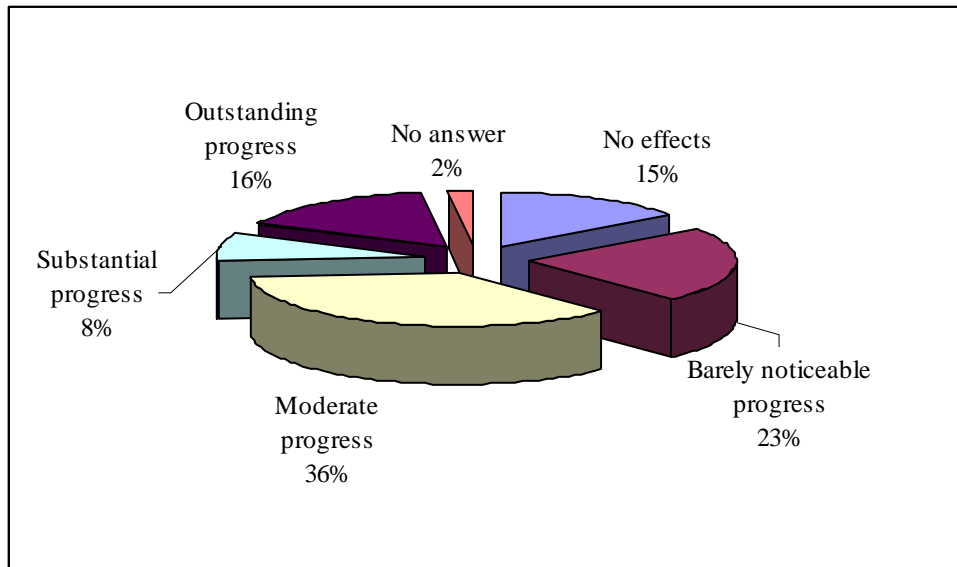
The companies that do not believe that the implementation of reduced and unified tax rate for the personal income tax will motivate the employers to report more realistically the employee's salaries are those with over 250 employees, annual profit of over 10.000.000€ and active overall assets over 11.000.000€. Their opinion is also shared by the companies with a dominant foreign private or legal entity ownership and companies in the production and construction businesses.

Those companies that do believe that the implementation of reduced and unified tax rate for the personal income tax will motivate the employers to report more realistically the employee's salaries are generally small companies that have up to 10 employees, that have annual profits of less than 50.000€ and the firms that have overall active assets in between 2.000.000€ and 10.000.000€. Additionally the same group is supplemented by companies with a predominant ownership by domestic legal and private entities as well as companies operating in the food industry.

<ul style="list-style-type: none"> • 36% of the respondents expect moderate progress in reporting the exact number of employees • 16% of the companies expect outstanding progress in improving the labour market statistics, whereas 8% of the respondents believe in substantial progress 	<p>Question 16</p>
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On the question if the implementation of flat tax would motivate the employers to register their employees in the official economy, the answers are slightly more optimistic.

Chart 2 - Expected progress in improving the reporting of the number of employees in response to the introduction of the flat tax



As Chart 2 reveals, 15% of the respondents have odium towards this issue, 23% are still skeptical, whereas 36% believe that the flat tax is an incentive to report more realistically the exact number of employees.

The cross-tabulations demonstrate that the most skeptical respondents are the managers of the large companies (over 250 employees, with annual profit between 50.000 and 2.000.000€ companies with active overall assets between 2.000.000€ and 11.000.000€ million), companies exclusively owned by foreign legal or private entities as well as companies from the textile sector.

In contrast, companies that are completely positive towards the issue are located mostly within the companies with over 250 employees (strong polarization within this group), companies with annual profits of over 10.000.000€ as well as companies with small active overall assets. Their opinion is also supported by the firms dominantly owned by domestic legal or private entities and companies from the metal industry.

