TAX REGULATION AND MACEDONIAN SECURITIES MARKET

Tax ambient for the functioning of the Macedonian securities market, to be created starting 1st January 2006, will be an important new determinant for the further development of the national securities market

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Introduction

Tax regulation in the field of functioning of the securities market in the Republic of Macedonia is execptionally favourable at the moment, having a stimulating effect on the development of this segment of the financial sector. At the same time, generally accepted estimate is that such fiscal regime makes the Macedonian securities market one of the most attractive securities market in the broader region.

Solutions in effect in this area in the Profit Tax Law and in the Personal Income Tax Law, exiting several years already, provide for significant stimulations for smooth functioning of the national securities market in terms of both the offer and the demand for securities.

Regarding the offer on the securities market, present tax regulation envisages exceptionally significant stimulation for the joint stock companies listed on the Macedonian Stock Exchange AD Skopje, i.e. these companies pay 50% less profit tax. Regarding the demand on the securities market, tax regime is even more favourable - at the moment, neither the legal entities nor the physical persons are taxed for the revenues realized on the basis of capital gains realized from trading with securities.

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Above-mentioned fiscal incentives are incorporated in the tax regulation in the Republic of Macedonia since the beginning of 2001. The legislator at that moment believed that these tax incentives should not be systemic solutions, but rather a temporary measure to serve as a catalyst for the further development of the Macedonian securities market, due to which such solutions will be in effect by 31st December 2005.

We are at the opinion that tax ambient for the functioning of the Macedonian securities market, to be created starting 1st January 2006, will be an important new determinant for the further development of the national securities market. Therefore, this text will try to summarize the following: a) to summarize the so-far conditions on the Macedonian securities market and their correlation with the existing fiscal regime; b) to give our projections what will happen on the securities market should all existing tax incentives stop to be applied; c) to indicate the solutions in this sphere that existed or exist in the countries with a similar level of development of the securities market; and d) to prepare appropriate solutions which we hope will be maximum objective.

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Conditions on the securities market and tax regulation - experience and perspectives

Offer of securities

Securities market in the Republic of Macedonia, in particular the segment of secundary trading with securities, has faced for a longer period of time and is still facing serious development-related obstacles on the offer side. Market structure was almost completely created with the corporatization of the enterprises within the privatization process.New issues of securities that the joint stock companies carry out in the post-privatization period are, formally or unformally, are mainly issues for a known buyer and, so far, no "real" public offer of securities is noticed. Initial public offers of shares, through which other organizational forms of enterprises would transform into joint stock companies, are completely absent from the securities market. Financing of the enterprises is predominantly based on the banking credits. The strategy of the significant shareholders in the companies was and is mainly to carry out concentration and consolidation of the ownership of shares and, in the meantime, to keep the control in the company management.

Therefore, Macedonian Stock Exchange AD Skopje faced, for a longer period of time, a big problem how to attract the Macedonian joint stock companies to apply for stock exchnage listing. In fact, since the Stock Exchange started operating in 1996, there were only 3 joint stock companies listed on the Stock Exchange by 2002. Such conditions were result of a mixture of the avobe-mentioned factors that characterized the overall ambient in which the Macedonian joint stock companies operate and, quite often, the negative expectations that, by being listed on the Stock Exchange, the joint stock companies would become more vulnerable targets for "hostile" takeovers and that the data on the ownership structure and the operating results should be treated as confidential data. Such conditions not only failed to do favour to the Stock Exchange, but were also interpreted as a negative image for the state and for the pace and the dynamics of the structural reforms in the national economy.

In order to overcome this situation, the legislator undertook significant systemic normative measures on two occasions in the past period. In 2001, by modifying and amending the Profit Tax Law, tax exemptions were introduced for the listed joint stock companies. This measure did not at all change the conditions regarding the offer on the securities market (only 1 company appeared to be listed on the Stock Exchange). The absence of a positive epilogue as a consequence of this legal change once again stressed the problem of the efficient corporate governance of the privatized joint stock companies and the intensity of the effort to increase the value of the shares and the level of paid dividends.

