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EU Begin Talks with Serbia and Montenegro on Preparing a Stabilization and Association Agreement for That Country

On 12 April 2005, the European Commission published a basically positive evaluation on Serbia and Montenegro in its Feasibility Study and it means the negotiation for a Stabilization and Association Agreement (SAA) could start with the Federation.

According to Olli Rehn, the European Union Enlargement Commissar, Serbia and Montenegro is ready to make the first step towards establishing an agreement-based relationships with the EU, negotiations could begin later in 2005 and last about one year.

Serbia and Montenegro has developed in case of price and trade liberalization, tax reform and the overall economic reform process, according to the Feasibility Study. In last year the macroeconomic stability has been improved but the current account deficit was considerably high and external debt has also increased, while a double-digit inflation characterized Serbia in 2004. Positive changes can be observed in case of fiscal policy, the fiscal transparency has improved due to new budgetary rules.

Table 1. – Basic economic indicators

	2000	2001	2002	2003	2004
Inflation					
Serbia	111,90%	40,70%	14,80%	7,80%	13,70%
Montenegro	24,80%	28,00%	9,40%	6,70%	4,30%
GDP growth					
Serbia	5,70%	5,70%	3,30%	1,50%	8,50%
Montenegro			0,84%	2,53%	2,97%
Current account					
Serbia (million USD)	-323	-354	-1434	-1757	-2922
Montenegro (million EUR)		-164	-154	-114	-182

Source: NBS, NBCG

The overall structural reform, the relatively tight monetary policy and the fiscal reform were the key elements of the macroeconomic stability but further changes are required. EU expects that the government of the republics can reduce the amount of social transfer to be able to rationalise public administration.

Reform of the law system is also necessary to harmonise the Serbian legislation system to the European Union. Thus, amendments will be made in case of laws on environment, transport, social and employment policy etc., in 2005.

In Serbia and Montenegro one of the most important goals is to join the WTO. The multilateral trade liberalization and the continuation of reform and privatization process in case of financial sector are preconditions of WTO membership.

Serbian government and IMF started negotiation on the prolongation of the three-year-long stand-by-arrangement which would be expired in May. IMF had approved the Arrangement in amount of 650 million SDR (around USD 830 million) on 15 May 2002. The Serbian Ministry of Finance expects that in case of the successful final revision of the arrangement (the sixth revision is expected to be in September 2005), the result could be that USD 700 million could be written off of the Paris club debt, so the external debt could be reduced to 50% of the GDP.

TABLE 2. – EXTERNAL DEBT IN 2004

in million UDS	Serbia	Montenegro
MEDIUM AND LONG-TERM DEBT	12917,7	-
International financial organization	5088,9	356,8
IMF	961,9	-
IBRD	2471,8	270
IDA	432,3	23,3
EUROFIMA	160,3	-
IFC	118,6	11
EIB	281,9	33,7
EU	353,7	4
EBRD	279,5	3
EUROFOND - CEB	28,9	4,4
Other	-	7,4
Government and their organization	3689,5	-
Paris club	3016	145,6
Other government	673,5	-
London club (unsolved)	83,6	-
London club	1080	0
SHORT TERM DEBT	998,6	-
CLEARING ACCOUTED DEBT	182,5	-
TOTAL DEBT	14098,7	502,4

Source: NBS, NBCG

The Stabilization and Association process (SAp) was confirmed at the Thessaloniki Summit in June 2003, as the European Union's policy framework for South Eastern Europe until accession to the EU. SAp is a long-term commitment to the region both in terms of political effort and financial and human resources. The main goal is the integration of Western-Balkans countries to EU. According to analysts, the Western Balkan countries can become candidates of EU membership in 2011, in case of Serbia and Montenegro this date can be 2019. It means Serbia and Montenegro lagged behind by more than 10 years compared to the front-runner Southeast European countries, such as Bulgaria and Romania which are expected to join the EU in 2007.

The cause of delay of Feasibility Study compared to other Western–Balkans countries was that Serbia and Montenegro has not realised the harmonization of trade policy and internal market integration after the two republics had adopted the Constitutional Charter of the State Union of Serbia and Montenegro in February 2003. The Commission suggested a "twin-track" approach, which implies unique negotiating position between the EU and the Federal republic. Basically it was a solution to treat Serbia and Montenegro as one country, but separate Serbia and Montenegro in case of the Stabilization and Association negotiation process.

