

Review article
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Tax Reform in Bosnia and Herzegovina and Serbia and Montenegro: Progress and Problems*

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Abstract

This paper looks at tax reform in two of the Yugoslav successor states: Bosnia and Herzegovina (BiH) and Serbia and Montenegro. These two countries have proved to be the most problematic of the former-Yugoslav countries for different reasons. Serious reform began in 1996 in BiH, after the war, but only in 2001 in Serbia. Along with the inherited Yugoslav system in both, the decentralized structure of post-war BiH and the existence of so many levels of government have made tax reform more difficult. The almost continuous difficulties in the ruling coalitions in Serbia have slowed economic and tax reform there. Montenegro has had more stable government since 1998 and has made the most progress by introducing an EU-compatible tax system with a VAT and global income tax in 2002-3. The goal of EU membership has played a positive role in gaining consensus to move towards modern tax systems in both countries, although there is still much to be done.

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Key words: Tax, tax reform, Bosnia and Herzegovina, Serbia and Montenegro, economic transition

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1. Introduction

The former Yugoslavia started the transition from a Socialist system in 1989 in what most people thought was an advantageous position. The country was relatively open to the west and seemed to have an economy that had found the middle way between the Soviet socialism and market economies. The standard of living was among the highest of the Socialist countries and people were free to travel to the West. However, 15 years and a number of armed conflicts later, five of Yugoslavia's six republics were independent countries and Kosovo, an autonomous province, was under United Nations (UN) protection. Transition to a market economy in some parts of the former Yugoslavia was only beginning³. By 2004, other former socialist countries that had previously been considered poor and backward by many Yugoslavs, such as Hungary and Poland, had joined the European Union (EU) and their standards of living far surpassed that in most former Yugoslav countries. Romania and Bulgaria, which really had been far behind 15 years ago, are scheduled to join the EU in 2007 or 2008. One major reason for the drastic economic deterioration was the series of internal wars that devastated parts of former Yugoslavia and caused major human, property and economic losses. The slow collapse of the Yugoslav self-managed socialist economy in the 1980s also played a larger part than has been generally acknowledged (see Lydall, 1989).

The Yugoslav system had a number of specific characteristics, including the central payment system, called the Social Accounting Service or SDK that was all encompassing. All financial transactions, including tax and contribution payments, as well as control of the financial and fiscal system were handled through the payment bureau. It kept all records on tax and contribution payments, handled virtually all financial transactions (everything over 10 DM), and was the major organ of enforcement for tax payments. This meant that any tax reform needed to address more than adopting new tax laws, the entire system, including the calculation, payment, collection and control of tax and social contributions had to be changed. Even before 1989, tax authorities were quite decentralized. The six Republics and two Provinces that made up Yugoslavia had a great deal of autonomy over direct taxes. The Federal level relied mainly on indirect taxes, that is, sales, excises and customs (Lydall, 1989).

This paper deals with tax reform in two of the Yugoslav successor states: Bosnia and Herzegovina (BiH) and Serbia and Montenegro.⁴ These two countries have proved the most problematic of the former-Yugoslav countries since 1989 for different reasons. However, the inherited Yugoslav system and the difficulty of getting consensus for reform with a number of different factions (whether ethnic or political) are similar. Both countries started reforms with weak democratic governments in charge of destroyed economies, although obviously BiH also faced the physical destruction from the war as well.⁵

³ Slovenia is the obvious exception. It was the most developed Republic before the breakup, and continued to outpace the others, joining the European Union in 2004.

⁴ In February 2003, what was left of Yugoslavia changed its name and formed the common state of Serbia and Montenegro.

⁵ Although the NATO bombing caused damage in Serbia, the scale was far less and civilian casualties minor.

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Reform in BiH started in 1996 after the signing of the Dayton Peace Accords⁶ in December 1995 that ended the war. Reform in Serbia and Montenegro started later. In Montenegro the new government under Milo Djukanovic began edging away from Milosevic's Serbia in 1998. Serbia began reforms only in 2001, after the fall of Milosevic and the elections in December 2000 that were won by the opposition DOS (Democratic Opposition of Serbia) coalition. Earlier attempts at reform had been done in isolation and were more meant to keep the government afloat in the face of sanctions and international isolation.

The following section focuses on Bosnia and Herzegovina. Section 3 covers Serbia and Montenegro. Finally, in Section 4, there will be some concluding thoughts on the challenges of tax policy in a post conflict situation with complex political systems as well as the role of the international community.