Further on, in 2002, the modifications and amendments to the Securities Law led to an introduction of so-called legally mandatory listing, imposing radical sanctions to the companies that will not respect this obligation. According to this amendment to the

Securities Law, all issuers of long-term securities who meet the requirements stipulated with the rules for listing on the Stock Exchange were obliged to list their securities on the official market of the Stock Exchange within six months at the latest after the entrance of this this amendment into force. As a result, by the beginning of 2003, there were 100 joint stock companies listed on the Stock Exchange. The obligation for mandatory listing was initially envisaged to last until 31st December 2003, but it was extended for an additional year, i.e. by 31st December 2004. Although there were a lot of opposite opinions regarding the viability of this concept of stimulating the development of the secondary securities market with such systemic and administrative measures, the practice has shown that this measure has led to many positive implications for the Macedonian securities market (it is worth to mentiont that a similar measure, after several years, was introduced in Croatia as well). The following can be pointed out as main positive features from the existance of a critical mass of joint stock companies listed on the Stock Exchange:

- **basic information base for the listed companies** - with the listing of the joint stock companies on the official market of the Stock Exchange, more comprehensive information base on the joint stock companies was created for the first time in the Republic of Macedonia. Thus, with the prepared prospectuses regarding the listing, the investment public, in addition to the revised financial reports for the last three years, also had an insight in the activity of the company, the qualification structure of the employees, the founding capital, the ownership structure, the trading dynamics with shares, the dividend and the divident policy of the company, as well as the development strategy.
- **permanent reporting to the listed companies on the financial results** - according to the rules in the Rulebook on Listing of Securities on the Stock Exchange, the listed companies were obliged to continuously submit to the Stock Exchange the revised financial reports, as well as quarterly unrevised cumulative income statements. The financial reports are the key factor to evaluate the operations of the company as a whole, its financial position and its market value.
- **publishing non-financial price-sensitive information** - various press releases by the listed joint stock companies in the post-listing period have contributed to more complete and accurate information for the investors on the activities and the important changes in the operations of these companies. This covers the information which, pursuant to the Rulebook on Listing, the listed companies should provide regarding the purchase of own shares, the changes in the capital structure, the changes in the management bodies, the received awards, acknowldegments and signed agreements on business cooperation. What is of special importance is the introduction of the obligation for the listed companies to timely inform the public on the convening the assembly of shareholders, as well as on the so-called dividend calendar. By publically announcing the divident calendars of the listed companies, the investment public has started to be informed on time about the dividend amount for the previous year, as well as the important dates related to the payment of dividends for the previous year (date on acquiring the right to dividend, laste day of trading with right to dividend, first date of trading without right to dividend, as well as the deadline for divident payment).

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- **significantly increased level of transparency in the operations fo the listed joint stock companies** - as a logical result from ther commenced process of continuous disclosure of the financial and other data on the operations, transparency of the joint stock companies has also significantly improved. Transparency and disclosure of data are one of the basic elements of efficient corporate governance in the national economy and a precondition for quality functioning of the securities market. If the investors do not have access to regular, timely, reliable and comparable information on the companies, they will not be in a position to assess the perspectives of the listed companies and, accordingly, to adopte information-based investment decisions.

With the expiry of the legal obligation for mandatory listing (31st December 2004), the Stock Exchange started 2005 with 68 listed joint stock companies. In the meantime, the Stock Exchange de-listed 11 joint stock companies because they did not meet their obligations regarding the disclosure of financial and other price-sensitive information and/or iliquidity in trading. As a result, there are 57 joint stock companies listed on the Stock Exchange at the moment. Besides this, it is estimated that large number of the joint stock companies listed on the Stock Exchange still perceive the existance of the present tax incentives as main stimulus. Further on, larger number of listed companies uses the tax incentive on the basis of being listed starting 2003, while the requirement for tax incentive under the Profit Tax Law is for the company to be listed at least 3 years (on the contrary, there is a possibility to retroactively pay the unpaid tax in case of de-listing). Taking this into account, although the legal obligation for mandatory listing does no loger apply, in order for the most of the companies to exercise the tax incentives they need to be listed on the Stock Exchange even in 2005.

