

**The Ifs and VATs of Taxation in Macedonia - Should VAT be Applied in Macedonia?**

**By Sam Vaknin, Ph.D.**

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To be justified, taxes should satisfy a few conditions:

Above all, they should encourage economic activity by providing incentives to save and to invest. Savings - transformed into investments- enhance productivity and growth of the economy as a whole.

A tax should be simple - to administer and to comply with. It should be "fair" (progressive, in professional lingo) - although no one seems to agree on what this means.

At best, it should replace other taxes, whose compliance with the above conditions is less rigorous. In this case it will, usually, lead to budget cuts and reduce the overall tax burden.

The most well known tax is the income tax. However, it fails to satisfy even one of the conditions above listed.

To start with, it is staggeringly complicated. The IRS code in the USA sprawls over more than 8,000 pages and 500 forms. This single feature makes it expensive to enforce.

Estimates are that 100 billion USD are spent annually (by both government and taxpayers) to comply with the tax, to administer it and to enforce it.

Income tax is all for consumption and against savings: it taxes income spent on consumption only once - but does so twice with income earmarked for savings (by taxing the interest on it).

Income taxes discriminate against business expenses related to the acquisition of capital assets. These cannot be deducted that same fiscal year. Rather, they have to be depreciated over an "accounting life" which is supposed to reflect the useful life of the asset. This is not the case with almost all other business expenses (labour, to name the biggest) which are deductible in full the same fiscal year expended in.

Income taxes encourage debt financing over equity financing. After all, retained earnings are taxed - while interest expenses are deductible.

We can safely say that income taxes in their current form were somewhat responsible to an increase in consumer credits and in the national debt (as manifested in the budget deficits). They also had a hand in the freefall in the saving rate in the USA (from 3.6% in the 80s to 2.1% in the 90s). And money evading the tax authorities globalised itself using means as diverse as off-shore banking and computer networking. This made taxing sophisticated, big money close to impossible.

No wonder that taxes levied on consumption rather than on income came to be regarded as an interesting alternative.

Consumption taxes are levied at the Point of Sale (POS). They are a mixed lot:

We all get in touch with Excise Taxes. These are imposed on products which are considered to be bad both for the consumer and for society. These products bring about negative externalities: smoke and lung cancer, in the case of tobacco, for instance. So, when tobacco or alcohol are thus taxed - the idea is to modify and reform our behaviour which is deemed to be damaging to society as a whole. About 7% of tax revenues in the USA come from this source - and double that in other countries.

Sales taxes have a more modest calling: to raise revenues by taxing the finished product in the retail level. Unfortunately, so many authorities have the right to impose them - that they vary greatly from one location to another. This adds to the confusion of the taxpayer (and of the retailer) and makes the tax more expensive to collect than it should have been.

Moreover, it distorts business decisions: businesses would tend to locate in places with lower sales taxes.

Sales taxes have a malignant effect on the pricing of finished goods. First, no tax credit is allowed (sales taxes paid on inputs cannot be deducted from the sales tax payable by the retailer). Secondly, the tax tends to cascade, increase the prices of goods (taxable and not, alike), affect investments in capital goods (which are not exempt). It adversely affects exports and domestic goods which compete with imports.

In short: sales taxes tend to impede growth and prevent the optimization of economic resources. Compare this with the VAT (Value Added Taxes): simple, cheap to collect, contain no implicit taxes on inputs. VAT renders the pricing structure of goods transparent. This transparency encourages economic efficiency.

VAT is used in 80 countries worldwide and in 22 out of 24 OECD countries, with the exception of the federal ones: the USA and Australia.

There are three types of VAT. They are very different from each other and the only thing common to them all is the tax base: the value added by the taxpayer.

Economic theory defines Value Added as the sum of all the wages, interest paid on capital, rents paid on property and profits. In the Addition VAT method, these four components are taxed directly. The State of Michigan in the USA uses this method since 1976. Experience shows that this method yields more predictable tax revenues

and is less susceptible to business or industry cycles.