2. Bosnia and Herzegovina

2.1. Background

Bosnia and Herzegovina was recognized as an independent country in April 1992 after a referendum, following guidelines set out by what was known as the Badinter Commission of the European Community. It was immediately plunged into war which ended only with the signing of the Dayton Peace Accords (hereafter, the Accords) in December 1995 (for a more complete discussion, see Tesche, 2000). The Accords created a complex political structure with two main sub-levels of government, called Entities, under a weak State. The Entities are: the Federation of BiH (the Federation) and the Serb Republic (Republika Srpska or RS). The authority for tax policy, with the exception of customs policy, rests with the Entities, while all tax administration was at the Entity level. Brcko District was set up as a separate jurisdiction under the State after later arbitration.⁷ The Accords, peacekeeping troops (first led by NATO, now by the EU), and massive amounts of aid have kept the peace and repaired a great deal of the war damage. There have been frequent elections at all levels of government. However, the final arbiter in BiH politics and the economy is the UN's High Representative (who is also the EU's Representative), with power to impose laws and dismiss people from virtually any position. Tax policy is an area where the OHR, with participation from the international donor community, has been active, following years of attempted persuasion to get the two Entities and three ethnic groups⁸ to cooperate on tax policy. The role of the High Representative is still

⁶ "The Dayton Peace Accords: General Framework Agreement for Peace in Bosnia and Herzegovina" were signed in December 1995 by leaders from BiH, Croatia and Yugoslavia. They deal with many areas: the political, economic and monetary structures, the BiH constitution, the role of the military and the international community among other areas.

⁷ The town of Brcko lies at a critical link between the two parts of the RS, and between the Federation and Croatia. Both Entities claimed it, but Brcko was set up an independent district under the State by the High Representative in 2000 after international arbitration.

⁸ The three main ethnic, or religious, groups in BiH are the Croats, Muslims (Bosniaks) and Serbs. The Federation has a majority of Croats and Bosniaks, while the Serb Republic, as the name implies, has a large post-war majority of Serbs.

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quite large, although it is currently being reconsidered. The current High Representative, Paddy Ashdown, will step down at the end of 2005. His replacement may have a smaller mandate and represent the EU only.

The post-war population of BiH is estimated to be around 3.8 million (Central Bank of BiH, Annual Report, 2004). There has been no census since 1991, and the effects of war, emigration and internal dislocation makes an accurate count difficult. Table 1 gives estimates for the Entity populations. The Federation is larger with nearly three-fourths of the total (two thirds using Entity reported numbers), with a bit more than one-fourth (or one third) in the RS. Brčko's population is quite small, at 45,000, although estimates vary between 40,000 and 80,000. Total GDP is higher in the Federation at \$1922 per person compared to \$1717 in the RS. Using Central Bank population figures, total GDP per capita was \$2150 in 2004. All of the data in Table 1 are estimates, and they vary by source.

Table 1: Population and GDP

| | Population 2000, (mln.) | Percent of Total | GDP 2004. (mln. KM) | 2004 (mln. USD) | GDP per capita 2004 (USD) | Average exchange rate 2004. (KM/USD) |
|---------------------------|-------------------------------|---------------------|---------------------------|--------------------|---------------------------------|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| BiH: | 3.832* | 100,0 | 12980 | 8239 | 2150 | 1.5755 |
| - Federation | 2.848 | 73.2 (66.1) | 8625 | 5475 | 1922 | |
| - RS | 1.460 | 25.6 (33.9) | 3950 | 2507 | 1717 | |
| - Brčko District | 0.045 | 1.2 | | | | |
| | | | | | | |
| Serbia and Montenegro: | 8.6 | | | | | |
| | | | Bil. Dinar | | | Dinar/\$ |
| - Serbia | 7.5 | 92.6 | 1263 | 21421 | 2856 | 58.9607 |
| | | | Mil. Euro | | | Euro/\$ |
| - Montenegro | 0.6 | 7.4 | 1475 | 1832 | 2955 | .80510 |

Sources: CBBH Annual Report, 2004, Federation Statistical Yearbook, 2004, RS Quarterly Statistical Review, 2005, Serbia and Montenegro Statistical pocketbook, 2004, IMF Country Report, BiH, 05/199, IMF Country Report, Serbia and Montenegro, 05/13, average exchange rates for the Dinar and Euro: www.OANDA.com.

* Population, and, therefore, per capita GDP figures vary. Here, total population is taken from the CBBH Annual Report, while Entity population figures are from Entity Statistical Agencies and do not sum to the total. The percentage of total in parentheses uses the Entity sum of 4.311 mil. The Federation Yearbook notes that around 500,000 citizens do not live in BiH.