According to the rules in the Rulebook on Listing of Securities on the Stock Exchange, the listed companies were obliged to continuously submit to the Stock Exchange the revised financial reports, as well as quarterly unrevised cumulative income statements

Thus, it comes out that the so-far experience of the Stock Exchange shows that the tax incentives were not the main impetus for the joint stock companies to apply for listing on the Stock Exchange. On the contrary, they have done that due to the legal obligation to be listed, or they will be penalised with rigorous sanctions. However, after the companies become listed on the Stock Exchange, most of them have gradually overcome the previous concerns that the listing can harm they interests, due to which the companies have accepted the advantage from the existence of tax incentives together with the other advantages arising from the listing, among which the image of the company. On the other hand, rules on listing on the Stock Exchange in the existing environment of legally mandatory listing were relatively flexible to absorb the joint stock companies that were obliged to appear on the Stock Exchange. Extending the application of the tax exemptions for the listed companies, without the existance of legal obligation to be listed, will enable the Stock Exchange, as an organized secondary market, i.e. the Securities and Exchange Commission, as a regulator and creator of the market conditions, to strengthen the requirements for listing on the official market of the Stock Exchange and to increase the supervision over the implementation of these rules by the listed companies.

This scenario is filly compliant with the recent recommendations of the international financial institutions for further revision of the Securities Law, the Rulebook on Listing on the Stock Exchange and adoption and implementation of a special Code on Corporate Governance of Listed Joint Stock Companies. These activities will also mean new possibility for additional harmonization of the business climate in which the Macedonian joint stock companies operate according to the EU Directive on transparency, as well as the so-called OECD White Paper on Corporate Governance in South Eastern Europe. More efficient corporate governance in the joint stock companies will mean greater openness of the companies to external investors (also including new issues of securities), which on the long term will alleviate the financing of their development and will, ultimately, contribute to the boost of the amcroeconomic growth of the country. At the same time, one should point out that the outcome of the overall reforms in the Macedonian economy would not be complete without the existence of standard developed secondary securities market, as an important segment where the prevailing influence should be the one of the non-banking financial institutions, for which the Republic of Macedonia continuously fails to receive positive estimates. (for example, 2003 and 2004 EBRD Transition Report).

Demand for securities

Development-related problems of the securities market in the past period were also recorded regarding the demand for securities. Small purchasing power and the low level of accumulation, i.e. savings, lost confidence in the financial system and the low level of education on the manner of functioning of the securities market were the most important factors that had an adverse impact in this field. Thus, main measure by the state aimed at stimulating the investors to make more investments in securities was the exemption from the payment of tax on capital gain for a period of 5 years. This measure was intended to stimulate and mobilize the domestic saving through the Stock Exchange, as well as to create conditions for attracting foreign portfolio investors on the local stock exchange and to include the national securities market in the regional and global financial trends.

Still, exemption from payment of tax on capital gain in the Republic of Macedonia in the past period, despite certain positive effects in the field of liquidity and attractiveness of the securities market, did not yield the maximum effects due to a simple reason that the market, from a structure point of vew, did not develop with an optimal dynamics.

not completed, a component is visable towards which all stock exchanges aim - to become a place where, with a moderate risk, money of both the domestic and foreign investors can be invested and multiplied. Significantly increased trading in 2005 only confirms such conclusions (in the first 6 months of 2005, the trading was twice as large compared to the same period in 2004).

Thus, one can freely say that tax incentives regarding the demand of securities might be abolished exactly at the moment when the market, after decade sluggishness, starts to be active for the first time and when financially motivated investors finally appeared (not only those using the market for one-off purposes just to acquire majority shares in the privatized joint stock companies) which, after all, will be the most affected by such scenario.

