THE ROLE OF TAX INCENTIVES IN CREATING "BUSINESS FRIENDLY" ENVIRONMENT: THE CASE OF REPUBLIC OF MACEDONIA

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Abstract

Tax incentives have been marked as a key ingredient for attracting fresh, domestic and foreign capital in Republic of Macedonia. In the last decade this country has strived to response to the global tax competition and to create attractive business environment for economic growth and direct investments. Promptly, Republic of Macedonia introduced flat tax treatment of corporate income and re-modeled fiscal surrounding for doing business. This paper analyzes the correlation between the flat tax and the various tax incentives on one side and the foreign direct investment inflows and newly opened domestic companies on another. Each tax incentive is analyzed separately, with an accent of their legal and economic aspects within Republic of Macedonia.

Keywords: tax incentives, corporate taxes, flat tax policy, foreign direct investments, doing business.

Topic Groups: Economic growth, Law and business, Macroeconomics.

1. INTRODUCTION

Globalization in terms of doing business promotes openness, overcoming of national borders and free movement of goods, services, capital and persons, new forms of entrepreneurship, new sources of wealth and increased company's competitiveness. Republic of Macedonia is not an exempt. This country jumped onto the globalization wave and accepted the benefits of the free trade with positive impact on competition, production efficiency and technological innovations.

However, the global integration of economic activities made serious pressure on Macedonia to be more attractive as investment location for FDI. In addition, it was pushed into reforms on the Euro integration process, in terms of speeding up the economic growth and achieving faster economic development. In order to increase its tax competitiveness, Macedonian authorities decided to create open door tax policy. As a result, last decade has been marked with serious tax changes undertaken in Republic of Macedonia. The flat tax treatment of personal and corporate income was introduced, seen as a key ingredient for fast economic development and factor for attracting FDI and opening new domestic companies. Tax competition has pushed Macedonia to go even further than the Flat tax adoption, placing additional fiscal measures and promoting fiscal policy "as friendly and comfortable as possible" for doing business. Tax incentives, such as tax exemptions, free technological zones, tax holidays, and non-taxation of reinvested profit, low or zero corporate tax rates, or even free financial zones were placed in action.

Was that a correct decision, or, is it still a proper tax policy for an EU candidate country from the Region of South East Europe? Is this a harmful tax policy that decreases state tax revenues or it is necessary remedy for tax competition? Are tax measures, tax incentives and other fiscal remedies enough to attract FDI and to stimulate the economic growth, or there is something missing in the legal, political and fiscal puzzle, that will provide stable economic development and attract new investments?

Nowadays, we argue that in order to set proper policy agenda for creating “business friendly” environment, primary is needed to identify the whole system of determinants for opening business, and subsequently (and strategically) to implement fiscal changes. Also, we agree that the correlation between the tax incentives and FDI inflows and newly opened domestic companies exist. However, it should be driven in relation to other determinants. The main aim of this paper is to provide answers to those questions, using the theoretical bases and empirical records, in order to provide an overall review of the open door tax policy reforms that are introduced for attracting and establishing new businesses in Republic of Macedonia.
The paper starts with a literature review focused on the reasons for introducing tax incentives as a part of open door tax policy, pros and cons for tax incentives. Third part explains tax incentives in Republic of Macedonia with an accent on legislatives and especially focusing on the flat tax. Forth part consequently analyzes the impact of the tax incentives towards foreign and domestic investments in recent years. The conclusion follows.

