Tax Expenditures Report

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1. Introduction

Estimating tax expenditures and publishing them on a regular annual basis is a practice in European countries. Namely, according to the Directive on Requirements for Budgetary Frameworks (2011/85/EU), Member States have an obligation to provide reports on tax expenditures and their impact on revenue. Unlike in the European Union, in the Republic of North Macedonia there was no legal obligation to date to regularly publish tax expenditures; however, with the new draft Law on Budgets, which is currently in its final stage of preparation, this obligation is being introduced, and after its adoption and entry into force the Ministry of Finance will be required to submit a report on the impact of tax expenditures on revenue. This report will be submitted to the Parliament of the Republic of North Macedonia on an annual basis, as an accompanying document to the Annual Budget Execution Report which shows the realisation of the national budget for the previous budget year. The publication of tax expenditures is also part of the Fiscal Transparency Action Plan, which was adopted by the Ministry of Finance in order to meet the obligations arising from the IMF Fiscal Transparency Report, which recommended the regular annual publication of tax expenditures reports.

In order to develop such a report, special activities were foreseen within the second component "Enhancing the capacities of the Ministry of Finance for conducting tax policy analysis and forecasting" of the twinning project "Improving revenue collection and tax and customs policy", in order to develop such reports in accordance with European best practices. This type of report compatible with European reports is being prepared for the first time in the Republic of North Macedonia.

2. Literature review

In general, the purpose of tax expenditures is to support certain economic sectors and activities, certain social groups, etc., and it is important to note that there is no unified definition of tax expenditures in the literature.

According to the World Bank, an example of tax expenditures, in a broader context, are tax provisions that deviate from a normative or a specific tax system and may take a number of forms: exemptions, allowances, deductions, rebates, credits, preferential tax rates or tax deferrals (WB 2006).

According to the Organisation for Economic Cooperation and Development (OECD), a tax expenditure is a transfer of public resources that is achieved by reducing tax obligations with respect to a benchmark tax (i.e., the standard tax system), rather than by a direct expenditure. Due to the fact that there is no single definition of tax expenditure that is applied everywhere, most countries use the definition of tax expenditure of the Organisation for Economic Cooperation and Development (OECD).

Tax expenditures may occur in various forms (e.g. exemption, relief, credit, etc.), which can be delivered through several types of direct and indirect taxes. Their provision is usually based on a specific goal that should be achieved, and those benefiting can be natural persons and legal entities. In addition to being expressed in their nominal value, tax expenditures are usually also expressed as a percentage of GDP or as a percentage of total tax revenues.

Table 1 Classification of tax expenditures

Category	Criterion	Examples
Mechanism for delivery	The mechanism through which the tax expenditure is granted	Exemption, deduction, credit, relief, tax-free threshold, deferral
Type of tax	The particular tax base to which the tax expenditure is applied	Personal income tax, corporate income tax, value added tax
Budget category	The budgetary heading to which the tax expenditure is attributable	By function, such as education, health, environmental protection, etc.
Policy objective	The specific policy objective for which the tax expenditure was designed	Salaries, housing, innovation
Beneficiary	The agent or entity that benefits from the tax expenditure	Producer(s), consumer(s), region(s)
Size	The magnitude of the tax expenditure in terms of revenue foregone	E.g. expressed in Euro,% of GDP,% of total tax revenues

Adapted from Redonda. A (2016), Tax Expenditures and Sustainability. An Overview, p. 6

The following three types of methodologies are commonly used in estimating tax expenditures:

- **Revenue forgone approach**: estimates the amount by which taxpayers have their tax liabilities reduced as a result of a tax expenditure based on their actual current economic behaviour;
- **Revenue gain approach**: estimates the additional revenue that would be collected if a tax expenditure was removed, and accounting for behavioural changes resulting from this removal; and
- **Outlay equivalent approach**: estimates the government cash outlay required for an alternative direct spending program replacing the tax expenditure that would have the same benefit for the taxpayers.[1]

Analogous to the considerations above, the revenue forgone approach will be used to estimate tax expenditures in the Republic of North Macedonia.

[1] Redonda. A (2016), Discussion Note 2016/3: Tax Expenditures and Sustainability - An Overview, Council of economic policies, Switzerland, p. 6

3. Experiences from other countries

Tax expenditure reporting has become a long-standing practice in most EU member states and OECD countries. Annual tax expenditure reports are prepared and published in order to ensure a higher degree of transparency in relation to provisions governing tax expenditures. Tax expenditure reports are issued on an annual basis; there are, however, some exceptions, with some countries reporting their tax expenditures once every two or three years (e.g.: Bulgaria). In the following section, we will briefly review some of the experiences of EU member states, as well as countries in the region, with tax expenditures reporting.

European Union. Since 2014, the Directive on Requirements for Budgetary Frameworks requires Member States to publish information on the effects of tax expenditures on national tax revenues. As noted by Kalyva (2014), 18 out of a total of 28 Member States report on their tax expenditures regularly. According to the Directive on Requirements for Budgetary Frameworks, EU Member States should provide detailed reporting on the impact of tax expenditures on government revenues. A key principle of this Directive is the fact that "A crucial element in ensuring the quality of fiscal data is transparency, which must entail the regular public availability of such data", which refers to tax expenditure reporting. While recent EU legislation recognises the importance of estimating and measuring the impact of tax expenditures, practices of EU Member States, including their methods, level of detail and timeliness, differ considerably. Tax expenditures have long been used as a tool to promote social and economic objectives. Tax expenditures can be categorised in different ways. Some countries categorise tax provisions according to their budgetary function, such as health, social welfare and housing, etc. Study conducted by the OECD on the impact of tax expenditures in EU member states included in the study concluded that tax expenditures in the area of taxation on income are high, from a low of 0.20% of GDP in Germany to a maximum of 3.85% in the UK. In general, OECD estimates suggest that the structure of tax expenditures on personal income tax is housing-oriented, at least in the cases of Spain, the United Kingdom, and Germany.

Bulgaria. The Bulgarian tax system provides a number of tax incentives aimed at encouraging taxpayer behaviour, in order to promote the development of certain regions, selected economic sectors and specific types of activities or change the progressive features of the tax system. The first tax expenditures report in Bulgaria, published in 2012, covers a period of three years (2007-2009). The second tax expenditures report covers a two-year period (2010-2011). The third tax expenditures report refers to 2012, where after the drafting of annual tax expenditures reports was introduced. The last published report refers to 2015. This tax expenditures report includes a quantitative assessment of the different types of tax relief. The report includes tax expenditures disaggregated by type of tax measure for the following types of taxes: personal income tax, corporate income tax, value added tax and excise tax. Tax expenditures are estimated on the basis of data contained in tax returns and customs declarations provided by the National Revenue Agency and the Customs Agency, as well as on the basis of statistics provided by the Bulgarian National Bank and the National Statistical Institute. The largest relative share (51.3%) comes from tax expenditures related to excise taxes (21.1%) and VAT (19.7%). However, analysis reveals that just over a third of tax expenditures have not been estimated, i.e. a significant portion of tax expenditures have not been measured, due to a lack of data on tax incentives related to the taxation on corporations and personal income, which precludes measurement of the actual size of tax expenditures and the preparation of a realistic report on tax expenditures. The inability to estimate is due to the fact that tax returns do not contain the required relevant data or contain aggregate data that cannot be used reliably to measure the corresponding tax expenditures. In this regard, due to the lack of detailed and comprehensive information that reflects the exact impact of some of the tax expenditures on the national budget, a quantitative estimate of their effects in the annual reports is not possible. On the one hand, it is necessary to simplify administrative procedures, including the procedure for filing tax returns, in order to reduce the administrative burden and compliance costs for taxpayers. On the other hand, the unavailability of certain information on tax incentives related to the taxation on corporations and personal income precludes the measurement of the true size of tax expenditures and the preparation of a realistic report on tax expenditures.

Also, as of 2015 the Republic of Bulgaria drafts tax expenditures projections, which are estimated based on macroeconomic variables and changes in tax policy, and refer to the next year.