Year	Shares Trading (denars)	Block Trading (denars)	Bonds Trading (denars)	Government Trading (denars)	Other securities Trading (denars)	Total Trading (denars)
2001	940.846.121	4.675.932.768	980.633.948	22.152.613.759	-	28.750.026.596*
2002	856.997.900	2.620.340.895	708.883.711	1.253.616.367	303.577.609	5.743.416.482
2003	777.407.896	3.768.536.883	1.275.811.631	1.481.751.735	256.294.050	7.559.802.195
2004	1.276.953.888	5.168.491.102	1.459.095.309	395.368.414	15.944.513	8.315.853.226
Total	**2.911.359.684**	**11.557.368.880**	**3.443.790.651**	**3.130.736.516**	**575.816.172**	**21.619.071.903**

(*Large volume of trading in 2001 was due to the increased sale of government securities by the Privatization Agency of the Republic of Macedonia on the market segment on which state-owned shares were traded, i.e. the privatization of Macedonian Telecom).

As an example, below is a table showing the structure and the volume of the trading on the Macedonian Stock Exchange AD Skopje from the moment tax incentives were introduced in 2001 to 2004.

In the first couple of years since its functioning (1996-1998), the Stock Exchange was in the initial stage of development, characterized with marginal trading and activity, followed by a lonegr period (1999-2003) during which the Stock Exchange primarely performed the function of necessary market infrastructure for completion of the privatization of the socially- and state-owned capital and consolidation of the ownership structures created with the privatization (dominance by the block transactions and government auctions).Appearance of a new development stage on the Stock Exchange started to be slowly identified even last year 2004, where, although the processes of consolidation of the ownership in the companies are still

Experiences of other countries with the emerging securities markets

Experiences of the other countries that were or are characterized by the existence of emerging securities markets show that in the initial stages of the economic transition, the countries undertook measures for introduction of tax incentives for the participants on the capital market (investors, issuers of securities and financial intermediators). Thereby, so-far practice has confirmed that long-term advantages of a well-organized and functional securities market for a country in transition overcome the short-term adverse effects of the tax incentives for the state budget.

In many countries that implemented or are implementing comprehensive market reforms to the end of promoting the functioning of the financial system (Peru, Egypet, Argentina, Chile, Greece, Turkey, Poland, Bulgaria, Romania, Croatia, Slovenia), tax incentives were introduced or existed in the intial stages of the development of the securities market in the field of demand for securities and in the field of offer of securities.

In the field of demand for securities, government measures are aimed at full tax exemption of the capital gains from trading with securities traded on organized secondary market (Turkey, Egypt, Bulgaria, Croatia) or tax exemption from the capital gains tax for a longer period of time (in Poland for example, capital gains tax has been introduced after 15 years of existence of the Stock Exchange in Warsaw). Thus, for example, regarding the tax exemption of the capital gain, it should be mentioned that at the moment, physical persons in Bulgaria and croatia are fully exempt from paying the tax on capital gains realized from trading with securities, while in Romania, the capital gain is taxed with the preferential rate of 1%. Just for the purposes of comparison, should there be no interventions in our tax regulations, capital gains of physical persons after 1st January 2006 will be taxed pursuant to the Personal Income Tax Law, with the marginal tax rate of 24%.

The so-far experience of the Stock Exchange shows that the tax incentives were not the main impetus for the joint stock companies to apply for listing on the Stock Exchange. On the contrary, they have done that due to the legal obligation to be listed, or they will be penalised with rigorous sanctions

In some countries, it has been noticed that, as measures to stimulate the demand on the securities market, they introduce tax incentives for both physical persons and legal entities when redeeming new issues of securities of companies listed on the Stock Exchange. Thus, development of the primary capital market is stimulated and conditions are created for more dynamic development of the secondary securities market (Brazil, Mexico, Egypt).

In the field of offer of securities, government measures are aimed at encouraging the companies to be listed on the stock exchange. These measures are aimed at introduction of a lower profit tax rate or other tax incentives for the listed joint stock companies for a certain period of time. For instance, in Egypt for more than a decade there are tax incentives for the listed companies (reduction of the tax base of the profit tax, exemption of the reinvested gain for investment purposes, etc.). As already mentioned in the text, the logic of these tax incentives is based on the assessment that the attracting of the companies to be listed increases the transparency of the operations of the joint stock companies and the level of corporate governance, which, from the piont of view of the functionality of the securities market, has multiple positive effects. Greater transparency of the listed companies provides for more realistic setting of the prices of the shares of the listed companies (market valuation), a possibility for their increase and higher value of all assets/property at macro level.