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2.2. Tax History

In 1995, BiH essentially still had the Yugoslav tax system, including the payment bureau, which at that point had been divided into three separate systems. Simply abolishing the payment bureau was not possible, since many of the tasks had to be moved elsewhere. Tax Administrations had to take on the roles of tax payment record keeping, audit, and enforcement. The main instrument of control had been the ability to block payment bureau accounts, which every business was required to have. Legislation had to be changed even to allow banks to accept tax payments. The payment bureaus were shut down in both Entities in 2000, with major effort by the international community and recourse to the imposition of some of the supporting legislation by OHR (Economic Newsletter, Vol. 4, No. 1, January 2001).

The complicated political structure due to the Dayton Accords has made tax reform even more difficult. Tax policy is on the Entity level, so any cooperation or coordination had to be voluntary. Given the recent wars, this was not easy, even within the Federation. In addition to this difficulty, many people in the Ministries of Finance did not understand the need for new laws, believing that it was only necessary to reconstruct the previous system. It has been a slow process to convince them that the system needed changing, particularly if BiH is to join the EU.

The international community played a much larger role in this process than is usual, given BiH's status as a semi-protectorate. The first years saw more use of persuasion, then as frustration with lack of progress grew, a more active role was taken. For example, there was a great deal of effort by the donor community put into both harmonizing indirect tax rates and dealing with the allocation of excise revenues from one Entity collected in the other. This was only fully accomplished with the introduction of the State level law in 2004, although some agreements were made before. For example, in 2002, both Entities agreed to an allocation mechanism involving credits with revenue belonging to the place of consumption (OHR Economic Newsletter, Vol. 5, No. 2). Simply harmonizing excise tax rates took years of effort. The Office of the High Representative and the International Advisory Group on Tax, started in July 2000 (OHR Economic Newsletter Vol. 4, No. 1) representing most donors, play a major role in formulating tax policy. The entire set up of the State level control of customs administration and indirect taxes has been driven by the international community. Starting with the "Decision on the Law on the State Border Service", 13, January 2000 (OHR Decisions), a series of decisions from the High Representative setting up State level institutions and laws followed. These included making major changes in the existing customs law (Sluzbene Glasnik BiH (SGBiH) No. 2/98) in 2000, setting up the Indirect Tax Authority in 2003 and 2004, and enacting and amending indirect tax laws

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including timing, cooperation and personnel in 2004 and 2005⁹ In August 2004, the Federation Parliament passed amendments to the sales and excise tax laws that were not consistent with the ITA. The Constitutional Court revoked the Law, subject to appeal (OHR Economic Newsletter, Vol. 7, Issue 4). All of this has been a mixed blessing. Laws are now in place, but it is still up to the Administrations to implement them. Blocking of progress may simply be moved from tax policy in the Ministries of Finance to tax administrations. In the end, the various Parliaments, Ministries and Administrations will have to implement the laws and move forward. It is not clear how much agreement there actually is with the new policies.

In the Federation, most tax changes were made in the first post-war years. There has been little change since. The statutory corporate profit tax rate has remained at 30% since 1997, which is high by regional standards now (Sluzbene Novine Federacije BiH (SNFBiH) No. 32A/97). Wage taxes and taxes on other sources of income are contained separate laws. The wage tax has been low, falling from 15% to 10% in 2000 (SNFBiH No. 29/00) and 5% in 2001 (SNFBiH No. 16/01), but rates on other sources of income can be quite high at 30-50% (SNFBiH No. 17/99). There is discussion of introducing a global income tax, but not until after the value added tax (VAT) is introduced, currently scheduled for January 2006. Contributions have remained at 45% in total, similar to Western European levels. There is considerable confusion over contribution rates in former Yugoslavia. This stems from the Yugoslav practice of stating rates on net salaries. These, of course, appear much higher.

Sales tax rates in the Federation were quite high, staying at 20% for goods and 10% for services since 1998 (SNFBiH No. 49/02). Note that the service tax base was not standard, it included retail sales inclusive of the sales tax on goods, as well as insurance, banking and margins on wholesale trade. At 20%, the sales tax on goods is higher than can be well enforced. A VAT is scheduled to replace the new State sales and excise tax law which came into effect in 2005. The VAT will have a single rate of 17%. As is typical in the region, soft drinks and coffee are subject to excises, along with the EU excisable goods: oil derivatives, alcohol and tobacco products. These were specific rates, with some changing to ad valorem only in 2005 when the sales tax law moved to the State level. The Federation collected sales tax on excisable goods at the wholesale level, whereas the RS collected all sales tax at the retail level. This allowed legal tax avoidance by shipping untaxed excisable goods from the RS at the wholesale level to the Federation where they are not taxable at the retail level. This loophole was closed when both Entities and the Brcko District passed legislation moving all sales tax collection on excisable goods to the place of production or import in 2003 (OHR Economic Newsletter, Vol. 6, No. 3).

