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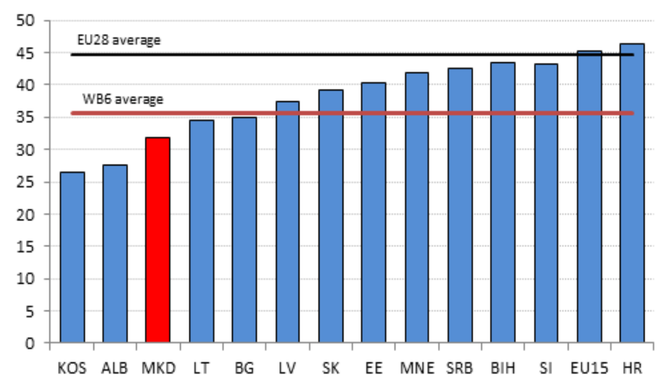
FYR Macedonia Special Focus Note: Progressivity and Equity in Personal Income Taxation

FYR Macedonia has kept taxes low and offered tax incentives to attract foreign direct investment (FDI), but that has had a sizable fiscal cost. Government revenue as a share of GDP, particularly from direct taxation, is much lower than in other European countries, and still eroding. Rationalizing exemptions and introducing progressivity in personal income taxation could increase revenue and improve equity. Reviewing exemptions in corporate taxation and value added tax, while strengthening tax collection efficiency in general would be recommended as well.

FYR Macedonia collects little in taxes

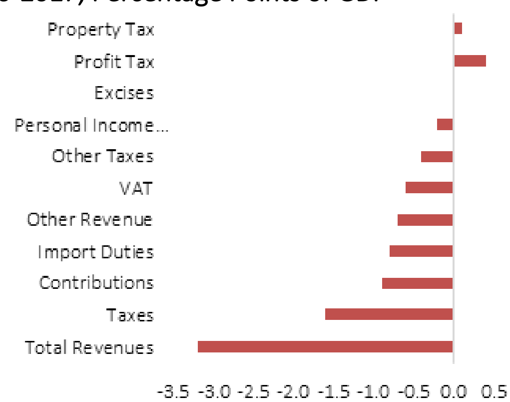
Government revenue as a share of GDP is not only one of the lowest in Europe, it has declined over the past 10 years. In 2017 it was only 31 percent of GDP; the European Union (EU) average is 45 percent (Figure 1), while among the Western Balkan countries, only Albania and Kosovo collected less. The personal income tax (PIT) rate in FYR Macedonia is one of the lowest in Europe (Table 1). From 2006 through 2017, total general government revenues declined by over 3 percentage points of GDP (Figure 2). While the decline was broad-based, exemptions to value added tax (VAT) and social security contributions (SSC) led the contraction.

Figure 1: General Government Revenues, Percent of GDP, 2016



Source: EUROSTAT, Ministry of Finance

Figure 2: Changes in General Government Revenues, 2006-2017, Percentage Points of GDP



Public revenues declined mainly for two reasons: (1) income tax and SSC rates were reduced; and (2) exemptions were introduced, including for foreign investors. These changes to attract investors and promote formalization of informal activities have had mixed impact. The country had been successful in reducing unemployment and poverty by limiting the impact of the global crisis on growth through attracting FDI in a landlocked country. Regional peers like Serbia and Montenegro, with 68 and 113 percent of GDP in accumulated FDI stock, however, still surpass FYR Macedonia that by now accumulated 49 percent of GDP in FDI stock. Moreover, the exemptions have eroded the tax base and created an uneven playing field for businesses. Finally, informality has held steady at 30 percent of GDP.

Table 1. Tax Rates for FYR Macedonia European Peers, Latest Available Percent

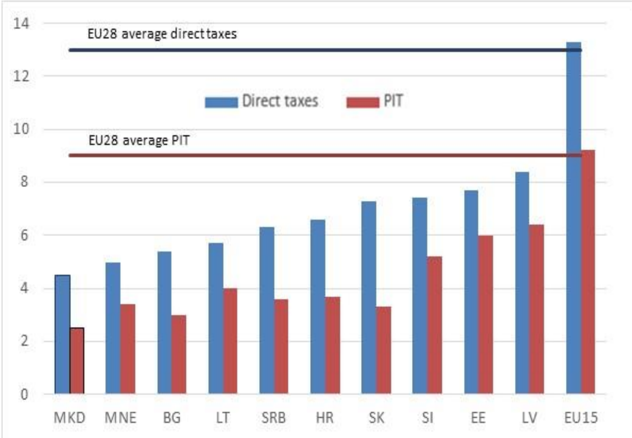
	MKD	ALB	BIH	SRB	MNT	BGR	HRV	EST	LVA	LTU	SVK	SVN
Corporate income tax	10	15	10	15	9	10	20	20	15	15	21	19
Personal income tax	10	23	10	15	11	10	36	20	23	15	25	50
Value-added tax	18	20	17	20	21	20	25	20	21	21	20	22
Social security contribution rates	27	24.5	42	37.8	33.8	32.4	37.2	35.4	34.09	41.98	48.6	38.2

Source: National legislation.

Fewer Distortions and Greater Progressivity of Income Taxes Would Boost Revenues and Equity

Since direct taxes contribute little to revenues, FYR Macedonia has room to increase its direct taxes. Personal income, corporate income, and property taxes together constituted only 4.5 percent of GDP in 2017, significantly less than in peer European countries. Just over half (2.4 percent of GDP) came from PIT, compared to 3.7 percent on average in the Western Balkans and 9 percent in the EU28 (Figure 3).