The Subtraction method, employed in Japan and a few much smaller countries, is admittedly the simplest. It taxes the difference between a taxpayer's sales and its taxed inputs. However, it becomes very complicated when the country has a few VAT rates, because the inputs have to be separated according to the various rates.

Thus, the most widely accepted system is the Credit Invoice. Businesses become unpaid tax collectors. They are responsible to get tax receipts from their suppliers (inputs). They will be credited with the VAT amounts on the receipts that they have collected, so they have a major incentive to do so. They will periodically pay the tax authorities the difference between the VAT on their sales and the VAT on their inputs, as evidenced by the receipts that they have collected. If the difference is negative - they will receive a rebate (in certain countries, directly to their bank account).

This is a breathtakingly simple concept of tax collection, which also distributes the costs of administering the tax amongst millions of businesses. In the fiscal year (FY) 1977/8 in the UK - the tax productivity (cost per 1 dollar collected) was 2%. This means that the government paid 2 cents to collect 1 dollar. But businesses paid the remaining 10 cents.

If introduced in the USA, VAT will cost only 3 billion USD (with 30,000 tax officials employed in a separate administration). To collect 1 dollar of income tax costs 0.56% in the USA. But, to collect VAT in Norway costs 0.32%, in Belgium - 1.09% and, on average, 0.68%. In short, VAT does not cost much more than income taxes to collect.

Yet, what is true for government is not necessarily so for their subjects.

The compliance cost for a business in the USA is \$49. It is \$53-282 in other countries.

Small businesses suffer disproportionately more than their bigger brethren. It cost them 1.94% of VAT revenue in FY 1986/7 in the UK. Rather more than big firms (0.003%!).

Compliance costs are 40 times higher for small businesses, on average. This figure masks a larger difference in retail and basic industries (80 times more), in wholesale (60 times more) and in manufacturing and utilities (45 times more).

It was inevitable to think about exempting small business from paying VAT.

If 16 out of 24 million businesses were exempted - the costs of collecting VAT will go down by 33% - while the revenues will decline by only 3%. KPMG claims that businesses with less than \$50,000 annual turnover (18 out of 24 million) exempted in the USA, revenues would have declined by 1.5%. About 70% of the tax are paid by 10% of the businesses in the UK. For 69% of the businesses there (with turnover of less than 100,000 USD annually) the costs of collection exceed 60% of the revenues. For 96% of the businesses (with less than 1 million USD a year) - the costs exceed 50%. Only in the case of 30,000 companies - are the costs less than 20%. These figures do not include compliance costs (=costs borne by businesses which comply with the tax law).

No wonder that small businesses borrow money to pay that VAT bills. Many of them - though exempt - register voluntarily, to get an endless stream of rebates. This is a major handicap for the tax system and reduces its productivity considerably. In a desperate effort to cope with this law-abiding flood, tax authorities have resorted to longer periods of reporting (instead of monthly). Some of them (in the UK, for one) allow annual VAT reports.

Part of the problem is political. There is little disagreement between economists that VAT is a tax preferable to income taxes. But this statement comes with caveats: the tax must have one rate, universally applied, without sector exemptions. This is the ideal VAT.

The world being less than ideal - and populated by politicians - VATs do not come this way. They contain many rates and exemptions for categories of goods and services.

This mutilated version is called the differentiated VAT.

An ideal VAT is economically neutral - though not equitable. This means that the tax does not affect economic decisions in ways that it shouldn't. On the other hand, its burden is not equally distributed between the haves and have nots.

VAT taxes value added in each stage of the production process. It does so by levying a tax on goods and services - but what is really taxed are the means of production, labour and capital. Ultimately, shareholders of the taxpaying businesses pay the price - but most of them try to move it on to the consumer, which is where the inequity begins. A rich consumer will pay the same tax as his poorer counterpart - but the tax will constitute a smaller part of his income. This is the best definition yet found for regressivity.

On the face of it - and for a very long time - VAT served as a prime example of regressive, unfair taxation.

For a very long time, that is until the development and propagation of the Life Cycle Theories. The main idea in all these theories was that consumption was not based on annual, current income only. Rather, it took into consideration future flows of income (income expectations). People tended to be constant in their level of spending (in different periods in their lives) - even as their annual income vacillated. With the exception of millionaires and billionaires, people spent most of their income in their lifetime.