Albania. Albania has not yet published official tax expenditure estimation reports. To date, estimates of the fiscal impact of some new tax expenditures have been published, but there is no systematic reporting of total costs for existing and new tax expenditures in budget documents or fiscal reports. In accordance with Albanian tax laws, there are tax expenditures related to value added tax, personal income tax, corporate income tax, excise taxes, the Customs Tariff, etc. In 2015, with the help of the IMF, those tax provisions were identified that deviate from the benchmark, i.e. from the standard tax system. Estimates provided by the Ministry of Finance show exemptions from corporate income tax, personal income tax, VAT, excise tax and some less significant taxes, which result in foregone revenue of 1.3% of GDP in 2016. The average tax rate in Albania is relatively low, indicating that tax expenditures are unlikely to be a major source of foregone revenue. This suggests that total tax expenditures may not be particularly high by international standards, but further analysis is needed to confirm this.[2]

Montenegro. Tax expenditures are not monitored and estimated regularly in Montenegro. However, some tax expenditures are elaborated in the annual tax policy analysis report. There are also some analyses and evaluations in the strategic documents ERP 2018-2020, Development Directions 2018-2021 and IMF FAD TA for Tax System. Tax exemptions are provided in the laws on value added tax, corporate income tax (1.3% of GDP), personal income tax and social security contributions. Given the fact that the aforementioned tax exemptions are mostly related to support to investments that are a key driver of Montenegrin economic

[2]Workshop, *Cost-Benefit Analysis of Tax Expenditures and other Revenue Measures*, Center of Excellence in Finance Ljubljana, April 16 - 18, 2018

growth, it can be concluded that the existence of these exemptions has a positive effect on the attractiveness of the Montenegrin investment environment and on overall economic activity. Of course, in the medium term and in line with EU recommendations, it is necessary to consider abolishing specific exemptions, in line with Montenegro's obligations in the frameworks of EU accession negotiations.[3]

Bosnia and Herzegovina. Tax expenditures are not periodically estimated, although they should be monitored. Some of these expenditures that need to be addressed are those referring to the law on personal income tax (personal deductions, contributions for voluntary pension insurance, as well as life insurance premiums), where the total revenue forgone amounts to about 7.2 million euro and the law on corporate income tax (interests on housing loans, tuition for children), where the revenue foregone amounts to about 1.1 million euro per year.[4]

4. Data

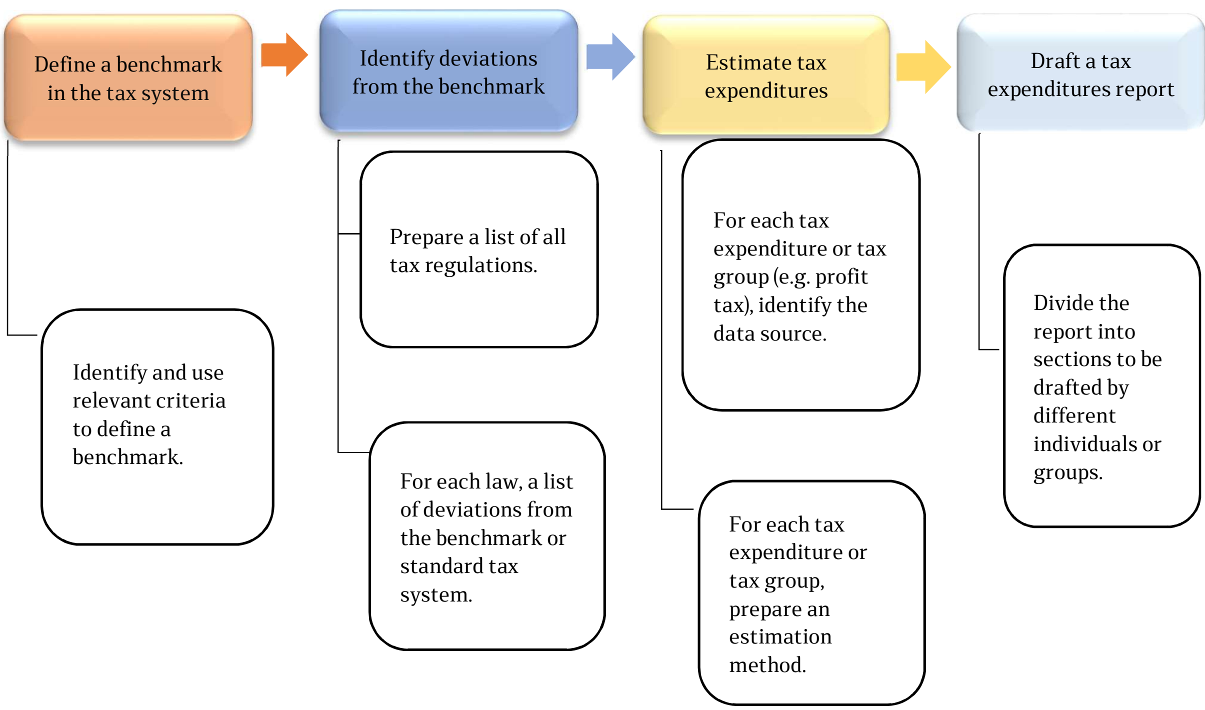
For the purposes of this report statistical data from the State Statistical Office and administrative data provided by the Public Revenue Office, the Customs Administration and Commission for Protection of Competition were used, which include:

- supply and use tables;
- micro data on personal income tax, compulsory social security contributions and corporate income tax;
- administrative data on the release for free circulation of excise goods;
- recorded duties on import of goods in accordance with the Customs Tariff;
- data from the report on Household Consumption in the Republic of Macedonia, 2017; and
- administrative data from Commission for Protection of Competition.

[3]Workshop, *Cost-Benefit Analysis of Tax Expenditures and other Revenue Measures*, Center of Excellence in Finance Ljubljana, April 16 - 18, 2018
[4] Ibid

Considering that the data necessary to estimate tax expenditures are available with a certain time delay, which for statistical data is usually from two to three years (e.g. supply and use tables, which are the basis for estimating the largest tax expenditures item), while for administrative data the delay is shorter (e.g. at the Public Revenue Office this delay is about 6-8 months after the end of the fiscal year for the previous year), the main focus in this report is placed on 2017, because complete data was only available for this year at the time of preparation of this report (e.g.: the first tax expenditures report that was prepared in Bulgaria in 2012 referred to a previous three year period, i.e. 2007-2009).

Chart 1 Schematic presentation of the preparation of the tax expenditure report



Adapted from IMF (2019), Tax Expenditure Reporting and Its Use in Fiscal Management, p.3

In order to estimate tax expenditures, micro-simulation models developed in the programming language R were used, as well as a model for estimating VAT tax expenditures developed by World Bank experts.

5. Direct taxes

5.1 Personal Income Tax

Tax expenditures arising from personal income tax are defined as deviations from the benchmark (i.e. the standard tax system), meaning as the difference between potential tax revenues and collected tax revenues. Potential tax revenues are determined by applying the tax rate to the gross income. For the purposes of this report, the following tax expenditures are indicated as the most significant:

- **An employed person with a disability is exempt from paying personal income tax**. This tax expenditure arises from the exemption from payment of personal income tax stipulated in the Law on Employment of Persons with Disabilities. Pursuant to Article 7 of this Law, any employed person with a disability is exempted from paying personal income tax. Tax expenditures on this basis amount to MKD 131 million, i.e. they participate with 0.9% in the total revenue from personal income tax and 0.02% in GDP. This exemption covers approximately 7 400 people;

- **Employment of an unemployed person who has been registered as unemployed for more than one year**. This tax expenditure on the basis of personal income tax arises from exemptions prescribed by the Law on Employment and Unemployment Insurance. Article 98 of this law stipulates that an employer, who employs a worker for an indefinite period of time over the existing number of employees, shall be exempted from paying personal income tax for the newly employed workers for a period of three years. The newly hired worker must have been registered as unemployed with the Employment Agency for at least one year. Tax expenditures arising from the exemption from payment of personal income tax are estimated at MKD 170 million, with a share of 1.1% in the total revenue from personal income tax and 0.03% of GDP. This exemption covers approximately 18 300 people; and

- **Exemption from personal income tax on employees' salaries for a period of ten years from the start of business activity in a technological industrial development zone TIDZ/Law on State Aid Control**. This exemption arises from the Law on technological industrial development zones. Namely, Article 5 of this Law stipulates that a taxpayer, user of a zone, shall be exempt from payment of: personal income tax on employees' salaries, for a period of ten years as of the beginning of business activity in the zone or as of the first month, in which the taxpayer pays salaries, regardless of the number of employees in the beneficiary, under conditions stipulated in this Law; and personal income tax on the salaries of newly employed persons, for a period of ten years as of the day of receiving: 1) a decision on starting work on expansion of the capacity of the existing enterprise; 2) a decision on starting work in case of diversification of the enterprise's production by introducing new, additional products or; 3) a decision on starting work in case of a substantial change in the entire production process of the existing enterprise; provided that the number of employees in the existing facility of the zone user before and after the decision is not reduced. Tax expenditures arising from the above mentioned exemptions from personal income tax amount to MKD 209 million, i.e. they participate with 1.4% in the total tax revenue from this tax and with 0.03% in GDP. This exemption covers approximately 11 900 people. In order to avoid a double calculation of this exemption, it is important to note that this amount includes state aid granted in the form of regional state investment aid, which according to the data of the Commission for Protection of Competition for 2017 amount to MKD 132.8 million on the basis of personal income tax.