- 15% of the respondents expects substantial progress in downsizing the informal economy, whereas one fifth of the respondents do not expect any significant impact of the flat tax on the informal economy
- Micro-businesses are the most optimistic category: nearly a third expects substantial progress in combating the shadow economy, whereas additional third contends there will be a moderate progress
- More than 40% of the responding small companies expect barely noticeable progress in downsizing the Macedonian grey economy
- Companies from the mining, metal and food-processing industries are the ones that expect significant reduction of the underground

Question

17

With respect to the expected effects in combating the grey economy and tax evasion, 21% of the respondents do not expect any progress in this area, whereas one third (33%) share the opinion that such tax policy would help a little. Hence, more than a half of the respondents is skeptical that the introduction of flat tax will reduce the incentives for staying outside the formal economy. Still, 15% contend that the flat tax rate would significantly decrease the grey economy and 29% expect moderate progress in combating the shadow economy. Although derived by qualitative assessment, they do offer a tentative picture of the relevance of the grey economy. These results reflect the opinion of the managers of the domestic companies, which constitute 78% of the sample.

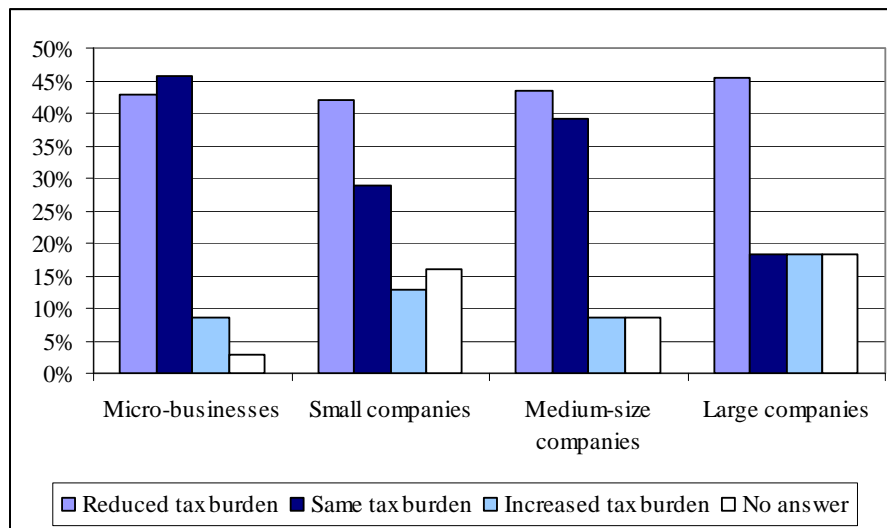
Respondents from the micro businesses are the most optimistic category towards the favourable impact of the flat tax. Almost a third of these respondents believe that such a policy would significantly reduce the tax evasion, whereas additional third believe in moderate progress in this area. Small companies that employ 11 to 50 people are the most skeptical category: more than 40% of the respondents expect barely noticeable progress in downsizing the Macedonian grey economy. Finally, the sectoral cross-tabulations reveal that companies from the mining, metal and food-processing industries are the ones that expect substantial reduction of the underground economy and tax evasion.

- **There is overwhelming impression that the overall tax burden has been reduced (43% of the companies share the perception it decreased with the introduction of the flat tax and other tax policy measures)**
- **The perception of unchanged tax burden is mostly shared by the micro businesses and medium-sized companies**
- **Agriculture, metal, pharmaceutical and textile industries are the sectors that have accentuated the benefits of recently adopted tax measures**

**Question
18**

With respect to the overall tax burden, 43% of the companies share the perception it decreased with the introduction of the flat tax and other tax policy measures. In 36% of cases, respondents reported unchanged tax burden, while only 11% of the companies reported increased tax liabilities.

Chart 3 - Perception of the tax burden after the introduction of the fiscal package in 2007



The perceptions of decreased tax burden are equally distributed across different categories according to the firm size (Chart 3). Interestingly, the responses of the micro businesses are mixed: 43% of those companies have seen a reduction of their tax burden, while 45% did not experience any change. The impression of increased effective tax burden due to the broadened tax base, despite the reduction of the statutory tax rates, is mostly pronounced in the responses of the large companies (18.2%). In total, 11.0% of the responding companies report an increase of their overall tax burden. In regard to the ownership, all firms with dominant foreign ownership perceived reduced tax burden, whereas the responses of the other categories are mixed. Agriculture, metal, pharmaceutical and textile industries are the sectors that have accentuated the benefits of the recently adopted tax measures.