2. WHY DO TAX INCENTIVES MATTER?

2.1. Literature Review

Generally, tax theory recognizes fiscal incentives, specifically tax incentives as solid instruments for attracting fresh capital. Usually these are defined as a deduction, exclusion, or exemption from a tax liability, offered as an enticement to engage in a specified activity (such as investment in capital goods), and often known as tax expenditures. They are becoming an important fiscal instrument especially in times of crisis, used by developing countries because governments can easy change and expend the existing tax incentives or introduce new ones (Simovic, 2010). Due to our investigation, Republic of Macedonia competes with other countries from the SEE region by offering a variety of investment incentive schemes. However, recent studies found that tax incentives have inferior importance for multinational enterprises in making location decisions (Kaditi, 2013). More exactly, analysis show that the quality of the institutional environment is the significant determinant for FDI, and therefore governments should, focus primarily on creating an effective legal system, having relatively stable political and economic conditions. Therefore, it's clear why UNCTAD' Global Survey (2000) pointed incentives as secondary factor for business investments, compared to more fundamental determinants, such as market size, access to raw materials and availability of skilled labor.

Investors generally tend to adopt a two-stage process when evaluating countries as investment locations. In the first stage, they screen countries based on their fundamental determinants. Only those countries that pass these criteria go on to the next stage of evaluation where tax rates, grants and other incentives may become important. Thus, the empirical records confirm that investment incentives have only moderate importance in attracting FDI. So, we can see a tax exemption like a dessert, it is good to have it, but it does not help very much if the meal is not there (Morisset, 2000).

But, although majority of authors argue that most important factors are the basic infrastructure, and political stability, most of them still give a significant dosage of usefulness for the tax incentives, claiming that they have valuable effect on FDI (Nuta, 2012). This argument is confirmed by the wide usage of tax incentives over the SEE countries aiming to attract FDI. The SEE countries data record shows that, if two countries do not differ too much in other (legal and political) factors, fiscal surrounding (tax incentives and Flat tax) can be effective. As a result, open door tax policy finds various instruments that have impact factor for attracting companies to invest in one country, such as: the establishment of free technological zones (Easson, 1998); the "tax holidays" or exemptions/reductions for certain types of investment companies (Kaditi, 2013); deductions or tax credits; "non taxation rule" of reinvested profit, "free financial zones" etc.

Kellermann and Kammer (2009) summarize that in order to be tax competitive, developing countries implement corporate taxation policy that follows the trend toward reducing tax rates and broadening tax bases. Recent studies address that tax competition tends to increase the need to reduce tax rates, which as a rule goes hand in hand with the broadening of the tax base, so called “tax cut cum base broadening (Carone, 2007). In fact, globally, most reforms lead to an expansion of the tax base and the reduction of tax rates. The conclusion is that low taxes on corporate profits straightens the country`s ability to attract international investors, and magnifies the positive effects of entrepreneurship in a number of other respects.

Literature shows that the spread of the Flat tax makes further intensive open door tax policy reforms in SEE countries. Besides the increased tax competitiveness and tax system's efficiency, flat tax is recognized as effective tool for FDI, and also as factor for stable tax revenues, increased tax culture and decreased tax evasion (Schiau, 2009). By the end of 2012, around 30 countries over the globe have introduced Flat tax; seven of those are SEE countries. The added value of this paper is in explaining the reasons why Republic of Macedonia introduced the Flat tax and numerous types of tax incentives in the last decade, and measuring the correlation between them and established foreign and domestic businesses.

2.2. The Background on Tax Incentives

Open door tax policy is rich in examples of various tax incentives, like: increase or accelerate depreciation of capital expenditures, reduced taxes on dividends and interest paid abroad, preferential treatment of long – term capital gains, loss relief and carry forward, signed multilateral free trade agreements, number of investment protection treaties and double tax treaties, etc. We find the following three tax incentives as essential features of Macedonian tax system for creating “business friendly” environment:

2.2.1. Free Technological Industrial Development Zones

Free zones are actually the pool where most of the tax incentives exist. The zones are free in terms of customs and tax laws. By legal definition, these are special territorial areas of the country where foreign direct investments are encouraged. They are geographically and administratively restricted, but used for realization of micro-economic objectives, such as new jobs creating and foreign exchange. Free Zones have macro-economic and political objectives, such as enforcement of regional economic development and structural reforms. Motivation for establishing such zone is to develop highly propulsive and modern technologies by introducing economically profitable production and efficient utilization of the resources by application of the highest environmental standards. Commonly, the following tax incentives are offered: beneficial custom arrangements, preferential tax regime for corporate tax, personal income tax and value added tax, advanced infrastructure, state aid etc. For several decades, these free zones have become a truly global economic phenomenon. As political tools and fiscal strategic measures they have a great impact on the economic development and structural reform in both developed and developing countries.