⁹ The following Decisions are published on the OHR website: "Decision on the Law on the State Border Service", 13 January 2000, "Decision on Law on Amending the Law on Customs Policy", 20 December 2000, "Decision Establishing the Indirect Tax Policy Commission to Establish the Indirect Tax Authority", 12 February 2003, "Decision Enacting the Law on Amendments to the Law on the Indirect Taxation System in BiH" 25 October 2004, "Decision on Enacting the Amendments to the Law on the Sales Tax on Products and Services in BiH", 14 July 2005, and "Decision on Enacting Amendments to the Law on Excise Duties in BiH, 14 July 2005.

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In the RS, some new tax laws were introduced before the end of the war in 1995, but in 1998, a radical change was made in direct taxes. Regressive rates for both the profit and personal income taxes were introduced (Sluzbene Glasnik Republike Srpske (SGRS) Nos. 24/98 and 23/98, respectively). Rates ranged from 20 to 10% for the profit tax and from 25% to 15% for income tax, with a 0% rate for the lowest incomes. This may be the only jurisdiction to introduce such regressive tax rates. In 2002 the RS moved to a single low rate for both profit and personal incomes: 10% for the profit tax and 10% for income tax (SGRS No. 51/01 and Decree 01-803-01, respectively). Total contribution rates remained at around 44% of gross wages, although the breakdown among pension, health, unemployment and child protection changed.

Sales taxes in the RS were 24% and 7% for goods and 10% for services at the beginning of the post-war period. In the RS, the bases for the sales tax on services differed from that in the Federation, the services tax was on services and retail markup only. In the 1998 tax reform, rates changed to 20% and 10% for goods and 10% for services. Two per cent of both types of sales tax was earmarked for the railroads. Part of the complexity of the Yugoslav tax system was the existence of multiple taxes on the same base, as with the railroad tax. The first step in many reforms was to unify these to a single tax on each base. The excise tax structure in the RS was the same as that in the Federation, with the addition of luxury products and timber.

As mentioned above, in January 2000, the High Representative imposed the "Decision on the Law on the State Border Service", (OHR Decisions). Under pressure from the international community, particularly OHR, the Entities ceded authority for indirect taxation to the State level with the creation of the State Indirect Tax Authority (ITA) in 2003. The ITA administers customs and indirect taxes, including the future VAT. At the end of 2004, laws were passed setting up a single account to handle all indirect tax revenues, and a State law on Sales and Excise Taxes (Central Bank of BiH (CBBH) Annual Report 2004). In February 2005, a Fiscal Sustainability Working Group, made up of the Ministers of Finance at the State and Entity levels, was formed to examine and recommend ways to decrease public sector spending (CBBH, Bilten, 2005-1).

2.3. The Tax system today

Since Serbia introduced a VAT in January 2005, BiH is now the only European country without it. The VAT's introduction had been in the planning stages for years, and is now finally scheduled for January 2006. However, the IMF Country Report of June 2005 (No. 05/199) notes that information technology systems, taxpayer registration, public information and staff recruitment are all behind schedule. The allocation of VAT revenue to sub-Entity levels has not yet been decided. All sales tax revenues currently go to the Canton and municipality levels in the Federation, and in the RS, municipalities receive more than 30% (see Tesche, 2005, for a discussion of local government revenue allocation in BiH). Much of the delay is because, according to the Dayton Accords, the Entities must voluntarily transfer this to the State level. This only happened at the end of 2003 for indirect taxes. The BiH Parliament adopted State level sales and excise tax laws (SGBiH Nos. 133/05, 134/05) the end of December 2004. Neither Entity has a global income tax. Again there are plans for its introduction, but the lack of agreement on the

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need for coordinated laws between the Entities, among other problems, has slowed progress. Although it is not necessary to have identical rates to ensure a single economic space, some coordination, at least by tax administrations, is vital.

In general the tax rates in both Entities are quite high, although not necessarily by Western European standards (see Table 2).