After 12th April 2005 when Serbia and Montenegro received a positive study from EU, the SAp can be launched. Beside the further reforms which were mentioned above, one of the main issues of accession process is that Serbia and Montenegro should fulfil its obligation to the International Criminal Tribunal for the Former Yugoslavia (ICTY) in the Hague.

Tax Regimes in the Former Yugoslav Republic of Macedonia and Serbia and Montenegro[1]

FYR Macedonia

The tax regime in the FYR of Macedonia was inherited from the former Yugoslavia. Changes were later made by the Government and the Parliament of Macedonia, aiming to transform the regime in a way to make it more suitable for attracting foreign investment.

The main taxes in the FYR of Macedonia are the following:

- Personal Income Tax
- Corporate Income Tax
- Value Added Tax
- Excise Duties
- Property Tax

The Personal Income Tax law was enacted in the 1st of January, 1994. The taxpayer is any physical person who is a resident of the FYR of Macedonia, for the income earned in the country or abroad. In practice the PIT is paid by the employer. Taxable receipts are personal income from employment, pensions and disability pensions, income from agricultural activities, personal income from financial and professional activities, income from property and property rights, and other types of revenues. All revenues mentioned, which are paid in cash, paid in kind or through other means, are subject to taxation. There are certain non taxable receipts determined by the PIT law, such as awards granted by the United Nations and other international organisations, etc. The tax base is the total income earned, less an allowance equal to ¼ of the average salary. The PIT rates are progressive, based on the amount of monthly average salary. The PIT rate is 23 percent for up to the double of the monthly average salary, with a progressive rate of 27 percent and 35 percent for the part of the income above the double amount of the monthly average salary.

The Corporate Income Tax is a tax on profits. The computation and payment of the tax is carried out by the taxpayer, who is a legal entity or a physical person performing a registered activity – resident of the FYR of Macedonia and earning a profit from an activity in the country or abroad. The tax rate of CIT for all legal entities is 15 percent on taxable income, made up of 15 percent pure profit tax plus 1.8 percent contributions for health insurance for injuries during working hours. An investment relief is provided based on the amount of profit reinvested in operational fixed assets. The tax base for companies with foreign shareholders (with holdings of at least 20 percent) is reduced by the proportion of the foreign investment, for the first three years following that investment.

The Law on Value Added Tax came into force on the 1st of April 2000. The VAT, as a general consumer tax, is calculated and paid in all phases of production and trade, as well as in the entire branch that performs services, unless it is otherwise provided by the Law. The VAT rates are a 19 percent general, and a 5 percent privileged proportional tax rate on the tax base of the turnover of goods and services and import.

Excise duties are levied on the consumption of liquors, tobacco products, fuel and natural gas, coffee, cars and other small vehicles where the seats of the vehicle do not exceed nine, and luxury goods. The rates range from 5 to 55 percent, or in absolute amounts from 3 to 1,350 denars per kg/liter or percent Vol. for liquors, coffee, import tobacco, and part of petrol products.

[1] Source: BA-CA SEE Online

The property tax mainly deals with the ownership of property, as well as inheritance and gifts, and the sale of property and property rights. Liability to property tax arises from the ownership of non-agricultural land, buildings and flats, business premises, administrative buildings, garages, moveable property, such as certain cars, buses, trucks, tractors, if the assets are not used for business purposes. Land and buildings are taxed on their market value at an annual rate of 0.10 percent, which is applicable to movable property as well.

Serbia and Montenegro

The taxation system in Serbia and Montenegro is regulated at the federal level and at the republic level (Republic or Serbia and Republic of Montenegro). The federal government is responsible for specifying what types of taxes the republics can collect and under what conditions. Detailed regulations for taxation, tax collection and control are the responsibility of each republic. A major tax reform was implemented in Serbia in April 2001, which brought a complete revision of tax legislation. A recent change in the Serbian tax regime occurred on the 1st of January 2005, when the new Value Added Tax was introduced.

The following taxes are collected in Serbia and Montenegro:

- income tax
- tax on profits
- VAT
- excise taxes
- wealth tax
- tax on the use of goods and permission to use goods.

The income tax is calculated on a progressive scale. The types of taxed income include income from dependent employment, income from agriculture, income from self-employment, income from licence fees, income from financial assets, rental income, and capital gains. All company forms that are regulated by Company Law are subject to corporate income tax. The corporate profit tax rate is set at 10 percent in Serbia, while, in Montenegro Corporate Income Tax is imposed at progressive rates. If taxable income is under EUR100 000 then the CIT rate is 15% while in excess of EUR 100 000 the rate is 20%.