- **34% of the respondents contend that the fiscal package has provided a significant improvement of the conditions for doing business in Macedonia**
- **More than 27% of the large companies (more than 250 employees) consider the flat tax policy as insufficient effort for improving the business climate**
- **The flat tax adoption improves the business environment, but there are other important aspects to be dealt with**

**Question
19**

The next question aims at investigating whether the introduction of the flat rate tax will improve the Macedonian business environment. The majority of the respondents (43%) believe that this policy measure will slightly improve the business climate, whereas 34% of them contend that it is a significant improvement of the conditions for doing business in Macedonia. In contrast, 14% of the companies share the opinion that such a policy measure will not improve the business climate at all.

The cross-tabulations indicate that the most optimistic categories that recognize a significant improvement of the business climate are:

- micro-businesses and small and medium-size enterprises;
- companies with dominant foreign ownership as well as companies with exclusive domestic ownership, and
- companies in food processing, construction and agricultural sectors.

Interestingly, nearly one third of the large companies (more than 250 employees) consider the flat tax policy as insufficient effort for improving the business climate in the Republic of Macedonia.

- **28% of the respondents consider the flat tax as a strong impetus for FDI inflows in the Macedonian economy, whereas 46% expect moderate increase in their magnitude**
- **The largest degree of pessimism is expressed by the managers of the large companies: 36% of them do not find a correlation between the flat tax introduction and the FDI inflows**

Question

20

Recent flat-tax ("race-to-the-bottom") revolution in Central and Eastern and South-eastern Europe bringing unification and substantial reduction of statutory income tax rates, inter alia, aimed at attracting large FDI inflows. The expectations of respondents from the Macedonian business sector are that the fiscal measures are going to be FDI-conducive. 28% expect the flat tax to be a strong impetus for FDI inflows in Macedonian economy, 46% expect moderate increase in their magnitude, whereas 20% doubt that this will be important parameter for the foreign investors. Again the largest degree of pessimism is expressed by the managers of the large companies: 36% of them do not find a correlation between the flat tax introduction and the FDI inflows.

The analysis of the cross-tabulations highlights the following points:

- More than 40% of companies of all sizes believe that the flat rate tax policy will moderately increase the foreign direct investments;
- More than a third of the small (less than 10 employees) and medium (between 51 and 250 employees) companies report that the flat rate tax policy will significantly boost foreign direct investments in the country;
- Companies with annual income less than 50.000 EUR have the most positive affiliation (43%) towards the favourable impact of flat tax policy on foreign direct investments in Macedonia.

It is important to note that 50% of the companies that have active assets above 10 Million EUR express serious doubts on the impact of flat tax policy on FDI in the Macedonian economy. The answers by the respondents from the large companies may

also reflect concerns with respect to the increasing competition on the domestic market, brought by the arrival of some multinationals in Macedonia.

With respect to the ownership structure, 40% of the companies that have dominant foreign ownership consider the flat rate tax policy as a significant factor in attracting foreign direct investments. Respondents from the mining and food processing sectors believe that the flat rate tax policy will significantly stimulate FDI in the Macedonian economy.

<ul style="list-style-type: none"> • Nearly half of the companies reported that the changes in Macedonian tax legislation were too frequent • Around 60% of the micro-businesses and 75% of the large companies believe that tax laws undergo frequent revisions 	<p>Question 21</p>
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Nearly one half of the responding companies (47%) believe that the tax legislation underwent too frequent changes. 29% of the respondents contend that the national tax laws and secondary legislation were revised in reasonable intervals, whereas 11% support the present practices of frequent changes and amendments. The micro businesses expressed serious concerns with respect to the frequent alterations of the tax policy and system: more than 57% within this category share the opinion that tax regulations undergo frequent revisions. This sentiment is also emphasized by the large companies. For instance, 75% of the companies with annual income above 10 Million EUR believe that tax regulations are being changed on a very fast pace.

When the ownership structure of the enterprises is concerned, the cross tabulated distribution of results demonstrates that 75% of the companies in dominant domestic ownership consider tax regulations to be a subject of change too often, and 61% of the foreign companies share the same sentiment. Finally, the sectoral analysis indicates that the concerns with the rapid changes of tax legislation are mostly expressed by the companies in the construction (76.5%) and manufacturing (66.7%) sectors.