Table 2: Tax Rates 2005

| | |
|---|---|
| 1. Personal Income Tax | |
| BOSNIA AND HERZEGOVINA FEDERATION | |
| 5% | flat rate on wage income |
| 30-50% | For other sources of income: varies by type, entrepreneurs 0, 15, 25% |
| Contributions: | Total: 45%--32% employee, 13% employer |
| RS | |
| 10% | wage income |
| 0-25% | other sources of income |
| Contributions: | Total 44%--22% each employee and employer |
| SERBIA & MONTENEGRO | |
| SERBIA | |
| 10% | flat rate on aggregated income |
| 14% | Withholding from salaries and employment income, deductible |
| Contributions: | Total: 35.8%--17.9% employee, 17.9% employer |
| MONTENEGRO | |
| 0, 15, 19, 23% | Global tax since 2002, progressive rates |
| | 15% capital gains, 5% interest |
| Contributions: | Total: 40.0%--20.0% employer, 20% employee |
| 2. Profit Tax or Corporate Income Tax—Statutory Rates | |
| BOSNIA AND HERZEGOVINA | |
| Federation | 30% |
| RS | 10% |
| SERBIA AND MONTENEGRO | |
| Serbia | 10% |
| Montenegro | 9% |
| 3. Sales Tax and VAT | |
| BOSNIA AND HERZEGOVINA-Sales tax at the State level from 2005 | |
| 20% | Standard rate goods and services |
| 10% | Standard rate services |
| 10% | Reduced rate-goods |
| | (17% VAT scheduled for January 2006) |
| SERBIA and MONTENEGRO- VAT | |
| Serbia (introduced January 2005) | |
| 18% | Standard rate |
| 8% | Reduced rate |
| Montenegro (introduced April 2003) | |
| 17% | Single rate |

Sources: Ministries of Finance web sites

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Although wage taxes are fairly low, at 10% in the RS and 5% in the Federation, other sources of income are taxed at much higher rates, depending on the type of income. These rates range from 0-25% in the RS and 30-50% in the Federation. Contribution rates are fairly high, at least by American standards, at around 44-45% including both the employer and employees payments. Sales tax rates are high, at 20% for most goods. This is too high for effective collection of a sales tax. Services are taxed at 10%, which is also the lower rate for goods. A single State level sales and excise tax law came into effect in 2005. Excise taxes cover oil derivatives, alcohol and tobacco products, as well as coffee and soft drinks. In both Entities the largest revenue sources are social contributions and goods and services taxes (sales and excise taxes), each with 40% of the total (Table 3).

Table 3: Tax Revenues 2004

| State | Total Taxes | Payroll taxes | Income, profit, cap. gains | Social contributions | Property | Goods and services | Trade taxes | Other |
|-------------------------|-------------|---------------|----------------------------|----------------------|----------|--------------------|-------------|-------|
| | 9 | | | | | 8 | 1 | |
| BiH: | | | | | | | | |
| - Federation | 3411 | 130 | 99 | 1364 | 6 | 1392 | 419 | 1 |
| % of total | 100.0 | 3.8 | 2.9 | 40.0 | 0.2 | 40.8 | 12.3 | 0.0 |
| - RS | 1339 | 96 | 26 | 533 | 0 | 492 | 113 | 79 |
| % of total | 100.0 | 7.2 | 1.9 | 39.8 | 0.0 | 36.7 | 8.4 | 5.9 |
| - Brcko | 157 | 5 | 4 | 14 | 1 | 117 | 14 | 2 |
| % of total | 100.0 | 3.2 | 2.5 | 8.9 | 0.6 | 74.5 | 8.9 | 1.3 |
| Saerbia and Montenegro: | | | | | | | | |
| - Serbia | 557.7 | 72.4 | 19.1 | 182.1 | 16.6 | 230.3 | 34.3 | 2.9 |
| % of total | 100.0 | 13.0 | 3.4 | 32.7 | 3.0 | 41.3 | 6.2 | 0.5 |
| - Montenegro | 626.2 | 61.2 | 16.5 | 278.8 | 1.9 | 219.6 | 36.7 | 11.5 |
| % of total | 100.0 | 9.8 | 2.6 | 44.5 | 0.3 | 35.1 | 5.9 | 1.8 |

Sources: CBBH Bilten 1, March 2005, CBCG Izvjestaj 2004, Ministarstvo finansija RS.

Note: mln. KM (BiH), bil. dinar (Serbia), mln. Euro (Montenegro)

Of the contributions, the two largest are for pensions and health. In total, contributions make up nearly 23% of GDP in the Federation and 14% in the RS (Table 4).

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Table 4: Contributions 2004

| | Pension | Health | Unemployment | Other* | Total | % of GDP |
|------------------------------------|---------|--------|--------------|--------|-------|----------|
| BiH (mln. KM): | | | | | | |
| - Federation of BiH | 801 | 577 | 78 | 4 | 1964 | 22.8 |
| - RS | 300 | 199 | 11 | 22 | 533 | 13.5 |
| Serbia and Montenegro (bn. Dinar): | | | | | | |
| - Serbia | 77.2 | 59.2 | 6,6 | | 182.1 | 13.3 |
| - Montenegro (mln. €) | 171.5 | 95 | 11,9 | 0.4 | 278.8 | 18.9 |

Sources: CBBH Annual Report, 2004, Federation Statistical Yearbook, Serbia and Montenegro Statistical pocketbook, 2004, IMF Country Report, BiH, 05/199, IMF Country Report, Serbia and Montenegro, 05/13.