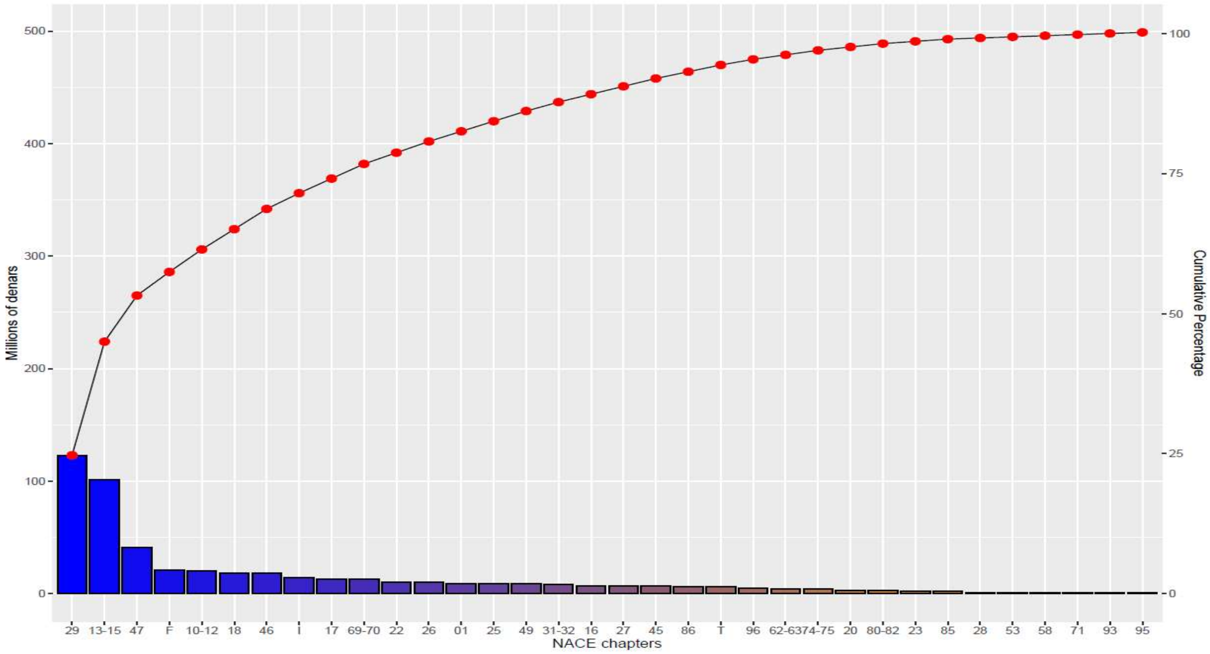
A detailed estimate of tax expenditures is shown in the following table, with total tax expenditures on the basis of personal income tax amounting to MKD 510 million, with a share of 3.4% of total revenues from this tax and 0.08% of GDP. Analysed by purpose, 59% of tax expenditures have a social purpose, while the remaining 41% have an economic purpose.

Table 2 Estimated tax expenditures from personal income tax

No.	Legal basis	Articles	Type of measure	Objective	Tax expenditures	Share of total revenue from PIT	Share of GDP
1.	Law on Employment of Persons with Disabilities	Article 7	An employed person with a disability is exempt from paying personal income tax.	Social	131	0.9	0.02
2.	Law on Employment and Unemployment Insurance	Article 98	Employment of an unemployed person who has been registered as unemployed for more than one year.	Social	170	1.1	0.03
3.	Law on Technological Industrial Development Zones/ Law on State Aid Control	Article 5 paragraphs 3) and 4)/Article 5	Exemption from personal income tax on employees' salaries for a period of ten years from the start of business activity in a TIDZ.	Economic	209	1.4	0.03
	TOTAL				510	3.4	0.08

Analysing according to the National Classification of Economic Activities-NACE, the top 3 divisions with the highest tax expenditures are the following divisions: 29 - Manufacture of motor vehicles, trailers and semi-trailers, divisions 13-15 Textiles, wearing apparel and leather and related products and division 47 -Retail trade, except of motor vehicles and motorcycles.

Chart 2 Estimate of tax expenditures on the basis of personal income tax according to economic activities (NACE Rev. 2)



5.2 Corporate income tax

Corporate income tax is a tax that legal entities (enterprises, financial institutions and other organisations) pay on their profit in the previous financial year. The tax is charged on the profit, which is determined as the difference between total revenue and total expenditures, in accordance with accounting regulations and the Law on Corporate income tax.

Under current tax regulations, there are several types of tax incentives that lead to lower revenue. For the purposes of this report, the following tax expenditures are indicated as the most significant:

- **Reinvested profit.** The tax base is reduced by the amount of investments made from the profit from the previous year (reinvested profit), in accordance with Article 28 of the Law on Corporate income tax. The estimated value of tax expenditures from this exemption for 2017 is MKD 1 486 million. Thus, the share of these tax expenditures in the total revenue from corporate income tax is 13.1%, while their share in gross domestic product is 0.24%;

- **Putting into operation up to 10 fiscal devices for registration of cash payments.** Pursuant to Article 30 of the Law on Corporate income tax, a taxpayer who is obliged, in accordance with Article 2 of the Law on Registration of Cash Payments, to introduce and use a fiscal device, shall be granted a reduction of the calculated tax in the amount of the value of up to ten purchased fiscal devices. The estimated value of tax expenditures from this exemption for 2017 is MKD 5.9 million. Thus, the share of these tax expenditures in the total revenue from corporate income tax is 0.1%, while their share in gross domestic product is 0.001%;

- **TIDZ/Law on State Aid Control.** Pursuant to Article 29 of the Law on Corporate income tax, a taxpayer who is a beneficiary of a technological industrial development zone shall be granted a tax exemption from the corporate income tax as state aid under conditions and according to the procedure stipulated in the Law on Technological

Industrial Development Zones. The estimated value of tax expenditures from this exemption for 2017 is MKD 144.5 million. Thus, the share of these tax expenditures in the total revenue from corporate income tax is 1.3%, while their share in gross domestic product is 0.02%. In order to avoid a double calculation of this exemption, it is important to note that this amount includes state aid granted in the form of regional state investment aid, which according to the data of the Commission for Protection of Competition for 2017 amount to MKD 21,9 million on the basis of corporate income tax;

- **Donations in sports**. Pursuant to Article 30-a of the Law on Corporate income tax, a taxpayer who donated funds to sports entities, which were paid to a special purpose account, shall be granted a deduction from the calculated corporate income tax in the amount of donated funds, but not more than 50% of accrued tax. The estimated value of tax expenditures from this exemption for 2017 is MKD 122.4 million. Thus, the share of these tax expenditures in the total revenue from corporate income tax is 1.1%, while their share in gross domestic product is 0.02%; and

- **Annual tax on total income**. Pursuant to Article 32 of the Law on Corporate income tax, companies referred to in Article 31 of the Law (small and micro companies) shall be exempt from the obligation to pay annual tax on total income, if the total income from all sources earned in the year for which the tax is determined did not exceed the amount of MKD 3 million on an annual level. The estimated value of tax expenditures from this exemption for 2017 is MKD 3.3 million. Thus, the share of these tax expenditures in the total revenue from corporate income tax is 0.03%, while their share in gross domestic product is 0.001%.