<ul style="list-style-type: none"> • One half of the responding companies reported that the Public Revenue Office has simplified the tax reporting and tax administration procedures • Additional 21% accentuate that there was substantial progress in this area • The most satisfied tax payers are the large companies (82% of the large enterprises have expressed positive attitude) 	<p>Question 22</p>
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The next question examined whether the introduction of the flat tax is associated with simplified reporting and administration procedures in the Public Revenue Office. Half of the enterprises argue that the Public Revenue Office has somewhat improved the

tax administration and additional 21% of the respondents believe that there has been substantial progress. More than a fifth of the respondents do not perceive any improvements in the tax administration procedures.

Accordingly, the cross tabulation results point towards the following arguments:

- Most large companies (with more than 250 employees) are satisfied with the impact that the flat tax has had on the administration of taxes implemented by the Public Revenue Office. Thus, 82% of the large enterprises have expressed positive attitude with 36.4% expressing strong satisfaction and additional 45.5% being somewhat satisfied.
- A vast majority (85.7%) of the small companies feel that the introduction of the flat tax rate policy has slightly improved the administration of taxes implemented by the Public Revenue Office.
- 80% of the enterprises that have foreign dominant ownership feel that the introduction of the flat tax rate policy has somewhat improved the tax administration by the Public Revenue Office

Companies working in the pharmaceutical industry (50.0%) and food processing industry (47.4%) believe there has been a significant improvement in the administration of taxes by the Public Revenue Office.

<ul style="list-style-type: none"> • Strengthened tax inspections are the most important factor behind the buoyant tax revenue collection in 2007, say 58% of the respondents • 37% of responding micro businesses consider the decreased incentives to stay in the shadow economy as a significant factor • The increased economic activity is accentuated as insignificant factor for explaining the surge in the budget revenue collection in 2007 	<p>Question 23</p>
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The next question refers to the driving forces behind the buoyant tax revenue collection in Macedonia in 2007. The increased economic activity, the strengthened tax inspections and the reduced incentive of the companies to stay in the informal economy were offered as potential factors explaining the dramatic surge in tax collection. As presented in Table 4, strengthened tax inspections are the main reason behind the increased tax revenue collection by the Public Revenue Office. In total, 54% of the enterprises give credit to the increased tax inspections with 23% giving it crucial importance. The relevance of the decreased incentives for staying outside the grey economy is perceived as limited, given that 18% of the companies attached some weight. The increased economic activity is accentuated as insignificant factor for explaining the buoyant revenue collection in 2007.

Table 4 - Perceptions on the factors contributing to the dramatic increase of tax revenue

Conditioning factor	5 = very important	4 = important	3 = quite important	2 = not really important	1 = not at all important
Increased economic activity	2%	3%	30%	32%	18%
Strengthened tax inspections	23%	35%	19%	13%	2%
Lower incentives for staying in the informal economy	8%	10%	19%	28%	20%

The cross-tabulations reveal that almost one third from the large companies consider that the increased economic activity does not have any influence on the tax revenue. The same sentiment is shared by the micro businesses, while half of the medium-sized companies (with annual income between 2.000.000 and 50.000.000 EUR) recognize only limited impact. Regarding the ownership structure, companies with dominant domestic and foreign ownership are cautious in finding correlation between the increased tax revenues and the increased economic activity.

Regarding strengthened tax inspections, cross-tabulations reveal that the positive answers are concentrated within micro businesses and large companies, companies with dominant foreign ownership as well as companies from the construction and metal industries. As previously noted, the decreased motivation of the companies to stay in the informal economy (which is associated with the reduced statutory tax rates) is perceived as a factor with limited importance. Thus, 20% of the enterprises argue that this issue does not have any impact on the increased revenue and additional 28% see it as "not really important". The cross-tabulated results demonstrate that the smaller companies do not follow such pattern, as 37% of these companies consider the decreased motivation of the companies to stay in the shadow economy to be a significant factor for the increased revenues of the tax authorities in the country. In contrast, the large companies are more negative towards this issue with 25% perceiving no impact at all and 50% recognizing only limited impact. Such sentiments are shared also by the companies that have dominant foreign ownership where 40% of the respondents consider that the decreased motivation of the companies to stay in the gray economy has no influence on the increased tax revenue.