Figure 3: Direct and PIT Revenues, Percent of GDP



Source: National authorities and World Bank staff estimates.
Notes: EU15 comprises members joining prior to 2004.

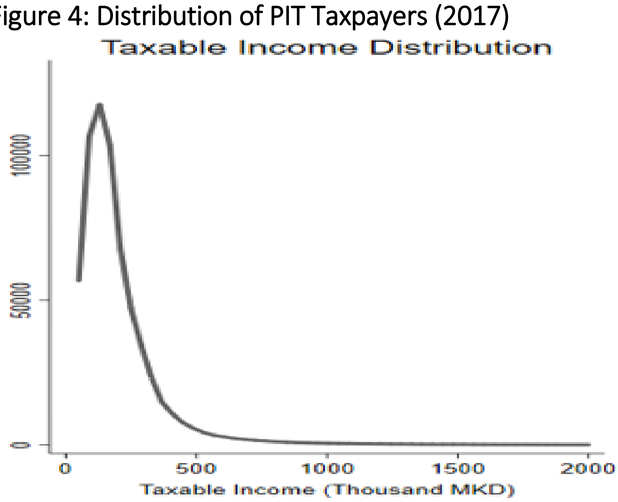
Deductions and exemptions for specific types of income are prevalent, regressive, and costly. Like other countries, FYR Macedonia draws on revenue from salaries, pensions, business activity and services, capital income, income from capital gains, and property income. However, exemptions are numerous. The tax base for capital gains is 70 percent, but gains from selling real property are reduced or exempt if the seller resided in the property for a specified time. Sales of securities are tax-exempt. Income from property and property rights is reduced by 30 percent for maintenance and management expenses, gross income from copyrights and patents by 25–60 percent, agricultural income up to 80 percent, and e-commerce income by 35 percent. Fully tax-exempt are some employment-related expenses, awards and scholarships, alimony payments, donations to qualifying institutions, specific types of interest income (deposits, government bonds), and salaries of employees of firms in technological industrial development zones for a period of up to 10 years.

If FYR Macedonia is to expand the tax base to raise more revenue, it must review the rationale for each exemption and deduction. This year's expiration of the exemption on gains from the sales of securities aligns with international best practices; reduction of capital and property income exemptions could be considered next. This would also improve progressivity of the system since capital income is heavily concentrated at the top of the income distribution: it represents 34 percent of the richest earners' income and only 2.5 percent of the income of the poor.

Increasing PIT progressivity would result in collecting a greater proportion of income from the rich than the poor. The current PIT system in FYR Macedonia has a 10-percent flat rate for all income groups and offers little progressivity[1]. With nearly 98 percent of taxpayers earning less than MKD 720,000, a relatively high-income threshold would deliver both revenue and equity gains; lower thresholds would quickly push up the number of taxpayers subject to the top marginal tax rate (Figure 4).

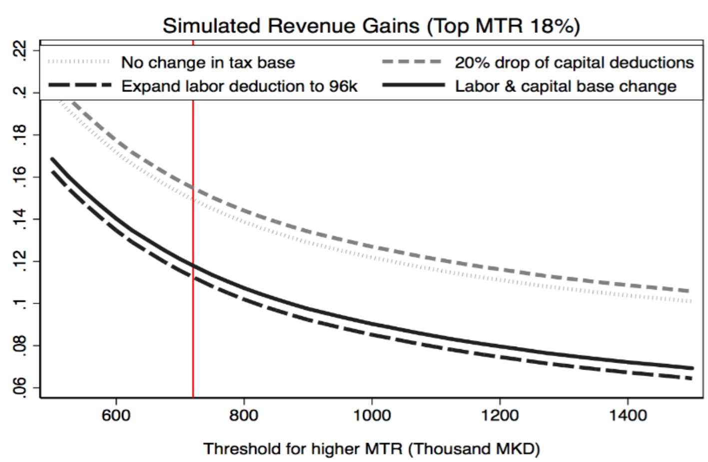
Combining a higher marginal tax rate of 18 percent above a high threshold with a broadening of the capital tax base and a moderate increase in the standard labor deduction would yield revenues of 0.35 percent of GDP. The combined measure would increase tax revenue and the progressivity of the personal income tax system. Figure 5 displays the assessed revenue gains from the income threshold of several tax base scenarios assuming an 18 percent higher tax rate above MKD 720,000 (monthly €1,000) in taxable income, a 20-percent reduction in permitted deductions on capital and an increase in the standard labor deduction to 96,000.

Figure 4: Distribution of PIT Taxpayers (2017)



Source: Administrative Tax Returns Data from PRO

Figure 5: Simulated Tax Revenue Gains from PIT Reform



Source: Administrative Tax Returns Data from the Ministry of Finance

[1] The 2015 Public Revenue Office data show that deductible individual tax allowance of MKD 90,000 (€ 1,450) increases the effective PIT rate from 4% for low-income earners to 7% for the top earners.

Increasing the tax burden for top earners is unlikely to raise efficiency costs. Revenue losses from decreased incentives to work because of the increased top marginal tax rate are likely to be low to moderate, as salary income represents 65 percent of top 2 percent income groups. However, difficult-to-monitor revenue sources and top taxpayers may require additional effort to help limit evasion and avoidance. And even with increased progressivity, FYR Macedonia would still be among the lowest income-tax countries in Europe.

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