Conclusions

Amendments to the tax regulation, in any direction and in any country, are always a sensitive issue encouraging, and deserving, a serious debate. Having this postulate as a starting point, economic policy creators in the Republic of Macedonia, according to our opinion, in the coming period will face a significant dilemma when setting the future tax ambient in which the national securities market will be operating.

In fact, from the point of view of the present intention to increase the public revenues, the existence of tax incentives, without any doubt, creates negative implications for the financing of the state budget. In addition, as already known, the existence of any tax benefit only for a certain number of entities in the national economy, by definition, also opens the issue of (not)respecting the principle of tax equality. What encourages the countries to forego part of their revenues on the basis of taxation is most often certain development or social purposes. The decision how to balance these opposite efforts is neve an easy one to reach and depends on the present assessment, the professional believes and the long-term strategy of the economic policy creators.

Taking into account that the issue we are analysing in this text is the present and the future tax regime in the Republic of Macedonia, from the point of view of the functioning of the securities market, we will try to anticipate the possible consequences from two possible alternatives: a) what will happen if the existing tax regime in the field of the securities market remains unchaged; and b) would would the effects be if the tax regulation changes in the direction of abolishment of the existing benefits.

Continuation of the existing regime would mean the following:

- in the future as well (in shorther or longer time period), the state to forego its revenues on the basis non-payment of the whole amount of profit tax by the listed companies and non-taxation of the capital gains. If one analyzes the data on the realized profit in the last 3 years from the revised financial reports of the listed joint stock companies, which asked the Stock Exchange for a confirmation that they are listed so as to realize tax savings, it can be determined that their aggregate profit amounts to around Denar 4.5 billion, i.e. that the total amount of the tax incentives for these companies in all three years amounted to around Denar 336.3 million. Total tax benefits for the companies listed on the Stock Exchange in 2004, which have by now asked for a confirmation for that purposes, amount, from a structure point fo view, only to 0.21% of the budget revenues for 2005. Foregone tax revenues on the basis of capital gains are impossible to quantify, taking into account that there are no histrical and statistical data on them.
- providing additional stimulus to the listed companies to remain listed on the Stock Exchange;
- a possibility (for the Stock Exchange and the Securities and Exchange Commission) to make more precise, and to adjust, the regulations in the field of securities related to the listed companies aimed at additional increase of the transparency in the operations of the companies (especially in the field of disclosure of the non-financially price sensitive information) and more serious implementation of the principles of efficient corporate governance, with all related positivie implications therefrom. General consensus of many domestic and foreign analysts is that if the Republic of Macedonia does not improve the level of corporate governance, we will face absence of efficient structural reforms and low rates of economic growth for a long time still;
- smooth continuation of the already commenced process of investments in Macedonian securities by the domestic and the foreign investors who, in the future as well, will not pay tax on their realized capital gains;

Changing the existing tax regime and introducing taxation for the listed joint stock companies and the realized capital gains would mean the following:

- additional revenues to the state budget;
- greater tax equality;
- need to reorganize the tax administration, taking into account the little experience in the field of taxation of capital gains realized from trading with securities;
- possible mass de-listing of the companies from the Stock Exchange, thus, among other things, significantly undermining the reputation of the Macedonian securities market and its attractiveness;

Tax incentives regarding the demand of securities might be abolished exactly at the moment when the market, after decade sluggishness, starts to be active for the first time and when financially motivated investors finally appeared, which, after all, will be the most affected by such scenario

- level of transparency regarding what is going on in the companies will only mean respecting the general obligations for reporting according to the legal regulations, whereby, at the same time, supervision over the process of reporting by the companies will be made distant from the market and the market institutions and will become an exclusive authority of the state and/or para-statal bodies;
- lower yields for the investors in securities due to the taxation of capital gains;
- decrease of the interest for investments on the Macedonian securities market due to the larger number of listed companies and relevant data on reaching rational investment decisions and lower investment returns, with a possibility to re-shift the invesments in other countries in the region.