VAT was, therefore, a just and equal tax. If income equalled consumption in the long run, VAT was a form of income tax, levied incrementally, with every purchase. It reflected a taxpayer's ability to pay (=to consume). It was a wealth tax. As such, it necessitated the reduction in other taxes. Taxing money spent on consumption was taxing money already taxed once (as income). This was classic double taxation - a situation which had to be remedied.

But, in any case, VAT was a proportional tax when related to a lifetime's income - rather than a regressive tax when compared to annual income. Because consumption was a parameter more stable than income - VAT made for a more stable and predictable tax.

Still, old convictions die hard. To appease social lobbies everywhere, politicians came up with solutions which were unanimously rejected by economists.

The most prevalent was exempting a basket of "poor people's goods" from VAT.

This gave rise to a series of intricate questions:

If food, for instance, was exempted (and it always is) - was this not a subsidy given to rich people as well? Don't rich people eat?

Moreover, who will decide what is or isn't food? Is caviar food? What about health food? It was obviously going to be very hard to reach social consensus.

If tax on these products were zeroed - taxes on other products would have had to go up to maintain the same revenue. And so they did. In most countries VAT is levied on less than 45% of the GDP - and is reckoned to be twice as high as it should be.

Some sought to correct this situation by subjecting services to VAT but this proved onerous and impossible to implement in certain sectors of the economy (banking and insurance, to name two).

Others suggested to dedicate VAT generated revenues to progressivity enhancing programs. But this would have entailed the imposition of additional taxes to cover the shortfall.

It is universally thought, that the best method to "compensate" the poor for their regressive plight is to directly transfer money to them from the budget or to give them vouchers (or tax credits) which they can use to get discounts in education, medical treatment, etc. These measures will, at least, not distort economic decisions. And we, the less lucky taxpayers, will know how much we are paying for - and to whom.

This is one of the budgetary items which increase with the introduction of VAT. Research shows that there is a strong correlation between the introduction of VAT and growth in government spending. Admittedly, it is difficult to tell which led to what. Still, certain groups in the population feel that it is their natural right to be compensated for every income reducing measure - by virtue of the fact that they don't have enough of it.

But VAT is known to have some socially desirable results, as well.

To start with, VAT is a renowned fighter of the Black Economy. This illegitimate branch of economic activity consists of three elements: The non official sales of legal goods (produced within the tax system) The sales of illegal goods (which never were within the tax system) The consumption of money not declared or disclosed to the tax authorities VAT lays its heavy paws on all three activities.

VAT is self enforced. As we said, VAT offers a powerful (money) incentive not to collaborate in tax scams. Every tax receipt means money begotten from the tax authorities.

VAT is incremental. To completely evade paying VAT on a product would require the collaboration of dozens of businesses, suppliers and manufacturers. It is much more plausible to cheat the income tax authorities. VAT is levied on each and every phase of the production cycle - it is possible to avoid it in some of these phases, but never in all of them. VAT is an all-pervasive tax.

VAT is levied on consumption. It is indifferent to the source of the money used to pay for it. Thus, it is as easily applied to "black", undeclared, money - as it is to completely legal funds.

Surely, there are incentives to avoid and to evade it. If the amount of inputs in a product is very low, the VAT on the sale will be very burdensome. A business non-registered with the VAT authorities will have a sizeable price advantage over his registered competitor.

With a differential VAT system, it is easy to declare the false sale of zero-rated goods or services to linked entities or to falsify the inputs, or both. Even computers (which compare the ratio of sales to inputs) cannot detect anything suspicious in such a scheme.

Yet, these are rare occurrences, easily detectable by cross examining information derived from several databases. All in all, VAT is the ultimate, inevitable tax.

Moreover, it is virtuous. By making consumption more expensive, it would tend to divert capital into investments and savings. At least, this is what our intuition tells us.