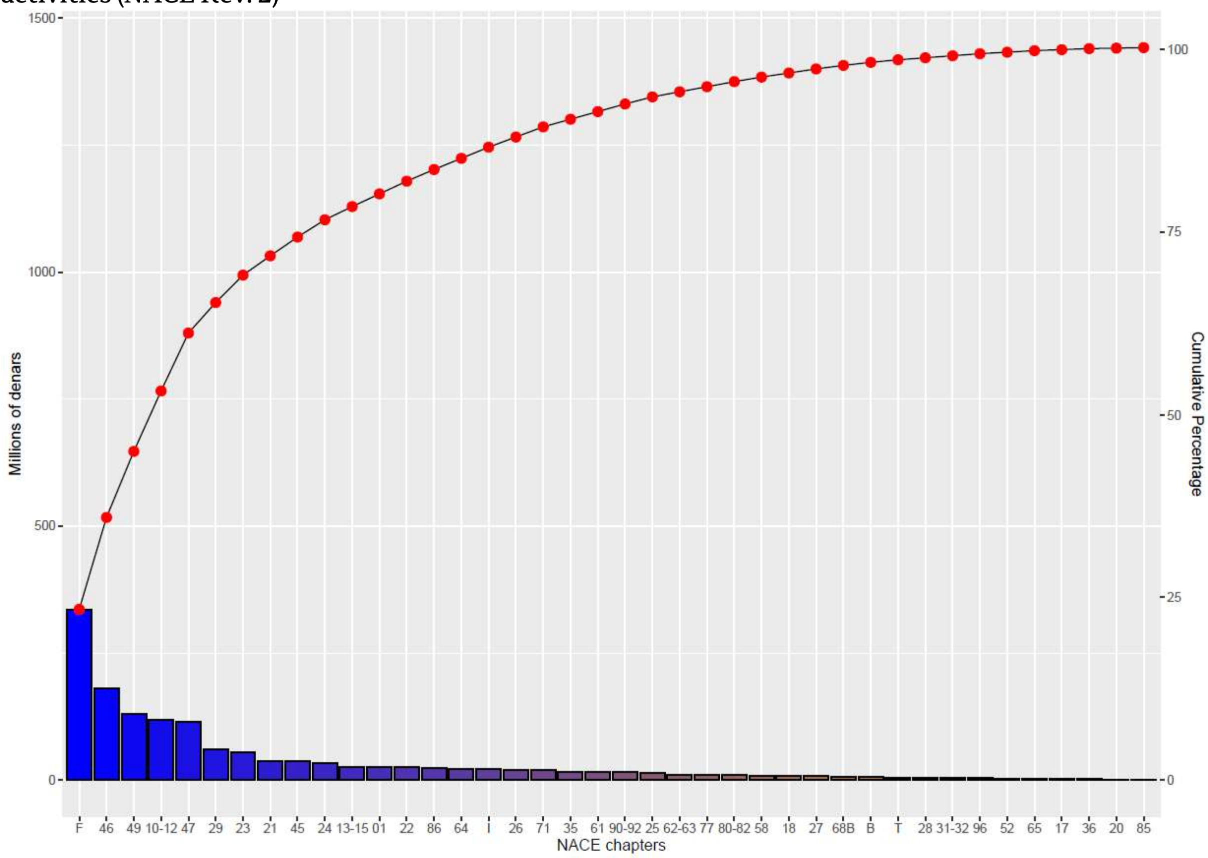
A detailed estimate of tax expenditures is shown in the following table, with total tax expenditures on the basis of corporate income tax amounting to MKD 1.7 billion, with a share of 15.6% of total revenues from this tax and 0.28% of GDP. Analysed by purpose, 100% of tax expenditures have an economic purpose.

Table 3 Estimated tax expenditures from corporate income tax

No.	Legal basis	Articles	Type of measure	Objective	Tax expenditures	Share of total revenue from CIT	Share of GDP
1.	Law on Corporate income tax	Article 28	The tax base is reduced by the amount of investments made from the profit from the previous year (reinvested profit).	Economic	1 486	13.1	0.24
2.	Law on Corporate income tax	Article 30	Reduction of the tax by the value paid for the purchase and putting into operation of up to 10 fiscal systems of equipment for registration of cash payments	Economic	5.9	0.1	0.001
3.	Law on Corporate income tax	Article 30-a and Article 30-b	Donations in sports	Economic	122.4	1.1	0.02
4.	Law on Corporate income tax/ Law on State Aid Control	Article 29/Article 5	A taxpayer who is a beneficiary of a Technological Industrial Development Zone shall be granted a tax exemption from the corporate income tax as state aid under conditions and according to the procedure stipulated in the Law on Technological Industrial Development Zones.	Economic	144.5	1.3	0.02
5.	Law on Corporate income tax	Article 32	Small and micro companies shall be exempt from the obligation to pay annual tax on total income, if the total income from all sources earned in the year for which the tax is determined did not exceed the amount of MKD 3,000,000 on an annual level.	Economic	3.3	0.03	0.001
	TOTAL				**1 762**	**15.6**	**0.28**

Analysing according to the NACE , the top 3 divisions with the highest tax expenditures are the following divisions: Section F - Construction and construction works, Division 46 - Wholesale trade, except of motor vehicles and motorcycles and Division 49- Land transport and transport via pipelines.

Chart 3 Estimate of tax expenditures on the basis of corporate income tax according to economic activities (NACE Rev. 2)



6 Indirect taxes

6.1 Value Added Tax

Tax Expenditures through consumption taxes are widely implemented worldwide. The main TE's related to consumption are those channeled through VAT. The standard VAT rate is usually applied as a straightforward benchmark in this context. Hence, reduced rates and exemptions are generally considered exceptions to the rule and, thus, as TE's. Nevertheless, in some countries, some VAT exemptions are considered part of the normal tax structure and are thus not identified as TE's. Value added tax, or VAT, is the most revenue-productive tax of the central government budget. In the Republic of North Macedonia, the standard VAT rate is 18%, while the preferential rate for certain goods and services is 5%. The standard VAT rate of 18% is a benchmark rate because each deviation from the benchmark is considered to be tax expenditure.

In order to estimate VAT tax expenditures, a model was developed with the assistance of the World Bank. The Macedonian VAT tax gap model estimates both the policy and compliance gaps. By default, the model takes policy inputs provided by officials to emulate the country's current tax system. However, the assumptions can be changed quickly and easily in the Model. The estimation of tax expenditures first requires defining the benchmark tax system which is a system free of any tax relief. The benchmark tax base used for this model is the total value of commodities purchased by individuals in the country. For the purposes of estimating tax expenditures, the zero-rating of exports are the only expenditures excluded from the benchmark tax base.

The tax expenditures are defined implicitly by the chosen definition of the benchmark, as any deviation from the benchmark is considered a tax expenditure.

Value-added taxes are categorized into three forms: taxable, exempt, or zero-rated. The traditional VAT, represented by the EU, uses the first two methods, and some modern VAT systems such as those in Australia and Canada use the second and third methods. The VAT is imposed at each stage of production. In most cases, firms charge VAT on all of their sales and can claim input tax credits on the value-added tax they pay. The difference between the two is remitted to the government. When the commodity is "taxable", the tax is paid by households, governments or non-profit organizations serving households. The VAT is levied on inputs at each stage of production. However, producers can claim input tax credits (ITCs) for the VAT that they incur. Households, governments and non-profit organizations do not have to pay VAT on "exempt" commodities. However, the vendor of the "exempt" commodity cannot claim input tax credits for the VAT they paid on their inputs. Consequently, the tax paid by the firm becomes embedded in the cost of the supply. When a commodity is "exempt", the value-added at the last stage of production is not subject to the VAT. Finally, commodities are "zero-rated" when firms can claim all of their input tax credits and the VAT is not charged to consumers; effectively, the tax rate is 0%. Consequently, determining the tax expenditure requires detailed knowledge as to whether the commodities are consumed by businesses that are eligible for ITCs, or final consumers.

While in theory any deviation from the benchmark is conceptually the equivalent of full taxation and a compensatory direct subsidy for the particular type of consumption, it is clearly far easier to hypothesise a rationale for deviations deliberately adopted to offset the regressivity of the VAT or to provide subsidies or incentives. Reduced rates or a zero rate applied to essentials such as food that account for higher proportions of the income of lower income persons than of the wealthy are intended to counter regressivity. Reduced rates and exemptions are used to encourage consumption of goods or services that have perceived social value or positive externalities and which would be under-consumed in a neutral market, particularly by lower income persons. Subsidised goods and services with perceived broad social benefits may include books, education, medical care, as well as cultural activities, . In some other cases, exemptions are used as tax incentives to achieve specific economic objectives or to support particular types of enterprises.

For the purposes of this report, the following tax expenditures are to be stated as the most important ones:

- **Tax exemptions from VAT**. Articles 23, 24, 24-a, 27, 27-a, 27-b and 27-c of the Law on Value Added Tax stipulate that there are certain tax exemptions from paying the value added tax. These exemptions refer to postal services provided by Macedonian Post; banking and financial transactions; insurance and reinsurance services; healthcare services; educational services that are tax exemptions without the right to deduction of the input tax, personal luggage of passengers arriving from abroad; domestic passengers for items of small value; etc. The estimated value of the tax expenditures for the above mentioned articles for exemptions from the Value Added Tax for 2017 is MKD 7 593 million. Having this into consideration, the share of these tax expenditures in the total revenues collected from the Value Added Tax is 15.9%, while their share in the gross domestic product is 1.2%.