* Cantons for the Federation, Child Protection for RS, and Development fund for Montenegro.

A serious issue in taxation in BiH is the existence of so many different tax authorities. This both makes evasion easier, especially when the various administrations do not cooperate, and increases the costs of administration. There were the three main administrations: the Federation, the Serb Republic, and Brcko District. Now the State Indirect Tax Authority has been added. The ten Cantons in the Federation also have some tax administration authority.

3. Serbia and Montenegro

3.1. Introduction

Yugoslavia started the economic transition from a socialist economy with the same legacy as the other former Yugoslav countries, but later, after the fall of Milosevic in October 2000. Yugoslavia became Serbia and Montenegro after the Serbian and Montenegrin governments agreed to form a looser union in March 2002. The formal change of name from Yugoslavia became effective in February 2003. The EU insisted on a three year waiting period before any referendum on independence of either Republic, implying that a referendum could be held in the spring of 2006. The State Union has not really functioned. There is still no Federal constitution and State Parliamentary elections have yet to be held. Only the Ministries of Defence, International Economic Relations, and Foreign Affairs really function at the State level. Although Yugoslav tax laws continue to exist, they sit on the books un-implemented. In the mean time, both Republics have pursued their own tax reforms. In 2005, the EU finally accepted a two-track approach in negotiations with Serbia and Montenegro, in essence admitting that a unitary approach was not working. Kosovo is still technically part of Serbia, but has been under UN protection since 1999 and will not be covered in this paper.

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The final Milosevic years saw the near collapse of the economy and infrastructure, particularly in Serbia. This is often blamed on sanctions and the NATO bombing in 1999, but in fact was more due to years of neglect of infrastructure investment, mishandling of the economy and financing the wars in Croatia, BiH and Kosovo, along with outright theft by government officials. When Milosevic lost the election in the fall of 2000 and was finally ousted after trying to falsify the results, the new reform coalition, DOS (the Democratic Opposition of Serbia, made up of 18 opposition parties), was elected in December 2000. Sanctions were ended quickly by the end of 2000. The new government coalition tried to make as much progress as possible in a short time, but reform slowed after the assassination of Prime Minister Djindjic in March 2003. However, a number of the tax reforms planned by the first reform government are being implemented. A complete review of the tax system with recommendations for changes had been commissioned by the Djindjic government before 2003 (see Begovic, et al, 2003, 2004), although much has yet to be implemented.

Elections after the death of Djindjic in March 2003 produced a minority government led by Vojislav Kostunica's party, which rules only with the cooperation of Milosevic's Socialist Party. However, even with coalition governments, Serbia has been successful in stabilizing the macroeconomic environment. The currency has been stable, and the exchange rate is now in a slow crawling peg against the euro, and inflation was brought near to 10% by last year.

Montenegro began a more independent path after the election of Milo Djukanovic as president in 1997, followed by his party's victory in the general election March 1998. Use of the threat of a referendum on secession from Yugoslavia allowed Montenegro to begin a series of steps to disassociate itself from Serbia economically as well as politically. The DM was adopted as its currency in January 2000 (changed to the euro when it was introduced). In response, the Yugoslav parliament changed the constitution in July 2000 to effectively deprive Montenegro of its voice in the upper house of Parliament by having members be directly elected. Montenegro has less than one tenth of the population of Yugoslavia (Table 1), so in direct elections, their votes would be swamped by Serbia's. Montenegro followed by boycotting the federal parliament. Another general election was held in April 2001 which confirmed Djukanovic's leadership. After the fall of Milosevic, rapprochement with Serbia was possible. The international community, particularly the EU, has been reluctant to consider the idea of Montenegro splitting from Serbia. However, the other four Republics were allowed to leave after referendums. It is true that this may raise border issues elsewhere, but it does not need to. This should be an issue for Montenegrins to deal with, as long as international norms are met.

Montenegro's government is stable, since it is controlled by a small number of people. The President, Milo Djukanovic, became Prime Minister after elections in October 2002, after his party had lost its parliamentary majority in July. The

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previous Prime Minister, Filip Vujanovic, became President. In any case, the stability of government has meant a slow but steady reform of the economy, beginning in 1998, as well as a higher Standard and Poor's country risk rating than Serbia in 2004.¹⁰ One can argue that merely passing laws is not enough without implementation, but Montenegro has shown itself to be more open to change and foreign investment than Serbia.

Table 1 gives the population figures for Serbia and Montenegro based on the census of 2002 in Serbia and 2003 in Montenegro. Only 7% of the total lives in Montenegro. Their per capita GDPs are similar at around \$3000.