There are three types of depreciation used in Serbia and Montenegro: straight-line depreciation, depreciation through use and the geometrically declining balance method (accelerated) depreciation. Once the method has been selected, it may not be changed until the last depreciation rate for the respective asset, except for a change from geometrically declining to linear depreciation. The straight-line depreciation rate on buildings is 1.5 percent, on industrial machines 8.3 percent, and 20 percent on computers and office equipment, and intangible assets.

The tax on the use of goods and permission to use goods is a tax for the items of practical use, which is collected on motor vehicles, mobile phones, ships and yachts, and on airplanes. The amount of tax to be paid depends on the value of the item, for motor vehicles on engine power or cubic capacity.

In Serbia, the introduction of the VAT was one of the prerequisites for launching the Stabilisation and Association talks with the EU. The VAT replaced the earlier 20 percent sales tax on goods and services, and it is applied at a general 18 percent rate, and at an 8 percent rate for basic provisions, medicines, textbooks, and newspapers. Every entity that posted over 25,000 euros in turnover in the past year, or is expected to post as much over the next 12 months, is subject to the VAT. As a result of the introduction of the VAT, tax obligations will now be charged far more quickly then before. The VAT introduction is expected to bring 25 million euros of budget revenue in 2005. Since the introduction of the VAT the retail prices of some products have risen. Earlier neither basic provisions nor computers were previously subject to sales tax. Now the former falls under the 8 percent, and the latter falls under the 18 percent VAT rate. It is expected that companies will need about half a year to adjust to the VAT. In Montenegro VAT was introduced on 1 April 2003 at a standard rate of 17%.

The Serbian tax regime contains various incentives for attracting foreign investment. The corporate profit tax rate is set at a low, 10 percent level. Tax credits are available for investing in fixed assets of up to 80 percent of the assets' value. A ten-year tax holiday is provided for investments of 8 million euros, or more. The government gives subsidies, tax exemptions, and other incentives for creating new jobs.

TAX REGIMES IN ALBANIA AND BOSNIA-HERZEGOVINA [2]

ALBANIA

The tax regime in Albania is applied on both national and regional level. Taxation on the national level is far more important then on the regional level. Local governments are financed through a mixed system of transfers and own revenue (property tax and local fees).

Both direct and indirect forms of taxation are applied. The most important direct taxes are the Corporate Income Tax (CIT) and the Personal Income Tax (PIT). CIT is imposed on Albanian and foreign legal entities, partnerships, or other groups of persons that conduct business in Albania, and any other person who is subject to Value Added Tax. The actual CIT rate is 25 percent, calculated on the basis of annual income. As for the rules of depreciation, buildings and machinery incorporated in the building may be depreciated linearly over 20 years, computers and software products in 4 years, and all other business assets in 5 years. Non-performing loans may be deducted under specific conditions. Personal Income Tax (PIT) is calculated on the basis of personal income of local residents and of foreign individuals who are residents in Albania for longer then 183 days of a tax period. Dividend payments to shareholders or partners having 25 percent or more of the stake are not liable to PIT. Property tax is also an important form of direct taxation in Albania. This tax is applied on agricultural land and buildings, equally to both local and foreign owners. It is calculated as Lek/sq m of the building area, and is paid on a monthly basis, through the electrical energy bills.

The most important forms of indirect taxation in Albania are the Value Added Tax (VAT) and excise duties. The VAT is applied on all individuals or juridical persons, who supply goods or services as a part of their activity in the Republic of Albania. Businesses are subject to this tax if their annual turnover exceeds the amount of 8 million Lek. The VAT rate is 20 percent. Excise is applied on a number of products designed for local consumption, either locally produced or imported. There are two ways of setting the excise rate, either in the form of Excise Percentage Rate or Excise Stamps.

BOSNIA AND HERZEGOVINA

In Bosnia and Herzegovina fiscal policy, the establishment of the tax system, and passing tax legislation are conducted separately in the two Entities (Federation of Bosnia and Herzegovina, Republic of Srpska). The Entity laws on sales tax are similar (both of them apply a one-phased sales tax), with some differences. At the same time there are significant differences in the personal and corporate income tax legislation.