- **Preferential tax rate**. Article 30 of the Law on Value Added Tax stipulates a preferential tax rate of 5% that is applied to the supply and import of certain goods and services. Such goods are: products for human consumption; drinking water; publications; agricultural mechanization; medications and medical equipment; computers; baby products; school supplies; pellets etc. Regarding services, the preferential tax rate is applied for transportation of persons; computer software; maintenance of public cleanliness and accommodation. The estimated value of the tax expenditures from this type of exemption from the Value Added Tax for 2017 is MKD 7 524 million. Having this into consideration the share of these tax expenditures in the total revenues generated from the Value Added Tax is 15.7%, while their share in the gross domestic product is 1.2%.

A detailed estimation of the tax expenditures is shown on the following table and as it can be seen the total tax expenditures on the basis of the value added tax are amounted to MKD 15.1 billion, i.e. their share in the total revenues on this basis is 31.6%, while the share in the GDP is 2.4%. While analysing them according to their purpose, 49.8% of the tax expenditures have social purpose, while the remainder of 50.2% has economic purpose.

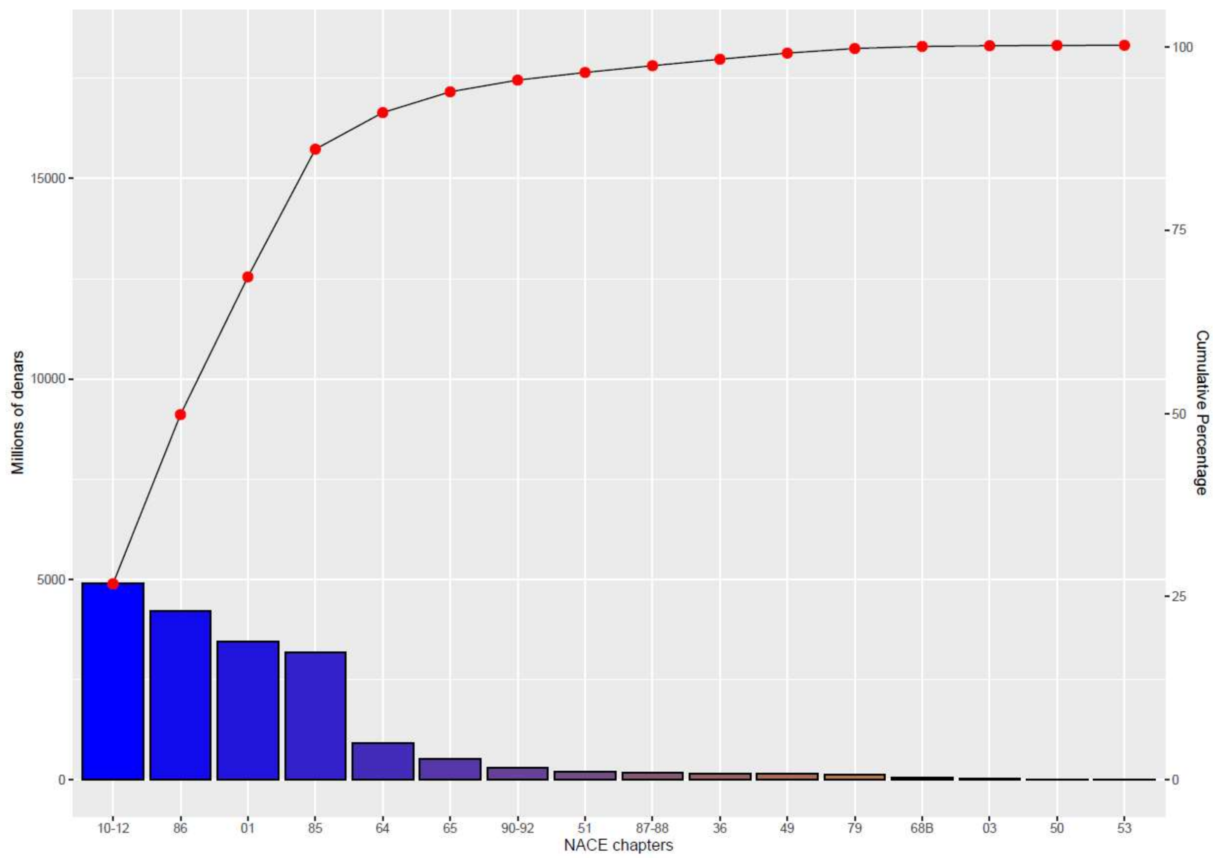
Just to compare, the tax expenditures of VAT in the EU are amounted to about 2-3% of the GDP in Italy, Poland, Spain and the United Kingdom.

Table 4 Estimated tax expenditures on the basis of VAT

No.	Legal basis	Articles	Type of measure	Purpose	Tax expenditures	Share in the total revenues generated from VAT	Share in GDP
1	Law on Value Added Tax	Articles 23,24,24-a,25,27,27-a, 27-b and 27-c	Tax exemptions	Economic	7 593	15.9	1.2
2	Law on Value Added Tax	Article 30	Preferential tax rate	Social	7 524	15.7	1.2
	TOTAL				15 117	31.6	2.4

When analysed according to the NACE, the top 3 categories having the highest tax expenditures are: 10-12 Food products, beverages and tobacco products, 01- Products of agriculture, hunting and similar services and category 86- Healthcare services.

Chart 4 Tax expenditures on the basis of VAT divided by economic activities (NACE Rev. 2)



6.2 Excise

Apart from their objective to provide revenues in the budget, the excises are most often designed as a response to negative externalities or to discourage some kind of behaviour such as the consumption of alcohol or emitting carbon dioxide in the atmosphere. For the purposes of this report, the following tax expenditures are presented as most important:

Mineral oils. In the direction of determining the tax expenditures of mineral oils defined pursuant to the Excise Law from 2017, the main focus will be put on the heating fuels and their emission factors CO2. In the following table the emission factors of CO2 are presented and expressed in '000 in accordance with the defined unit of measurement, i.e. liters or kilograms.

Table 5 Emission factors and specific excise for mineral oils

Fuel	Units	Emissions Factor	Specific Excise (MKD)
Diesel	tCO_2 per 1000 litres	2.68	6136
Heavy fuel oil	tCO_2 per 1000 litres	2.83	100
Kerosene	tCO_2 per 1000 litres	2.54	1800
LPG	tCO_2 per 1000 Kg	2.98	4900

For the purposes of this analysis the emission factors and the net calorific value (NCV) will be the standard factors used according to EU ETS, i.e.:

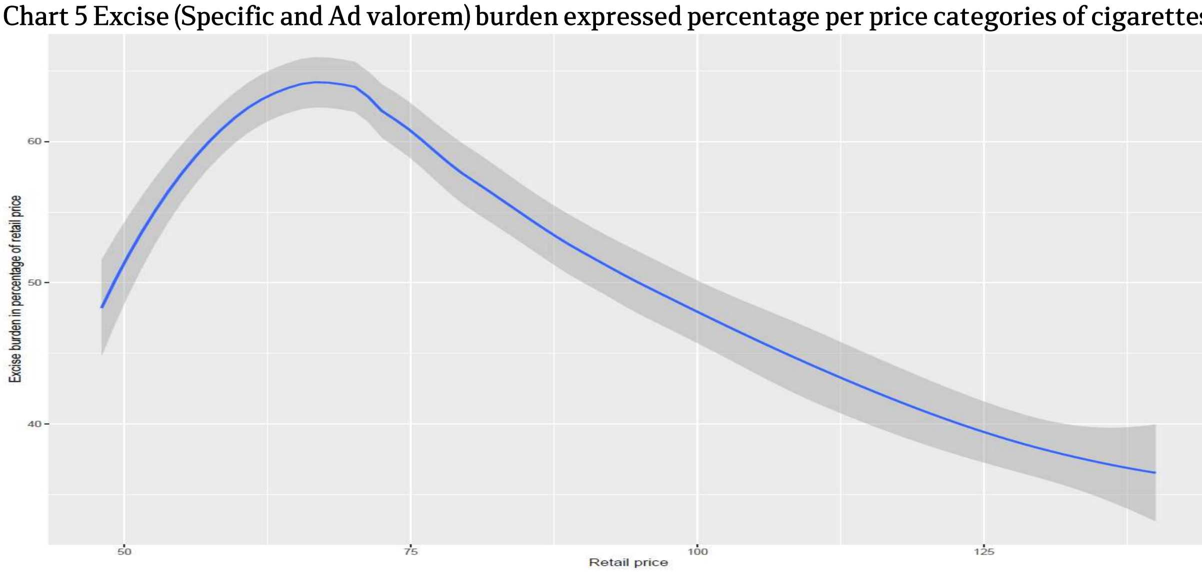
- According to the EU Monitoring, Reporting and Verification Regulation (Regulation of the Commission (EU) no. 601/2012 dated June 21, 2012 for monitoring and reporting greenhouse gasses emissions pursuant to Directive 2003/87/EC of the European Parliament and of the Council)[5] and
- Article 31 of MRR referring to Annex VI of MRR for standard factors used in the Guidelines for IPCC 2006 [6]. The above stated documents provide emission factors in the energy units (i.e. tons of CO2 per TJ).