3.2. Tax history

Serbia still had a variation of the old Yugoslav tax system until the new government came into power in 2001. The first phase of tax reform began immediately in the spring of 2001, with the goal of decreasing the number of taxes and different rates. The second phase started the fall of 2002 and decreased rates further, along with increasing incentives for employment and investment (Deloitte and Touche, 2002). The enterprise profit tax rate had been lowered from 25% in 1998 to 20% in 1999. The new government lowered it again to 14% in September of 2002 (Sluzbene Glasnik Republike Srbije (SGRSrbije) No. 25/01). The wage tax was changed to a single rate of 20% (SGRSrbije No. 24/01), then decreased to 14% in 2003 (SGRSrbije No. 80/02). The citizen income tax (on non-wage income) rates had been 24%-40% since the mid 1990s. These were lowered to 20% for most non-wage types of income. An additional amount on wages, up to 3% was allowed for municipalities and cities from 2001 (SGRSrbije No. 27/01). In 2004 rates were lowered further to 10% on all types of income (www.mfin.sr.gov.yu, July 2005). Contribution rates were decreased from over 40% to just over 35% by September 2004 (SGRSrbije No. 713/04).

Sales tax rates were 20% for goods and 10% for services from 1998, plus a 3% railroad tax on the same base (Mihajlovic, 1998). From 2002, the rate on goods and services was 20% (SGRSrbije No. 22/01). VAT introduction was planned for January 2004, to be followed by a global income tax. The VAT was postponed, partly because of the assassination of Prime Minister Djindjic in March 2003, followed by new elections. The new coalition that followed elections in the fall of 2003 continued with VAT introduction in 2005. There were some excise tax rate changes, but the same goods were subject to taxation. In Serbia, excise rates were all ad valorem.

¹⁰ Montenegro received a BB rating in December 2004. Serbia had received a B+ in November, 2004. Note that Serbia's rating has been raised to BB- in July 2005, based on faster reform and decreased political risk (Standard and Poor's, 2005).

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Montenegro started with smaller changes in 1998, but introduced a major tax reform in 2002 (Sluzbene List Republike Crne Gore (SLRCG) Nos. 65/01 and 12/02). The main thrust of the reform was to move towards EU standards. They have retained the single rate of profit tax since 1998, but lowered the rate from 25% to 20% in 1999. In 2002 a lower rate of 15% was added for smaller enterprises. There is a final withholding tax rate for dividends and capital gains at 15% and for interest at 5%. The income tax was changed to a global tax, and the progressive rates were lowered substantially. The top rate of 40% was lowered to 25%. Other income was then subject to a preliminary withholding rate of 15%. Contributions have remained at 40% including both the employer and employee portions (SLRCG No. 4/04).

Montenegro began moving towards EU norms with indirect taxes in 2002 as well. In April 2003, a single rate VAT was introduced at 17% (SLRCG Nos. 65/01, 38/02, 72/02, 21/03). This replaced very high sales tax rates of 24% for goods and 7% for services. There was an additional railroad tax of 4% on both goods and services (Mihajlovic, 1998). The tax reform of 2002 removed excises on coffee and soft drinks, making the coverage the same as in the EU. From 1998, when customs started operating independently from Yugoslavia, in essence from Serbia, the entire system had to be set up.

3.3. The tax systems today

Although there is talk of coordinating tax policy between Serbia and Montenegro, in fact each has pursued its own reforms. There has been little sign of alignment of the two systems. Table 2 gives the details of the main taxes in 2004.

Serbia has made major progress in simplifying the tax system since 2001 (Table 2). Profit and personal income taxes both have a single low rate of 10%. Contributions are less than 36% of gross wages in total. Serbia introduced a VAT with rates of 18% and 8% in January 2005, and plans to introduce a global PIT in January 2006. The same goods are subject to excise taxes as in BiH, plus some luxury goods. Serbia has lowered the share of contributions in total revenues the furthest, to 33%. Sales and excise taxes are the largest tax source at more than 40% (Table 3). As in BiH, the pension and health contributions make up the major part of total contributions. Taken together, contributions make up 13% of GDP, with the RS, the lowest of these jurisdictions (Table 4).

Montenegro is the closest to the EU in their tax system. They have had a VAT system since April 2003 with a single rate of 17%. A new draft amendment will add a lower rate of 7% from January 2006 if passed (www.ministarstvo-financija.cg.yu). They moved to a global income tax system in 2002, and a single low rate, 9%, for corporate income in 2005. A single low rate of corporate tax is actually ahead of most EU countries, although it has been introduced in several former Socialist counties such as Estonia and Slovakia, among others. Contributions are around 40% in total. Excise taxes are in line with the EU, they are levied only on oil derivatives, alcohol and

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tobacco products. Montenegro has the highest share of contributions of the four jurisdictions at 45%. VAT and excise taxes account for 35% of total taxes, lower than the others (Table 3). Contributions make up nearly 19% of GDP in Montenegro (Table 4), more than in Serbia, but still lower than in the Federation of BiH.