2.2.2. Tax Holidays

Tax holidays are a common form of tax incentives used by transitional and developing countries to attract FDI. Under a tax holiday, newly-established companies are exempt from paying corporate tax for a specified period and investor`s benefits are presumed during the initial stage of the new investment. Tax holidays are seen as a simple incentive with a relatively low compliance burden and easy to manage.

2.2.3. Non-Taxation of Reinvested Profit

Non taxation of reinvested profit is seen as most popular tax incentive, where countries unilaterally and voluntary give up from their potential corporate tax revenues by allowing non taxation of the profit for the company that decides to reinvest it (profit exemption). State authorities assume that this tax incentive will stimulate further investments, expend and improve the business activities and produce new employments. The tax exemption as incentive has existed even before the open door tax policy was introduced.

3. CREATING “BUSINESS FRIENDLY” ENVIRONMENT IN REPUBLIC OF MACEDONIA: TAX INCENTIVES AND FLAT TAX IN ACTION

3.1 Tax Incentives

3.1.1 Free Zones

There are four major designated free trade zones, known as Technological Industrial Development Zones (TIDZs) and seven other smaller TIDZs in Macedonia. The Law stipulates that investors are exempt from payment of value added tax and customs duties for goods, raw materials, equipment and machines. The land in the free zones is available under long-term lease for a period up to 99 years at relatively low or even exempts concessionary prices. Investors are, also, exempt from paying utility taxes to the local municipality and fees for land building permits. There is a free connection to natural gas, water and sewage network in the Macedonian TIRZs. Government of Republic of Macedonia may participate in construction costs of the user in the TIDZ up to EUR 500.000 depending on the number of the new employees and investment amount of the user.

3.1.2 Tax Holidays
Macedonian tax holidays are allowed only in the free zones. The companies are entitled to 10-year profit tax exemption and to 100% reduction of personal income tax for a period of 10 years, so that the effective rate of personal income tax will amount to 0%.

3.1.3 Non-Taxation of Reinvested Profit (Profit Exemption)
Macedonian Law on Profit Tax sets a possibility for decreasing the tax base for the amount of profit reinvested for development purposes i.e. investment in tangible assets (property, plant and equipment) and intangible assets (computer software and patents) intended to expand the activity of the taxpayer. However, the taxpayers must maintain ownership over the assets purchased with the reinvested profit for a period of five years.

3.2 Flat Tax System
Positive experiences with the flat tax from economically more advanced post-socialist countries from the Central European Region like Estonia, Lithuania, Latvia, Russia, and Slovak Republic gave strong stimulation for the tax reforms in Macedonia. Their results in attracting FDI, encouraged Macedonian government to accept the flat tax system, aiming to stimulate the economic development and growth, improve tax environment for investments and increase tax compliance. 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. Specifically, with the amendments to the Law on Personal Income Tax the three existing tax rates of the income tax, from 15% for income up to 360 000 MKD, 18% of income from 360 00 to 720 000 MKD 54 000 +18% of the share of income from 360 000 to 720 000 MKD, and for income above 720 000-118 800 +24% of the portion of income over 720 000 MKD, were replaced with a single rate of 12% in 2007 with its reduction at 10% in 2008. The rate of profit tax of 15% was replaced with 12% in 2007, decreased to 10% in 2008. Hence, the Law on Personal Income Tax, article 12 states: “personal income tax is taxable by tax rate of 10%”, followed by the Law on Corporate Tax, article 28, where it's stated “the tax rate of the corporate tax is 10%”.

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).