[5] You can see Annex VI of the Regulation at the following link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02012R0601-20190101
[6] https://www.ipcc-nggip.iges.or.jp/public/2006gl/vol2.html

Similar to what was stated, in this case the CO2 emission and the specific excise paid for this type of fuel are considered to be the benchmark, i.e. the excise for 1000 liters of heating diesel is amounted to MKD 6 136 or MKD 2 290 for the emission of 2.29 CO2 per 1000 liters. If the benchmark defined in this manner is to be applied to the other heating fuels and afterwards we deduct them from the realistically paid excises, the tax expenditures on this basis would be amounted to MKD 131 million. Having this into consideration, the share of these tax expenditures in the total revenues based on gross excise is 0.49%, while their share in the gross domestic product is 0.02%.

Tobacco. In the direction of determining the benchmark for tobacco, it is very important to firstly determine the contents of the tobacco contained in one cigarette. Pursuant to the data available on the webpage of the European Commission it is considered that one cigarette contains 700 mg tobacco, i.e. 0.7 grams of tobacco. With the objective to determine the ratio of the excise for fine-cut tobacco and the excise of cigarettes, estimation has been made in which the taxation basis is considered to be the amount of tobacco contained in one cigarette. Namely, one cigarette contains 0.7 grams of tobacco which means that one pack of cigarettes contains 14 grams of tobacco, while 1000 cigarettes contain 700 grams of tobacco.

Chart 5 Excise (Specific and Ad valorem) burden expressed percentage per price categories of cigarettes



The amount of the combined excise (ad valorem 9% and 2.053 specific excise or 2.253 minimum) leads to regressive tax burden with excise as shown in the chart above. Having into consideration that the tax burden with excise varies from one price category to another, for the need to define the benchmark of this type of products the average burden with excise per kilogram of tobacco contained in cigarettes, amounted to MKD 3 309 is taken as a benchmark. If the benchmark defined in this manner is to be applied to the fine-cut tobacco and then we deduct the realistically charged excise, the tax expenditures on this basis are in the amount of MKD 4.4 million. Consequently, the share of these tax expenditures in the total revenues on the basis of gross excise is 0.2%, while their share in the gross domestic product is 0.001%.

Wine. Even though it is an excise good and contains alcohol, the wine unlike strong beverages that are subject to excise amounted to 340 Denars/liter pure alcohol, it has an excise of 0 Denars. The 0-Denar taxation generates tax expenditure and influences the collection of revenues based on excise. In the direction of estimating this tax revenue in cooperation with the State Statistical Office, an estimation of the wine market in the Republic of North Macedonia has been made based on the average amount of wine consumption that in 2017 was 6,3 liters on average per household, or when multiplied by the number of households that is 566 171, an amount of 35 669 hectolitres is obtained. If this consumption is converted in pure alcohol and the specific excise applied to ethyl alcohol/litre pure alcohol is applied to it, then the tax expenditure of this type of excise product would be MKD 152 million, i.e. its share in the total revenues on this basis would be 0.57%, while its share in the GDP would be 0.02%.

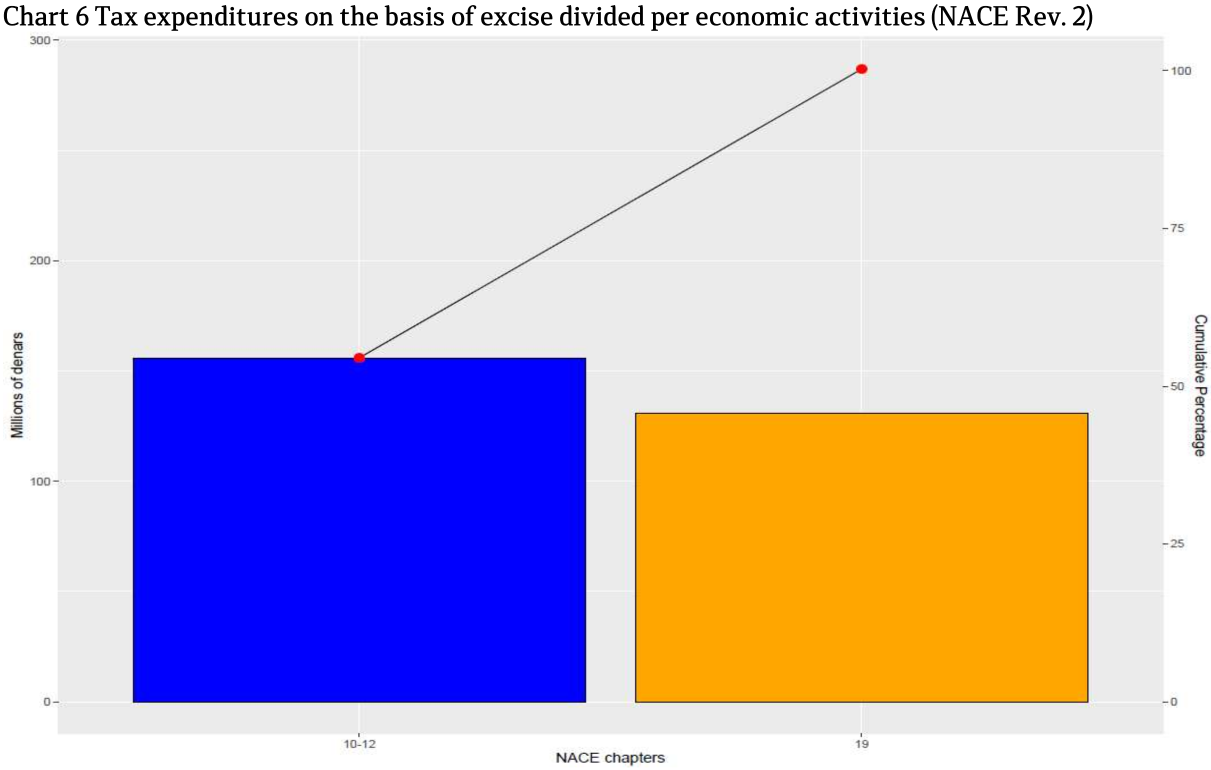
The detailed estimation of the tax expenditures is shown on the table below where the total tax expenditures on the basis of excise are in the amount of MKD 287.4 million, i.e. their share in the total revenues on this basis is 1.08% and their share in the GDP is 0.04%. Analysed according to their purpose, the purpose of these expenditures is fully economic.

Table 6 Estimated tax expenditures on the basis of excise

No.	Legal basis	Articles	Type of measure	Purpose	Tax expenditures	Share in the total revenues from excise	Share in the GDP
1	Excise Law	Article 28	Specific excise for mineral oils	Economic	131	0.49	0.02
2	Excise Law	Article 42	Specific excise for fine-cut tobacco	Economic	4.4	0.02	0.001
3	Excise Law	Article 36	Specific excise in the amount of 0 Denars for wine	Economic	152	0.57	0.02
	TOTAL				287.4	1.08	0.041

Analysed according to the NACE, all of the expenditures that have been stated are classified in two groups, i.e. group 10-12 Food products, beverages and tobacco products and 19- Coke and refined petroleum products.

Chart 6 Tax expenditures on the basis of excise divided per economic activities (NACE Rev. 2)



7. Customs duties

Pursuant to the existing customs regulation there are several types of customs incentives that result in reduction of the revenues, i.e. tax expenditures.