4. Concluding thoughts

There are both similarities and differences in the tax reform experiences in BiH and Serbia and Montenegro. The level of political gridlock in both Serbia and BiH is high, for different reasons. In this sense, Montenegro is more stable. In BiH, nationalist political parties, most of which appear to have little interest in the country becoming more stable and prosperous, have won recent elections, although elections are due again in 2006. In Serbia, it is political bickering among the various parties and the subsequent unstable coalitions that are the problem, without the ethnic excuse. The similarity of problems in tax reform highlight that some of the problems are due more to the inherited system, rather than each country's unique situation.

Post-war BiH began with a high level of fragmentation of decision making due to the Dayton Accords. It was seen as a way to overcome the nearly complete lack of trust among the three main groups. Cooperation has increased over the last ten years, but it is by no means functioning well. The existence of so many levels of government has made tax reform more difficult. Since previous warring parties make up the new government, getting them to work together constructively has been a challenge. They need to be convinced that progress in the economy is in everyone's best interest.

The role of a criminal element and its corrupting effect on the political system is sometimes overlooked in relation to economic reform. The intransigence of the ethnic groups in BiH is sometimes just cover for the continuation of criminal activity started during the war. Many of Milosevic's former allies also continue to preach ethnic hatred as a way of slowing positive changes in the rule of law, for example. Better tax policy and administration is part of increasing transparency in governments that can help to break this cycle.

Serbia and Montenegro are not post-conflict countries in the sense of the destruction of infrastructure, records and the loss of personnel, but they do face serious economic problems. The changes in government and almost continuous difficulties in the ruling coalitions in Serbia have certainly slowed economic and tax reform.

The role of the international community in BiH is large in all areas, including tax reform. The impetus for reform in Serbia and Montenegro came from the governments themselves. The goal of EU membership has played a large part, first in Montenegro and now also in Serbia and BiH. The pull of possibility of joining the EU is still the strongest positive force for change in both countries.

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One important role of international donors is to teach best practices in tax policy and administration. There is now enough experience from many countries to know that when a country disputes best practices because their country is different and that the general rules do not apply, it is simply not true. There may be an issue of timing and emphasis, but some practices work everywhere. On the other hand, many foreign advisors will say that the system they know is the only correct way to proceed, which is also not true. International organizations and advisors should strive to inform themselves of international practice and to pass on best practices such as those compiled by the OECD, the Intra-European Organization of Tax Administrators (IOTA) and others.

Some aspects of the experience in the countries discussed here are unique. Unfortunately, many are not. The task of helping put back together countries after wars and isolation continues to be necessary. The need for good tax policy in countries where the previously warring parties need to work together as in BiH or where weak coalition governments are trying to follow corrupt failed governments will continue. Although tax policy is often not considered a priority in post-conflict situations, it is extremely important. All new governments need resources, and the sooner the tax system can start producing revenues and the government can move away from dependence on donors, the better.

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Porezna reforma u Bosni i Hercegovini i Srbiji i Crnoj Gori: Progres i problemi

Jean Tesche¹

Sažetak

Ovaj rad razmatra poreznu reformu u dvije države nastale nakon raspada bivše Jugoslavije: Bosne i Hercegovine, i Srbije i Crne Gore. Ove dvije države su se pokazale kao najproblematičnije od bivših jugoslovenskih republika, iz različitih razloga. U Bosni je ozbiljna reforma počela 1996, nakon završetka rata, a u Srbiji tek 2001. Pored naslijeđenog jugoslovenskog sistema u obje države, decentralizirana struktura u Bosni nakon rata i postojanje toliko nivoa vlasti, učinile su poreznu reformu još težom. Skoro konstantne teškoće s vladajućim koalicijama u Srbiji su usporile ekonomsku i poreznu reformu. Crna Gora ima stabilniju vlast od 1998, i većinu svog napretka ostvarila je uvođenjem poreznog sistema kompatibilnog s europskim sistemom, tj. uvođenjem zakona o porezu na dodanu vrijednost i globalnom porezu na dohodak građana u 2002.-2003. godini. Cilj pridruživanja Europskoj uniji je doprinio ostvarivanju konsenzusa da se krene s uvođenjem modernog poreznog sistema u obje zemlje, iako se još dosta toga mora uraditi.

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