FEDERATION OF BOSNIA AND HERZEGOVINA (FBIH)

Direct taxes

In FBiH the corporate income tax rate is quite high, it reaches 30 percent, but there are numerous incentives available. The Corporate Income Tax law allows losses to be carried forward for a period of 5 years. Depreciation on a straight-line basis is available. A tax relief for newly founded companies amounts to 100 percent for the first year, 70 percent for the second year, and 30 percent for the third year of business. Full tax exemption is granted to companies with 100 percent foreign participation. There is a 15 percent withholding tax on dividends, authors' fees and interest paid to non-residents in the FBiH. With regard to corporate income tax in FbiH, a reduction of the tax rate is expected in the near future, along with the reduction of the number and types of tax exemptions.

[2] Source: BA-CA SEE Online

The personal income tax in FBiH is levied at the Federal or at the cantonal level, depending on the type of income. At the Federal level the regular wage or salary of employees is taxed at the rate of 5 percent based in the net wage or salary. Other income received on the basis of regular employment relationships (vacation pay, per-diem for business trips, compensation for meals during work, severance pay for retirement, anniversary awards, etc.) is not taxable up to a set maximum amount. Amounts exceeding these limits are taxed at a rate of 69 percent. Other income from regular work (fee contract, remuneration of members of supervisory boards, income of professional athletes, etc.) is taxable at a 30 percent rate. There are certain types of tax-free income, such as scholarships and grants for pupils and students, social support, benefits from health insurance, etc. The following types of income tax are levied at the cantonal level: personal income tax of individual craftsman (rates between 25 and 30 percent), taxation of income from leasing and from the transfer of ownership rights (rates between 0 and 20 percent), income from authorship rights, patents, and technical advancements (rates between 0 and 20 percent), inheritance and gift tax (rates between 0 an 10 percent), tax on winnings from games of chance (rates between 0 and 20 percent). In the near future it is expected that a uniform law will be passed on personal income tax, which will mean the end of tax regulation on the cantonal level.

Indirect taxes

Indirect taxes levied in FBiH are the sales tax on products and services (with a standard rate of 10 percent for services, and clearly specified products, and 20 percent for other products, with tax exemptions provided on a social bases), excise tax (on oil and petroleum products, tobacco and tobacco products, alcohol and alcoholic beverages, soft drinks, beer, coffee and coffee products), real estate transfer tax (with rates varying between 5 and 8 percent), property tax, and other indirect taxes and fees (such as fees for signs put up along roads, consumption tax on alcohol payable to the caterers, etc.).

Republic of Srpska (RS)

Direct taxes

The corporate income tax rate in RS amounts to 10 percent, with a relatively small number of tax incentives (exemptions) being granted. Unlike in FBiH, loss carry-forwards are not allowed. There are some tax-unrecognised expenditures, which increase the income/loss in the income statement (and therefore the tax basis as well).

Personal income tax is payable by RS residents on income earned in RS territory, in another Entity, or in another country. It is also payable by non-residents in the RS on income earned in RS territory. Personal income tax is payable after income earned form dependent work or employment, income from agriculture and forestry, income from individual craftsmanship, authorship rights, patents, and technical advancements, income from capital and capital gains. Income from capital includes income from letting real estate or leasing out movables, but not interest and dividends, which are not taxable. The uniform personal income tax rate is 10 percent in RS.

There is a third kind of direct tax, levied on winnings form games of chance, with a 15 percent rate.