The tax expenditures presented in the table below are estimated on the basis of the reporting information stated in the customs declarations provided by the Customs Administration as well as estimation of Ministry of finance. For the purposes of this report, the following tax expenditures are selected as most important:

- **Goods received as a gift from international donors, as well as imported goods bought with the money assets received as a gift by state authorities, municipalities and the city of Skopje and public legal entities.** Article 198 of the Customs Code stipulates that import duty payment relief is granted for goods that have been received as a gift from international donors, as well as imported goods bought with the money assets received as a gift by state authorities, municipalities and the city of Skopje and public legal entities. The estimated value of the tax expenditures from such relief in 2017 is in the amount of MKD 38 million. Having this into consideration the share of these tax expenditures in the total revenues on the basis of customs is 0.7%, while their share in the gross domestic product is 0.01%;

- **Duty payment relief of goods on the basis of a donation agreement and project financed under the Instrument for Pre-Accession Assistance IPA.** Article 198 paragraph 2 and 3 of the Customs Code stipulates that import duty payment relief is granted to goods necessary for the realization of a project financed by monetary assets received on the basis of a donation project concluded between the Republic of North Macedonia and foreign donors which contain the clause that the donated finances may not be used for payment of import duties, as well as the goods necessary for the realization of the projects financed under the Instrument for Pre-Accession Assistance (IPA) implemented under the framework of decentralized management and for the part of assets from national cofinancing provided from the budget of the Republic of North

Macedonia or a loan. The estimated value of the tax expenditures from this type of relief for 2017 is MKD 157 million. Having this into consideration, the share of these tax expenditures in the total revenues on the basis of customs duties is 3%, while their share in the gross domestic product is 0.03%;

- **TIDZ/Law on State Aid Control.** Article 42 of the Law on technological industrial development zones stipulates import duty payment relief for goods that are used as equipment in the technological industrial development zone. The estimated value of the tax expenditures from this relief for 2017 is in the amount of MKD 32 million. Having this into consideration, the share of these tax expenditures in the total revenues on the basis of customs duties is 0.6%, while their share in the gross domestic product is 0.01%. In order to avoid a double calculation of this exemption, it is important to note that this amount includes state aid granted in the form of regional state investment aid, which according to the data of the Commission for Protection of Competition for 2017 amounted to MKD 27.4 million on the basis of customs duties; and

- **Autonomous measures**. The autonomous measures are adopted by the Government of the Republic of North Macedonia upon the proposal of the Minister of Economy with a consent of the Minister of Finance and after having previously obtained an opinion from the Minister of Agriculture, Forestry and Water Economy or another Minister that is head of the state management authority in the appropriate field depending on the type of goods for which the autonomous measures are being prescribed for the reduction or abolishment of import duties. The autonomous measures for the reduction or abolishment of import duties may be determined for a definite or indefinite time period and for limited or unlimited amount of goods. In the course of 2017 two autonomous measures were active referring to import of textile fabric consisting of warp filament yarns of nylon or other polyamides that fall into the tariff code 5407 10 00 00 and goods of leather or composition leather that fall in the tariff code 4205 00 90 00. The estimated value of the tax expenditures from this reduction/abolishment of the customs duties for 2017 is MKD 313 million. Having this into consideration, the share of these tax expenditures in the total revenues on the basis of customs is 10.4%, while their share in the gross domestic product is 0.05%.

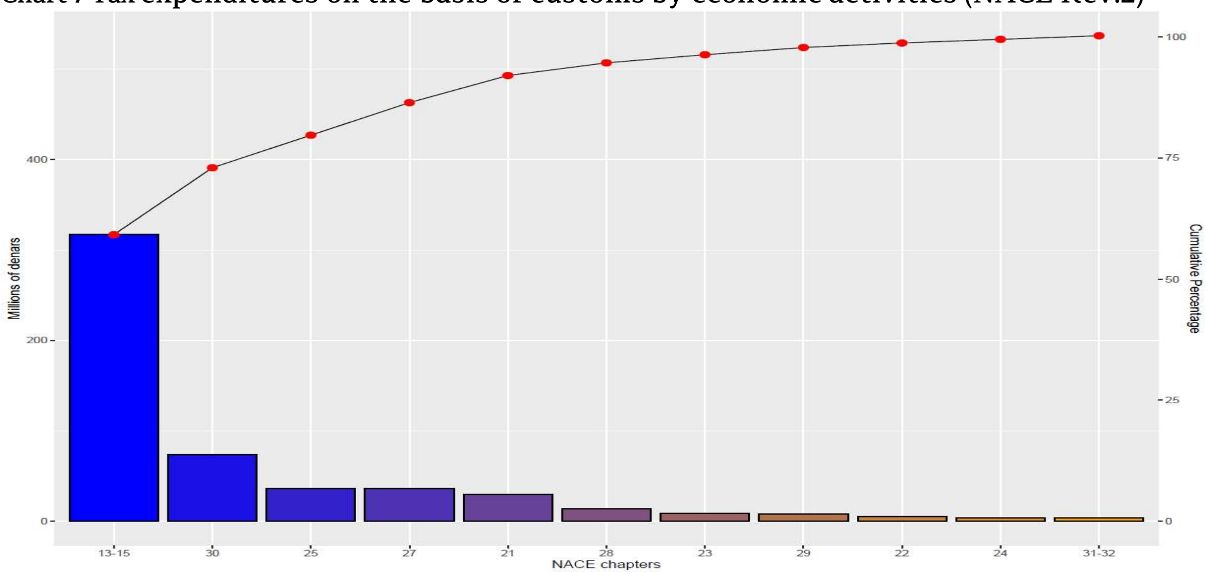
In the table below a detailed estimation of the tax expenditures is presented where the total tax expenditures based on customs duties are in the amount to MKD 540 million, i.e. their share in the total revenues generated on this basis is 14.7% and their share in the GDP is 0.09%. Analysed according to their purpose these expenditures have a completely economic purpose.

Table 7 Estimated tax expenditures of revenues generated on the basis of customs duties

No	Legal basis	Articles	Type of measure	Purpose	Tax expenditures	Share in the revenues generated on the basis of customs	Share in the GDP
1.	Customs Code	Article 198 1)	Goods received as a gift from international donors, as well as imported goods bought with the money assets received as a gift by state authorities, municipalities and the city of Skopje and public legal entities.	Economic	38	0.7	0.01
2.	Customs Code	Article 198 2 and 3)	Duty payment relief of goods on the basis of a donation agreement and project financed under the Instrument for Pre-Accession Assistance-IPA	Economic	157	3.0	0.03
3.	Law on technological industrial development zones/ Law on State Aid Control	Article 42/Article 5	Goods that are used as equipment in the technological industrial development zone	Economic	32	0.6	0.01
4.	Customs Code	Article 19 7)	Autonomous measures	Economic	313	10.4	0.05
	TOTAL				540	14.7	0.09

Analysed according to the NACE, the following are the top 3 groups with the highest tax expenditures: 13-15 Production of textile, clothing and products of leather, group 27-Production of electrical equipment and group 25-Manufacture of fabricated metal products, except machinery and equipment.

Chart 7 Tax expenditures on the basis of customs by economic activities (NACE Rev.2)



8. Contributions from the compulsory social insurance- Social contributions

Contributions from the compulsory social insurance are the following:

- Compulsory pension and disability insurance -18%;
- Compulsory health insurance -7.3%;
- Additional health insurance contribution in case of an injury at work and a professional illness-0.5% and
- Compulsory contribution for insurance in case of unemployment-1.2%.

They are calculated on the basis of the gross salaries of the insured persons and are revenues contributed to the corresponding funds financing the current and future rights exercised by the insured people- right to health protection, right to pension or benefits in the event of unemployment. For the purpose of this report, the following tax expenditures are selected as most important:

- **Employment of an unemployed person who was registered as unemployed for a period longer than one year.** Articles 98, 98-d, 98-e, 98-f and 98-i of the Law on employment and insurance in the case of unemployment stipulate exemptions from paying contributions for compulsory social insurance and/or personal income tax for unemployed persons under certain conditions. The estimated value of the tax expenditures from this exemption was MKD 7.7 million in 2017. Having this into consideration the share of these tax expenditures in the total revenues generated on the basis of social contributions is 0.015%, while their share in the gross domestic product is 0.001%;

- **The employed disabled person for whom disability is confirmed is exempted from paying contributions for compulsory social insurance.** Namely, Article 7 of the Law on employment of disabled persons stipulates that the assets for the pension and disability contribution, health insurance contribution and contribution for employment of disabled persons are provided by the budget of the Republic of North Macedonia with a maximum amount equal to the contributions paid for the base of two average net salaries in the Republic of North Macedonia paid in the previous month and if this amount is surpassed than the employer is to pay the difference. The estimated value of the tax expenditures from this exemption was MKD 18.7 million in 2017. Having this into consideration the share of these tax expenditures in the total revenues generated on the basis of social contributions is 0.035%, while their share in the gross domestic product is 0.003%; and

- **50% mandatory social security contributions**. The legal framework for state aid control consists of the Law on state aid control and bylaws for its implementation. It is realized in the form of regional state investment aid, which according to the data of the

Commission for Protection of Competition for 2017 amounted to MKD 217 million on the basis of social contributions. Having this into consideration the share of these tax expenditures in the total revenues generated on the basis of social contributions is 0.410%, while their share in the gross domestic product is 0.035%.