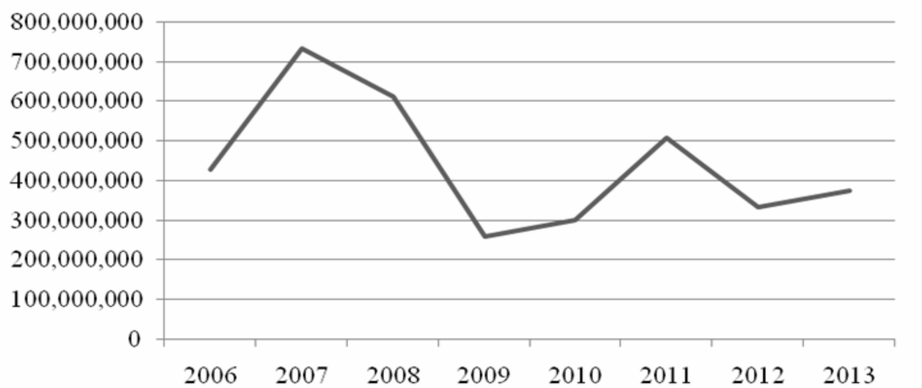
Desperate for foreign direct investment inflows, burdened with high unemployment and willing to provide movement for vigorous restructuring, the Government was dedicated to be most tax competitive in the Region, to cut the tax evasion and grey economy that were almost a key trade mark, and to attract as much as possible FDI. Surely, the flatting of tax rates of income taxes, one of the lowest tax rates in Europe of 10%, made it looks more possible. Today, 9 years later, after summarizing the results of the introduced flat tax policy there is compelling evidence that it revolutionized the Macedonian tax system and provided economic stimulus for the far-from-vibrant private sector in Macedonia (Pendovska and Neshovska, 2014). Key benefits of the Macedonian flat tax are: tax simplicity, replacing the complexity of tax calculations; decreased tax compliance costs; increased fiscal discipline, and the personal income tax and corporate tax demonstrated satisfactory performance in terms of revenue mobilization.

4. THE IMPACT OF MACEDONIAN TAX INCENTIVES OVER THE AMOUNT OF FOREIGN AND DOMESTIC BUSINESS INVESTMENTS

Macedonian "open door" tax policy in recent years has been driven by the desire to improve further the environment for doing business. Thus, the implementation of tax incentives can be seen as a continuation of efforts to improve efficiency in the allocation of real capital, to enhance productivity and promote innovation and investment, to strengthen the competitive position of firms and encourage foreign direct investments. For better assessment of the correlation between tax incentives and initiatives for doing business in Macedonia, we analyzed the changes in the amount of FDI inflows and the number of newly-established resident companies from the very first year after introducing tax incentives and the flat tax.

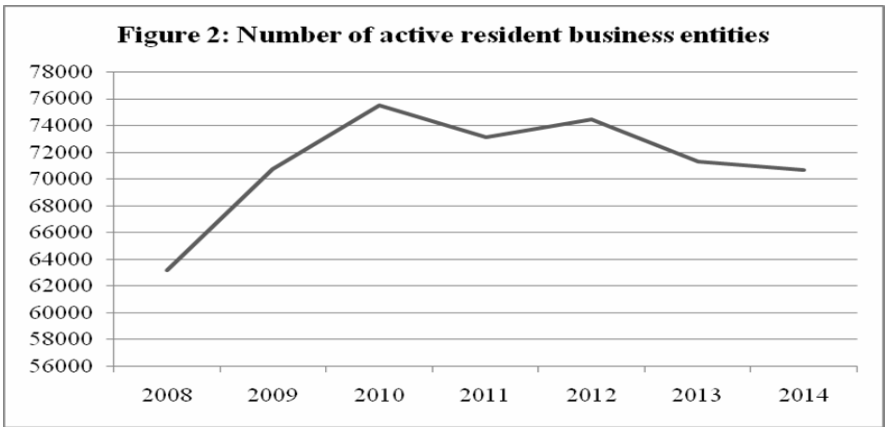
Republic of Macedonia experienced a significant increase in FDI inflows in the very first year after introducing flat taxation and other tax incentives (increase of 71%). The forecasted effects from the theory (as a direct benefit in the first few years of the flat tax introduction) undoubtedly occurred in Republic of Macedonia. It is evident that inflows of foreign direct investment increased in the period 2007-2008 (the first two years of the introduction of open door tax policy), but in 2009-2010 came to a relative decline of FDI inflows, primary affected by the financial and economic crisis. However, FDI inflows are now higher than in 2007 indicating justification of the introduction of every tax incentive as a device to attract FDI. Modest signs of improvement have been felt in 2011, but still, the current amounts of FDI inflows cannot reach the FDI amounts before the 2008 economic recession. In the following figure, the changes in the FDI inflows are shown, from the very first year after introducing open door tax policy. See Figure 1: FDI inflows in Republic of Macedonia: 2006-2013.