Indirect taxes

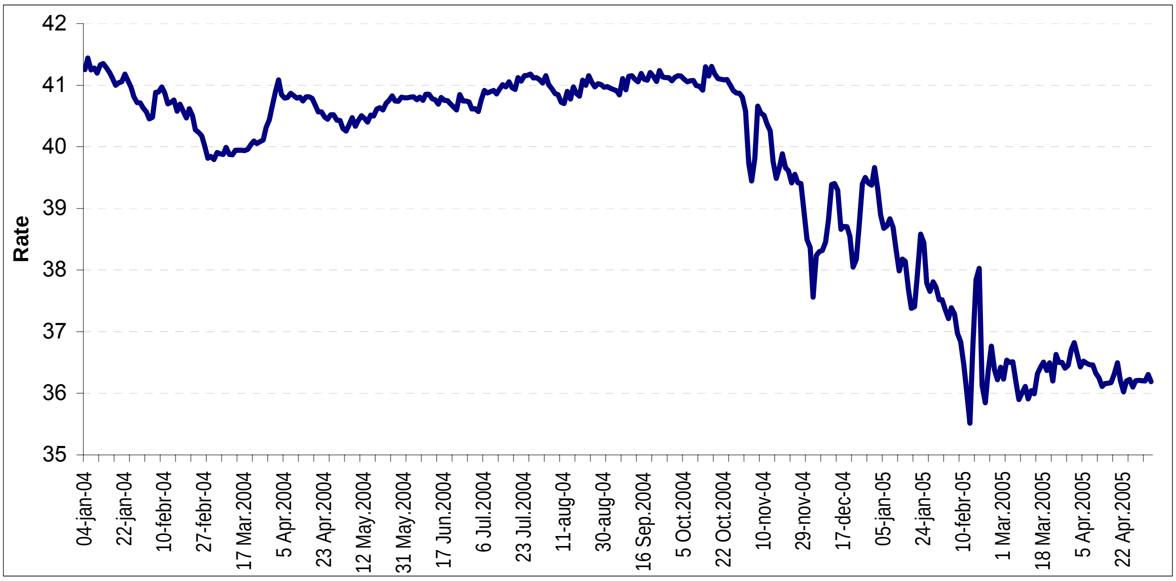
Indirect taxes in RS include the sales tax, the excise tax, the property tax, the real-estate tax and other taxes. There are two rates of sales tax, 8 and 18 percent, but as sales tax is payable together with the 2 percent railroad tax, the effective tax rates amount to 10 percent and 20 percent. Paid services are taxed at a 10 percent rate. There are exemptions from the sales tax. Excise tax is levied on oil and petroleum products, tobacco and tobacco products, alcohol and alcoholic beverages, soft drinks, beer, coffee and coffee products. The property tax rate amounts to 3 percent, and is payable at the change of ownership of real estate, as well as in the case of selling of other rights (intellectual property, permanent right to use city land, etc.). Real-estate tax is payable on ownership right of real-estate, on the right to enjoy real-estate, the right to let apartments or business premises, and the right to use construction land. The tax is determined by the size of the real property. Other taxes are levied on legal entities and individual businessmen, as well as agencies of foreign legal entities.

Value added tax is expected to be introduced in both Entities of Bosnia and Herzegovina on the 1st of January 2006. The rate will be 17 percent, with no exemptions available. The VAT will replace the various sales tax systems currently used in the country. It will be collected at a national level, and will thus move the country towards centralization.

INTEREST RATE POLICY IN ROMANIA: 10 PERCENT OFF IN 5 MONTHS

The present interest rate policy of the National Bank of Romania (NBR) is easily summarisable: keeping back speculative capital inflows after the liberalisation of the current account on 11 April. With cutting back on the reference interest rate, as can be seen on the following chart, the central bank successfully stopped the strengthening of ROL, which started at the end of last year, but we point out that in the meanwhile other aspects of these not well-established measures seem to be forgotten.