Research begs to differ. It demonstrates the resilience of consumers, who maintain their consumption levels in the face of mounting price pressures. They even reduce savings to do so. We say that their consumption is rigid, inelastic. Also, people do not save because it "pays better" to save than to consume. They don't save because the relative return on savings is higher on savings than on consumption. They save because they are goal oriented. They want to buy something: a car, a house, higher education for their children.

When the yield increases - they will need to save less money to get to the same target in the prescribed period of time. We could say that, to some extent, savings display negative elasticity.

Markets balance themselves through a series of intricate feedback loops and "true models" of economic activity. Take an increase in savings generated by the introduction of VAT: it is bound to be short lived. Why? because the equilibrium will be restored.

Increased savings will increase the amount of capital available and reduce the yields on this capital. A reduction in yield would, in turn, reduce the savings rate.

Moreover, narrow (differentiated, non-ideal) based VATs lead to higher rates of VAT (to generate the same revenue). This reduces the incentives to work and the amount of income available for savings.

In a very thorough research, Ken Miltzer found no connection between the introduction of VAT and an increase in the rate of saving in 22 OECD countries since 1965 (VAT was first introduced in France in 1954). He also found no connection between VAT and changes in corporate (profit) and income taxes.

In Europe VAT replaced various turnover taxes so its impact on anything was fairly insignificant. It had no influence on inflation, as well. VAT apparently has two conflicting influences: it raises the general price level through a one time "price shock", on one hand. On the other hand, it contracts the economy by providing a disincentive to consume. If VAT does influence inflation - its impact will be echoed and amplified through wage indexation and the linking of transfer payments to the Consumer Price Index (CPI). In this case, maybe its effects should be sterilized from the calculations of the CPI.

But research was able to demonstrate only the potentially dangerous contracting, deflationary (stagflationary, to be exact) influences of this tax. The recommendation is surprising: the Central Bank is advised to increase the money supply to accommodate the reverberations of the introduction of this tax.

Finally, VAT is a "border adjustment" tax (under the GATT and WTO charters).

This means that VAT is rebated to the exporter and imposed on the importer.

Prima facie, this should encourage exports - and equally discourage imports.

Surprisingly, this time the intuition is right - albeit for a limited period of time.

Despite a raging debate in economic literature, it seems safe to say the following: VAT increases the profits of exporters and producers of import substitutes. VAT increases the investments in the trade sector. VAT increases exports and decreases imports. These advantages are, ultimately, partially offset by the movement of exchange rates. If certain sectors are not taxed - investment will flow to that sector and badly affect the trade sector and the competitiveness of the country in world markets.

With its burgeoning black market, under-developed export industries, huge shortfall in tax revenues - Macedonia urgently needs VAT.

It will do well to learn from the experience of others and introduce a VAT which is as ideal as socially permissible and politically possible.

The draft law that I have seen is a copy - almost verbatim - of laws in the European Union and is riddled with exemption to various goods, services and sectors.

VAT is a good idea - but it seems to be starting on the wrong footing in Macedonia.

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Monitoring Macedonia

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Close to 500,000 people - one in four - live under the poverty line in a country where the average monthly salary is less than 150 US dollars. More than one in three members of the workforce are chronically unemployed. With inflation up 5.5% in the last 12 months and taxes - borne disproportionately by the poor and the working class - at 37% of GDP, life is tough in this small, landlocked country. When faced with the choice between raising VAT from 5% to 19% on bare necessities (such as bread and milk), or extending the "temporary" "war" tax (0.5% on all financial transactions) - the finance minister of Macedonia, after an emotional all-night consultation involving the Prime Minister, chose the latter. The "war" tax brought in the equivalent of 2% of GDP (on an annualized basis) since it was introduced in July this year and helped to contain a dangerously soaring budget deficit, now at 9% (and rising) of a shrinking GDP. Yet, the controversial decision to extend it brought on sharp rebukes by local tax experts. The finance ministry also plans to cut expenditures by a further 50 million US dollars.

