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**FROM FLAT TAX GOING BACKWARD TO PROGRESSIVE TAXATION:
NATIONAL PERSPECTIVE ON TAX POLICY MEASURES AGAINST
TAX EVASION AND INCOME INEQUALITY IN THE REPUBLIC OF
NORTH MACEDONIA**

Since declaring its independence (September 8th 1991, Independence Day of Macedonia), Republic of North Macedonia had faced a number of challenges and difficulties pursuing a political and economic reform aimed to build a democratic society and open market economy. One of the most important challenges was the need of new tax policies, which would replace those inherited from socialist regime, designed to promote economic growth through expansion of private enterprises. The current fiscal system is based on market principles, private property, competitiveness, modernization of the system and orientated toward convergence to the European Union. The tax system from 1993/94 introduced the following types of taxes, typical to modern tax systems: income taxes (corporate tax and personal income tax), consumption taxes (VAT, excises, custom duties etc.) and property taxes (property tax, tax on inheritance and gift, tax on real estate turnover).

After its introduction, the second most significant period in the Macedonian tax system followed. By the end of 2006, the Macedonian Government introduced a number of supply-side policy measures aiming to reduce the tax burden and improve the business environment. Desperate for foreign direct investment inflows, burdened with high unemployment and willing to provide impetus for vigorous restructuring, the Government 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 flattening the taxes.

The Macedonian system of flat taxation was introduced in 2006 by amending the Law on Personal Income Tax from January 31 2006 and the Law on Profit Tax also from January 31 2006. The main pillars of this 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

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income and corporate taxes, and introduction of zero tax rate on reinvested profit. The so called *flat tax* refers to personal income and corporate profits being taxed at one marginal rate (12% in 2007 and 10% from 2008 till 2018).

The Macedonian government that introduced the Flat tax (that was re-elected four times continuously) argued that the flat, generally low, tax rates are good way to achieve their fiscal goals and pro-growth policy. Additionally, the Government intended to illustrate and demonstrate that the state budget and financial institutions appetite will be satisfied and tax payers will be complacent with reduced tax rates. Flat tax insured this. Additional strength that inspired Macedonian authorities to engage in adventure of reduction of the tax rates was, also, the requirement for decreasing the tax evasion and grey economy, that were almost a key trade mark not only in the Republic of North Macedonia but in all other ex federation' states. For almost 10 years, North Macedonia had new trade mark that can be called EPS, meaning *Everybody Pays Taxes* (Maksimovska, Stojkov and Neshovska, 2013). Surely, the flattening of tax rates of income taxes, as one of the lowest in Europe, made it accurate.

Surely, the greatest benefit from the flat rate system was the introduction of tax simplicity, replacing the complexity of tax calculations that taxpayers had to go through. The single and proportional tax rate for taxation of personal and corporate income, small number of tax deductions and the low tax rate had encouraged an improvement of taxpayers` behavior that resulted with increased level of voluntary tax compliance. Thus, at that time Republic of North Macedonia was one of the few countries that had around 90% of voluntary compliance of tax obligations. Cutting the tax rates and broadening the tax base hinders the incentives for tax evasion. In return, the tax culture of Macedonian tax payers and the awareness for tax importance improved and it was verified by the increased number of submitted tax declarations in 2007 (according the Public Revenue Office`s Annual Reports, there was a rapid increase of 296% compared to 2006).

The enhanced fiscal literacy and discipline of taxpayers as seen by the improved collection of direct taxes made the flat tax system more efficient. As a consequence, tax revenues grew which was exactly the case with the Macedonian corporate income tax where the rate of revenue growth was over 60% compared to the planned one in the first half of 2008. The personal income tax also demonstrated satisfactory performance in terms of revenue mobilization.

Although the Republic of North Macedonia had experienced reduction of overall tax burden and significant economic growth thanks to the flat tax reform, the unemployment rate and evident inequality in the income distribution have made the country a “loser” in the battle for social welfare. The rival political party that at the moment has the majority in the Macedonian Parliament has constantly disputed about the positive effects of application of the 10% tax rate, arguing that this model has drastically increased the gap between the rich and the poor. According the World Bank Estimation, in 2015 the Macedonian GINI index was 35, 6. Moreover, the statistics of the Macedonian Ministry of Finance have shown that while the richest 1% earns 14,4% of total state income, 21,9% of the population is poor. Therefore, the Macedonian Government was proclaiming the idea for reintroducing the progressive personal income taxation in order to: (1) achieve fair income redistribution; (2) improve social justice, and (3) increase budget revenues.

The beginning of 2019 has marked the new phase in the development of tax law system in the Republic of North Macedonia. The new Law on Personal Income Tax put an end on the application of the "flat tax" model. After 12 years the system of personal income taxation with a single, proportional tax rate of 10% was abandoned, while the corporate tax rate has not been changed. As a result, the Republic of North Macedonia has returned to progressive taxation, as a characteristic of the period after its independence when the Macedonian tax system was created.

According the positive tax legislation, the Macedonian system of personal income taxation is characterized by a double income tax regime, i.e. division of income into two groups: income from labor and income from capital, where the progressive taxation through implementation of two tax rates of 10% and 18% is applicable for the income from labor, while the income from capital is taxable by a single tax rate of 15%.

The 5-month period is not enough to determine and feel the very first effects from returning to progressive taxation, but the results of recent surveys (that nearly 20% of the wage is paid in an envelope) and government reports (that in 2019 the average wage in the IT sector records a decrease of 300-400 Euros, that is specious decrease in order to reduce or avoid the tax obligation) are worrying. The future will demonstrate whether the progressive income tax will satisfy the principle of fairness in taxation or it will return as a boomerang, bringing back the already overcome problems with tax evasion and grey economy.