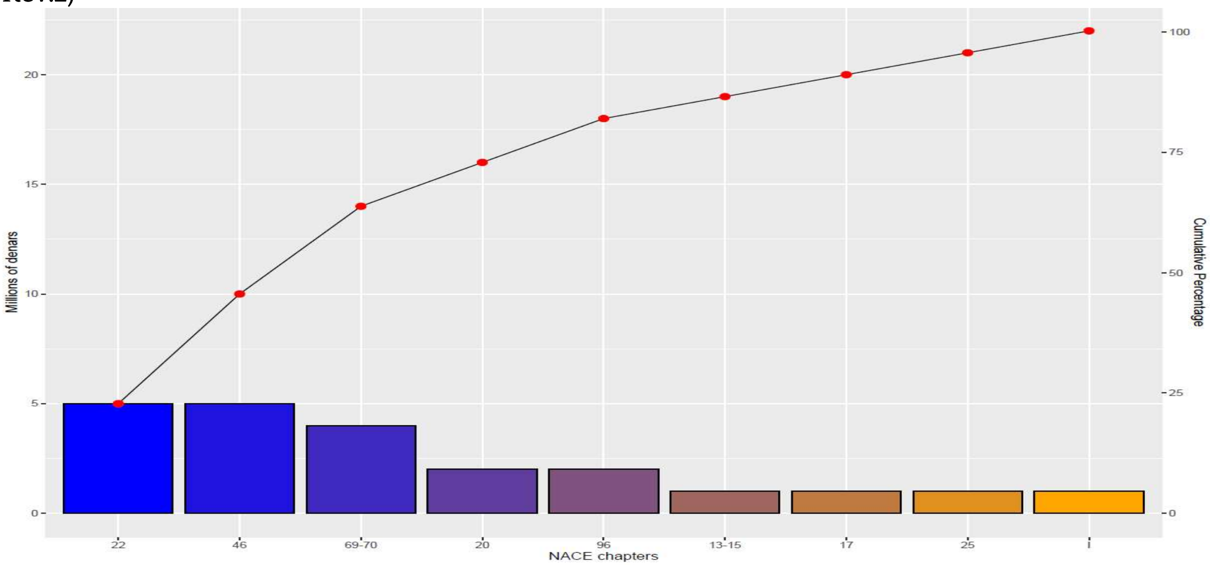
Detailed estimation of tax expenditures is shown on the following table where the total tax expenditures on the basis of social contributions are in the amount of MKD 243.4 million, i.e. their share in the total revenues generated on this base is 0.5%, while their share in the GDP is 0.39%. Analysed according to their purpose, 89.2% of tax expenditures have economic purpose, while the remainder of 10.8% has social purpose.

Table 8 Estimated tax expenditures based on social contributions

No.	Legal basis	Articles	Type of measure	Purpose	Tax expenditures	Share in the total revenues generated from social contributions	Share in GDP
1.	Law on employment and insurance in the event of unemployment	Article 98,98-d, 98-e, 98-f, 98-g	Employment of unemployed person who was registered as unemployed for a period longer than one year.	Economic	7.7	0.015	0.001
2.	Law on employment of disabled people	Article 7	Employment of disabled person for whom disability has been confirmed and who is exempted from paying contributions for compulsory social insurance	Social	18.7	0.035	0.003
3.	Law on State Aid Control	Article 5	50% compulsory social security contributions	Economic	217	0.410	0.035
	TOTAL				243.4	0.5	0.39

Analysed according to the NACE the top 3 groups with the highest tax expenditures are as follows: 22- Production of products of rubber and products of plastic masses, Group 46- Wholesale, except from trade with motor vehicles and motorcycles. 69-70- Legal and accounting activities; management activities; management-related counselling. This division does not include data from the Commission for Protection of Competition that are on an aggregate basis.

Chart 8 Estimation of tax expenditures based on social contributions per economic activities (NACE Rev.2)



9. Conclusion

The estimation of the total tax expenditures showed that they are in the amount of MKD 18 460 million, i.e. their share in the total revenues generated from taxes and social contributions is 11.7%, and their share in GDP is 3.0%. Analysed according to their purpose, 44.9% of the tax expenditures have social purpose, while 55.1% have economic purpose.

Table 9 Total tax expenditures by type, 2017 (in MKD million)

Type	TEs	Structure
Direct taxes	2 272	12.3
Indirect taxes	15 404	83.4
Social contributions	243	1.3
Customs duties	540	2.9
Total	**18 460**	**100.0**

Analysed according to the National Classification of Economic Activities, the top 3 groups with the highest tax expenditures for PIT, CIT, VAT, excise, customs duties and social contributions respectively, are as follows:

- PIT. 29 - Manufacture of motor vehicles, trailers and semi-trailers, divisions 13-15 Textiles, wearing apparel and leather and related products, and division 47 - Retail trade, except for motor vehicles and motorcycles;
- CIT. Section F - Construction and construction works, division 46 - Wholesale trade, except for motor vehicles and motorcycles, and division 49 - Land transport and transport via pipelines;
- VAT. 10-12 Food products, beverages and tobacco products, group 86 - Health care services, and group 01- Products of agriculture, hunting and similar services;
- Excise. 10-12 Food products, beverages and tobacco products, and 19 - Coke and refined petroleum products;
- **Customs duties.** 13-15 Production of textile, clothing and products of leather, group 27- Production of electrical equipment, and group 25 - Manufacture of fabricated metal products, except for machinery and equipment;

- **Social contributions.** 22- Production of products of rubber and products of plastic masses, group 46 - Wholesale, except from trade with motor vehicles and motorcycles, 69-70- Legal and accounting activities; management activities; management-related counselling.

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Law on employment of disabled persons ("Official Gazette of the Republic of Macedonia" number 44/2000, 16/2004, 62/2005, 113/2005, 29/2007, 88/2008, 161/2008, 99/2009, 136/11, 129/15, 147/15 and 27/16)

Law on employment and insurance in the event of unemployment ("Official Gazette of the Republic of Macedonia" number 37/97, 25/2000, 101/2000, 50/2001,25/2003, 37/2004, 4/2005, 50/2006, 29/2007, 102/2008,161/2008, 50/10, 88/10, 51/11, 11/12, 80/12, 114/12,39/14, 44/14, 113/14, 56/15, 129/15, 147/15, 154/15 and 27/16)

Law on technological industrial development zones ("Official Gazette of the Republic of Macedonia" number 14/2007, 103/2008, 130/2008, 156/10, 127/12, 41/14, 160/14, 72/15, 129/15, 173/15, 192/15, 217/15 and 30/2016)

Law on capital gains tax ("Official Gazette of the Republic of Macedonia" number 112/14, 129/15, 23/16 and 190/16)

Law on Value Added Tax ("Official Gazette of the Republic of Macedonia" number 44/99, 86/99, 8/2001, 21/2003, 19/2004, 33/2006,101/2006, 114/2007, 103/2008, 114/2009, 133/2009,95/10, 102/10, 24/11, 135/11, 155/12, 12/14, 112/14,130/14, 15/15, 129/15, 225/15, 23/16 and 189/16)

Excise Law ("Official Gazette of the Republic of Macedonia" number 32/2001, 50/2001, correction 52/2001,45/2002, 98/2002, 24/2003, 96/2004, 38/2005, 88/2008,105/2009, 34/10, 24/11, 55/11, 135/11, 82/13, correction 98/13,43/14, 167/14, 188/14, 129/15, 154/15, 192/15, 23/16 correction 31/16 and 171/16)

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Law on contributions from compulsory social insurance ("Official Gazette of the Republic of Macedonia" number 142/2008, 64/2009, 156/2009, 166/10, 53/11,185/11, 44/12, 15/13, 91/13, 170/13, 97/14, 113/14,180/14, 188/14, 20/15, 48/15, 129/15, 217/15, 190/16 and 171/17)

Law on state aid control ("Official Gazette of the Republic of Macedonia" number 145/10)