

# Progressive income tax: Much ado about nothing?

In November 2018, the Government suddenly announced a design of the progressive and higher personal income tax, to enter into force as of January 2019, after the issue has been long debated in the public discourse. The move apparently sparked again heated debates - especially angry voices stemming from the business sector, although the entire society expected that sufficient time would be allowed for discussion and consultation, which was obviously not the case. Against this backdrop, the new Law on personal income tax was adopted by the parliament at end-December and entered into force as initially announced.

## Policy Brief No. 35

We recommend to the Government that any tax reform, particularly ones related to tax increases, should be communicated and consulted with stakeholders well in advance, to secure proper environment for its implementation. This approach should be indisputably accompanied by debates and research on sources of inequality as well clear steps to tackle shadow economy and the regressive social system and to strengthen institutional order, rule of law and, particularly, the efficiency of public spending.

### Problem

Macedonia has had – until recently - a flat personal income tax rate of 10% introduced in 2007, with its primary objective to make the business environment friendlier to businesses and hence support job creation. The flat tax was introduced after progressive tax systems of various compositions were in place since North Macedonia's independence in 1991. North Macedonia faces large inequality, currently (2017) of 32.5% as measured by the Gini coefficient. However, it has been declining from levels above 40% before 2010, mainly due to populist-minded social policies including ad-hoc increases in pensions, social assistance, public wages, as well other policies with emphasized poverty-

reduction component like the agricultural subsidies, all of which at the expense of soaring public debt.

At the end of 2017, the Ministry of Finance published inequality indicators based on tax administrative information. These data revealed the desperate picture of Macedonian inequality: the top 1% earners earned 14% of the total income in 2016, while the rest of the 99% earned below 1500 EUR per month; the rest 98% earned below 1000 EUR per month, while the bottom 90% earned below 495 EUR per month. For comparison purposes, the gross average wage in North Macedonia is approx. 600 EUR (2018). However, when the composition of the top 1% earners is considered, then the average is inflated by circa 500 individuals who

earn enormous amounts, compared to all the rest (cca. 10.000 in the top 1%) who earn between 1500 and 3000 EUR per month. Hence, these data actually revealed that we are all poor, with the exception of a subgroup of individuals within the top 1%.

The policy reform of November 2018 – towards progressive and higher income tax - stipulated a second bracket for the income earners whose income exceeded 90.000 MKD per month (cca.1.500 EUR), of 18%. The income tax on capital remained flat, but increased, from a nominal 10% to 15%, although several exemptions which existed before were considerably reduced, implying even higher real increases. Despite the heated debate about the reform, it took into account at least two important aspects long present in the public discourse. First, the initial rumors that the bracket for the higher tax rate would be set at 700 EUR or 1.000 EUR, produced a debate on penalization of a productive share of labor force, notably, IT professionals, consultants, scientists. This pressed the bracket frontier to 1.500 EUR, being an implicit recognition, by the government, that the source of income inequality in North Macedonia is not wages per se. Second, the discourse argued that the extra collected funds must be earmarked for specific pro-poor programs, to secure the allocative function of the budget, which proved inefficient in the past; even worse, it was accompanied by doubts for corruptive behavior of high government officials. The government announced that the extra-collected funds from the progressive and higher income tax will be directly used for funding of the reform in the social assistance system (composed of its redesign towards guaranteed minimum income, along introducing of a social pension), which has been accepted as a robust response to the second important request of the public debate.

**Objective**

The objective of the analysis is to provide robust evidence about the expected and preliminary effects of the progressive and higher income tax in North Macedonia. We first provide research evidence about the expected distributional effects and reveal if the tax reform may play its redistributive role: to pick form the richest and to give to the poorest, therefore affecting inequality and poverty. Then, we provide evidence about the expected effect of the progressive income tax onto employers’ and workers’ behavior in a broader sense.

**Methodology**

The research is based on two strands of methodological approach. The quantitative part is based on the already developed tax and benefit microsimulation model for North Macedonia MK-MOD. It is a static model where individual behavior (labor-market activity, employment, childcare, saving, etc.) is assumed to be exogenous to the tax-benefit system. It belongs to the family of “standard” static models

where individuals/households choose to supply labor (hours of work) until the point where the “marginal disutility of work equals the marginal utility of disposable (net-of-tax) income.” (Saez, 2010, p.180). In this setting, taxes and social transfers affect the labor-market behavior by changing the relative value of work vs. leisure. It allows the simulation of income assistance, child benefits, unemployment benefits, direct taxes and social security contributions. We use the 2017 Quality of Life Survey. We collected qualitative information through interviews and focus groups. Three in-depth interviews have been conducted: one with the chair of a large chamber of commerce, another with the chair of IT association and a third with the CEO of large foreign company in the country. The focus group was conducted with workers affected by the policy change and coming from a variety of industries. The interviews and the focus group have been conducted over April 2019, hence respondents were able to speak about the early effects of the new tax policy, though also about the broader picture in which the policy change occurred.