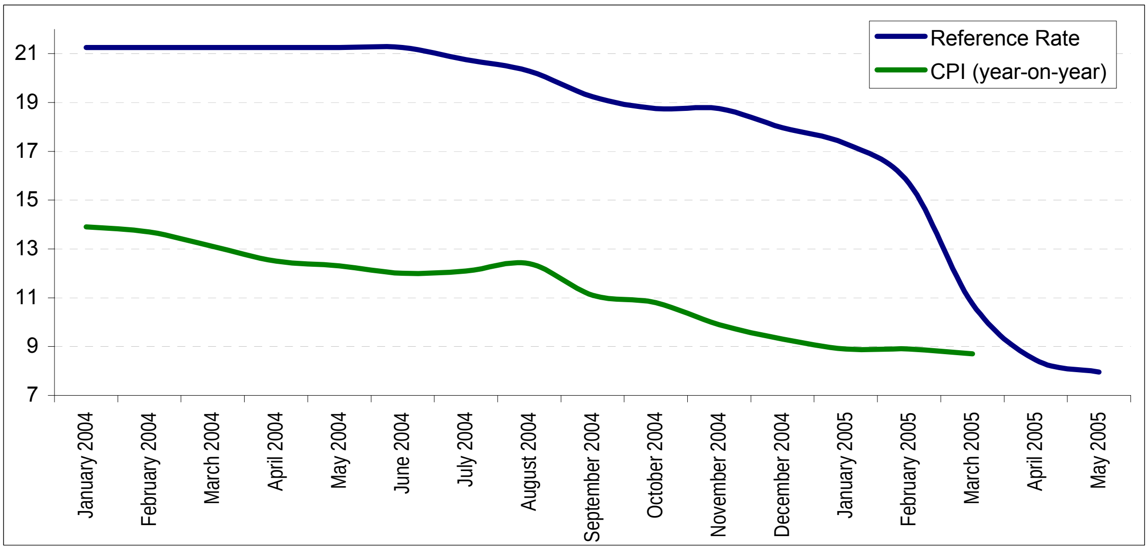
CHART 1. – ROL/EUR EXCHANGE RATE



Source: National Bank of Romania

In the first five months of 2005 the NBR has decreased its reference rate by 10 percentage points, from 17.96 percent to 7.96 (see following diagram). As the inflation is around 7 percent the real interest rate is close to 0 what firmly communicates the commitment of the central bank, but it incorporates economic risks too. The economic and political risks of Romania are higher than this interest rate could compensate. A moderately higher, and to the macroeconomic indicators more suitable interest rate also would be able to keep speculative capitals back. It is especially true if we take it into account that the decline in capital inflows is generated not only by the shrinking interest rates but it is assisted by future raise of taxes on transactions in the capital market, real estate transactions and interests from the former 1 percent to 10 percent, effective from 1 July.

CHART 2. –THE NBR'S REFERENCE RATE AND INFLATION IN ROMANIA



Source: National Bank of Romania

We argue that the inflow of speculative capitals is not hindered directly by the low interest rate; it has only an indirect effect in case of Romania. Experiences show that many times the interest rate in itself has got only low effect on speculative capitals and the exchange rate expectations of speculants are more important. Thus, the central bank of Romania might have only generated real economic dangers with drastically pressing down the rate, and the absence of capital inflow might be only an indicator of economic risks, like an expected depression of the national currency, accompanied by increasing price level. The steps of the Romanian central bank may generate real economic effects, through higher volatility of the exchange rate which bears the risk of exploitable speculative opportunities with even higher volatility in the future.

So the calm surface may hide problems, meanwhile a higher but still moderate interest rate could eliminate these real economic dangers, keeping and attracting medium and long term foreign capitals for the economy, closing off the possibility of exaggerated volatility and speculation generated by disturbed real economic factors.

In 2005, according to the NBR, the top priority of the central bank is to keep down the consumption demand, what has got two goals: to disadvance inflation and to keep the current account deficit sustainable on the medium term. The present interest rate policy does not support these aims, at least the following statements indicate that:

- The decreasing interest rates take effect not only on foreign speculative capital inflow, the internal savings are sliding down too, whilst the cumulated volume of loans to companies and people is on the rise. And what is even more interesting, the structure of the loan disbursement: in March ROL loans accelerated by 1.5 percent while foreign currency loans advanced by 5.7 percent, a much faster growth. For comparison, the saving rate fell down from 5,8 in February to 2,4 percent in March.
- Therefore the consumption is gathering pace (increasingly based on import goods and services), generating a worsening trade balance (the deficit of the foreign trade reached 265 million EUR in January and 651 million in February whilst the current account reached EUR 516 million deficit in the same month), what can not be financed from internal savings but from foreign currency loans of the non-public sector.
- If we have a look at the structure of the worsening current account: the negative trade balance is equilibrated by cheap foreign currency borrowings. The short and medium term foreign debt rose by 7.9 percent by end-February compared to the end of last year and it is still on the rise. It colours the picture

even more that the percentual proportion of public and publicly guaranteed debt is falling in the whole indebtedness (it was 54.6 percent in the end of February, that is lower by 2.1 percentage point than in the end of last year). Meanwhile the non-public sector debt rose to EUR 8.66 bln in the first two months, what means a 13 percent higher (!) amount than as of 31 December. These loans are flowing into goods and services, making it difficult to keep inflation down.

Pressing down the nominal interest rate so fast, practically to the level of inflation is not reasonable in the case of a developing country with such macroeconomic indicators like Romania. Presently, despite the expectations of the central bank, an increase of the inflation is easily imaginable, what can cause even (though most likely only temporarily) negative real interest rate what is far from ideal in case of a developing country characterised by strong economic growth. In fact, the NBR is taking on real economic risks.