- **Political party protection of privileged companies, high labour costs and poor quality of the public services highlighted as the main reasons for tax evasion in Macedonia**

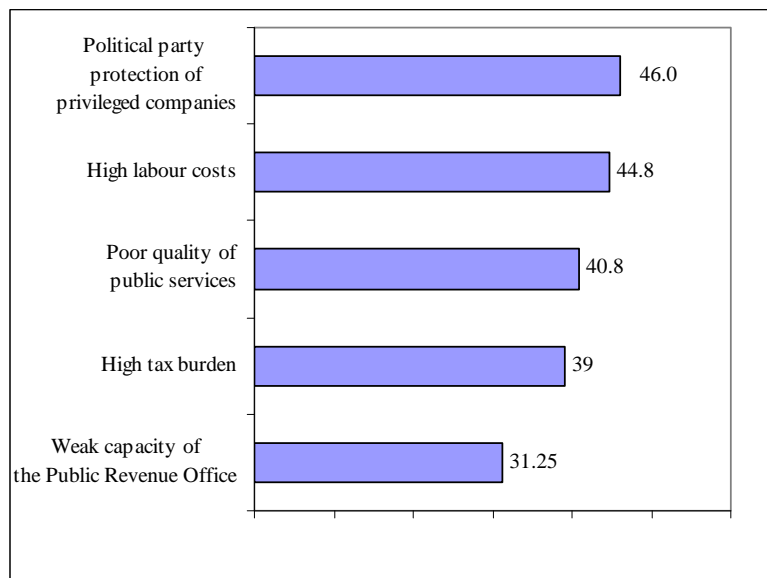
**Question
24**

The last question of the survey aims at assessing the main reasons behind the tax evasion in Macedonia. The options offered to the respondents encompass: excessive tax burden, poor quality of public services, weak capacity of the Public Revenue Office, political party protection of privileged companies, and high labor costs. As presented in Table 5, there is a rather even distribution of negative responses, except for the weak capacity of the Public Revenue Office is not perceived as a major problem.

Table 5 - Perceptions on the main reasons behind the tax evasion in Macedonia (combination of the two answers that have highest negative intensity)

Conditioning factor	5 = very important	4 = important	3 = quite important	2 = not really important	1 = not at all important
Implicit weights	100	75	50	25	0
High tax burden	9%	23%	16%	19%	25%
Poor quality of public services	11%	24%	11%	25%	14%
Weak capacity of the Public Revenue Office	3%	11%	28%	24%	17%
Political party protection of privileged companies	15%	26%	16%	14%	10%
High labour costs	12%	27%	16%	18%	14%

Chart 4 - Implicit weighted-average responses



Note: 0=irrelevant, 100=highly relevant.

The cross tabulated results point towards the following conclusions:

- The political party protection of privileged companies is accentuated as a major problem by the micro businesses; companies exclusively owned by foreign investors and those belonging to the manufacturing and construction sectors. For all these categories the combination of the two answers that have highest negative intensity is above 40%.
- High tax burden and poor quality of public services are highlighted as a major problem by the micro businesses, companies exclusively owned by foreign nationals and companies in the manufacturing sector;
- The weak capacity of the Public Revenue Office is considered a major problem by the large companies and companies exclusively owned by foreigners;
- High labor costs are seen as a key driving force behind the tax evasion by the large companies, companies exclusively owned by foreign nationals and companies belonging to the manufacturing and textile industry sectors.

Concluding remarks

The Government of the Republic of Macedonia has introduced the flat rate tax system twenty months ago. From the very beginning it was widely campaigned through the media as part of the election platform of now, the governing party. After the parliamentary elections in 2006, the foreign investors also became important segment of the target group. Today, after summarizing the first results of such policy there is compelling evidence that it revolutionized the tax system and provided economic stimulus for the far-from-vibrant private sector in Macedonia. Such policy was also welcomed by the IMF and a number of independent experts.