Figure 1: FDI Inflows in Macedonia 2006-2013 (in U.S dollars)



Source: World Bank Database, visited on June 25th, 2015

Different to all benefits for foreign investors, Macedonian resident companies experienced positive effects thanks to flatting corporate tax rate and non-taxation of reinvested profit. Flat tax system and the profit exemption resulted with significant increase of the number of newly-established companies in the first two years of implementation of "open door" tax policy. Majority of these companies are small and medium firms that have a great impact on reducing Macedonian unemployment, increasing tax revenues and stimulating the economy. However, the world financial crisis has hampered the work of Macedonian enterprises and part of them did not recover from the difficulties. Additionally, the Macedonian government has put some pressure on their work by increasing the social contributions and eliminating some tax incentive that have increased their overall tax burden. As a result, some newly-established resident companies did not survive in 2014. However, the Macedonian government has recognized its responsibility for the serious enterprises` deaths and in 2014 introduces new form of state aid for opening new firms by giving state subventions for every newly-established company and for every new employee in existing companies. Figure 2 shows the changes in the number of active business entities in Macedonia in the period from 2008, when the tax incentives were introduced, till 2014. See Figure 2: Number of active resident business entities.



Source: State Statistical Office of Republic of Macedonia

5. CONCLUSION

The global integration of economic activities made serious pressure on Republic of Macedonia to be more attractive as investment location for FDI. In addition, it was pushed into reforms on the Euro integration process, in terms of speeding up the economic growth and achieving faster economic development. In order to increase its tax competitiveness, Macedonian authorities decided to create open door tax policy. As a result, last decade has been marked with serious tax changes undertaken in Republic of Macedonia. The flat tax treatment of personal and corporate income was introduced, seen as a key ingredient for fast economic development and factor for attracting FDI and opening new domestic companies. Tax competition has pushed Macedonia to go even further than the Flat tax adoption, placing additional fiscal measures and promoting fiscal policy "as friendly and comfortable as possible" for doing business. Tax incentives, such as tax exemptions, free technological zones, tax holidays, and non-taxation of reinvested profit, or even free financial zones were placed in action.

After evaluating the role of tax incentives in creating “business friendly” environment, we can summarize the following findings:

- Tax incentives and the flat tax system have improved the Macedonian tax competitiveness in the neighborhood and SEE region.
- In the very first years, Macedonian “business friendly” environment has really had positive effects on the amount of FDI and the number of newly-established resident enterprises.
- Macedonian tax incentives are more in favor of foreign investors than resident companies causing unequal treatment of tax payers.
- Although, there is an improvement of Macedonian tax environment-open door tax policy full with tax incentives, lowest corporate tax rates, friendly business

environment- nowadays, there is evident decrease of FDI inflows and number of active business entities.

- This only confirms that tax incentives are not the ultimate condition for creating "business friendly" environment. The number of active business entities, resident and non-resident, does not depend solely on the structure of tax incentives. Macedonian government has to take into consideration other business determinants, such as macroeconomic and political stability, rule of law, infrastructure and administrative regulations. Still, after measuring the impact of most significant tax incentives and flat tax, the correlation between open door tax policy and conditions for doing business is strongly relevant.

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