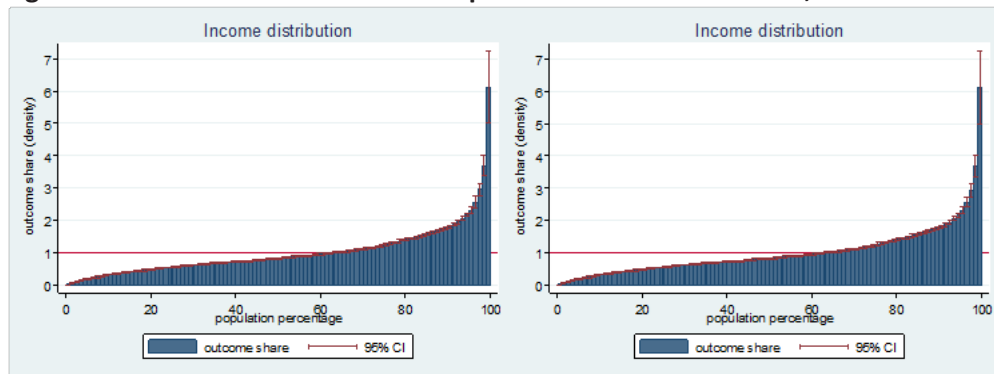
**Results**

Based on the quantitative calculations, results suggest that the tax reform produced plausible results for inequality in North Macedonia, despite these results are very small and potentially without any real significance. Figure 1 presents the centile distribution of total income of the households before (left) versus after (right) the imposition of the progressive tax. One could hardly see any difference between the two graphs, suggesting that any effects of the reform onto the income distribution have been small. The combination of the tax and social reform led to further plausible, though small outcomes, as the collected funds from the progressive and higher tax, if directed to fund the guaranteed minimum assistance (including the child and educational allowances) further acts as poverty-reducing and equalizing factor with potentially stronger real impact.

Similarly, Figure 2 presents the centile distribution of wage income only, before and after the imposition of the progressive tax. It suggests that the tax reform affected only the top 1% earners and still in a relatively trivial way: their share declines from 4.5% to only 4.4%, further suggesting that wages are not the source of the income inequality in North Macedonia. Male workers were found more affected than female workers, as well managers more than the other occupations, while none sector proved especially sensitive to the tax progressivity. Based on the qualitative insights, results suggest prevalently negative effects of the progressive and higher income tax in North Macedonia, although dominantly in perceptive/psychological rather than quantitative sense. The policy change has been judged as fairly mild and quantitative insignificant, corroborating our quantitative calculations, but the main concern was its suddenness, brought in times of

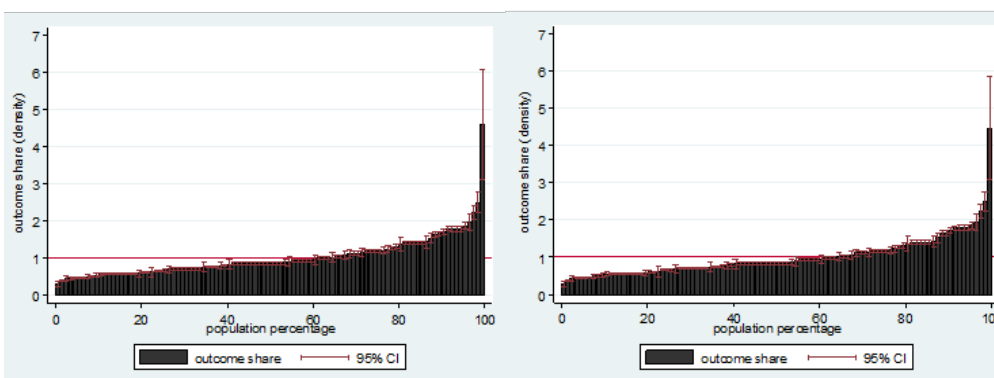
impaired institutions and rule of law, before and without widespread consultation on its design. Although, there was a prevalent niche discussion about the readiness of concerned taxpayers to pay the additional tax without any significant burden. However, coupled with the inefficient public spending and the perception of misuse of public funds created a psychological rather than real bubble that most productive employees are penalized for their education, skills and effort, which then feeds into their inclination to emigrate. Respondents agreed that the engineering occupations have been most affected. Overall, both the quantitative estimates and the qualitative insights unanimously suggest that the quantitative effects of the tax policy reform – for the budget and the income and wage inequality – have been small if at all significant in any extent. In addition, qualitative results suggest that the context in which the progressive income tax has been enacted may actually deliver a very high (political) price to be paid, incomparably higher than the economic benefits.

**Figure 1 – Distributional effects of the personal income tax reform, before vs. after**



Source: Authors' calculations based on Quality of Life Survey 2017.

**Figure 2 – Distributional effects of the personal income tax reform for wages, before vs. after**



Source: Authors' calculations based on Quality of Life Survey 2017.

## Recommendations

Based on the analysis presented here, we provide the following policy recommendations:

- Any tax reform, particularly ones related to tax increases, should be communicated and consulted with stakeholders well in advance, to secure proper environment for its implementation
- A discussion about inequality is the core basis for introducing higher taxes, particularly: i) the dichotomy between income and wage inequality; and ii) the causes of inequality in North Macedonia

- A discussion about the formalization of existing shadow economy and emigration of high-skilled workers, with clear pathway of their addressing, will significantly aid introduction of higher taxes

- Immediate addressing – even before enacting higher taxes – of regressive social contributions (e.g. no social contributions on wage part exceeding 16 average wages)

- Strengthening of the institutional order, rule of law and, particularly, the efficiency of public spending may be key to successful progressive tax reform, also securing climate for easier introduction of such reform



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