What were the main driving forces behind the tax reform? Desperate for foreign direct investment inflows, burdened with high unemployment and willing to provide impetus for vigorous restructuring, the Government of Macedonia decided to design competitive tax system. Positive experiences from other countries (Estonia, Lithuania, Latvia, Russia, and Slovak Republic) that have already introduced the flat tax system gave strong justifications for the tax reforms.

The greatest benefit from the flat rate system is the introduction of tax simplicity, replacing the complexity of tax calculations that taxpayers have to go through. It also fosters the administering and audits performed by the Tax Administrations decreasing the compliance costs. Cutting the tax rates and broadening the tax base hinders the incentives for tax evasion. In return, the fiscal discipline of taxpayers increases as seen by the improved collection of taxes that makes the flat tax system more efficient. As a consequence, tax revenues grow which was exactly the case with the Macedonian corporate income tax where the rate of revenue growth was over 60% comparing to the planned one in the first half of 2008. Despite the replacement of three progressive tax rates with uniform, and reduced rate, the personal income tax also demonstrated satisfactory performance in terms of revenue mobilization.

With respect to the level of the tax rate it seemed unavoidable to envisage lower tax rate as part of the new tax reform proposals, given the fierce tax competition in the region. Despite some calls for radical reforms, the rate of VAT was not aligned with direct tax rate, because of the substantial risk that tax revenues will fall dramatically. The tax structure with dominant share of revenues from indirect taxes is not entirely consistent with the tax structures in OECD countries, but it corresponds to country's stage of economic development.

So far, there were no projections or analyses that could forecast the effects of proposed tax changes, apart from the intuitive thinking. Despite the concomitant risk of revenue loss, the collection of tax revenues has been surprisingly good. This leads to a conclusion that Government needs a more thorough data analyses on various taxes that would help in making forecasts on tax revenues and to substantiate them on sound basis.

The survey results indicate that despite the initial success of the tax reform there is still more to be done in the tax legislation and the preparation of legislative changes. The main conclusions and policy recommendations are summarized as follows:

- a. Profitability and liquidity of the companies should not count on further fiscal stimulations, given that statutory tax rate was decreased from 15% in 2006 to 10% in 2008. Undertaking further reduction of the statutory tax rate could send a different signal to foreign investors instead of improvement of the business climate itself.
- b. The latest data analyses of the tax declarations submitted to the Tax Administration (August 2008) underscores the strong performance of Macedonian companies in terms of profitability. The flat tax policy measures have obviously been justified.
- c. Therefore, the flat tax system should continue to be aggressively advertised to potential foreign investors.
- d. Further simplifications should be envisaged in terms of reporting made by taxpayers to the Tax Administration and tax administration procedures to be as much as possible simple, precise and with less bureaucracy involved.
- e. Few months after the introduction of the flat system, a new 1.5% tax for small businesses on total income up to 3 million Denars annually has been enacted. A significant percentage of respondents in survey results attached strong resistance for such conflicting tax policy measures. Elimination or decrease of this tax rate in order to ease the tax burden for micro businesses must be considered.
- f. The survey indicated mixed record for the reinvestment allowance incentive. This uncertainty shows reluctance for such incentive by the companies that are favouring the previous way of investment allowance. The most probable cause is depreciation charges that should be added back in the tax declaration as not recognized expense and the additional need for record evidence for such depreciation. CEA recommends simplification of such reinvestment incentive and reduction of the complexity in administering it. Another option is to replace it with more acceptable allowance for the companies (and more simple) such as the accelerated depreciation for equipment.
- g. Tax legislation is subject to changes too frequently. CEA team suggests considering a rewording of the texts of the tax laws and preparing comprehensive texts which could contribute to more precise provisions and avoid further small and partial changes in the laws. Particular emphasis should be given to international aspects of the taxation as more and more foreign companies are present in Macedonia. Hence, tax rules should be reconciled to those internationally recognized rules.
- h. Further development of the Tax Administration in terms of human resource management and strengthening of the knowledge base is needed.

- i. The Public revenue office must improve the audit performance and build a reputation of institution subject to less political influence and less corruptive elements. The politically independent approach will contribute to more efficient administering of the tax laws and greater capacity to deal with the new challenges of taxation, communication with other countries' tax authorities and harmonization with the EU Directives.