This gaping hole in public finances is not the result of profligacy. Most of the government's budget is "locked" into paying pensions, state obligations, wages, and other mandatory items. Only 2% are discretionary. The vertiginous 15% of GDP tilt from surplus to deficit is the direct result of the six months of civil war that gripped Macedonia between February and August this year. The damages were direct - in new military spending, increased security expenditures, and about 500,000 US dollars a day used to accommodate and feed c. 80,000 internally displaced citizens, most of them non-Albanian Macedonians. But the war also had indirect consequences. The tax base shrank as GDP collapsed by at least 4-5% and industrial production contracted by 9-10%. The direct damages to the agricultural sector alone are estimated to be c. 100 million US dollars. The textiles sector has suffered even more. At least 17% of the country became physically inaccessible and the panic that gripped the population well into July interrupted tax collection. Tax, customs, and excise revenues, VAT excepted, decreased by 20-40% (!). The government was forced to use some of the proceeds of the sale of the telecom company, Makedonski Telekom, to MATAV.

In an effort to stem the monetary flood and to fend off potential currency speculation (which consumed more than 100 million US dollars of the National Bank's reserves by mid-June) - the central bank was forced to raise interest rates and to absorb excess liquidity. On October 15, one week and two weeks treasury bills (zero coupons) yielded 11% to maturity - and the same bills for 28 days yield 17%, a yield curve which signals distrust in the macroeconomic stability of the country. Eerily, after a brief, speculation driven, spurt, the currency settled to its 4 years old average exchange rate of 31 to the DM and 67 to the US dollar.

In its ten years of independence - mostly due to external shocks such as trade sanctions and wars - Macedonia has developed a chronic case of acute trade deficit, equal to c.

15% of GDP (c. half a billion US dollars annually). Luckily for it, unilateral transfers - remittances by expatriates, international aid and grants, international credits, and growing, though small, foreign direct investment - served to ameliorate the problem. The World Bank alone has invested more than 550 million US dollars in Macedonia since 1991. But a sharp collapse in exports (by c. 20%), coupled with increased foreign exchange expenditures on weaponry, and the drying up of Albanian remittances (at least through official channels) - have exacerbated the financing gap that Macedonia faces from a projected zero to more than 100 million US dollars in 2001.

The Macedonian side has a vested interest in exaggerating both the damages of the civil war and its financing needs. Macedonia, to its great detriment, has long been addicted to foreign aid. Nor does it seem to have any coherent plan to cope with the crisis - ad hoc, stopgap, measures notwithstanding. The IMF was forced to place Macedonia under "Staff Monitoring" - the equivalent of freezing of all credit arrangements with the fund for a period of 6 months. This, though, does not prevent Macedonia from reverting to a standby arrangement down the road, or from participating in a donor conference.

Actually, Macedonia has received more financing and pledges for financing during the first 9 months of 2001 than during the comparable period last year. Spain has promised to finance the "Lera" hydroelectric power station. Italy has granted Macedonia 4 million US dollars in "urgent financial aid". The EU has earmarked 198 million euro to remedy war damages. The EU CARDS program (project financing) was signed (43 million euro). The World Bank added 37 million US dollars to 3 new projects since March 2001 and has disbursed 15 million to projects already approved. And this is a partial list.

Yet, the majority of these funds - whether approved or pledged - are conditioned upon the fulfillment of the August 13th Ohrid Framework Agreement between the Macedonian and the Albanian political parties. The EU has made it abundantly clear that its financial assistance will be withheld if what it calls "Macedonian intransigence" continues. A donor conference, already postponed three times, had to be put off yet again indefinitely (though the World Bank expresses unfounded optimism regarding a date sometime in December). Such a conference is supposed to tackle Macedonia's balance of payments needs and the costs of reconstruction and implementation of the Framework Agreement. With each postponement, Macedonian disappointment and xenophobia grow. The West is seen widely as interested mainly to assist the Albanians at the expense of all other segments of the population. The euphoria that gripped Macedonia after the September 11 attacks on the USA ("now they will understand what it means to confront terrorism") - has evaporated. It was replaced by grim realism. The USA and the EU are bent on securing a pacified Macedonia. The IMF and the World Bank are subject to political considerations, constraints, and arm twisting. The economy is fast deteriorating. Macedonia has very few choices.

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